INTERNATIONAL STUDIES PROGRAM

THE UNITED REPUBLIC OF TANZANIA

PO-RALG Local Government Reform Programme
and the Ministry of Finance

Final Report

Development of a Strategic Framework for the Financing of Local Governments in Tanzania

Atlanta and Dar es Salaam
June 2005

Georgia State University

ANDREW YOUNG SCHOOL OF POLICY STUDIES

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FINAL DRAFT – JUNE 1, 2005

This report was prepared for the Government of Tanzania by:

Georgia State University
International Studies Program
ANDREW YOUNG SCHOOL OF POLICY STUDIES

This final report, “Development of a Strategic Framework for the Financing of Local Governments in Tanzania” was prepared by the Andrew Young School of Policy Studies at Georgia State University. The study team which conducted the study and drafted this report consisted of Dr. Roy Bahl, Dr. Jamie Boex (Team Leader), Dr. Jorge Martinez-Vazquez, Mr. Philip van Ryneveld, and Dr. Andrey Timofeev. The study was commissioned by the Local Government Reform Program and the Ministry of Finance with support from the Royal Netherlands Embassy.

TRANSMISSION LETTER

Mr. Peniel Lyimo
Permanent Secretary, Ministry of Finance
Dar es Salaam, Tanzania

Mr. D.M.S. Mmari
Permanent Secretary, PO-RALG
Dar es Salaam, Tanzania

June 1, 2005

Dear Sirs,

We are pleased to submit the Final Report of the study "Development of a Strategic Framework for the Financing of Local Governments in Tanzania." As you know, the study assesses the strengths and weaknesses of the present system of local government finance in Tanzania and proposes options and recommendations for strengthening the overall system of financing local government authorities.

The study's recommendations represent the views of our entire team.

We wish to express our sincere appreciation for the invaluable assistance provided to us by the Local Government Reform Team, including Mr. Alfred Kabagire, Mr. Simon Lapper and Mr. Joseph Mallya. We would further like to recognize the invaluable feedback from the members of the Fiscal Decentralization Task Force chaired by Mr. Paul Tholen, as well as the Tax Reform Task Force chaired by Mr. Ramadhani Khijjah. Similarly, we would like to thank all government officials and stakeholders who took time to meet with us and shared their views. We could not have been able to complete this study without their help.

We hope that you find our observations and recommendations useful in taking forward the reform of local government finance in Tanzania.

With best regards, on behalf of the study team,

Jamie Boex, Team Leader

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ACRONYMS

ALAT	Association of Local Authorities in Tanzania
AYSPS	Andrew Young School of Policy Studies
CBF	Common Basket Fund
CSD	Civil Service Department
CSD-LGB	Civil Service Department – Local Government Board
DED	District Executive Director
DEO	District Education Officer
DMO	District Medical Officer
FDTF	Fiscal Decentralization Task Force
FY	Fiscal Year
GSU	Georgia State University
IFMS	Integrated Financial Management System
IFMS	Integrated Financial Management System
IMF	International Monetary Fund
JGDR	Joint Government Donor Review
LGA	Local Government Authority
LGFA	Local Government Finance Act
LGLB	Local Government Loan Board
LGRP	Local Government Reform Programme
LGRT	Local Government Reform Team
LGSP	Local Government Support Programme (/Project)
LTU	Large Taxpayer Unit
MOP	Member of Parliament
MTEF	Medium Term Expenditure Framework
NGO	Non-Governmental Organization
OC	Other Charges
PE	Personal Emoluments
PEDP	Primary Education Development Program
PO-RALG	President's Office – Regional Administration and Local Government
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
PWC	PriceWaterhouse Coopers
RALG	Regional Administration and Local Government
SWAP	Sector-wide approach
TOR	Terms of Reference
TRA	Tanzania Revenue Authority
TSH	Tanzania Shilling
VAT	Value-added tax
ZRT	Zonal Reform Team

At the current time, approximately US$1 = TSh. 1,050

EXECUTIVE SUMMARY

A STRATEGIC FRAMEWORK FOR THE FINANCING OF LOCAL GOVERNMENTS IN TANZANIA

The first seven sections of this study contain all the ingredients for a strategic framework for local government finance in Tanzania. The final section of the *Final Report* (Section 8)-in a clear and concise manner - pulls together the conclusions and recommendations from the previous sections into a proposed strategic framework for local government finances.

As such, Section 8 is drafted in such a fashion that it can be used as a separate, stand-alone strategy document, while also being an integral part of the overall report. The draft strategy document clearly indicate how each level of local government should be funded (i.e., with what mix of own revenue sources and national transfers) and how each source of local revenues could be optimized. As such, Section 8 of this report concurrently functions as the Executive Summary of this Report.

Section 1

Taking stock of the state of local government finances and the policy debate on local government finances in Tanzania

Given that there are numerous ongoing reform initiatives that could have a significant impact on the financial situation of local government authorities in Tanzania, the Government of Tanzania has determined that it would be useful to undertake a comprehensive review of the policy framework underpinning the structure of the financing of local government in Tanzania. As such, the purpose of this study is to thoroughly review the current environment for local government finance in Tanzania and to assist the Government in developing an overall and strategic framework to guide decisions on the structure of the financing of Local Government Authorities, including the role of intergovernmental transfer schemes, the collection of own local revenues, as well as local government borrowing. The Final Report for this study is divided into eight sections.

Section 1 of the Final Report takes stock of the current state of local government finances in Tanzania and presents the manner in which local government finances are currently perceived and debated. As such, this section provides a synopsis of the Government's local government reform agenda, and the government's general policy stance with regard to local government finances.

In addition to providing some context for the current study, Section 1.1 of the Final Report will review the current legislative and regulatory framework, and reference the government's local government strategy. Section 1.2 takes stock of the current system of local government finances and recent local government finance reforms based on previous research and policy studies pertaining to local government revenues and fiscal decentralization in Tanzania.

In order to gain insights from a broad variety of viewpoints on the current system of local government finance, the study team engaged in discussions with key stakeholders, including officials from PO-RALG, the Ministry of Finance, ALAT, TRA, and relevant

donor and technical advisory programmes.[1] Based on these discussions held with key stakeholders during the Inception Mission in November 2004, we identified four themes around which much of the debate on local government finances is centered. Section 1.3 provides a discussion of four misconceptions which were held by some stakeholders surrounding these four issues in local government finance. The study team felt that it was important to clarify these misconceptions early-on in order to create a neutral starting point on the discussions surrounding a sound strategic framework for local government finances in Tanzania.

Subsequently, a high-level Stakeholder Workshop, co-chaired by PO-RALG and the Ministry of Finance, was held in January 2005. An important purpose of this workshop was to establish a common vocabulary among the various stakeholders on local government finance issues. In addition, the purpose of the workshop was to reach consensus on the broad outlines of the evolving framework for local government finances. Such consensus on the underlying principles of the system of local government finance was important for the study team in order to carry forward as a basis for addressing many of the particular details of the proposed local government financing framework. Indeed, the stakeholder workshop revealed a broad consensus among stakeholders on the direction of the system of local government finance and endorsed the four key principles proposed by the study team (Section 1.4).

The concluding subsection of Section 1 of the Final Report (Section 1.5) provides an overview of the key issues to be addressed in the framework for local government finance, and a mapping of how the remainder of the Final Report (Sections 2-8) addresses these issues. Section 8 of the Final Report is drafted as a stand-alone document that contains an overview of the entire study (thereby effectively functioning as the executive summary) as well as a draft strategic framework for local government finance in Tanzania.

1.1. Background of the Study

It would be wrong to consider this study as a stand-alone activity. In fact, quite the opposite is true: the study is an integral part of the Government's ongoing efforts to pursue its policy of "decentralization by devolution." Within the context of the Government's policy agenda, and guided by the current legislative and regulatory framework, the overall objective of this study is to assure continued convergence between the various local government finance reforms by providing a formal strategic framework for local government finances in Tanzania.

1.1.1 Purpose of the Study

[1] Annex 1.1 contains the study's Terms of Reference; Annex 1.2 contains a description of the study team activities, include the team's meeting schedules, a list of the persons interviewed, workshop schedules, and so forth.

As noted in the Local Government Fiscal Review 2004, local governments are an important and an integral part of the public sector of Mainland Tanzania today, as local governments have significant responsibility in the delivery of key government services such as primary education and basic health care. While local government authorities collect roughly 5 percent of all public sector revenues, they are responsible for over 20 percent of public sector spending. As such, a sound framework for local government finance is a key factor in assuring that the public sector delivers quality public services; provides an enabling environment for economic growth; and pursues an aggressive agenda of poverty reduction.

As part of its ongoing efforts to restructure its public sector, significant reforms have been taking place in the system of local government finance in Tanzania over the past several years, including:

- In February 2004, Tanzania's Cabinet approved a proposal to introduce a formula-based system of recurrent block grants for the funding of primary education, health, and other local priority sectors (agriculture and livestock; water; and local roads). Reform of the recurrent grant system also envisions the introduction of a formula-based (equalizing) general purpose grant.
- Introduction of the formula-based Local Government Capital Development Grant scheme is to take place during the first half of 2005. The LG CDG is to be funded from a variety of sources, including government resources, proceeds from the World Bank's Local Government Support Project (LGSP), as well as contributions from bilateral and multilateral donor agencies.
- As part of the Budget Speeches presented to parliament in 2003 and 2004, the Minister of Finance announced a substantive change in the assignment of revenues to local authorities by announcing the elimination of the Development Levy, the elimination of significant reduction of other "nuisance taxes", and the introduction of a "closed list" of local revenue sources. Due to the sudden elimination of these local revenue sources, the Government introduced a compensatory grant to local authorities for FY 2003/04.

Given the numerous reform initiatives, the Government of Tanzania has determined that it would be useful to undertake a comprehensive review of the policy framework underpinning the structure of the financing of local government in Tanzania. As such, the purpose of this study is to thoroughly review the current environment for local government finance in Tanzania and to assist the Government in developing an overall and strategic framework to guide decisions on the structure of the financing of Local Government Authorities, including the role of intergovernmental transfer schemes, the collection of own local revenues, as well as local government borrowing.

1.1.2 Policy Agenda of the Government

Fiscal decentralization is not a new theme in the policy agenda of the Government of Tanzania. Since the formulation of the reintroduction of democratically elected local

governments in 1984, the Government has been systematically expanding the roles and financial responsibilities of Local Government Authorities in a well-structured and considered manner.

The Government's current vision of the country's local government system is clearly set forth in its Policy Paper on Local Government Reform (MRALG, 1998), which was developed in a deliberative and consultative process. The vision is based on the principle of "decentralization by devolution" by which autonomous local governments are empowered with political and administrative control and provided with the financial resources to assure the effective delivery of services to the public.

While the Policy Paper provides the broad outlines for the system of local government finances (in Section 5.6), the document falls short from defining a comprehensive strategic framework for local government finances. With respect to the framework of local government finance, the Government's policy paper envisions the following:

- Local governments should have their own sound sources of public revenue. The revenue assignment should be fair, efficient and transparent, so that local governments have realistic sources of revenue. Increased local revenue yield and enhanced taxpayer compliance should be pursued by a simplification of the local tax structure; improvement of local tax administration to reduce administrative costs and compliance costs; and provision of regulations on local revenue collections.

- Intergovernmental fiscal transfers should be provided to local governments to provide an efficient level of funding for the delivery of (mandated) local services; improve local revenue generation, assure equity in access to services, and transparency and fairness in allocation. Further details on the nature of the transfer system envisioned in Policy Paper include:
    - Local governments should not be assigned responsibilities or mandates that are unfunded.
    - The grant system should allow national (priority) policies to be executed through local authorities, which could be funded with conditional grants and guided by national minimum standards.
    - Outside these national priority areas, the grant system should encourage local government councils to set their own priorities through the introduction of significant unconditional grants and development grants.
    - The unconditional grants should be allocated in an equalizing manner by compensating local governments with a weak resource base.
    - Calculation of all grants should be done on a formula-basis, based on objective, reliable and fair criteria.
    - To assure that the new grant system is fair, a negotiating mechanism should be set up to advise government on the division of resources between the two government levels.
    - Grants from particular line ministries' budgets should be avoided as much as possible.

- Local financial management capabilities should be improved to enhance local government planning and budgeting; local accountability; and improved coordination between central and local governments.

Although the Policy Paper lacks further details on the envisioned system of local government finances, the framework that it outlines should be viewed as generally sound.[2] As such, in the development of a strategic framework for the financing of local governments in Tanzania, the study team views the Policy Paper as a valuable starting point for the framework for local government finance, and the current study could be seen as building on and complementing the Policy Paper in the development of the framework for local government finance.

1.1.3 Legislative Framework[3]

The legislative framework for local governance and local government finance is provided by a series of Acts jointly referred to as the Local Government Acts adopted in 1982. In fact, two different laws (Act Number 7 and 8, respectively) govern the establishment and authority of urban councils (Urban Authorities Act) and rural district councils (the District Authorities Act). The financial framework for all local government authorities is provided by the Local Government Finance Act (Act Number 9). Other laws, namely, Act No. 10 relating to local government service and Act No. 11 relating to local government negotiating machinery, both of 1982, have since been repealed by the Public Service Act No. 8 of 2002 and the Public Service Negotiating Machinery Act of 2003 respectively. The Regional Administration Act (No.19 of 1997) defines the roles and responsibilities of the regional administration.

The Local Government Acts have been amended intermittently since their enactment in 1982 in order to adjust the legislative framework to the evolving reality of an increasingly decentralized public sector. In particular, a number of amendments made in 1999 gave more authority to District and Urban Councils to approve their plans and budgets. The amendments also allow the central government to provide conditional and unconditional block grants to local government authorities. In addition, various amendments made to the Acts in 2003 and 2004 significantly reduced the revenue-raising authority of local councils. One consequence of the various amendments of the Acts over time is that the Acts contain a series of repetitive, duplicative, and in some cases contradictory clauses.

[2] There are only a few areas where the recommendations of the study team may deviate from the broad outlines set forth in the Government's Policy Paper. For instance, although we believe that there is a need for a strengthening of the institutional framework surrounding local government finances, the ultimate mechanism for determining the vertical allocation of resources is the Cabinet. Likewise, the degree to which the grant system should be actively used to improve local revenue generation (beyond avoiding negative incentives that discourage revenue generation) is a matter to be discussed in this study. Finally, the manner in which national minimum standards should guide the delivery of local government services is an issue that has been the topic of quite some analysis and discussion; see the Intergovernmental Transfer Study (GSU, January 2003) and LGRP Technical Note 2004-3. On all other issues, the Policy Paper provides a sound framework for the local government finance system.

[3] This description of the legislative framework is drawn from the Local Government Fiscal Review (2004).

As a result, there is a need to review and revise the Local Government Acts to assure a prudent and consistent legal framework.

1.2. Taking Stock of the Current System of Local Government Finances and Recent Local Government Finance Reforms

Based on the extensive literature on local government finances (and in particular, the existing research done on local government finance issues in Tanzania), this section takes stock of the current system of local government finances in Tanzania. The overview is structured along the four main building blocks of intergovernmental fiscal relations, namely expenditure assignments, revenue assignments, intergovernmental transfers, and local government borrowing. The overview predominantly is provided for context, and should not be expected to be an exhaustive discussion of all decentralization issues in Tanzania, many of which will be addressed in greater detail later in this report. It should be noted that the Local Government Fiscal Review 2004 provides a more comprehensive overview of Tanzania's local government fiscal situation, as well as more detailed discussions of recent reforms. In addition, Section 2 of this Final Report presents additional quantitative analyses. For completeness, Annex 1.3 provides a synopsis of previous research and specific policy studies pertaining to local government revenues and fiscal decentralization in Tanzania.

1.2.1 Expenditure Assignments to Local Authorities

Expenditure responsibilities have been quite stable in Tanzania since the reintroduction of local governments in the early 1980s. Expenditure responsibilities are assigned to local governments in the Local Government Act of 1982 (Acts 7 and 8, for rural and urban local governments, respectively), which assigns responsibility to local governments in three broad policy areas, including:

- Maintaining peace, order and good governance
- Promoting social welfare and economic well-being
- Subject to national policy, promoting economic and social development

According to the Act, the objective of local governments in performing their functions is to give effect to meaningful decentralization; to promote participatory and democratic decision-making; and to provide local government services in an efficient and cost-effective manner. In addition, a more detailed enumeration of specific local government responsibilities is provided in the Act, listing specific functional responsibilities of local government, including important government services that are generally considered local government services. Government services delivered by local governments include:

- Basic education. Local governments are responsible for building and maintaining schools and providing for the primary education of children.

- Basic health care. Local governments are responsible for promoting public health and the establishment and maintenance of hospitals, health centers, maternity clinics, and dispensaries.
- Roads. Local governments are responsible for making and maintaining streets and roads.
- Water. Local governments are responsible for establishing, providing, maintaining and controlling public water supplies.
- Agriculture extension. Local governments are responsible for providing services for the improvement of agriculture and livestock.
- Local administration. Local governments are expected to take all necessary, desirable, conducive or expedient measures for the execution of their functions, including the imposition of local taxes and collection of fees.
- Other local government services. Local governments are further responsible for the establishment of fire brigades, public markets, slaughter houses, community centers, public parks, refuse collection, and other local amenities.

In practice, local governments in Tanzania indeed play an important role in the delivery of government services, as the *de facto* expenditure assignments closely match their legislated expenditure responsibilities. The responsibilities that are assigned to the local government level are typically "local" services, and the assignment of expenditure responsibilities generally follow the subsidiarity principle and broadly coincide with sound principles of expenditure assignment.[4]

1.2.2 Revenue Assignments

Local government revenue sources are specified in the Local Government Finances Act No. 9 of 1982. According to the Act, local governments essentially depend on three key sources for financial resources: own revenues, intergovernmental grants from the central government, and donor assistance. Until recently, the Local Government Finances Act of 1982 followed an "open list" or permissive approach to local taxation, empowering local governments to define their own local tax structure and freely raise their own revenues from taxes, licenses, fees, charges and other revenues with few limitations.

As a result, the type and number of local taxes, levies and fees differed from one local authority to another. Common local revenue sources charged by many local governments included (TRA, 1999):

- The Development Levy: The Development Levy was a broad-based levy which was common all over Tanzania, although the base and administration of the Development Levy varied across jurisdictions. In most local authorities, the levy was essentially a flat rate "head tax" or "poll tax" payable by every adult resident above the age of 18. In some districts, women and the elderly were exempted from the Development Levy. Prior to the reform of the Development Levy in the mid-1990s, the Development

[4] See Martinez-Vazquez (1998) for a discussion on the sound assignment of expenditure responsibilities.

Levy had the nature of a local income tax. (As noted above, the Development Levy was abolished in June 2003).

- Property tax: Property tax is charged on the owners of property, particularly in urban jurisdictions. The property tax rate is fixed by the local authority, but for simplicity many councils charge property taxes at a flat rate according to the location of the property.
- The Service Levy: The Service Levy is a local tax on business turnover that replaced the previous Industrial Cess. The Service Levy –collected only from corporations with turnover in excess of TSh 20 million- is charged at a rate of 0.3% of turnover (excluding VAT).
- Agricultural Produce and Livestock Cess: Most rural districts levy cesses (taxes) on the sale of major crops produced within the council's jurisdiction. The rates imposed vary from council to council and from crop to crop, but the rate is not to exceed 5% of the farm-gate price.
- Business licenses: Until 2004, business licenses provided a good source of local revenues. The tax base for this source was always relatively narrow, as local authorities were entitled to issue licenses and collect fees from businesses not licensed by the central government.

Compared to other developing economies, particularly in Africa, local governments in Tanzania had a relatively high degree of control over their revenue sources, including regulatory discretion to introduce their own local taxes and fees, as well as substantial rate-setting discretion over local revenue sources.

At the same time, the revenue assignment in Tanzania that prevailed until 2003 had a number of important limitations:

- The revenue sources available to the local government level had limited revenue-raising ability and were not expected to be buoyant. Most of the "good" tax sources (including the personal income tax, the value-added tax (VAT), excises, payroll taxes, and corporate taxes) are collected by the central government.
- The historical proliferation of local revenue instruments increased compliance and administrative costs, complicated equity and efficiency impacts and stretched the administrative capacity of the LGAs
- Local taxes were often poorly designed, resulting in a large number of low-yielding revenue sources which yield little revenue but were costly to administer.
- The local capacity for tax administration was limited and hindered by corruption.
- Tax compliance was low. Among others, the response of taxpayers was caused by poor delivery of services and manner in which taxes are collected; poor tax administration and high-handedness on the part of local tax collectors often results in mistrust between the LGAs and taxpayers (Fjeldstad, 2004).

As a result of the perceived negative efficiency and equity impacts of the local tax system, the central government introduced a series of local government reforms in 2003 and 2004 in order to rationalize and harmonize the local revenue system. This has resulted in the introduction of a restrictive, closed-list approach to local taxation; the

elimination of some local revenue sources (including, most prominently, the Development Levy); and the sharp reduction of other local revenue sources (including business licenses and agricultural cesses).[5]

In addition to the LGA's exclusive own revenue sources, local governments collect a shared revenue source: the Land Rent. Land rent comprises rents paid to the state for leases on registered commercial, industrial and residential land in areas occupied under non-traditional forms of tenure. The revenues are collected by local authorities, deposited in the bank account of the national treasury and a portion (currently 20%) is supposed to be sent back to councils in which they were collected.[6]

1.2.3 Intergovernmental Grants

There are several types of intergovernmental transfers in the system of local government finance in Tanzania. Recurrent grants provide at least 80-85 percent of all local government resources (see Table 1.1, LGFR 2004).

Sectoral recurrent grants. Transfer to local authorities in Tanzania (traditionally referred to as local government allocations) are predominantly made through earmarked sectoral transfers, which are contained in the regional votes of the national budget (votes 70-95) and are disbursed directly from the Treasury to the local government accounts. Sectoral grant schemes are available for primary education; local health services; agriculture and livestock extension; local water supply; and local road maintenance. Approximately 17 percent of the national recurrent budget is funnelled to the local level as sectoral grants (see Table 4.1 and 4.2, LGFR 2004). A more detailed analysis of the vertical allocation of resources is performed in Section 2 and Section 5 of this report.

Prior to July 1, 2004, sectoral transfers provided to local governments were made as highly discretionary, earmarked sectoral allocations, which were notionally based on a system of national minimum standards. However, the Intergovernmental Transfer Study (GSU, January 2003) identified that this system had numerous shortcomings and resulted in an inequitable, non-transparent, and inefficient allocation of resources. Therefore, starting with FY 2004/05, formula-based allocations were introduced for primary education and health care. Formula-based allocations for all other priority sectors have been agreed upon (see Table 1.1) and are to be introduced with the beginning of FY 2005/06.

[5] These revenue measures are discussed in greater detail in Chapter 3 of the Local Government Fiscal Review (2004).

[6] Similarly, a decision was made in 1999 that land block hunting fees should go to those councils where the fees are collected.

Table 1.1 Sectoral Allocation Formulas		
Sectoral grant	**Grant Pool FY 2004/05**	**Allocation formula**
Primary Education	TSh 245.9 billion	Number of school-aged children: 100% (plus earmarked amount for special schools)
Health Services	TSh 63.6 billion	Population: 70% Number of poor residents: 10% District medical vehicle route: 10% Under-five mortality: 10%
Agriculture Extension	TSh 13.9 billion	Number of villages: 60% Rural population: 20% Rainfall index: 20%
Water	TSh 11.2 billion	Equal shares: 10% Number of unserved rural residents: 90%
Local Roads	TSh 5.0 billion	Road network length: 75% Land area (capped): 15% Number of poor residents: 10%

Administration grant. In addition to the sectoral block grant, each local authority is provided with an Administration Grant through the regional votes. In the current system, the Local Government Finance Act provides for a central government matching grant (at 33.3 - 50 percent) for local department heads and local government administrative staff above a certain pay grade, although it appears that in reality the cost of personal emoluments for local administrative staff are in fact fully funded from central government resources. The Administration Grant further supplies a small earmarked OC component, including resources for the purchase of fire-fighting equipment. Until now, the current mechanism has provided the central government level with virtual control over the size of the administration grant, since it is the central government level that determines the posting of administrative staff at the local government level. The discretionary nature of central government decisions in this regard is reflected in enormous variations in the size of administrative grants (in per capita terms) to local authorities.

General-purpose (Compensation) Grant. With the abolition of the Development Levy and other "nuisance taxes" in July 2003, the central government committed to providing local governments with a compensation grant to replace the lost resources. During FY 2003/04, a total of TSh. 8 billion was provided in compensation funding, allocated among council in proportion to the revenues lost. For FY 2004/05, an amount of TSh. 25 billion was allocated for this purposes, and renamed "General Purpose (GP) Grant" reflecting the unconditional, general purpose nature of the grant. Although the compensation grant assured resource neutrality for the local government level, it did not fix the loss in revenue autonomy suffered by local authorities. In order to offset the further impact of revenue rationalization in 2004, the GP grant is expected to grow to approximately TSh 37 billion for FY 2005/06. For the coming budget year, the GP grant will be allocated on

a formula-basis, as the grant is expected to merge with the Administration Grant in the subsequent year to form a single, unconditional, equalizing, formula-based general purpose transfer scheme.

Local Government Capital Development Grants. The allocations of capital development resources from the central government's Development Budget to local government authorities are generally quite small and highly irregular. An analysis of the development budget approved for FY 2003/04 revealed that out of the total budget of TSh 807.4 billion, only 4% (TSh 35.5 billion) was allocated to regions and local government authorities.[7] In order for local governments to be empowered with respect to their development activities, the government is currently in the process of introducing a formula-based system of Local Government Capital Development Grants (LG CDG). The LG CDG system provides Capital Grants and Capacity Building Grants for councils who qualify by meeting certain Minimum Access Conditions. A synopsis of the design of the LGCDG is provided in Box 4.3 of the LGFR (2004).

Sectoral and ministerial subventions. In addition to the resources directly allocated to local government authorities in the recurrent budget, there are numerous recurrent resources that are provided to the local government level that are not funnelled through the regional votes. Although these resources are intended for local government activities, they are in one way or another embedded in ministerial votes, often in less-than-transparent ways. As such, it is hard to monitor whether these resources are actually provided to the local government level and –if so- to what extent the central government controls the use of these resources. Such sectoral and ministerial subvention –which are provided to local authorities through sectoral modalities in parallel to the regular recurrent block grant mechanism- include:

- PEDP Capitation Grant from donor partner contributions
- Health Sector Common Basket Fund
- Medical Stores (medicine/ drugs) (Ministry of Health)
- Local portion (30%) of the Roads Fund (through PO-RALG)
- Earmarked resources provided for the salaries of WEO and VEOs (PO-RALG)

If these sectoral and ministerial subventions are taken into account, the share of local government activities that is funded from intergovernmental transfers is likely to exceed 90 percent of local expenditures. In order to have a more comprehensive picture of the true degree of expenditure decentralization in Tanzania, Section 2 of this report seeks to catalogue these parallel funds, and document the degree of central control over these resources.

[7] LGSP/PWC. 2004. Background Paper: Development Funding To Regions and Local Government Authorities. It should be noted that in addition, most of the donors are financing the development budget through sector-based programmes such as the Primary Education Development Programme. These sector-based programmes are included in the amount budgeted for MDAs but are transferring substantial development funds to Local Government Authorities.

Other parallel transfer mechanisms. In addition to the sectoral and ministerial parallel mechanisms embedded in the national budget, there are numerous additional mechanisms that provide resources to the local or community level for public purposes, although in some instances these resources in fact circumvent the official government structure. Some bilateral donor agencies and donor-funded NGOs continue to provide district-wide support to individual councils, villages or through Area-Based Programs (ABPs), or agree to fund specific local community projects on a case-by-case basis.[8] Likewise, programs such as TASAF (as well as TASAF II) are in fact *designed* to circumvent he district level and provide funding directly to villages or communities. Similarly, it is expected that a fund currently being structured for community responses to HIV/AIDS are to be provided directly to villages or community levels, thereby circumventing the local government system.

1.2.4 Local Government Borrowing

Local government borrowing plays an extremely minor role in local government finance in Tanzania. In fact, borrowing represents less than 0.1 percent of the resource inflows to local government authorities per year (LGFR 2004, Table 1.1).

While in principle the Local Government Finance Act (1982) allows local government authorities in Tanzania to borrow with ministerial permission, PO-RALG and the Ministry of Finance currently oppose providing loan guarantees for local government borrowing; likewise, fearing the accumulation of local debt and loan defaults, the central government also opposes local government borrowing in the absence of loan guarantees. In the absence of a well-developed capital market in Tanzania where local government authorities can borrow for the purpose of funding capital development, the only avenue available to local government authorities is to borrow from the Local Government Loans Board (LGLB), a government-supported financial intermediary for local government authorities. Additional information on local government borrowing and the LGLB are provided in Chapter 5 of the LGFR (2004).

Challenges faced by the system of local government finance in providing adequate access to loan funds through the LGLB include (1) inadequate capitalization of the LGLB to fulfil the demand for capital for local borrowing purposes; (2) inadequate and shrinking own resources available to repay loans; (3) the absence of appropriate incentives to repay, resulting in high default rates.

1.2.5 Role of the village level

[8] The latest PO-RALG Letter of Sector Policy makes it official government policy to channel donor resources in a unified manner through the government's intergovernmental transfer system and the regular local government planning and budget processes, as parallel mechanisms generally result in significant inequity and a lack of transparency in the local resource allocation process. Most donors are moving to align their practices with the Letter of Sector Policy, for instance, by integrating their ABPs into the LG CDG system.

Although the village level is a distinct part of Tanzania's local government structure specifically provided for in the Local Government (District Authorities) Acts, the village level is often overlooked in Tanzania's local government structure. Correspondingly, villages are relegated only a minor role in the provision and financing of public services and infrastructure at the community level.

Structure of village-level governments. At the time of writing, there are 10,349 villages in Tanzania, with an average population of about 3,000 - 3,500 residents each. Village areas are established by directive from PO-RALG, and become a corporate body after the election of their first Village Council. Villages are predominantly established in rural areas; in fact, PO-RALG is actively eliminating villages in urban areas (where Mtaa, or neighborhood associations serve a similar purpose). Given the current structure of village governments, the size of most villages is too small to be viable for the delivery of major public services such as primary education or health care. Yet, the smaller size of the village gives the village an advantage of being able to be close to the community it serves, allowing the village level to retain a sense of community participation and joint ownership over its activities.

Expenditure responsibility of the village level. The functions and expenditure responsibilities of village councils are poorly defined by the Local Government Act, beyond stating that a village council shall "do all such acts and things as are necessary or expedient for the economic and social development of the village (Act. No. 7, 1982; Section 142). Furthermore, with concurrence between a District Council and the Village Council, Districts can delegate any of their functions to the village level. In practice, Districts operate in a highly centralized fashion and rarely rely on the village-level for the provision of any local services.

As such, it is important to recognize that it is not the responsibility of the village level to provide services in the key priority sectors (primary education, health, etc.), which are \functions assigned to the district level. In stead, in practice villages engage in minor community-level capital development projects, such as community roads and other small infrastructure projects. Villages also tend to take initiative on capital development in the social sector, such as starting to build new classrooms, clinics, and so on. In this regard, the division of responsibilities between the various government levels (village, district and central) is not well-defined. To the extent that village-level capital projects (especially in the education and health sectors) have implications for operation and maintenance expenditures, this could potentially be a problem, since the District is generally responsible for the provision of local services.

Financial management practices at the village level are weak, and village-level budgets (revenues and expenditures) are not aggregated into higher-level fiscal accounts, so there is no accurate financial picture of the overall size of village-level financial activities. An analysis of financial management practices in 26 lower-level local governments (conducted in 2003) provides limited insight in village level finances. Even for the sample villages, limited data was available on village expenditures or revenues. Village

expenditures typically fell in the range of TSh 1,000,000 – 1,500,000, and more than half of village and ward expenditures were allocated for administration (i.e., VEO, WEO, etc.). Since the legislated expenditure assignments for the village level are quite vague, it is virtually impossible to determine whether the available resources are adequate to meet the relative fiscal needs of villages (compared to the available resources in the public sector, and the relative needs of districts and the central government).

Many village-level councils lack a budget plan or keep rudimentary books of account; many councils do not have a bank account, or even lack a proper safe for the storage of cash (see Table 1.2). There are no financial regulations or guidelines issued by PO-RALG for the village level.

Village-level own source revenues. Village councils have a number of legislated own revenue sources (LGFA 1982: 9), including the Entertainment Tax, Hotel Levies, certain specific income taxes in "non-major trading centers" (collected by TRA), "all moneys derived from licenses, permits, dues, fees, charges or tariffs" specified in village by-laws (and approved by the District), as well "all revenue accruing … by way of contributions or … any other manner of payment." As such, village-level revenues have faced the same problem of non-uniformity and fragmentation caused by a permissive approach to local taxation.

Table 1.2
Financial management practices at the village level

Criteria	Number	Percent
Expenditure budget	16	62
Revenue Collectors Cash book	14	54
Receipt Book	22	85
Financial reporting	20	77
Bank account	14	54
Safe	1	4
Good financial mgmt practices (5 or 6 of the above)	6	23

Source: Computed by authors based on PO-RALG. 2003. Local & Lower Local Government Revenue Sharing and Management of Finances at the Village, Ward and Mitaa Levels. UNCDF/DFID.

In addition to the legally assigned own revenue sources, village officials had been entitled by PO-RALG circular to retain 20% of the Development Levy collected within the

village area as an incentive to improve collections.[9] This revenue retention scheme also provided funding for the salaries for VEOs and WEOs. Since the abolition of the Development Levy in 2003, such revenue sharing ended, practically starving village councils of revenues. Since the "closed list" of local revenues introduced in 2003 does not accommodate any village-level taxes (other than strictly voluntary contributions), villages have essentially been starved of any real revenue sources.

Intergovernmental transfers to the village level. Although the LGFA authorizes villages to receive grants, there are no formal transfer mechanisms, neither from the central level to the village level, nor from the district-level to the village level. Subsequent to the abolition of the Development Levy, preparations are being made to assure that VEOs and WEOs are paid from grant resources. Caution has to be used in structuring this grant scheme in order to prevent unnecessary earmarking of resources and to prevent subverting the loyalty of VEOs away from their village council.

Although the village level does not receive direct intergovernmental transfers, the new Local Government Capital Development Grant earmarks 50% of the capital grants allocated to each district to be spent on priorities determined by to the village level; instead of an actual transfer, each village is to be given an "indicative planning figure" for the LGCDG which is to determined on a capitation basis. Similarly, parallel funding mechanisms such as TASAF II either funnel money directly to the village-level, or use village councils to identify community priorities to be funded externally.

1.3. An Evaluation of the Main Issues in Local Government Finance: Four Misconceptions

The preceding subsection section provides a rather technical description of the system of local government finance. However, the ultimate objective of the current study is to formulate, recommend and enable the adoption of a strategic framework for local government finance. Thus, in developing a strategic framework for the financing of local governments in Tanzania, it is equally important to determine how the current system of local government finance is perceived by key stakeholders. This is a task that involves achieving consensus and buy-in by a large and varied number of stakeholders across the public sector in Tanzania. Although PO-RALG and LGRP have been championing a sound local government finance system in the context of the government's overall decentralization policy (1998), and the Ministry of Finance has been increasingly supportive of improving the system of local government finances, the formulation of a system of local government finances has significant implications for different areas of government policy. For instance, the way in which local governments are funded is crucial to the Government's Poverty Reduction Strategy (PRS II), since local

[9] For greater details on how this circular was executed and interpreted in different districts, see: PO-RALG. 2003. Local & Lower Local Government Revenue Sharing and Management of Finances at the Village, Ward and Mitaa Levels. UNCDF/DFID.

governments are responsible for delivering a number of pro-poor government services (including primary education an basic health care services).[10] In addition, the system for local government financing will impact all sectors that deliver government services at the local level. In addition, to the extent that the system of local government finances requires local governments to collect own source revenues, the formulation of a system of local government finance should involve those government officials and private sector representatives (combined in the Tax Reform Task Force) that are leading the effort to ensure the rationalization and harmonization of Tanzania's tax system.

During its initial fact-finding mission in November 2004, the GSU study team consulted with a broad variety of stakeholders from diverse backgrounds. Unsurprisingly, the points-of-view taken by many stakeholders were shaded by the particular focus or experiences of the respective government officials and experts consulted. These initial consultations made clear that the policy debate surrounding the system of local government finances lacked a common "vocabulary" which would allow different stakeholders to effectively engage each other on the topic of local government finance. In addition, the study team identified a number of misconceptions about local government finances which it felt would stand in the way of achieving consensus on a sound framework of local government finances unless resolved. The four main misconceptions initially identified by the study team included:

- Misconception 1: As a rule, own local government revenue sources are low-yielding, inefficient, inequitable, and impose high compliance costs. Own local government revenue sources are not a necessary ingredient for a sound system of local government finance.

- Misconception 2: The sole objective of taxation is to maximize revenue yield. Local government taxes are mostly nuisance taxes that are less efficient than central government taxes. Revenue yield and efficiency can be enhanced by eliminating local taxes and leaving to the central government the business of raising all taxes.

- Misconception 3: Local governments do not need any new revenue sources as long as they don't use the ones that are currently assigned to them, regardless of how hard the enforcement of those existing taxes may be. The lack of progress in collecting certain taxes at the local level is a clear sign that the best way to deal with inadequate local tax administration is by eliminating local taxes, so that local governments can focus on collecting several other minor sources of revenue, such as local fees, for which they have an administrative advantage.

[10] Under the original PRSP, pro-poor activities were classified into priority sectors, consistent with the five priority sectors funded at the local level. Under PRS II, the government's strategy does not automatically presume that spending in a sector is pro-poor: instead, PRS II is based on three clusters: (1) economic growth and income poverty; (2) service delivery and quality of life; and (3) governance and accountability. However, the activities funded by intergovernmental grants are aimed at delivering pro-poor local government services, and therefore these local government activities continue to fall squarely within the poverty-reduction focus of the Government's despite the re-orientation of the PRS II.

- Misconception 4: Tanzania's economic structure is unique because of the uneven distribution of economic activity, and local revenue autonomy will cause insurmountable regional inequalities.

A complete discussion of each of these four misconceptions is identified on the Inception Report for this study. During the stakeholders' workshop in January 2005, these misconceptions were discussed and the study team clarified that although counterexamples could be conceived of where these statements are true, each of these misconceptions should generally be accepted as not true as a starting point for the development of a framework for local government finance. A synopsis of the four misconceptions is provided here for completeness. In the next section, rather than dwelling on these misconceptions, we seek to build consensus on the way forward with the system of local government finance based on four corresponding positive principles of local government finance.

Misconception 1: As a rule, own local government revenue sources are low-yielding, inefficient, inequitable, and impose high compliance costs. Own local government revenue sources are not a necessary ingredient for a sound system of local government finance.

It is clear that there are problems with local government revenues in Tanzania. A common critique of local government revenues in Tanzania is that local government revenue sources are low-yielding, inefficient, inequitable, and impose high compliance costs. Based on such a negative assessment of local revenues –and influenced by misconceptions 2 and 3- some stakeholders have jumped to the conclusion that own local government revenue sources are not a necessary ingredient for a sound system of local government finance. Instead, it has proven expedient to accept the argument that it is easier to just eliminate local taxes and introduce compensatory grants to provide resources to the local government level.

In order to provide a sound starting point for Tanzania's system of local government finance, it is important to assess local government revenue points in a fair and balanced way. The summary judgment that local revenues are (1) low-yielding, (2) inefficient, (3) inequitable, and (4) impose high compliance costs, does not provide a balanced view of local taxes. Based on international experiences, it is certainly not true to state that local government revenues necessarily have all these negative features. As such, Tanzania's negative experience with local governments is more the exception than the rule, and many of the shortcomings of Tanzania's local government revenue system are caused by a poor assignment of revenue sources (which assign local authorities too many, fragmented revenue sources that yield little) and poor tax administration.

While it is true that each local government revenue instrument yields relatively little revenue and even taken together local revenues are only a small share (currently about 3 percent) of national revenue collections, the primary cause of the low revenue yield of local governments is the fact that all major revenue sources (such as the personal income

tax, corporate taxes, the VAT, and so on) are assigned to the national level. Furthermore, recent local revenue reforms have not improved the overall fragmented nature of local own revenue sources. While the "rationalization" of local government taxes eliminated a number of trivial, pesky and low-yielding local tax instruments, the process of rationalization also eliminated (or sharply reduced) three of the highest-yielding local revenue sources, including the Development Levy, business licenses and crop cesses.

A second argument that is often heard is that the cumulative effect of local tax rates is causing inefficiently high tax rates, especially when several local taxes are imposed on the same tax base. While economic theory is unequivocal that high tax rates discourage economic production and cause an economic loss to society, the prevailing evidence does not support the contention that (cumulative) local tax rates are excessively high. While there are widespread anecdotal claims of local tax rates on certain commodities in the range of 30-40 percent, many of these claims are based on bad analysis. [11] We believe that –to the extent that such high cumulative local rates indeed exist- these should be viewed as the exception rather than the rule. Although we don't mean to diminish the importance of efficiency in the design of an efficient local tax structure for Tanzania, based on the prevailing marginal tax rates, in most instances the efficiency impacts of local taxes should be much less than the efficiency impacts of the main central government taxes (such as the VAT, the personal income tax, and the corporate income tax), which –at rates of 20 to 30%- are several times higher than typical local government tax rate.

A third concern often raised with local government revenue sources is equity. In fact, it is true that revenues sources assigned to the local government level (such as user fees or property taxes) tend to have a more regressive impact on income distribution. However, it is important to recognize that five decades of economic thought (Musgrave, Tiebout, Oates, Buchanan, McLure) has concluded that it is simply not the role of local revenues to be redistributive! Rather than focusing on the "ability to pay principle" which guides many central government taxes, local taxes are often designed to adhere to the "benefits principle" of taxation.[12] In fact, to the extent that user fees and benefits taxes tend to be regressive, it is unlikely that local taxation in any country is found to be progressive. Furthermore, it would be incorrect to consider the incidence properties of the local revenue system in isolation from the poverty-impact of local spending, or the "net fiscal

[11] For instance, see DAI/PESA (2004) for a discussion of central and local taxes on cashew nut. The report clearly portrays a biased picture of taxes and levies imposed on the industry, and lumps a variety of "charges" that are truly producer costs (inputs) into the category of "taxes and contributions". Even though Figure 10 in the report highlights effective farmer taxation rates for individual districts in the range of 17-45 percent (with a majority of rates above 30 percent), Annex 3 in the same report shows that in aggregate, total taxes and levies paid by the sector (to local and central governments) amount to an average of 16 percent of total turnover. Excluding central government taxes, levies, and input charges, our calculations show that the cumulative local tax on cashew nut is in fact less than 12 percent.

[12] The benefits principle states that those taxpayers who benefit more from public services should pay more. For instance, a household with a larger house is likely to benefit more from local services (such as police and fire protection) and thus should be expected to pay more in local taxes (e.g, property taxes). The ability-to-pay principle states that those taxpayers in a better position to pay taxes should do so. For instance, this is the case for a progressive national income tax. However, since redistribution is a central government function, progressive taxes should generally only be levied by the central government.

incidence" of central government programs at the local level. Suffice it to say that the equity properties of local taxation are the result of careful policy design and thus the finding that local taxes are regressive should not at all be an automatic reason to eliminate a revenue source.

Again, in fairness it should be noted that the recent reforms in Tanzania have not necessarily improved the overall equity impact of local government revenues. For one, the business license fees which were essentially eliminated in 2004 likely had a progressive incidence across and within local governments. Furthermore, it is interesting to note that while in 2001 the Development Levy was essentially reduced to a regressive head tax, prior to that time the Development Levy actually had a more progressive rate structure. As such, using the equity argument to support the abolition of the Development Levy is a bit disingenuous: to the extent that equity concerns indeed contributed to the demise of the Development Levy, a more effective policy alternative would have simply been to keep the previous more progressive rate structure.

A fourth general problem often raised with respect to local government taxes is that the costs to taxpayers for complying with local government taxes is high, particularly for firms (tax payers) that operate in multiple districts. While compliance costs are indeed a concern at the local level in Tanzania, we should note that local government revenues do not *necessarily* have high compliance costs. The diversity of local taxes and tax administration processes at the local level and the associated high compliance costs in Tanzania are due in large part to the historical "permissive approach" or "open list" approach to local taxation. As a result, there has been an absence of a centrally-defined set of local taxes, uniform local tax bases and uniform local collection procedures. The compliance cost for local revenue sources can be reduced by the central government providing a more uniform framework for local government taxation, including standard local government tax bases, standard local tax administration procedures, standard local tax forms, and so on. In some cases, the administration of local government taxes can be harmonized or integrated –to a greater or lesser degree- with the collection of central government taxes, thereby reducing administrative duplication and compliance costs.

Misconception 2: Local government taxes are mostly nuisance taxes that are less efficient at collecting revenues than central government taxes. The sole objective of taxation is to maximize revenue yield. As a result, revenue yield and efficiency can be enhanced by eliminating local taxes and leaving to the central government the business of raising all taxes.

A misconception regarding the system of local government revenues held by some stakeholders was that the sole objective of taxation is to maximize revenue yield. While revenue yield is an important element of any tax system, it is never the only objective of a tax system, particularly not at the local level. Instead, several other objectives and features are important in the design of any local tax system:

Accountability. An important function of a local tax system is for the tax system to serve as an important accountability mechanism. A well-known battle cry during the American War of Independence was "No taxation without representation." However, it can be said that the converse is also true: "No representation without taxation." Those who provide tax revenues to a government have a better chance of being listened to by that government. This is especially true at the local level: local control over some own revenue instruments can serve as an important accountability mechanism for local government officials, as local taxpayers will have a strong interest in assuring that local officials use local tax resources wisely. Without any local revenue autonomy, local government officials are able to ignore local residents and will be almost completely beholden to the interests of the central government.

Broad tax coverage. In order to be efficient, sound tax systems should have broad coverage, since the broader and more inclusive the tax base, the lower the rate that can be applied to this base in order to generate the same amount of revenue (and lower tax rates will reduce the inefficiency imposed by the tax). As such, a sound tax system should seek to eliminate loopholes in the coverage of the tax base that would allow taxpayers to avoid being taxed. This concept is well-illustrated by the recent introduction of an alternative presumptive tax as part of Tanzania's tax system. The presumptive tax can assure that taxpayers who fall below some income threshold or taxpayers that do not keep adequate books of account are not able to avoid income taxes altogether. Even though this gap in the tax net may not be a large revenue-generator for the central government in itself, leaving this loophole open may result in a decline in tax coverage over time.[13]

Basic fairness in taxation. An important objective in the design of tax systems –in addition to revenue yield- is to assure basic fairness in taxation. If the government were only interested in revenue yield, the most effective way to maximize revenues would be to focus exclusively on taxing the 100 or 1000 largest taxpayers in a country, which typically generate 90% or more of total tax revenues. While it is true that many countries around the world employ large taxpayer units (LTUs) to assure compliance by large taxpayers, it would also be seen as inherently unfair to only impose taxes on a handful of the wealthiest taxpayers. Instead, countries around the world rely on broad-based taxes that require a large proportion of households and firms to submit tax forms and pay taxes, even though the poorer taxpayers generally only contribute a small share of tax revenues. For instance, in the United States, the poorest 60% of American households only contribute 6 percent of federal personal income tax revenues. However, wealthier taxpayers -in the U.S. and in Tanzania alike- would surely consider it inherently unfair if the tax system were to impose the full national tax burden on the rich and automatically exclude almost two-thirds of all taxpayers from the obligations to pay taxes. In fact, doing so would surely have a disastrous impact on the compliance of wealthier taxpayers.

[13] A presumptive tax (sometimes referred to as an "alternative minimum tax") involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on taxpayer accounts. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayers' income is no less than the amount resulting from application of the indirect method. This presumption may or may not be rebuttable. The concept covers a wide variety of alternative means for determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.

Thus, while revenue yield is an important characteristic of a sound tax system, assuring an inclusive and basically fair tax system is an equally important attribute.

Misconception 3: Local governments do not need any new revenue sources as long as they don't use the ones that are currently assigned to them, regardless of how hard the enforcement of those existing taxes may be. The lack of progress in collecting certain taxes at the local level is a clear sign that the best way to deal with inadequate local tax administration is by eliminating local taxes, so that local governments can focus on collecting several other minor sources of revenue, such as local fees, for which they have an administrative advantage.

A third misconception encountered by the study team during its initial discussions is that local governments do not need new revenue sources as long as they do not use the revenue sources that are currently assigned to them. Inherent in this statement are the assumptions that, first, local governments do not currently have (or do not use) the administrative capacity to collect the local taxes that they are due, and second, that local governments are actually assigned sound local revenue sources that can be efficiently administered and that have the potential of raising a substantial amount of revenues.

In reality, tax administration capacity is a chicken-and-the-egg problem. As a result, the local capacity to administer taxes won't be strengthened unless LGAs are assigned sound local revenue sources and are provided with adequate guidance from the central government to collect these revenue sources. Once specific local taxes are eliminated, it will in fact become harder to introduce new local tax instruments that can be administered well by local government officials.[14] Instead, a more sustainable approach would seek to harmonize the existing local government revenue sources in a sensible way, while developing an institutional framework to support LGAs in improving their revenue administration procedures. In addition, it needs to be pointed out again that there is a need to separate between what is a local tax and the administration and enforcement of this tax. It is quite possible to have local taxes, with rates decided by the local governments, and administration and enforcement conducted by the central government tax authorities.

With respect to the second assumption (the assumption that local governments currently have worthwhile own source revenues), of course, we have already established that in many cases the opposite is true: local governments are generally assigned revenue sources that tend to be low-yielding, politically unpopular and not necessarily easy to administer. Under those circumstances, it is understandable that local government officials have little incentive or interest in collecting many of the available revenue sources. Of course, this should not be construed in any way as an indication that local governments do not need different (sound) local revenue instruments.

[14] One could suggest the parallel that when the tax administration capacity at the central government level was weak in Tanzania in the mid 1990s, did the central government eliminate several central government taxes and rely on the easiest revenue sources to administer (likely to be import taxes), or did it embark on a program to simplify and harmonize the available central government taxes?

Misconception 4: Tanzania's economic structure is unique because of the uneven distribution of economic activity, and local revenue autonomy will cause insurmountable regional inequalities.

Numerous stakeholders that met with the study team during the inception mission raised the concern that Tanzania's economic structure is unique and that the presence of local revenue autonomy would cause insurmountable regional inequalities. While it is factually correct that most rural districts in Tanzania have extremely low fiscal capacity and are not likely to generate much revenue, this is not an insurmountable obstacle in the design of a sound system of local government finances that provides adequate revenue autonomy to local governments. Tanzania is by no means unique in its uneven distribution of economic activity throughout the national territory. In fact, many decentralized countries face the same type and degree of regional fiscal disparities that are prevalent in Tanzania. The important issue here is to keep in mind the golden rule for economic policy: one instrument for one objective. A significant degree of local tax autonomy enables us to obtain accountability and more revenue sufficiency. The objective of equalization requires a different instrument. In the presence of local revenue autonomy, variations in local fiscal capacity can be overcome by putting in place an equalization system that provides equalization grants to deserving LGAs (those with relatively lower fiscal capacity). For instance, out of 88 regions in the Russian Federation, only 8 (mainly urban) regions do not qualify for equalization transfers. A similar story is repeated in numerous other countries.

1.4. Towards a Consensus on the Framework for Local Government Finance: Four Principles

Section 1.3 summarized four broad misconceptions regarding the framework for local government finance in Tanzania that were held by some stakeholders at the outset of the current study. In order to resolve these misconceptions and establish a positive starting point for the development of a local government finance framework in Tanzania, the study team proposed four principles in the study's Inception Report upon which the team felt the strategic framework for local government finance should be developed. During a joint stakeholder workshop –jointly chaired by PO-RALG and the Ministry of Finance- in January 2005, broad-based consensus was reached on these principles. We reiterate these principles here as the foundation for the strategic framework for local government finances developed in the remainder of this report:

- Principle 1: Both intergovernmental transfers and own local revenues play important but distinct roles in the system of local government finance. Finance should follow function. Expenditure assignments form the foundation for a framework for local government finances

- Principle 2: The role of taxation in the public sector is more than maximizing revenue yield. If structured appropriately, local taxation empowers communities, enhances accountability, helps improve vertical imbalance problems, and overall, it improves the efficiency of the public sector.

- Principle 3: Each government level requires control over at least one good revenue source. The deficiencies in local tax administration should not be addressed by eliminating local taxes without consideration of their revenue impact; rather, deficient local taxes should be transformed into sound revenue instruments. There is a need for a limited "closed list" of local taxes that captures the diverse circumstances of local government authorities in Tanzania. Revenue autonomy should be separated from the issue of tax administration; local taxes can be administered by the central tax administration as needed.

- Principle 4: There is an important future role for sectoral block grants, equalization grants and capital development grants in Tanzania's system of local government finance.

Principle 1: Both intergovernmental transfers and own local revenues play important but distinct roles in the system of local government finance. Finance should follow function. Expenditure assignments form the foundation for a framework for local government finances

In the previous section we argued that it was a misconception to argue that it would be equivalent to replace own source revenues with a compensatory grant. We argued that allowing local governments a certain degree of revenue autonomy provides important benefits including greater local accountability.[15] Then, if we believe that both own source revenues and transfers play an important role in local government finance, then how do we decide what local government activity gets funded by which revenue source?

One of the most important principles in intergovernmental fiscal relations is the notion that "finance should follow function" and thus that a sound and complete expenditure assignment forms the foundation for a framework for local government finances (Bahl 1999). Thus, before we can address the question what type of resource mechanism should be used to fund each local government activity, the first step should be to clarify the assignment of expenditure responsibilities in Tanzania, since different stakeholders may be using the term "devolution" differently.

While the Local Government Act in Tanzania enumerates what government services are to be provided by local governments, the Act does not recognize that expenditure assignments are in fact multi-dimensional in nature. As such, it is insufficient, for example, to state that "the responsibility for primary education is assigned to local

[15] Below, under Principle 2, we also argue that revenue autonomy has other benefits, such as enhancing efficiency at the margin by ensuring greater correspondence between the costs and benefits of the services provided by the public sector.

governments." Instead, the assignment of functions, roles and expenditure responsibilities to different government levels should be broken down into several attributes, including the responsibility for (1) actually producing a good or delivering a service (which could be done either by the public sector or by a private firm or NGO); (2) providing or administering the service; (3) financing a service; and (4) setting standards, regulations or policies guiding the provision of government services. In order to assure a comprehensive assignment of expenditure responsibilities, the legislation should clearly address all four dimensions of expenditure assignment for both recurrent and capital infrastructure expenditures.[16]

Thus, while there appears to be broad support for Tanzania's pursuit of "decentralization by devolution," different stakeholders may be actually considering different degrees of devolution (see Table 1.3). On one extreme, there are a number of government services which are fully devolved to the local government level, so that local governments are accorded full responsibility over all dimensions of a public good or service, including planning, financing, providing and producing the service.[17] Public finance theory suggests that such "truly local" or "fully devolved" services should be funded from general local funding, which comprises of own source revenues (e.g., local taxes or user fees) as well as unconditional grants.

However, in other cases the term "devolution" may refer more narrowly to the fact that the responsibility to deliver or provide a central government service may be devolved to the local government level, while the central government remains responsible for many other facets of the government service, including national policy direction (regulation) and financing. Although the legal framework in Tanzania needs to be clarified in this respect, it appears that primary education and other "local priority sectors" are in fact deemed to be central government responsibilities where only the delivery of the service is devolved (or "delegated," a term more frequently used in this context) to the local government level.[18] In this case, however, the responsibility to provide funding for the delivery of these services generally lies with the central government. In this situation, it is

[16] In other words, for each local government function the Local Government (Finance) Act should define which government level is responsible for each dimension of the expenditure assignment. For instance, for primary education: the central government is assigned the responsibility of setting policies and regulating; the central government is assigned the responsibility of financing; LGAs are assigned the responsibility for provision; LGAs are assigned the responsibility for production, although primary education may also be delivered by the private sector. Currently the Act only indicates which services are to be provided by the local government level and states that certain intergovernmental grants are to be provided for certain purposes.

[17] As noted under Principle 2, fully devolved government services should uphold the correspondence principle.

[18] As explained in greater detail in Section 3, devolution of the responsibility to deliver a government service implies that the local government has substantial control over the delivery of a service. Devolution of service delivery allows local governments to respond to local priorities, and enables local residents to hold their local government officials accountable for the efficient and effective delivery of the service. Note that this is technically different from delegation, in which case local governments are merely agents of the central government in delivering a service, and local governments are ultimately only accountable to the center.

appropriate for the service to be funded from targeted grants (such as sectoral block grants), as is provided for by the Local Government Finance Act.

Table 1.3
Considering Different Degrees Of Decentralization: Deconcentration, Delegation And Devolution

	Centralized provision	**Deconcen-tration**	**Delegation**	**Devolution of provision**	**Full devolution**
Local govt. elected?	NO	NO	**YES**	**YES**	**YES**
Local responsibility for policy/regulation?	NO	NO	NO	NO	**YES**
Local responsibility for financing?	NO	NO	NO	NO	**YES**
Substantial local discretion of provision?	NO	NO	NO	**YES**	**YES**
Local responsibility for provision?	NO	NO	**YES**	**YES**	**YES**
Local responsibility for production? (*)	NO	**YES**	**YES**	**YES**	**YES**

Note: (*) Local responsibility for production typically means that a government service may be produced by the local government itself or production may be subcontracted to private producers (e.g., private schools, refuse collections, etc.).

The issue of expenditure assignments –and how the system of local government finance should fund the various local government expenditures from different funding sources- is taken up in greater detail in Section 3 of this report. Much of the system of local government finance –for instance, the importance of sectoral grants, unconditional grants and own source revenues- is dictated, to a large extent, by the need for finance to follow function.

Box 1.1
Feedback from Stakeholders' Workshop on Principle 1

Broad consensus was reached on this principle: the system of local government finance should depend on the level or extent of devolution of responsibility. Stakeholders agreed that both intergovernmental transfers and own local revenues play important roles in the system of local government finance, although it was noted that they are not necessarily distinct in the sense that that they flow into the same budget at the local government level.

Workshop participants further concluded that "decentralization by devolution" does not mean the same thing for all local expenditures. For the priority sectors, It was agreed that "decentralization by devolution" means devolution of provision, so that the central government will have responsibility for sector policy, standards, and financing. For other local activities, "decentralization by devolution" means "full" devolution (including local responsibility for priorities, financing, and implementation), so that local governments need adequate general-purpose resources (from own source revenues and unconditional grants) to finance these activities.

Principle 2. The role of taxation in the public sector is more than maximizing revenue yield. If structured appropriately, local taxation empowers communities, enhances accountability, helps improve vertical imbalance problems, and overall, it improves the efficiency of the public sector.

In the previous section, we dispelled the myth that the only thing that mattered in the design of (local government) taxation was revenue yield. Instead, revenue autonomy at the local level is also important to assure a more broad-based, fairer and more accountable system of governance. In fact, the existence of local tax instruments and local revenue autonomy is an important avenue to establish local accountability and enhance economic efficiency in the context of a decentralized system of governance.

There is widespread agreement among public economists that a centralized system of government generally results in a non-optimal allocation of public resources because the link between costs and benefits is lost. Unlike in a competitive market, a good may not be provided by a central government even though the benefits to residents outweigh the costs. For instance, a local infrastructure project may not get funded by the central government because (a) it is hard for the central government to accurately assess the economic importance of the project, and because (b) the average national tax payer would likely benefit little from the project.[19] In contrast, in a decentralized system where local governments have a degree of revenue autonomy, communities are able to provide additional public services as long as the benefits to the community exceed the costs. Thus, if a local infrastructure project has a large positive impact on the local economy

[19] On the other hand, a local project may get funded by a central government even if its costs outweigh the benefits, for instance, if the project benefits the constituents of a powerful politician. Boex and Martinez-Vazquez (2004) find that political influence is a crucial factor in the incidence of intergovernmental transfers in (almost) every country.

(for instance, by allowing a large number of local farmers to bring their product to market more easily), the local community is able to finance such a project by raising own source revenues. However, when local governments are not given any revenue autonomy, local governments are not able to respond to such local needs. This case illustrates how a centralized approach to public finances actually reduces efficiency and economic growth.

Under a decentralized system of local governance, truly local government services should be provided and funded by local governments themselves.[20] As long as local governments have a certain degree of revenue autonomy, the local government can decide to pursue local projects or local services when the benefits of the project or service outweigh the cost to the local community. Thus, reliance on the correspondence principle can make a decentralized system of government finance more efficient rather than less efficient. Yet by eliminating local revenue sources over the past few years, the options for local governments in Tanzania to finance local priorities have been reduced. In the longer run, the reduction of revenue autonomy will result in an overall reduction in the efficient provision of public services by reducing reliance on the correspondence principle.

In order for the correspondence principle to hold, local governments need to demonstrate a link to the local community between own source revenue collections on one hand and improved local service delivery on the other hand. Without seeing this link, local residents will be unwilling to pay local taxes. In fact, this is exactly what is currently happening in Tanzania: according to a recent survey, 40 percent of local taxpayers do not pay local taxes and fees, largely because of their perception that local tax payments are not used for the provision of local services (Fjeldstad 2004). An additional challenge in establishing links between local revenues and local services is that many Tanzanians have come to expect free public services from the public sector as a result of the country's socialist past.

While some skeptics blame the absence of a link between local revenues and local expenditures on low-quality local government leadership, local elite capture, or on corruption at the local level, this problem is in fact structurally caused by the overall system of local government finance. Since LGAs receive no unconditional grant for the operation of the council and administration of the local authority (other than the Administration Grant), LGAs have no choice but to use a significant share of locally collected revenues for local administration and administrative overhead. Various studies that have looked at local spending from own sources conclude that local authorities (both at district as well as at village level) typically spend 50-60 percent of own source revenues on local administration.[21] This provides a tremendous disincentive for local residents to pay local taxes. Thus, as noted below under Principle 4, while local taxation is an important part of a sound system of local government finance, there is a need for

[20] Truly local government services that could be fully devolved to the local government level are generally local "club goods" where the local government acts like a local "club" through which members of the community are able to access these services. Local provision of club goods is efficient if there are no inter-jurisdictional spillovers associated with the good and there are no equity issues to be considered.

[21] For instance, see three studies on local public finances conducted by UAPP in Mbeya, Mtwara and Singida in 2001. Also see: PO-RALG. 2003. Local & Lower Local Government Revenue Sharing and Management of Finances at the Village, Ward and Mitaa Levels.

other unconditional resources to be provided to the local level as well, especially for those governments that have limited fiscal capacity.

Another less well-known but important side effect of local revenue autonomy is that it helps address one of the most intractable issues in decentralized finance: vertical imbalances. Typically it is the case that local governments are assigned larger expenditure responsibilities than they are able to finance with their own revenues. This leads to a vertical imbalance. The problem is that quantifying this vertical imbalance is often very hard since costing expenditure responsibilities can be quite arbitrary depending on who is doing the costing (central or local governments and whether service standards are available and so on.) The benefit of local tax autonomy is that it tends to melt this issue away: as local governments have the instruments to raise their own revenues, they can use these instruments as needed to generate financing for the desired level of services.

Box 1.2
Feedback from the Stakeholders' Workshop on Principle 2

Consensus was reached in the stakeholder workshop on this principle. Grants do not provide sufficient resources to LGAs, and it was felt that local communities should contribute from own source revenues to meet their needs. This will improve local accountability.

It was generally felt that current local revenue collections fall short of what is needed for the funding of expenditure responsibilities assigned to the local level. There was also general agreement that local revenues should follow the "benefit principle", so that there is a broad correspondence between local revenue payments and local government services. (It was noted that in the case of user fees, the linkage between revenues and benefits may be direct; in the case of local taxes, the correspondence might be less direct, but nonetheless, taxpayers should be able to feel that they will receive service in return for their local taxes).

Workshop stakeholders further came up with a series of recommendations that would make local taxes more attractive to local taxpayers and easier to collect for local governments, including suggestions for simplifying the local tax structure, more taxpayer-friendly tax collection, more participatory local spending plans, better communication between local authorities and residents, creating clearer links and publicity to link local revenues to local spending, and so on.

Principle 3. Each government level requires control over at least one good revenue source. The deficiencies in local tax administration should not be addressed by eliminating local taxes without consideration of their revenue impact; rather, deficient local taxes should be transformed into sound revenue instruments. There is a need for a limited "closed list" of local taxes that captures the diverse circumstances of local government authorities in Tanzania. Revenue autonomy should be separated from the

issue of tax administration; local taxes can be administered by the central tax administration as needed.

By providing local governments with an adequate amount of revenue autonomy, local governments are able to collect local revenues from taxpayers to pay for local government services, just like taxpayers pay taxes to the central government to pay for government services provided by the central government. In doing so, it is important that the taxes and revenue sources assigned to the local government level are carefully coordinated or harmonized with the revenue sources assigned to the central government level in order to avoid double taxation and in order to minimize collection and compliance costs. The study team recommends that the following points should guide the further harmonization and rationalization of local taxes and revenues:

Each government level requires control over at least one good revenue source. With consensus on the fact that local revenue autonomy has important benefits for local accountability and efficiency (through the correspondence principle), a first step towards a sound assignment of revenues is that each government level is given control over at least one good revenue source. In particular, it appears that after several rounds of eliminations and restrictions, most local governments have few worthwhile revenue sources left. Given the unsatisfactory nature of the taxes currently assigned to the local government level, we should not expect local governments to exert a very high level of effort in collecting the remaining local revenue sources. The current poor performance of local governments in collecting revenues may be more the result of the poor revenue assignment as much as the relatively limited capacity of local governments to administer their own revenue sources.

Thus any improvement in the capacity of local governments to collect local revenues needs to go hand in hand with a review and revision of the revenues assigned to the local government level. We propose that such a review is done as part of the Final Report, and that the Final Report will come up with a number of options for an improved revenue assignment.

At this stage, it is important to note that several features may make a tax a “local” tax, including whether (1) the tax is defined in local by-laws; (2) whether local governments define the tax base; (3) whether local governments are able to set the tax rate; and (4) whether local governments administer or collect the tax. However, economists consider a tax a local tax if –and only if- the local authority has control over the local tax rate. Thus, economists argue that for a local tax, it is not important whether the central government defines the tax base or whether the central government collects the tax, as long as the local council is able to set the tax rate. This is true because as long as the local government is effectively allowed to set its own tax rate (even if within a band defined by the central government), this gives the local government effective revenue autonomy by giving the local government control over the marginal size of its resource envelope. As a result, in reviewing and transforming the local tax system (as part of the remainder of this study), we need to keep in mind that a stronger role by the central government in legislating local tax structure and defining local tax bases will reduce the compliance

costs associated with local taxation without hurting local revenue autonomy. Furthermore, whenever appropriate, transformation of local revenues may consider shifting the responsibility to collect local revenues to the Tanzania Revenue Authority, which again would not hurt local revenue autonomy as long as the TRA is clearly identified as a collection agent and local councils are empowered to determine the local tax rate.

The deficiencies in local tax administration should not be addressed by further eliminating local taxes without consideration of the revenue impact. Instead, a systematic review of local tax instruments should transform and integrate them into sound revenue instruments. The study team believes that the assignment of petty taxes to the local government level and poor local administration should not result in throwing out the proverbial baby (revenue autonomy) with the bath water, and that rationalization of local taxes should not be equated with the elimination of local taxes. As such, the Government should commit to the principle of revenue neutrality in its pursuit of local government tax reform, meaning that the Government should commit that further reforms will not result in further reductions of local government revenues.

Then, how should the government go about restoring an adequate level of revenue autonomy at the local level, while assuring that the revenue instruments assigned to the local government level are worthwhile and sound? Although a detailed review and recommendations are envisioned to be part of the Final Report, it is important to recognize that it is much harder from a tax administration viewpoint to introduce a new tax after eliminating an old tax, than it is to transform a poorly designed local tax into a sound tax instrument.

An important issue to consider as part of the transformation of local government revenues is the institutional arrangements at the central government level. Currently, no central government agency (not PO-RALG or LGRP, not the Ministry of Finance, nor the TRA) is taking an effective lead role in implementing local revenue harmonization or strengthening the capacity of local governments to collect their own revenues. The absence of an effective administrative structure is contributing to a growing schism between the legislated revenue assignment (which is increasingly set by the Ministry of Finance) and the actual administration of local government revenues (which falls under the auspices of PO-RALG). The failure to fill this institutional void will effectively make it impossible to put in place a sound system of local government revenues.

There is a need for a limited “closed list” of local taxes that captures the diverse circumstances of local government authorities in Tanzania. As a starting point for a local revenue assignment that fits within a larger strategic framework of local government finance, the study team envisions a “closed list” of a limited number of local taxes. For every tax on the list, the tax bases and administrative procedures should be clearly and uniformly defined for all LGAs by the central government, which will reduce compliance costs for tax payers.

Perhaps the biggest challenge in defining a single closed list is that because local authorities in Tanzania face substantially diverse circumstances –particularly in rural areas, with many small producers who do not necessarily keep books of account- local governments have introduced a large number of taxes that are specific to the economic activities in their district. For instance, in many cases districts heavily rely on a number of sales taxes or excise taxes on specific crops or other specific economic production. Some stakeholders have been inclined to seek outright elimination of these revenue instruments because they do not appear to strictly comply with the current list of permitted local taxes. However, a more prudent reform approach recognizes these taxes for what they are: these taxes are in many cases *de facto* local presumptive taxes on economic production, and as such, a logical local adaptation of permitted local taxes.[22] At the same time, we need to recognize that historical practices have led to a highly fragmented network of *ad hoc* presumptive taxes, where the relationship between the value of the presumptive tax base and the amount of local taxation may have been lost (and thus, the effective tax rate may be excessive).

Given the nature of Tanzania's economy, it will likely be necessary (and practical) for local governments to rely on some type of presumptive taxation for small taxpayers.[23] Thus, to the extent that local tax payers fall outside the formal economy, it would be desirable for the regulatory framework for local government taxation to specify detailed guidelines for presumptive local taxes for various trades, crops or industries. This would allow the current presumptive local taxes to be brought into the current local tax framework in a harmonized fashion, at appropriate effective tax rates.

Box 1.3
Feedback from Stakeholders' Workshop on Principle 3

Consensus was reached by the workshop that deficiencies in local tax administration should not be addressed by eliminating further local tax sources without consideration of their revenue impact. For the coming budget year, local revenue reforms should concentrate on balancing the need for a sound local tax system with the revenue needs of local communities. As such, the focus of reforms in the coming year should be to improve the effective implementation of previous policy decisions.

It was broadly agreed that there is a need for a limited "closed list" of local taxes, since a permissive approach to local taxes has led to an unviable and excessively fragmented local tax system. However, the list of local government taxes and revenue sources should contain broad-based taxes that are flexible enough to provide all local authorities with revenue autonomy, regardless of the diversity in economic bases across the country.

[22] For instance, since many local taxpayers do not have formal business books, a LGA may impose a "proxy" Service Levy on smaller producers by estimating the value of their turnover on a presumptive rule of thumb. As a result, a nominal levy per truck may be imposed on a quarry as a proxy for its output, while a different nominal levy is imposed locally on cashew nut producers as a proxy for the value of turnover of the cashew nut producer.

[23] In fact, as noted earlier, the central government is itself moving to introduce a presumptive tax as part of the national income tax.

In fact, in order to improve local tax administration, it was further felt that local tax administration procedures be standardized by the central government across all LGAs. It was further felt that as long as LGAs have rate discretion, the collection of local taxes could be outsourced to the private sector or administered by the TRA as deemed appropriate by the Council. (It was noted that when collection is outsourced, tax collection procedures should clearly identify the LGA as the taxing authority.)

Principle 4. There is an important future role for sectoral block grants, equalization grants and capital development grants in Tanzania's system of local government finance.

Despite the positive features associated with local revenue autonomy, there are two major negative concerns associated with funding local government services from own sources. First, as pointed out below, to the extent that local governments rely on own sources to pay the operational and administrative overhead of running the local authority; this reduces the value-for-money that local residents receive from their local government for local services. Secondly, local tax autonomy tends to be un-equalizing, since poorer local governments would have fewer resources than wealthier local governments. Both of these concerns can be addressed by introducing a general purpose grant that is allocated in an equalizing manner. This is what the vast majority of countries with a decentralized system of finance actually do.

Local governments are known to operate most efficiently and receive more support from residents if local taxpayers receive one Shilling of visible local government services for every Shilling that they pay in local taxes. If local tax collections are used for local administrative purpose (which may be also considered part of local service provision, but where the direct benefits are less tangible or less visible), local voters and tax payers would no longer perceive that they receive a one-to-one benefit from their financial contributions to their local authority. Thus, if local governments would be able to fund the core cost of their administrative apparatus from a transfer, this would allow local authorities to apply 100 % of own source revenues directly to visible and tangible local service provision. As such, an important rationale for having an unconditional grant in Tanzania is to fund the core administrative, and operational cost of the local government apparatus, so that locally collected resources in principle can be used for the delivery of local government services that visibly and directly provide benefits to the local community. Thus, in order to strengthen the overall system of local government finance, the reform of a sound system of local government finance would require the introduction of an unconditional grant to supplement own source revenues, particularly for local government authorities where tax capacity is low (i.e., an equalizing general purpose grant). The resources currently allocated to local governments as Compensation Grant (now known as the General Purpose Grant) could serve as the basis for such a formula-based equalizing unconditional grant in the future.

Box 1.4
Feedback from Stakeholders' Workshop on Principle 4

The workshop achieved consensus on the statement that there is an important future role for sectoral block grants, equalization grants and capital development grants in Tanzania's system of local government finances. However, a concern was raised as to the ability of local authorities to absorb additional resources. Another concern that was raised by stakeholders was that although different funding mechanisms may be appropriate for different local activities, that there is a need to assure the use of a single, harmonized planning and reporting mechanism.

With regard to the recurrent block grants, it was noted that the current size of the sector transfer pools is clearly not adequate based on the service levels that can be afforded with the current resources. This concern points to a need to consider the vertical allocation of resources as an important topic for discussion in the remainder of the final report.

The workshop further reached consensus on the fact that the General Purpose Grant should evolve into a formula-driven (unconditional) equalization grant, as provided for by the Local Government Finance Act. It was noted by workshop participants that the equalization grant scheme should be carefully designed, so as not to provide a disincentive to local authorities to collect revenues (for instance, which would happen if equalization is based on actual local revenue collections).

1.5 The Analytical Framework for Assessing Tanzania's Decentralized System of Local Government Finance

The overall vision or framework for Tanzania's system of local government is provided by the Government's Policy Paper on Local Government Reform (PO-RALG, 1998). While the policy paper firmly establishes "decentralization by devolution" as the core principle behind Tanzania's decentralization approach, it does not establish (nor was it intended to establish) the details of the framework for local government finance. As such, the original policy paper does not provide a great amount of detail on the exact nature of expenditure responsibilities, the envisioned revenue assignment to achieve greater decentralization, the structure of the intergovernmental transfer system, or the role of local government borrowing. While the policy paper mentions the need to strengthen central-local relations, no guidance is given on the desired institutional reforms to make the new system of local government work.

In many ways, it is the role of the current study to fill the existing gaps in the financing framework for local government in a manner that is consistent with the vision set out in the Policy Paper. Neither the devolution of expenditure responsibilities, nor the system of local government revenues or the intergovernmental grants system are stand-alone issues. While the first steps in formulating an overall framework for local government finances were to evaluate the current state of the policy debate on the issue (Part 1 of this report)

and to consider the current profile of local government finance (Part 2), the next step is to sketch out the "big picture" and broadly relate the resource needs of Local Government Authorities (also referred to as local expenditure needs) to the sources and levels of resources (own source revenues, intergovernmental grants and loans) available to LGAs.

1.5.1 The analytical framework for assessing the local government finance system

In order to lay the foundation for such a framework (and for the rest of the study), this subsection provides a broad assessment of the current local government finance system and considers the broad outlines of the proposed local government financing framework for Tanzania. In order to maximize the comprehensiveness of the analysis of Tanzania's system of local government finance experiences, it is necessary to reach a balance between the desire for greater detail and specificity in the assessment of reforms on one hand, and the need for coherence and parsimony (which is need to provide the bigger picture) on the other hand. Unless such analysis is done in the context of a structured analytical framework, the analysis is likely to result in unstructured discussions and unsubstantiated opinions. As such, the assessment in this study follows a structured approach.

The framework for this analytical structure is provided by a two-dimensional matrix (Table 1.4), whereby one dimension of the matrix captures the functional building blocks of decentralization (such as expenditure assignments, revenue assignments, transfers, and so on) while the other dimension will capture the technical nature or the entry points for reform and actions (for instance, legislative reforms, regulatory issues, and so on).[24] The matrix helps to assess the current state of local government finances by mapping out and assessing the status (strengths and obstacles) of all the constituent components of the current framework for local government finance.

The first dimension of the matrix (contained in the rows) considers the status of the local government finance system along several main functional policy areas, which delineate the key functional building blocks of intergovernmental fiscal relations. In this light, we consider five pillars of decentralization. The five areas of policy concerns are:

(1) Structure and scope of the government sector. How large is the role of the public sector in the economy, and to what extent is the government sector well-structured to make effective policy decisions and to efficiently provide public services in a decentralized framework? Among others this area includes issues such as the size of the public sector vis-à-vis the private sector, the number of tiers of government in the system; the basic scope of each tier; and mechanisms for dialogue and cooperation within each tier and between different tiers of government. This dimension also

[24] This basic methodology for this assessment matrix was developed and successfully applied for previous assessments of decentralization reforms, including an initial assessment of decentralization reforms in Bangladesh (UNDP/Bangladesh, 2002), for the assessment of decentralization reforms in Indonesia (USAID, 2004), and for the assessment of fiscal decentralization reforms in selected transition economies (UNDP/Bratislava, 2005).

considers whether the correct degree of political decentralization and local empowerment is in place to institute effective fiscal decentralization.

(2) The assignment of functional / expenditure responsibilities. To what extent is the assignment of functional or expenditure responsibilities consistent with an efficient and effective approach to decentralization and local governance? Is there a complete assignment of expenditure responsibilities between the different levels of government, for all sectors (education, health care, etc.) as well as clarity in the distribution of attributions in co-shared responsibilities (delivery of services, capital development, staffing, regulation and setting of standards, financing, etc.). Is the prevailing assignment consistent with the subsidiarity principle? How pervasive are national mandates? What functions or expenditure responsibilities –if any- are "falling through the cracks"? To what extent are local governments able to properly administer their assigned functions?

(3) Revenue assignment and local tax administration. To what extent is the assignment of revenue sources between different levels of government consistent with an efficient and effective approach to decentralization and local governance? What is the degree of revenue sufficiency and the extent of vertical and horizontal imbalances? Is there sufficient revenue autonomy at the local level?

(4) Intergovernmental fiscal transfers. To what extent is the design and implementation of the system of intergovernmental fiscal transfers in Tanzania consistent with an efficient and effective approach to decentralization and local governance? Is there sufficient equalization to address horizontal disparities? Is the system of transfers incentive-compatible at the subnational level so that local governments exercise their tax effort and strive for an efficient production of public services? Are there adequate transfer instruments to pursue central government objectives? To what extent are there central government mandates that are improperly funded by the system of subnational government finance?

(5) Subnational borrowing and infrastructure development. Do local governments have adequate access to funds for capital development through borrowing or other mechanisms? Is the current regulatory and monitoring framework sufficient to avoid macroeconomic destabilization?

Within the context of the assessment of each of these five building blocks of intergovernmental fiscal relations, we consider the technical nature of the strengths and weaknesses of the framework for local government finance. As such, the second dimension of the proposed matrix classifies the different potential points of entry by stakeholders and the different types of policy reforms needed for a successful and sound system of intergovernmental relations. These policy entry points include:

(1) Policy stance. Is the general policy stance of the national government consistent with a sound, decentralized approach to intergovernmental relations and local governance? If applicable, the matrix should assess if and how the policy stance of governmental institutions or agencies is obstructing (or threatens to hinder) sound decentralization reforms.

(2) Legislative reform. To what degree is the current constitutional and legislative framework appropriate for the implementation of decentralization reforms? What reforms are needed to assure that the legislative framework is consistent with a sound decentralized approach to intergovernmental relations and local governance?

(3) National institutional or regulatory reform., To what extent does the institutional framework and the system of government regulations (including Government Decrees, Presidential Decrees, Ministerial Decrees) at the central government level form an obstacle to the implementation of a sound, decentralized approach to intergovernmental relations?

(4) Local regulatory and procedural reforms. To what extent are various regulatory and procedural reforms necessary at the local government level in order to assure the efficient performance of local government functions, including the efficient delivery of local government services?

(5) Capacity building needs. To what extent is capacity building, technical assistance, and socialization needed within government agencies at different levels of government and within civil society in order to achieve the benefits of successful decentralization reforms?

1.5.2 An overall assessment of the current local government finance system

A "big picture" assessment of the current system of local government finance in Tanzania is captured in Table 1.4. The rows in the table consider a broad functional dimension of local government finance, including the local government structure in Tanzania (in row 1) as well as the four main pillars of decentralization reform listed above (in subsequent rows). The columns in the table consider different levels of policy intervention, including policy reforms, legislative reforms, regulatory and institutional reforms, and so on. The cells in the table contain a brief assessment of the intersection between the relevant functional dimension and the type of policy intervention. A more detailed discussion of each the various dimensions of the local government finance system is contained in the subsequent sections of the study.

Local government structure. The first row of Table 1.4 provides a brief assessment of Tanzania's current structure of subnational government, considering the number of government levels, the size of subnational jurisdictions, and so on. The subnational government structure was considered a given (exogenous) factor during the formulation of the local government finance framework.

Table 1
Assessing The Current Framework Of Local Government Finance In Tanzania

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society (CS) and private sector
(1) Structure and role of public sector	District and urban councils main LG level Role of village should be clearer and increase	Rural and urban Gov Act; provides sound framework, but duplicative	PO-RALG evolving from controller to facilitator Improved coordination between RALG, MOF, sectors	LGAs have adequate control over own affairs / internal organization, except local public servants	LGAs (ALAT), other NGOs, need stronger voice/link into the LG reform process
(2) Functional and expenditure assignments	"Decentralization by Devolution"	Assigned as listed in LGFA; D-by-D should be clarified further Admin of Public Svc Act limits local discretion	Generally, sectors OK in dealing w/LGAs Excessive central control over LG hiring/firing	Weak local planning and budget process; needs review and strengthening (Epicor; Plan-Rep)	Limited CS participation in local budget processes (formulation / accountability)
(3) Assignment of revenue sources	Some ambiguity about strengths (importance) and weaknesses of local revenues	LGFA does not provide clear "closed list" (contradicts itself)	No single CG institution responsible for local govt revenue policy	Very weak local tax admin capacity; need for unified regulatory frame-work for local govt revenue administration	Limited CS input in local revenue decisions (local tax payer's associations?)
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandates	Clear commitment to formula-based sectoral grants and CDG system	LFGA provides adequate framework; but contains duplicative provisions	Need firmer link to central budget processes (PER/ MTEF/ PRS) Sectoral block grants coordinated though BGIT	Budget guidelines provide clear guidance for transfers	Limited CS transparency/ monitoring of grant-funded programs
(5) LG borrowing and infrastructure development	Willingness to accommodate needs of urban LGAs, but concern about soft budget constraint	Allowed by law with ministerial permission	LGLB currently only mechanism; inadequate source for local borrowing	Need for unified local budget approach (budget recurrent and dev budget spending together)	Currently no private sector borrowing

The current local government structure in Tanzania provides an adequate basis for moving forward, as district and urban councils are generally of an adequate size and have sufficient administrative capacity to operate as local government jurisdictions and to assure the delivery of the range of public services assigned to them. The facilitative role of the Regional Administrations (as opposed to their previous more hierarchical role) is appropriate and is seemingly allowing local governments greater control over their own affairs.

Expenditure assignments. The current assignments of expenditure responsibilities in Tanzania are generally sound, as reflected by the second row in Table 1.4. The government's policy position of "decentralization by devolution" is unambiguous; the legal framework for decentralized provision of services is in place and sectoral laws to a large extent respect this decentralized mode of service delivery; and the services assigned to the subnational level generally follow the subsidiarity principle.

Despite the devolution of expenditure responsibilities, local governments are not yet able to operate with full budget autonomy. The predominant way in which the central government interferes with local governments' ability to provide public services is through its control over (the hiring and transfer of) local government staff. Although outside the main scope of this study, serious problems will arise in the local government finance system unless the local service system is properly aligned with the local government finance system by allowing local governments to make their own hiring and firing decisions (and to eliminate central government intervention in local public service decisions).

Section 3 discusses the expenditure responsibilities assigned to the different government levels; the focus of the section lies on quantifying the amount of resources required by each subnational government level in order to fulfill its obligations and perform its assigned functions.

Revenue assignments. The revenue assignment question -how much of the national revenue pie should be given to the local government level, and how local revenues should be administered- is probably the weakest component in Tanzania's system of local government finance. Recent reforms of the local revenue system that were aimed at a "rationalization and harmonization" of local government revenues instead has resulted in an elimination of a number of significant local revenue sources, including the Development Levy and a number of minor local ("nuisance") taxes. In addition, a number of other local revenue source were sharply reduced or strictly limited, including the collection of business licenses and agriculture cesses.

While there is widespread agreement that the previous local revenue system as well as the manner in which local taxes were administered were wholly inadequate, there is now an increasing realization (both at the central government as well as at the local government level) that local revenues are an integral part of a sound system of local government finance. This leaves the Government with the difficult challenge to transform the current,

inadequate and imperfect system of local government revenues into a sound and well-administered system of local government revenues.

Section 4 of our report assesses the current assignment of revenue sources, and provides a clear description of pros and cons, and options and recommendations with regard to the reform of revenue assignments. Rather than limiting ourselves to the current local revenue sources as the scope of our evaluation, Section 4 approaches the review of revenue assignments from the most comprehensive angle possible. As such, the section appraises the appropriateness of the entire spectrum of revenue assignments, considering all revenue instruments used in Tanzania (i.e., both central and local government revenues) and reviewing whether each revenue source is assigned to the appropriate level of government in accordance with principles of sound revenue assignment. Instead of classifying revenue instrument as "strong" or "weak" local government revenue sources, we explore the weaknesses of the local tax or revenue source and consider whether each revenue source has the potential to become a string revenue source. In order to explore all options, we also consider if each particular revenue source is a possible candidate as a central-local shared revenue source or as a "piggy-back" tax.[25] Section 4 concludes with a series of policy recommendations on the composition of the future local government revenue system in Tanzania.

Intergovernmental fiscal transfers. Once expenditure responsibilities and revenue sources have been assigned to the local government level, intergovernmental fiscal transfers are needed to achieve vertical and horizontal fiscal balance in the system of intergovernmental fiscal relations. The transfer system in Tanzania –discussed further in Section 5- plays an extremely important role in financing local governments, as most councils rely for 80-90% on intergovernmental transfers to fund their activities.

A study on the intergovernmental transfer system in Tanzania (GSU, 2003) identified a number of serious shortcomings with regard to the manner in which intergovernmental transfers (local government allocations) were allocated; the allocation of local government resources was done in a highly discretionary manner, lacked objective standards for allocating resources, failed to provide local governments with a predictable stream of resources, and was generally counter-equalizing. As such, transformation of the transfer system has taken center-stage in the reform of local government finances in recent years. The positive steps taken by the Government to reform the intergovernmental transfer system has been one of the major successes of local government reform in recent years (JGDR, 2004).

The broader vision for a formula-based system of intergovernmental transfer was developed as part of the Government's Local Government Reform Policy. Detailed

[25] As considered in greater detail in Section 4, a shared revenue source is a revenue source that is collected by the central government, but from which the revenues are shared with local governments, often on a derivation basis. Piggy-back taxes are an approach to subnational taxation by which local governments are allowed to determine a sur-charge to a national tax (for instance, a piggy-back income tax or a piggy-back sales tax). In that case, the local authority is provided revenue autonomy (with the ceiling determined by the central government), but the collection is administered by central revenue authorities.

proposals for a system of formula-based recurrent sectoral block grants were adopted by Cabinet in February 2004. The system of formula-based sectoral block grants is currently in the process of being implemented: formula-based grants for primary education and local health services were introduced in July 2004; formula-based grants for the remaining priority sectors are being introduced as part of the FY 2005/06 budget.

In addition to conditional sectoral funding, local governments receive a number of additional intergovernmental transfers, including a (discretionary) Local Administration Grant and a Compensation Grant provided in compensation for local revenue sources abolished in 2003 and 2004 (since 2004, the Compensation Grant is known as the General Purpose Grant). The government is on the threshold of introducing a comprehensive, formula-based Local Government Capital Development Grant system, which is funded from government resources, World Bank loan proceeds and various donor agencies.

Local government borrowing. Borrowing plays only an extremely minor role in Tanzania's system of local government finance. While the legislative framework allows LGAs to borrow with ministerial permission, the only conduit currently available (the Local Government Loans Board) is not in a position to properly address the lending needs of local authorities.

However, the fact that local governments have limited access to lending for the purpose of infrastructure is increasingly becoming a constraining factor in the local government finance system. This is especially the case for urban councils that have a sufficient resource base to engage in lending and repay their loans, and which have a strong interest in developing their infrastructure. There appears to be an interest within the Government of Tanzania to expand the possibilities for LGAs to use borrowing as a way to finance local capital infrastructure, as long as the framework ensures prudent borrowing in the context of a "hard budget constraint". This dimension of the local government finance framework is further discussed in Section 6 of the report.

Cross-cutting fiscal decentralization issues. In order for a system of local government finances to work, it is necessary –but insufficient- for each of the individual components of fiscal decentralization to be well designed. In addition, it is critical that the various components of the system are seamlessly integrated; failure of the overall local government finance system will result if the system lacks proper linkages between the various components. For instance, unless local governments are assigned the appropriate expenditure responsibilities, it is unlikely that local residents are willing to pay for local services from own source revenues. Similarly, the existence of unfunded mandates may cause local governments to borrow beyond what is fiscally sustainable. In turn, unless the system of local government finance provides LGAs with a hard budget constraint (among others by limiting borrowing), the presence of a "soft budget constraint" could provide local governments with perverse incentives to engage in inefficient local expenditures and suboptimal local revenue collections. Specific cross-cutting issues in need of being addressed include:

- The lack of formal links between local expenditure responsibilities and the modalities for funding these functions.
- In particular, the manner in which local government administration is funded has been ill-considered, and has potentially important implications for the quality of local government services and revenue-raising ability.
- Obstacles to local revenue collection that are caused by other "pillars" of decentralization, including problems with expenditure assignments and local financial management, and the presence of a soft budget constraint as part of the transfer system.
- The need to more strongly tie local government borrowing into the overall framework for local government finance.

Specific attention will be paid in the various sections of this study to such cross-cutting fiscal decentralization issues.

The institutional and administrative framework. In addition to a technically well-designed system of fiscal decentralization (within components and between components), a sound institutional and administrative framework for the system of intergovernmental fiscal relations is critical in assuring a solid system of local government finance.

For instance, some of the more serious weaknesses of the local government finance system are caused by problems with financial management at the local government level. Planning and budget processes at the local government level tend to be weak; the local budget process further involves only limited civil society participation and oversight of budget planning, formulation and execution. While the standardization and computerization of local financial management processes is currently being rolled out, the local financial management processes should be reviewed and strengthened to assure greater participation, transparency and local oversight.

The institutional framework needs to assure coordination between the various central government stakeholders with an interest in local government finance issues, including PO-RALG and the Ministry of Finance, as well as certain line ministries and other central government agencies. The inter-ministerial linkages have historically been weak in Tanzania, but the establishment of a Coordinating Block Grant Implementation Team has significantly improved the effectiveness with which the central government has been able to deal with local government finance issues. While additional institutional strengthening of the various stakeholders is needed in coming years, the production of the Local Government Fiscal Review (2004) by this inter-ministerial team should be seen as a strong indication of their improving institutional framework.

In addition to the need for horizontal coordination at the central government level, there is also a need to assure that adequate coordination takes place between different government levels, as well as between the public and private sector. A sound fiscal decentralization approach cannot be driven from the center alone; ultimately, a sustainable decentralized system requires civil society (NGOs, local chambers of commerce and other interest groups) to be involved in the local decision-making process,

just like a sound decentralized system requires local governments to have a real voice in the national policy debate on local government reform issues. Since the focus in recent years has been on addressing some main fundamental challenges in local government finance, this has been an area that has received less attention. However, now that the overall framework for local government finance is on an increasingly sound footing, these institutional concerns are becoming increasingly important for a sustainable local government system.

Overall assessment. When taken together, it would be fair to state –based on the assessment summarized in Table 1.4- that although the current system of local government finance has a number of shortcomings, many of the features of the current system of local government finance are quite sound. The overall policy direction of the Government on local government finance has been prudent and is consistent with overall sound principles for decentralization reforms. In general, the legislative framework provides appropriate guidance, although the relevant laws should be revised to eliminate outdated, duplicative or contradictory clauses. Although the local government revenue system has not received adequate attention in recent years, substantial progress has been made on transforming the previously highly discretionary transfer system into an objective, transparent, stable and pro-poor funding mechanism for local governments.

While in most respects the overall structure is sound, specific features may need sharpening and fine-tuning in order to form an overall financing framework that is well-integrated and internally consistent. At the very least, the current local government finance system provides a solid stepping stone for the incipient strategic framework for local government finance.

1.5.3 Structure of the remainder of the study

The remainder of this study is structured as follows. As noted immediately above, Section 3 through Section 6 assess in detail how the four main pillars of fiscal decentralization are operationalized in Tanzania, and how each of these pillars could be strengthened and improved in order to achieve a more cohesive and stronger system of intergovernmental fiscal relations. Section 7 deals with the institutional and administrative framework of local government finance in Tanzania. Preceding these sections, Section 2 provides a (quantitative) revenue profile of local authorities in Tanzania. The final section of the report (Section 8) pulls together the key findings and recommendations and -as requested by the TORs- prepares a draft Policy Paper On Local Government Finance in Tanzania.

Section 2. A revenue profile of LGAs in Tanzania. Although some data regarding local government resources and local revenue collections are collected on a regular basis, the available data are often incomplete and lack specificity. No systematic analysis is performed on these data. Based on the first comprehensive, detailed data set for local government revenues collected by LGRP, Chapter 3 of the Local Government Finance Review (2004) conducts a basic analysis of local revenue patterns in Tanzania. The

quantitative assessment of the current system of local government finance is an important input into the new strategy, as the revenue profile helps in identifying bottlenecks in the current approach to financing local governments that ought to be resolved.

Section 2 of the current study builds on the Local Government Fiscal Review in providing a resource profile of Local Government Authorities in Tanzania from FY 2001/02 onwards; the LGFR (2004) further notes main trends in the composition and amount of local resources. For completeness, the resource profile developed in Section 2 will include both local government allocations (i.e., intergovernmental grants) as well as own source local revenues. However, since the composition of intergovernmental grants is already analyzed extensively by the Intergovernmental Grant Study, the current analysis will focus mainly on own source revenues.

Specifically, the local government resource profile includes:

- An analysis of the aggregate importance of different revenue sources (intergovernmental transfers; own revenue sources) for the subnational government sector as a whole (Section 2.1);
- A quantitative analysis of local revenue sources (Section 2.2);
- An analysis of the impact of the 2003 abolition of the Development Levy and the so-called nuisance taxes on the revenue profile of local governments. The estimates will consider not only the direct revenue loss from the nuisance taxes, but also the indirect impact of the local revenue reforms on other local revenue sources, as LGAs *may* have responded by increasing collection of other local revenue sources (Section 2.3);
- A quantitative analysis of the system of intergovernmental transfers (Section 2.4);
- An analysis of the special role of Dar es Salaam City Council in the structure of local government finances in Tanzania (Section 2.5).

Section 8: A strategic framework for the financing of local governments in Tanzania. The first seven sections of this study contain all the ingredients for a strategic framework for local government finance in Tanzania. The final section (Section 8) of the *Final Report* -in a clear and concise manner - pulls together the conclusions and recommendations from the previous sections into a proposed strategic framework for local government finances.

As such, Section 8 will be drafted in such a fashion that it can be used as a separate, stand-alone strategy document, while also being an integral part of the overall report. The strategy will clearly indicate how each level of local government should be funded (i.e., with what mix of own revenue sources and national transfers) and how each source of local revenues could be optimized.

Concluding comments. Before we proceed, we should be clear that the current study is intended to assess the overall *framework* of local government finance and intergovernmental fiscal relations in Tanzania. Of course, it is impossible to assess the overall framework without taking on board a relatively high level of detail of the various mechanisms that constitute the overall system of local government finance (i.e., local

government revenue sources, intergovernmental transfer schemes, and so on). As a result, we describe, assess and (as appropriate) make reform suggestions for each of these component parts of the overall system of local government finances in Tanzania in order to assure that the local government finance system as a whole is able to function optimally. However, the reader should bear in mind that this study is intended to develop the overall framework (i.e., the "big picture" of the system) for local government finances in Tanzania. It is not the intention of the current study to conclusively address all the technical issues (i.e., "the nuts and bolts") of the myriad of local government financing instruments used at the local government level. As such, this study seeks to provide a comprehensive framework within which to transform local government revenue instruments (and introduce new intergovernmental transfer schemes) rather than arriving at specific technical recommendations to reform specific local government revenue sources. Follow-on activities are needed to finalize the detailed transformation of the local revenue system and the system of intergovernmental transfers in the context of the overall strategic framework.

Annex 1.1
Terms of Reference / Scope of Work

DEVELOPMENT OF A STRATEGIC FRAMEWORK FOR THE FINANCING OF LOCAL GOVERNMENTS

1.0 Background:

1.1 The Government of Tanzania has determined that it is useful to undertake a comprehensive review of the policy framework underpinning the structure of the financing of Local Governments and Local Government revenues.

1.2 In the last budget speech, the Minister of Finance announced that Government was abolishing a variety of Local Government nuisance taxes, including the development levy. This tax has been an important source of Local Government revenue, especially for rural local authorities, many of which received over 50% of their revenues from the development levy. Although the development levy was flawed, the abolition of the tax has proved a challenge for local authorities.

1.3 The President's Office, Regional Administration and Local Government (PO-RALG) has, through the Local Government Reform Programme (LGRP), developed a formula based allocation system for the recurrent grants to Local Government Authorities, and this will be implemented in respect of Health and Education from 2004/05 and the remaining grants from 2006/07. The consultants to that initiative are to be retained to support the completion of that work and the development of an institutional framework that will bring together this and other grant systems, both recurrent and development, into one consistent process. While this is expected to result into equity among Councils, it will not address the level of required transfers and the capacity of Councils to generate own revenues.

1.4 To help consider the issues systematically, and to provide a solid policy foundation for considering individual Local Government revenue sources, it is proposed that a study be undertaken. The Government is therefore interested in developing an overall and strategic frame of reference to guide decisions on the structure of the financing of Local Government Authorities, intergovernmental transfer schemes, and on specific local taxes.

2.0 SCOPE OF WORK:

2.1 The Consultant will work under the direction of the Permanent Secretary - PO-RALG or such official as he may designate, and shall consult regularly with the Ministry of Finance.

2.2 The work will include:

(i) Review of previous research and policy work with regard to Local Government revenues and fiscal decentralisation.

(ii) Limited collection of data:

a) Ideally, this should be collected from existing sources (such as the Government's Local Government Reform Program) rather than primary research

b) Sampling of data from 5 to 10 Local Government Authorities of various sizes may be necessary if existing data sources are inadequate to provide a reasonable estimate of the current situation and relevant trends.

c) The objective is to document the current revenue profile of Local Government Authorities in Tanzania, and any significant trends in the composition and amount of local revenues. This should specifically include:

- Estimates of the aggregate revenues received by each level of Local Government Authority, by source, in absolute and percentage terms, and

- Estimates of the impact of the 2003 abolition of nuisance taxes.

(iii) Review any documentation of the functions and responsibilities of each level of government authority, including the Lower Local Governments.

(iv) Discussions with key stakeholders, including PO-RALG, the Ministry of Finance, any relevant Local Government association(s), and relevant donor and technical advisory programmes.

(v) Providing a clear description of options, pros and cons, and recommendations for Government to consider in regard to:

a) Revenue needs of Local Government Authorities: quantifying the total revenue required by each level of Local Government Authority in order to fulfil its obligations and perform its assigned functions in terms of the Constitution, legislation, and national policies, particularly the Poverty Reduction Strategy.

b) Revenue-generating capacity of Local Government Authorities:
   i) Identifying the most effective and efficient current sources of revenue for Local Government Authorities, and what measures would be required to optimize the revenues from each of these sources. In this regard, the Consultant may wish to consult with the Local Government Support Programme (LGSP) based in PORALG.
   ii) Identifying any current sources of revenue for Local Government Authorities that are reasonable candidates for elimination as inefficient or ineffective, or that require substantial reform in order to optimize their revenue potential.
   iii) Identifying any significant and efficient taxes, fees and charges that are now not being used by Local Government Authorities, and any legislative or institutional reform measures that would be required to enable Local Government Authorities to impose and administer such taxes, fees or charges.
   iv) Estimating the amount of revenue which each level of Local Government Authority, and each individual Authority, can reasonably be expected to raise from own-source taxes, fees, and charges in the near term and over the coming 5 –10 years.
   v) Identifying significant issues with regard to the distribution of local revenue capacity (e.g. urban vs. rural issues and other significant geographical or demographic issues affecting local revenue capacity)

c) Transfer capacity of national Government:
   i) estimating the total amount and proportion of nationally raised revenues that can reasonably be made available as transfers to Local Governments in the aggregate and to each level of Local Government, in the near term and over the coming 5 – 10 years;
   ii) analysis of the degree to which the amount that can reasonably be made available from national sources is, or is not, adequate to close the gap between local revenue needs and local revenue-generating capacity, for each level of Local Government.

d) Transfer criteria: regulating the manner in which transfers from national Government could be distributed (e.g. by what formulae or criteria, with what degree of predictability and stability) with due regard to:
   i) Capacity of Local Government Authorities
   ii) Transparency and participation in budget decisions
   iii) providing funding for local infrastructure
   iv) providing adequate funding for operating expenditures of Local Government Authorities
   v) redistribution to regions with lower revenue raising capacity

   The policy framework for transfer criteria should take, as its point of departure, the work which has already been done by James Boex of Georgia State University, for the Local Government Support

Programme, and should integrate that work with the overall Local Government revenue policy framework.

e) Co-ordination of Local Government revenue policy with overall national tax policy, including:
   i) Impact and allocation of the overall tax burden;
   ii) Impact on the business and economic development environment.

(vi) Clear and concise recommendations, drawn from the above work, as to:
   a) How each level of Local Government should be funded, i.e. with what mix of own revenue sources and national transfers.
   b) How each source of local revenues could be optimised.

3.0 THE CONSULTANT:

Consultants are expected to be individuals, but may incorporate one or more national or internationally recognized experts with substantial technical expertise regarding local revenue policies. Where other experts are incorporated, the Consultant remains responsible for the discharge of obligations under the contact.

4.0 LEVEL OF EFFORT:

4.1 The above-described expert/s is/are expected to work for a total period of approximately 20 person-weeks during the period from January 2004 to May 2004.

4.2 This level of expert effort, together with such additional effort as is required to complete the research, documentation, and other tasks required by the Scope of Work will be provided by the Consultant for a lump sum. The additional effort is anticipated to be not less than 40 additional person weeks for researchers and support staff, but it is the Consultant's sole responsibility to provide such staff as may be necessary to complete the work in a professional, workmanlike and timely manner.

4.3 PO-RALG has carried out a great deal of work in the area of fiscal decentralisation in both the recurrent and development areas. PORALG intends to continue this work not only to develop a basis for the extension of the formula based recurrent grant allocation system to the remaining grant areas, but also to develop proposals for the institutional framework through which a consistent and harmonised fiscal transfer system will operate.

4.4 The consultant for this assignment should therefore liaise closely with the consultant for this study and the Local Government Reform Programme of PO-RALG to ensure a consistent approach. The consultant should also liaise closely

with the implementers of the Local Government Support Programme in PO-RALG, and the Ministry of Finance. Widespread consultation should take place with all stakeholders including the donor community.

5.0 CRITICAL DOCUMENTS FOR REVIEW

The Consultant must familiarize himself/herself with recent research and policy work relevant to Local Government revenues and fiscal decentralization in Tanzania. Key documents include, but are not limited to:

i) The Local Governments Laws (as revised, 2000).
ii) Studies for capital grant design undertaken by Price Waterhouse Coopers in connection with the Local Government Support Programme;
iii) Studies for recurring transfer design undertaken by James Boex of Georgia State University.
iv) Studies for Dar es Salaam revenue enhancement undertaken by Riel Franzsen of the University of Pretoria.
v) Property Taxation in East Africa: The Tale of Three Reforms, by Roy Kelly of the Lincoln Institute of Land Policy, 2000.
vi) Implementing Property Tax Reform in Tanzania, by Roy Kelly and Zainab Musunu of the Lincoln Institute of Land Policy, 2000.
vii) The Scope for Fiscal and Institutional Restructuring in Dar es Salaam as a Component of the Tanzania Local Government Support Programme, by Chris Heymans and Krish Kumar, 2002
viii) TRA Study on Local Government Revenues, 2000 (unpublished);
ix) Any available research from the Local Government Support Programme.

6.0 OUTPUTS:

The above work will be documented in the form of:

i) an Outline for a Preliminary Report, due one week after signing the contract.
ii) a Preliminary Report, due one month after receipt of comments on the outline.
iii) a workshop on the preliminary report, to be conducted by the consultant in Tanzania, on a date agreed with the Ministry of Finance and PO-RALG.
iv) a Final Report, due within two weeks after the workshop, to address comments on the Preliminary Report, including those received at the workshop and any other revisions requested by the Government of Tanzania.

6.0 SHORT LISTED CONSULTANTS

The following Consultants have been short-listed for the assignment, and are invited to submit proposals:

(i) Jamie Boex,
Georgia State University,
prclfb@langate.gsu.edu

(ii) Jorge Martinez,
Georgia State University,
prcjlm@langate.gsu.edu

(iii) Roy Bahl,
Georgia State University,
prcrwb@langate.gsu.edu

(iv) Philip van Ryneveld,
philip@vanrynefeld.com

(v) Roy Kelly,
Duke University Center for International Development
roykelly@duke.edu

(vi) Odd-Helge Fjeldstad,
Center for Development Research
odd.fjeldstad@cmi.no

7.0 SUBMISSION OF PROPOSALS

7.1 A Combined Technical and Financial Proposal should be submitted to reach the address below not later than 1500 hrs local time on the **15th April 2003**.

The Secretary
Ministerial Tender Board
Ministry of Finance
P O Box 9111
DAR ES SALAAM, TANZANIA

7.2 The Technical Proposal may be sent in a hard copy or electronically to mkamugisha@mof.go.tz and should contain, among others, a brief discussion of the Terms of Reference, a CV showing the consultant's experience in undertaking similar assignments, and the methodology to be applied. If the Consultant intends to co-opt other persons, the CVs of such persons should be submitted.

7.3 The Financial Proposal should show a lumpsum amount requested for undertaking the work.

For inquiries, please contact:

Commissioner for Policy Analysis,
Ministry of Finance,
Phone: +255 – 22 – 211 0331
E-Mail: mkamugisha@mof.go.tz

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Annex 1.2 Meetings Held and Individuals Consulted

Inception Mission: Local Government Financing Study
Jamie Boex (JB), Jorge Martinez-Vazquez (JM) and Philip van Ryneveld (PvR)
October-November 2004

Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday
October 25	**October 26** 22:00 Arrival JB	**October 27** 10:00 Roads (JB) 14:00 Agriculture (JB)	**October 28** Editing of LGFR (JB)	**October 29** LGRP Program Assessment Meeting, Golden Tulip	**October 30** 14:00 Arrival PvR	**October 31** 23:00 Arrival JM
November 1 Site visits: Morogoro TC, DC, VC (WEO/VEO)	**November 2** 10:00 MOF Team 14:00 LGRP/ PO-RALG	**November 3** 09:00 Bagamoyo (PvR) 10:00 Lapper/Mallya (JB) 13:00 SG, ALAT 19:00 Dinner / Lapper	**November 4** 09:00 FDTF Meeting 11:30 Ilala Mun Dir 14:00 Team Meeting	**November 5** 9:00 TRA / Dir Rsrch 10:00 Tax Task Force 16:00 World Bank 18:00 PSF/ Lyimo	**November 6** 10:00 Team Wrap-Up 13:00 Per Tidemand (JB) 15:00 Departure JM	**November 7** 15:00 Departure PvR
November 8 10:00 Kagaruki, MOF 13:00 PM, OM/Fin & FA LGRP (JB)	**November 9** 00:30 Departure JB	**November 10**	**November 11**	**November 12**	**November 13**	**November 14**

Interim Mission: Local Government Financing Study, Jamie Boex, January 2005

	Week 1	Week 2
Monday	**January 17**	**January 24** 08:30 LGRP 10:00 Meeting with Kiondo & Mwamanyanga 13:00 Drafting Reports *20:00 Per Tidemand*
Tuesday	**January 18**	**January 25** --
Wednesday	**January 19** 18:00 Arrival in Dar (from Swaziland)	**January 26** 09:00 Budget officers (formula-based transfers) 14:00 Pippa Bird, DFID 15:00 Meeting with Mallya (re: workshop) *18:00 Susanne H., GTZ* *20:00 Geir Sundet, REPOA*
Thursday	**January 20** 11:00 Coordinating meeting with SL 14:00 Meeting with Cliff Muga	**January 27** 9:00 – 16:00 Local Govt Finance Workshop
Friday	**January 21** 11:00 Meeting with SL and JM 13:00 Update budget allocation figures	**January 28** 9:00-11:00 Donor briefing (Irish Embassy)
Saturday	**January 22** Prep workshop materials (PPTs for LGFR & Inception Report)	**January 29** 00:30 Departure from Dar
Sunday	**January 23**	**January 30**

Final Mission (Presentation of Draft Final Report)
Local Government Financing Study

Jamie Boex, Jorge Martinez-Vazquez, Philip van Ryneveld

	Week 1: May 2 – 8, 2005	**Week 2: May 9-15, 2005**	**Week 3: May 16-22, 2005**
Monday	**May 2** 22:00 Arrival DAR (Boex)	**May 9** 09:00 FDTF Meeting 16:00 Meeting with MOF (Kamugisha, Magambo, Shallanda, Nyanguli)	**May 16** 10;00 Ministry of Finance w/Simon 12:30 Lunch with Sundet and Tidemand
Tuesday	**May 3** 09:00 Meeting with BD/RALG 10:00 Lapper and Mallya 13:00 Presentation preparation	**May 10** Preparations for Friday Workshop 19:00 Dinner at Simon Lapper's	**May 17** 10:30 Natalie Houlou (PEDP) 12:30 George Yambesi, PSM 14:00 Coordinating BGIT Meeting 23:00 Departure Boex
Wednesday	**May 4** 10:00 Initial meetings with MOF 13:00 Report writing	**May 11** 9:00 Simon Lapper Preparations for Friday Workshop	**May 18**
Thursday	**May 5** 8:00 Reporting writing	**May 12** 10:00 Education donors (RNE) Preparations for Friday Workshop	**May 19**
Friday	**May 6** 10:00 Lapper and Mallya 11:00 (verify budget figures) 12:00 Kamugisha	**May 13** 09:00 Stakeholder Workshop Millenium Towers 23:00 Departure DAR (Martinez)	**May 20**
Saturday	**May 7** PM:00 Arrival DAR van Ryneveld 22:00 Arrival DAR Martinez	**May 14** 16:00 Departure DAR (van Ryneveld) 17:00 Afua Sarkodie (PWC)	**May 21**
Sunday	**May 8** Team meeting Preparation of presentations	**May 15** 12:30 Lunch PWC / Elizabeth K.	**May 22**

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Annex 1.4
Glossary of Fiscal Decentralization Terms

Allocation formula
A formula used in a formula-based grant system to distribute or allocate grant resources among different subnational government jurisdictions. *Also referred to as a horizontal allocation formula.*

Allocation factor
A measurable variable used as part of an allocation formula. *Sound allocation factors have a number of desirable statistical characteristics.*

Ability to pay principle
The principle that in order for a tax system to be considered fair, taxpayers should pay taxes in accordance with their ability to pay: those with greater ability should pay more. *Contrast with benefits principle.*

Ad valorem tax
A tax that is specified as a percentage of the value of the tax base. *For instance, a sales tax of 5% of the value of sales is an ad valorem tax. Contrasts with a nominal (specific) tax.*

Allocative efficiency
Resources are used in such a manner that firms produce the goods that are most desired by society. *See Efficiency.*

Area-Based Programs
Donor-funded development programs which target a specific regions or area. *Areas-based programs often provide (sectoral or non-sectoral) capital development funding to local governments or communities in a region, along with providing capacity building support to local governments and/or community organizations.*

Avoidance
Tax avoidance encompasses legal actions that taxpayers take in order to reduce their tax burden. *Moving to a different local government in order to avoid high local property taxes is an example of tax avoidance. Contrast with evasion.*

Benefit principle
The principle that in order for a tax system to be considered fair, taxpayers who benefit from a publicly provided service should pay taxes roughly in proportion to the benefits received. *(See Benefits tax) Contrast with the ability to pay principle.*

Benefits tax
A tax that adheres to the benefit principle in taxation. *Common examples of subnational benefits taxes include user fees, road tolls, and property taxes. (See the benefits principle).*

Block grant
A block grant is an intergovernmental fiscal transfer that is non-matching in nature. *Block grants may be unconditional, sectoral or earmarked grants. Contrast to Matching grant.*

Buoyancy
An indication of how revenue collections from a revenue source respond to changes in the economic base or tax base. *Buoyancy is typically measured as the percentage change in revenue that occurs as the result of a percentage change in the tax base.*

Cess
An assessment, tax or levy collected by local authorities for local purposes. Also used to refer to a tax levied on a specific object (with a prefix to define the object of taxation). *Superceded in British English by the term "Rate."*

Club good
Private (i.e., rival and excludable) goods and services that are provided by local governments because they can be provided more cost-effectively when produced for a group of residents instead of a single household. *For instance, a swimming pool is both excludable and (to some degree) rival, yet most households do not have a swimming pool of their own due to significant scale economies involved in building a private swimming pool. Buchanan (1965) argues that in many cases local governments simply function as clubs to provide certain desired local goods or services, and then collects user fees from households, or proxy user-fees in the form of local taxes.*

Closed list (restrictive) approach to subnational taxes.
An approach to subnational taxation by which the central government enumerates an exclusive list of subnational taxes that subnational governments are allowed to collect. *Contrast with permissive (open list) approach.*

Compliance
The degree to which taxpayers comply with tax laws and regulations. *Often measured as a ratio of tax receipts to assessed tax liabilities.*

Compliance costs
The cost incurred by taxpayers in order to comply with tax regulations. Compliance costs include actual costs (i.e., the cost of a tax preparer) as well as the time costs for preparing a tax return.

Conditional grant

An intergovernmental fiscal transfer to which certain conditions are attached by the central government. *Conditional grants range from highly conditional earmarked grant to much more permissive sectoral grants. Contrasts with Unconditional Grant*

Consumption taxes
Taxes imposed on the consumption of goods and services. *Examples of consumption taxes include general sales and use taxes, VAT, and excise taxes.*

Correspondence principle
The principle that a sound local tax should establish a link between the jurisdiction in which a tax is levied and the area in which the benefits are received from the local services funded with that revenue source. *Adherence to the correspondence principle gives local governments the right incentives to fund an optimal amount of locally provided goods (where marginal costs equal marginal benefits). Tax exporting is a practice that violates the correspondence principle.*

Deadweight loss
The value of the economic loss incurred as a result of the imposition of tax and the subsequent reductions in production and consumption. *Deadweight loss equals the sum of the reduction of consumer surplus and the reduction of producer surplus in excess of the amount of revenue generated with this tax.*

Decentralization
Decentralization is the empowerment of local communities by the empowerment of local governments. *Deconcentration, delegation, and devolution provide progressively decentralized approaches to organizing the public sector. Decentralization can be divided into political decentralization; fiscal decentralization and administrative decentralization.*

Delegation
The process of shifting the responsibility of providing certain services from the central government to local government bodies that are not wholly controlled by the central government, but that are ultimately fully accountable to it. *Delegation requires local governments to be semi-autonomous (i.e., elected), but it does not give local governments substantive decision-making authority over how the service should be provided/produced. Local governments are used as agents to produce the government service, but in the end the central government is actually responsible for all facets of the provision of the service.*

Deconcentration
The process of shifting decision-making power within the central government structure from central government officials in the capital to central government officials that are located outside the capital, at the local (or regional) level. *Although government services are produced by a (deconcentrated) local entity, all decision-making authority remains with the central government. There is no need to have elected local government authorities Compare with delegation and devolution.*

Derivation basis
Refers to the basis of where revenues are derived or collected. *For instance, if a revenue source is shared on a derivation basis, then the collections from this revenue are shared with subnational jurisdictions in proportion to where these revenues were collected.*

Devolution
The process of assigning substantive responsibility for the delivery of a public good or service to a subnational government level. *Either the central government could devolve the responsibility to provide a central government service to the local government level, or the central government could devolve responsibility over all aspects of a functional responsibility. (Also see expenditure assignment).*

Direct taxes
Originally denoted taxes whose burden is intended to be borne by the very subject who pays these taxes. In practice is used to denote taxes which are levied on permanent and recurring occasions (e.g., on income or property) regardless of the ultimate incidence of the burden. *Compare to indirect taxes.*

Distributive Efficiency
Goods are consumed by people who value them relatively the most. *See Efficiency.*

Double taxation
The instance in which two or more taxes are imposed on a common tax base. *For instance, the imposition if a federal income tax and a state-level income tax on the some tax base (household income) could be considered double-taxation.*

Earmarked grant
Am earmarked grant is a conditional intergovernmental fiscal transfer that is required to be spent on a specific program or for a specific purpose. (At times, earmarked grants are used to fund a specific items such as a particular capital project).

Economic burden (economic incidence)
Economic incidence represents how the burden of a tax is ultimate distributed among tax payers (based on the change in the distribution of private real incomes). *Compare to legal (or statutory) burden*

Effective tax rate
Expresses the total tax liability as a percentage of actual tax base. Can be lower than the nominal tax rate due to exclusions, exemptions, and underassessment of the tax base. *Compare Tax Rate.*

Efficiency
Economic efficiency is achieved when a society produces the combination of outputs with the highest attainable total value to society, given its limited resources. For

economic efficiency to be achieved, three separate notions of efficiency need to be satisfied: allocative efficiency, productive efficiency, and distributive efficiency.

Effort (Revenue Effort or Fiscal Effort)
The degree of effort with which a subnational government pursues revenue collections, given the revenue instruments and tax bases that are available to it. *Typically measured as the ratio of collections to the underlying tax base. Also referred to as Revenue Performance.*

Equalization
Policy of the higher-level government aimed at equalizing capacities of subnational governments to discharge functions assigned to them.

Equity
The principle that a tax system should be designed so as to be fair. *Also see ability to pay principle; benefits principle; vertical equity, horizontal equity.*

Evasion
Tax evasion encompasses illegal actions that taxpayers take in order to reduce their tax burden. *Failure to register as a tax payer or the underreporting of income on a tax declaration in order to avoid higher income taxes are examples of tax evasion. Contrast with avoidance.*

Excess burden
See Deadweight loss.

Excises
An excise tax is a duty levied on specific goods and services – usually luxuries and "sin" goods, such as alcohol, tobacco, gasoline, etcetera.

Expenditure assignment
The delineation of roles and functional responsibility among levels of government for regulating, financing, administering, and producing public goods and services

Expenditure incidence
The analysis of how benefits from a government expenditure program are distributed across different groups of the population, typically by income group.

Externalities
A situation in which a benefit or a cost results from a market transaction that affects a person or persons who are not part to the transaction. *Externalities can be either positive or negative; externalities can occur either in production (production externality) or in consumption (consumption externalities). Also see Inter-jurisdictional spillover.*

Fiscal capacity
Fiscal capacity reflects the ability of a jurisdiction to raise revenue for public spending. This capacity is determined both by the level of economic activity within the boundaries of the jurisdiction and the government's ability to translate this economic activity into public revenues. *The ability to transform the economic base into public revenues is determined with legally available taxing powers (such as authority to tap particular taxable bases or to set tax rates) and tax administration capacity.*

Fiscal decentralization
The empowerment of local communities by the fiscal empowerment of their local governments. *See Decentralization.*

Free-rider
A situation in which someone benefits from a good or service without contributing to cost of providing of that good or service. *Free-riding can become a problem when a good or service is non-excludable.*

General-purpose local governments
A local government unit or jurisdiction that has a general mandate to provide numerous local government services; for instance, a county or municipality. *Contrast special-purpose local governments.*

Grant
See intergovernmental fiscal transfer.

Holding Harmless
A transitional measure sometimes put in place when introducing a new transfer scheme to assure that local governments who would receive fewer resources under the new transfer mechanism are (fully or partially) compensated for that loss.

Horizontal
Within the context of intergovernmental fiscal relations, referring to relations or interactions between different government units at the same level of government. *Contrast with vertical.*

Horizontal allocation formula
See allocation formula.

Horizontal equity
The principle that taxpayers in essentially equal positions should be treated equally by the tax system.

Horizontal fiscal balance
Horizontal fiscal balance refers to the existence of balance in fiscal needs and resources between different government units at the same level of government. Also referred to as

regional or local fiscal inequity. *If the revenue assignment causes horizontal fiscal imbalance, this can be addressed through the transfer system.*

Income taxes
Taxes imposed on the income of households and business firms. *Examples of income taxes include the personal income tax, the corporate income tax and may include local income taxes.*

Indirect taxes
Originally denoted taxes whose burden is expected or intended to be ultimately shifted to someone other than the subject who statutorily pays these taxes. In practice, this term is used to denote charges on occasional and particular events (e.g., consumption purchases, the import of goods, etc.) regardless of the ultimate incidence of the burden. *Compare to direct taxes.*

Intergovernmental fiscal relations
Intergovernmental fiscal relations relates to how different levels of government interact with each other on fiscal issues. *Intergovernmental fiscal relations comprise four broad dimensions, including expenditure assignments, revenue assignments, intergovernmental fiscal transfers and the framework for local government borrowing and debt.*

Intergovernmental fiscal transfer
A non-compulsory, non-repayable financial payments between government units; typically (although not always) from a higher-level government to a lower-level government unit. Usually intergovernmental fiscal transfers are aimed at achieving vertical fiscal balance, horizontal equalization, or other specific objectives of the payer.

Inter-jurisdictional spillover
A case in which costs or benefits from the provision of a subnational good in one jurisdiction spill over onto neighboring jurisdictions, or onto the nation as a whole. *For instance, primary education causes inter-jurisdictional spillovers, since the nation as a whole benefits from a more educated, productive workforce. Also see Externalities.*

Large Taxpayer Unit
Subdivision of tax administration dedicated to registration, taxpayer service provision, collections, tax accounting, and auditing of major contributors of government tax revenue.

Legal tax burden (legal incidence)
Indicates who is legally liable to pay a tax. *Compare to economic burden/ incidence.*

Levy
The imposition or collection of an assessment. The term levy is frequently used to refer to a tax levied on a specific object, or to a revenue source collected for a specific purpose.

Local expenditure needs
Denotes the amount a locality must spend to obtain a standardized service quality for a standardized package of uniform service responsibilities.

Marginal tax rate
The rate at which the marginal increment (e.g., the last and the next dollar) of the taxable base is taxed. *Under a proportional tax, the marginal tax rate is constant. Under a progressive tax, the marginal tax rate increases as the tax base increases.*

Market fees
A type of user fee, typically paid by a seller of goods in order to sell his or her wares at a public market.

Matching grant
Intergovernmental transfer that matches at a predetermined rate every dollar of the recipient government's own funds allocated for a specific purpose.

Minimum Access Conditions
Conditions that a subnational government must fulfill in order to become eligible or to gain access to an intergovernmental transfer scheme.

Moral hazard
Moral hazard is a situation in which one of the parties to an agreement has an incentive after the agreement is made to act in a manner that brings additional benefits to himself or herself at the expense of the other party.

National Minimum Standards (for local service delivery)
The minimum level of service that the national government wishes to secure for all citizens regardless of where they reside. *Sometimes this National Minimum Standards are imposed on local governments, irrespective of whether they are affordable.*

Net fiscal incidence
Analysis of the combined distributional effect of government expenditure programs and public revenue sources on the well-being of different groups of population, particularly difference income groups. *See Expenditure incidence and Revenue Incidence.*

Nominal (specific) tax
A tax or charge that is determined as a nominal or specific amount. *As opposed to an ad valorem tax.*

Non tax revenue
Government receipts that generally involves a *quid pro quo* (Latin: "this for that") provided to the payer in exchange for the payment, such as a benefit, good, or service. Non tax revenues include licenses, fees, charges, as well as other revenues, such as rent, sales of property, and interest. *In addition to these revenue sources, this category also includes fines that are compulsory and do no involve any benefits in exchange.*

Nuisance tax
A low-yielding tax for which the collection costs exceed the revenue yield of a tax. *Examples of typical nuisance taxes include taxes of fountain drinks, bowling, haircuts, movie tickets, dry cleaning, parking, and shoe repairs. A broader definition of the term defines a nuisance tax as a small excise tax levied on separate purchases and collected directly from the purchaser.*

Own source revenues
Indicates a revenue source over which a subnational government has substantive control. Economists consider this to mean a tax a tax for which (a) the collections flow to the local level and (b) over which local government jurisdictions have control over the marginal tax rate, either through policy discretion or through direction over its collection. *See Revenue assignment.*

Permissive (open list) approach to subnational taxes.
Allows subnational government to utilize any tax base which is not specifically barred or exclusively assigned to another level of government. *Contrast to the closed list approach.*

Phasing-in
A transitional measure sometimes put in place when introducing a new transfer scheme to assure that local governments that would receive a large increase in their resource allocation under the new transfer mechanism are gradually brought up to the new, higher level. *A common reason for phasing-in is to prevent absorption problems associated with sudden, large resource increases.*

Poll tax
A tax imposed on households at an identical rate or on the basis of the number of people or adults in the households. *Examples of poll taxes are "head taxes" or "hut taxes." Poll taxes are relatively simple to administer but tend to be highly regressive.*

Piggy-back tax
A tax that is legislated and collected by the central (or other higher-level)_government as a surtax on a central government tax, while local governments are allowed to set the rate for the surtax and receive the proceeds from the subnational surtax on a derivation basis. *Common forms of piggy-back taxes include piggy-back sales taxes and income taxes. As a result of the local control over the tax rate, a piggy-back tax is considered a local government revenue source.*

Presumptive taxes
A presumptive tax (sometimes referred to as an "alternative minimum tax") involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on taxpayer accounts. *The term "presumptive" is used to indicate that there is a legal presumption that the taxpayers' income is no less than the amount resulting from application of the indirect method. This presumption may or may not be rebuttable. The concept covers a wide variety of alternative means for determining the tax base, ranging*

from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.

Private good
A good that is rival and excludable in nature. "Rival" means that a person cannot enjoy the benefits of a good without reducing the benefit received by others; "excludable" means that a person can easily be excluded from enjoying the benefits of the good. *Most regular consumption goods are private goods; for instance, consider food. The market mechanism is typically the most efficient mechanism to provide private goods. However, sometimes central or local governments provide private goods. See Public Goods; Club Goods; Publicly provided goods.*

Productive Efficiency
Goods are produced in the least costly way; opportunity costs in production are minimized. *See Efficiency.*

Progressive taxes
A tax for which the liability as a percentage of taxpayer's income or wealth increases with the level of income or wealth. *Compare to proportional and regressive taxes.*

Property taxes
A type of tax for which the liability of the tax stems from ownership of assets. Usually the taxable assets are limited to "real property" which includes land, buildings, structures, and other improvements that are constructed on or in the land, attached to the land, or placed upon a foundation. However, in some countries taxable property extends to boats, vehicles, aircraft and even business inventories.

Proportional taxes
A tax that has the same liability as a percentage of taxpayer's income or wealth regardless of the level of income or wealth. *Compare to progressive taxes and regressive taxes.*

Public good
A good that is non-rival and non-excludable. Non-rival means that a person can enjoy the benefits of a good without reducing the benefit received by others; non-excludable means that a person cannot be excluded (or it is prohibitively expensive to exclude him/her) from enjoying the benefits of the good. *Good examples of pure public goods are national defense and radio transmissions.*

Publicly provided good
A good that is provided by the public sector (i.e., central government or subnational government). *Publicly provided goods may either be public goods or private goods.*

Rate
British English: a local tax. *Not used in American English; term causes potential confusion with the tax rate.*

Regressive taxes
A tax which requires lower-income taxpayers to pay a greater percentage of their income in tax than upper-income taxpayers. *Compare to progressive and proportional taxes.*

Residence basis
Refers to the jurisdiction in which the taxpayer resides. *For instance, if a revenue source is assigned on a residence basis, then the revenues from this source are collected by (or assigned to) the subnational jurisdiction in which the taxpayer resides.*

Restrictive (closed list) approach to subnational taxes.
An approach to revenue assignment that allows local governments to utilize only those revenue sources that are explicitly authorized by the national government

Revenue adequacy
The principle that a good revenue source should generate an adequate amount of revenue. *A number of different approaches can be used to consider what is relatively "adequate."*

Revenue assignment
A comprehensive definition of a revenue assignment considers which government level (1) legislates each tax; (2) defines the tax base (and exemptions); (3) determines the tax rate; (4) collects/administers the tax; and (5) receives the revenues from the tax. *See Own source revenue.*

Revenue autonomy
The extent of control that subnational governments are able to exercise over the sources of their revenue. Revenue autonomy is determined by the local governments' discretion to determine taxable bases, determine rates, introduce the tax, or any combination of these three.

Revenue decentralization
The degree to which control over revenues is decentralized to subnational governments. Typically measured as the ratio of subnational revenues and total national revenues.

Revenue incidence
The analysis of how economic burden from a tax or another government revenue source is distributed across different groups of the population, typically by income group.

Revenue neutrality
The concept that –in order to maintain the overall tax burden and fiscal balance- any reduction in one revenue sources should be offset by a proportional increase in another revenue source.

Revenue Performance (or Fiscal Performance)
See Effort.

Revenue sharing
Transfer of revenues generated at one level of government to finance a portion of expenditures carried out by another level of government. Revenue sharing can be done on a derivation-basis based on a predetermined, uniform sharing rate; on a derivation-basis using "regulated" sharing rates or formula-driven sharing rates; or on a formula basis. *Usually revenue sharing aims at rectifying the mismatch in the vertical division of expenditure responsibilities and revenue sources. When shared revenue sources are collected by the higher-level government, revenue sharing should be considered a type of intergovernmental transfer, since the subnational government has no control over the tax rate, base or collection.*

Revenue yield
The amount of money generated by the application of a tax rate or set of rates to a tax base.

Scale economies
A situation in which the cost of producing a unit of a good or service declines as the scale of production (the number of units produced) is increased.

Scope economies
A situation in which the cost savings can be achieved in the production (or provision) of a good or service by combining the production (provision) of the good with the production (provision) of another good. *Scope economies could make it more cost-effective for one general-purpose local government to provide several local government services, as opposed to having several separate special-purpose local governments.*

Sectoral grant
Intergovernmental transfer targeted toward funding activities in a particular sector of public services, such education, healthcare, etcetera.

Special-purpose local governments
A local government unit or jurisdiction that has a single or special purpose; for instance, local school districts or local water districts. *Contrast general-purpose local governments.*

Spillover effect
See Externalities.

Subsidiarity principle
The principle holding that nothing should be done by a larger and more complex organization which can be done equally efficiently by a smaller and simpler organization. Recognized as a driving principle in the assignment of expenditure responsibilities. The principle is restated in the EU treaty to allow the Union to undertake an action "only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States".

Subvention
See Intergovernmental fiscal transfer.

Surtax / Subnational Surtax
See Piggy-back tax.

Tax
An involuntary payment to a government (by households and business firms) that does not involve a *quid pro quo* (Latin: "this for that") benefit. *Common categories of taxes include income taxes, consumption taxes, property taxes and transaction taxes. Tax instruments can be regressive, proportional or progressive.*

Tax base
Collective value of assets and activities that are subject to a tax.

Tax exporting
Shifting of a tax burden to non-residents of a given jurisdiction. *For instance, a local sales tax allows a locality to export the burden of the tax to the extent the tax is borne by residents from other localities who do not necessarily benefit from the public services in the locality.*

Tax coverage
The share of the potential taxpayers in a universe that are covered by a tax instrument. *For instance, x % of households in the United States are subject to the Personal Income Tax.*

Tax rate
The ratio, scale, or standard at which a tax liability is determined in relation to the tax base. *Compare with Effective Tax Rate.*

Tiebout hypothesis
A hypothesis set forth by Charles Tiebout that, under a number of assumptions about household mobility and local government structure, local governments provide a mechanism for households to reveal their demand for local government services and for local governments to provide these services in an efficient manner, just as competition leads to efficiency in the private sector.

Transaction taxes
A type of tax for which the liability of the tax stems from a specific transaction, such as the sale of property assets, or the import or export of a good or service.

Transfer
See Intergovernmental fiscal transfers.

Turnover taxes
A tax imposed on business firms on the basis of the firm's turnover (sales revenue). *Turnover taxes are often considered to be inefficient –particularly in developed economies- because they can have a cascading or "snowballing" effect as each stage of production is fully taxed.*

Unconditional Grant
An intergovernmental transfer provided without any specific conditions attached. *Contrast with conditional grant.*

Value-Added Tax (VAT)
A tax imposed on business firms on the basis of the value added by the firm. *Value-added taxes avoid the cascading effect of turnover taxes.*

Vertical
Within the context of intergovernmental fiscal relations, referring to relations or interactions between different levels of government. *Contrast with horizontal.*

Vertical allocation rule (vertical allocation formula)
A formula or budget rule or practice that determines how a transfer pool or a shared revenue source is shared vertically between different government levels.

Vertical equity
Vertical equity means that those with limited ability to pay should be treated more favorably by the tax system relative to those with a greater ability to pay. *Note that this does not necessarily mean that a tax should be progressive in order to be vertically equitable.*

Vertical fiscal balance
Balance that exists when there is a broad correspondence between the aggregate revenue sources assigned to *each level of government* and relative expenditure responsibilities of each government level. Vertical fiscal imbalance results when one government level receives a disproportionate amount of revenue sources compared to its expenditure responsibilities, and this imbalance is not corrected through the transfer system.

Withholding tax
A tax which is deducted or withheld at source (for instance, from wages, pension, dividends, or other sources of income) before it is paid to the person entitled to receive the payment. *Introduction of a withholding tax can be justified by administrative convenience (for instance, there are fewer employers than employees), political considerations (it makes a tax less visible and therefore more politically palatable), or compliance considerations (e.g., facilitates reaching foreign beneficiaries)*

Yield
See Revenue yield.

Section 2

A revenue profile of local government authorities in Tanzania

Although some data regarding local government resources, local taxes and local non-tax revenues are collected on a regular basis (some variables by both PO-RALG, and other statistics by the Ministry of Finance), no single, comprehensive database of local government fiscal data is currently available (see Box 2.1). But even to the extent that analysts are able to collate the available data, no systematic analysis is performed on these data to monitor the overall local government finance system. To this end, the TORs for the current study requested the development of a revenue profile for local governments in Tanzania. However, in this regard, the TORs for the current study were largely overtaken by the completion of the Local Government Fiscal Review in November 2004.

In response to the need for local government finance statistics, a number of coordinated efforts are under way by LGRP and MOF (under the auspices of the Coordinating Block Grant Implementation Team) to assure that a more complete set of local fiscal data is generated and systematically analyzed. In November 2004, these efforts by the CBGIT culminated into the first annual Local Government Fiscal Review document. The purpose of the Local Government Fiscal Review 2004 is to provide an accurate, comprehensive and up-to-date overview of intergovernmental fiscal relations in mainland Tanzania. Based on data from the Ministry of Finance, as well as self-reported local government budget data aggregated by the LGRP, the Review provides the first comprehensive profile of local government expenditures, revenues, transfers, and local government borrowing. Local government revenues are specifically dealt with in Chapter 3 of the Review, documenting the current resource profile of Local Government Authorities in Tanzania, and noting any significant trends in the composition and amount of local resources.

This section of the Final Report builds on the basic analyses contained in the Local Government Finance Review (2004), and engages in certain policy-specific analyses. First, for completeness, Section 2.1 considers the overall resource profile of local governments in Tanzania, including not only local revenue

sources, but local government allocations (i.e., intergovernmental grants) as well as local borrowing. However, since the composition of intergovernmental grants is already analyzed extensively by the Intergovernmental Grant Study (GSU, 2003), the current analysis will focus mainly on own source revenues (Section 2.2) and the fiscal impact of the recent local revenue rationalization measures implemented by the central government. Some additional and updated quantitative analysis on the allocation of intergovernmental transfers is included in Section 2.4. Finally, Section 2.5 sketches the fiscal profile of Dar es Salaam region, which is distinctly wealthier in terms of economic and fiscal resources than other regions in Tanzania.

Box 2.1
Availability of local government fiscal data in Tanzania

Few stakeholders in Tanzania have a complete picture of the availability of local government fiscal data. In addition to case studies, surveys and limited samples incorporated in the literature review in Section 1of the report (Annex 1.3), the following key sources of data are available that provide fiscal indicators for all (or almost all) local government authorities in Tanzania:

- The central government budget (Annex 3) provides detailed data on planned local spending of intergovernmental transfers. This budget plan data is also reflected as aggregated by sector and type of expenditure (PE/OC) for each LGA.
- The Ministry of Finance is able to produce treasury disbursement data broken down by LGA. For each LGA, the treasury is able to show the total amount of PE transferred to the LGA (for all sectors combined only!), and OC transferred to each LGA by sector. However, total year-end disbursements to each LGA are never tabulated, and no reconciliation of budget figures ever takes place.
- PO-PSM data provides a monthly break-down of PE disbursements by sector and Activity Head. This is the data used by Treasury to release the PE, but again, no formal reconciliation ever takes place.
- As part of the annual Budget Speech, the Director of Local Government (PO-RALG) produces an annual tabulation of total own sources revenue by LGA, but the report does not break down total local revenues by type in any manner.
- In 2004, the LGRP started to gather self-reported fiscal data by broad categories of local expenditures and revenues (including local expenditures, own source revenues, and intergovernmental transfers). So far, this exercise has been conducted twice, roughly bi-annually. Although this source provides greater detail on local government finances than any of the other sources, the data are still rife with inconsistencies and reporting problems. For instance, in the initial data set, reported local expenditures exceeded reported resource inflows by more than TSh 210 billion.

To complicate matters further, until July 1, 2004, there was a clash between the central government budget year (July-June) and the local government budget year (calendar year). As such, it is not possible to compare local government transfers as reported by the central government with the amount of transfers received by local authorities over the same period.

2.1. Overall resource profile of local governments in Tanzania

Like in most developing countries, local governments in Tanzania rely heavily on intergovernmental transfers. Table 2.1 shows that revenues from transfers account for around 80-90% of total local government financial resources. Not only do grants play an important role in local government finances, the importance of transfers has steadily increased over the years. Whereas local government grants contributed almost 80% of local funding in FY 2001/2002, by FY 2003/04 almost 86% of total local government finances was derived from transfers. This trend is likely to have continued during the current fiscal year (FY 2004/05) for which data are not yet available.

Both own source local revenue collections and local government borrowing play a much more limited role in the total financial inflows for LGAs. Before the revenue rationalization that was announced in June 2003, own revenue sources accounted for approximately 19-20 percent of local government financial resources. Since then, own source revenues experienced a significant decrease in its importance as a share of total local government finances, dropping to only 14.2% of the total. Preliminary estimates by the authors suggest that this percentage may fall further to 9 or even 8 percent for FY 2004/05 and 2005/06. The share of own source revenues in the local government finances would be even lower (7-8 percent) if we were to take into account local government expenditures funded from ministerial subventions (as further discussed in Section 2.4).

The high reliance of LGAs on intergovernmental grants is even more obvious when we examine local government revenues broken down at the regional level. Table 2.2 shows the aggregate importance of intergovernmental transfers and own source revenue (in per capita terms, as well as a percent of total) for the year 2004

across each of the country's 21 regions.[1] Out of 21 regions, LGAs in 16 regions rely on transfers for more than 93% of their resources. For most regions, aggregate own local revenues account for only between 3-7 percent of their resources; local governments in only 3 regions actually rely less than 90% on grant resources; The outliers in this regard are local governments in Arusha, Pwani and Dar es Salaam, which collected 13.4%, 10.7% and 35.7% of their total revenue inflows from local own sources, respectively.

Borrowing is another possible source of revenue for local governments, although borrowing has not played a very significant role in local government finance in Tanzania: Table 2.1 shows that only 0.1% of local government revenues come from this source. The current state of local government borrowing is discussed in Chapter 5 of the Local Government Fiscal Review (2004). Section 3.4 of this report further explores local government borrowing as a financing option for LGAs in Tanzania.

2.2. A Profile of Local Government Own Source Revenues

Data issues pose an important challenge in drawing up a highly detailed revenue profile of local government revenues in Tanzania. Until June 2003, local governments had wide discretion in structuring their own revenue systems, and local government revenue instruments therefore varied widely from council to council.[2] No system was in place to gather data on revenue collections by different types of local revenue instruments or by type of tax (e.g., sales tax, income tax, etc.), and to analyze (the variations in) local government revenue collections in a systematic manner.

The most detailed data source available for local government revenues in Tanzania is the self-reported local government fiscal data gathered by LGRP (see Box 2.1) This source provides data for eight broad types of local revenues, notably: the Development Levy, property taxes, taxes on agricultural production and livestock, taxes on production by larger firms (i.e., the Industrial Cess /

[1] In Table 2.2, transfers reflect budgeted allocations for the five local priority sectors plus the administration grant (but excluding the General Purpose Grant). Local revenues amounts are annualized estimates based on self-reported collections for January-June 2004. Local borrowing or ministerial subventions are not excluded from the current analysis.

[2] Further confusion is caused by the fact that most local government taxes are known as fees, levies, or cesses, but not as taxes. The nomenclature for local non-tax revenues is (licenses, fees, charges, contributions) is equally opaque.

Service Levy), land rent, licenses and fees, charges, and other taxes and levies.[3] A number of taxpayer surveys are also available that are able to reveal taxpayer-level incidence of local taxes (for instance, see Box 2.2).

Before the revenue rationalization of 2003, the Development Levy, agricultural and livestock taxes, and licenses and fees (including business licenses) were the three revenue categories that generated the highest yield for local governments (Tables 2.3 and 2.4). For 2001, these categories contributed 21.5%, 18.2% and 16.7% respectively to total local own source revenue collections; together, they accounted for almost 60 percent of local government revenues. All local revenue sources together generated a revenue yield of TSh 51 billion in 2001 and almost TSh 58 billion in 2002.

Table 2.5 shows own source revenue collections in per capita terms, ranging from TSh 1,028 (2004) to TSh 1,725 (2002). These numbers provide some insight into the nominal tax burden imposed by local government revenues; on average, local taxpayers only pay a very small amount of local government taxes. The limited nature of local revenue autonomy is further accentuated by the realization that per capita local revenue collections reflects how much money is available at the local level to finance the provision of "truly local" public services. Even before the rationalization of 2003, one could wonder whether the revenue sources assigned to the local government level were adequate if local governments only had TSh 1,700 per person at their discretion to deliver local government services. As such, this table calls attention to the fact that local governments need to be provided access to better revenue instruments in order for LGAs to be able to provide better local public services to their constituents.

The nature of own source revenue collections in Tanzania is further explored in Table 2.6, which presents descriptive statistics for per capita local government revenues by type for 2002. This table confirms the conclusion based on regional data (in Table 2.2) that there is indeed substantial variation in revenue collections across LGAs. In per capita terms, the wealthiest local government generates 40 times the amount of revenue than the most poorly-endowed local government. The table further confirms that licenses and fees, agricultural and livestock taxes, and the Development Levy were the three most important types of local government revenues, although the order of importance is different when considering averages as opposed to the aggregate total (as in Table 2.4). It is

[3] Analysis of specific local revenue instruments is obviously hindered by the extent to which data for different instruments are grouped together. For instance, the data set does not identify business licenses as separate from other license revenues. This obviously would have been very helpful in identifying the revenue response to the sharp diminution of business licenses in 2004.

further interesting to note that (based on the Coefficient of Variation) these three revenue categories show relatively the least variation among local governments. Instead, we observe (much) higher variations between districts for the relatively less important revenue sources such as land rent, the property tax, and the Service Levy.

However, the general description in Table 2.6 does not hold when we break regions into urban and rural districts. In 2002, the main revenue sources for urban local governments were licenses and fees, the Service Levy and property taxes, in that order (Table 2.7), which together account for roughly two-thirds of total revenues for an average urban government. Revenue collections from these main sources again displayed limited variation among jurisdictions, with the exception of the Service Levy.

Urban revenue patterns contrast with those in rural districts, in that the Development Levy plays a much less important role in urban areas, whereas licenses and fees as well as the Service Levy play much more important roles in urban finances. In contrast, resource patterns for rural regions (Table 2.8) in general followed similar patterns as uncovered in Table 2.6.

2.3. The revenue impact of rationalization and harmonization

The revenue "rationalization" and "harmonization" measures had significant impact on the profile of local government revenues in Tanzania, as revealed by the available fiscal data. Three significant reforms were introduced in June 2003. First, the Government of Tanzania decided to abolish the Development Levy. Second, the government reiterated the maximum rate of 5% for the Agricultural Cess. Third, the government eliminated a number of nuisance taxes. These changes brought a significant alteration to revenue patterns from the year 2003 onward.[4] In 2004, a major reform of (business) licenses was implemented, sharply reducing the yield of business license fees collected by local government authorities.

With the abolition of both Development Levy and the other reforms, local governments in Tanzania lost substantial income from their own source revenues; total own source local government revenue collection decreased from a high of TSh 57.7 billion in 2002 to TSh 36.4 billion in 2004. The revenue declines were

[4] Note that the impact of the reforms introduced in June 2003 is not fully represented by the budget figures for 2003, since half of the local budget year preceded the reforms. The same, of course, is true for the reforms introduced in June 2004.

most obvious for the Development Levy, but licenses and fees, agricultural taxes and "Other Taxes" were also directly impacted by the reforms.

There was some expectation that in response to the local government reforms, LGAs would shift the tax burden quickly to the remaining available revenue sources. Although property tax and Service Levy collections indeed increased over the period under consideration, these increases were clearly not enough to offset the revenue losses caused by the reforms. In fact, declines in revenue collection were observed for many other revenue categories, including land rent and charges, two categories not directly impacted by the reforms. Tanzanian experts have suggested that the overall effect of the reforms has been to lower voluntary compliance by local tax payers and to reduce the tax handle by local tax administrators, thereby causing an overall decline in local revenues that exceeded the direct impact of the reforms.[5]

Re-considering Table 2.3 in light of the local revenue reforms of 2003 and 2004, the table clearly shows the significant changes in the revenue pattern since 2003. Although the Development Levy was formally abolished in June, the budget outcomes for 2003 still reflect several months of collection during the first half of 2003. It is further interesting to note that some LGAs still report some Development Levy collections for the year 2004, despite the abolition of the DL in 2003.[6] In terms of per capita own source revenue collections, Table 2.5 shows how per capita collection declined rapidly over time. From 2002 to 2003, per capita collections dropped from TSh 1,725 to TSh 1,401, and revenue collections continued to decline sharply, to a mere estimated TSh 1,028 per person in 2004.

With the abolition of the Development Levy and the other reforms in 2003, the relative importance of the various categories of local revenues changed significantly (Table 2.4). The abolition of the Development Levy expectedly caused a natural relative importance of local revenues. The Service Levy moved from contributing only 10% of revenues in 2001 to yielding over 25% of total

[5] Specifically, some of the reforms mandated by the Ministry of Finance weakened the tax handle of local government. For instance, LGAs' tax handles were directly reduced by disallowing LGAs to collect other local taxes at the point of collection for the market fee or the produce cess. Indirectly, LGAs may have benefited from scope economies in collecting the Development Levy simultaneously with other revenues; based on rational calculations, local revenue effort and enforcement may have been sharply reduced after the main local revenue source was eliminated.

[6] The fact that ten LGAs continue to report Development Levy collections for 2004 can mean one of a number of things: (1) These LGAs are non-compliant with the Local Government Finance Act; (2) these LGAs are collecting a tax called "Development Levy" which in fact qualifies as an approved local government tax; or (3) the collections are erroneously reported as Development Levy.

local government revenues. Although the yield from agriculture and livestock taxes declined in nominal terms, its relative importance in fact increased slightly in relative terms. The importance of licenses and fees first increased from 19.1% in 2002 to 24.9% in 2003, only to decline again due to the 2004 reforms to 17%. In fact, business license revenues should be expected to decline even further during FY 2004/05, since the reform of business licenses did not take place until halfway through the calendar year.

Although the local revenue rationalization program hurt urban and rural regions alike, it seems that rural districts are the ones that hurt relatively the most.[7] The decline in revenue collection shown in the tables indicate a 37% decrease in overall own source revenues. In contrast, rural districts experienced a 48% decrease in revenues, compared to 24% decrease in urban revenue collections.

Sometimes, a visual representation of these numbers in a diagram can provide a clearer picture of the decline in local government revenues. Figure 2.1 clearly shows the declining trend of revenue collection by sources over time after 2002. The decline in agricultural/livestock cesses is another impact of the reforms in 2003, as the government set a limit on the maximum rate to be levied on this produce and livestock.

Figure 2.2 shows the situation for urban councils. The limited impact of the elimination of the Development Levy on urban areas is clearly visible. In contrast, the impact of the business license reform in 2004 is already visible. In response, the increasing trends in property tax collections and the boost in the Service Levy in 2004 is also evident. This suggests that urban areas –more so than rural areas- had the opportunity to utilize these taxes as substitutes for the loss revenues from the Development levy and Business licenses.

Rural councils experienced the most significant loss of revenue in 2003 and 2004, as shown in Figure 2.3; the diagram clearly shows the substantial drop in total own source revenue collection. After the reforms of 2003, rural revenue collections are strongly dominated by taxes on agricultural production and livestock, and even this category of revenues experienced a nominal decrease from 2002 to 2004. This trend seems to suggest that given the present revenue structure and the reforms imposed on them, rural councils have not been able to

[7] However, in nominal terms both urban and rural districts were impacted almost the same. In fact, strictly speaking, the average decline in urban revenues from 2002 to 2004 was slightly greater than the decline for rural districts (an average decline of Tsh 800 per capita for urban areas, versus TSh 600 per capita for rural areas).

find any other revenue instrument to serve as a substitute for the Development Levy and the other abolished or curtailed revenue sources.

Tables 2.9 through 2.11 showing the local revenue profile for 2004 is a replication of Tables 2.6 through 2.8, which showed the profile for 2002. These tables reflect many of the changes in revenue patterns noted above. For all local governments, Table 2.9 shows a sharp general decline in revenues vis-à-vis Table 2.6. Table 2.9 further reveals that on average, taxes on agriculture and livestock are now the most important revenue source for local governments. In the post-reform table, the Service Levy, which in aggregate terms is the most important local revenue category by 2004, also clearly stands out as the most highly variable revenue source among LGAs based on its Coefficient of Variation.

Urban regions show a slightly different pattern, as revealed in Table 2.10. For these regions, the agricultural produce and livestock levies are not among the most important revenue sources, for obvious reasons. Local revenues for an average urban area mainly come from the Service Levy, property tax and other taxes. Contrary to the variability of the Service Levy among all LGAs, per capita revenue collections from the Service Levy in urban regions is relatively stable.

Rural local governments (for which descriptive statistics are shown in Table 2.11) again show a similar revenue pattern as was revealed by Table 2.9 (for all LGAs).

Box 2.2
The vertical equity of local government revenues

As discussed in Section 4 of this study, the "fairness" of local government revenues is an important dimension in the design of a sound system of local revenues. There is consensus among public economists that a (local) revenue sources should follow the ability-to-pay principle in order for the revenue to be considered fair, meaning that taxpayers that are better able to afford the tax should pay more.

However, this does not necessarily mean that (local) revenue sources should be progressive. In fact, the public finance literature explicitly suggests that it generally not the role of local governments to finance redistributive activities. Nonetheless, it is important to take into account the concept of vertical equity in the assessment of the system of local government revenues.

The aggregate local government revenue collection data (reported by local governments) is unable to reveal the incidence of local taxes across taxpayers. In response, a Poverty and Social Impact Analyses (PSIA) study was commissioned by the World Bank (2005)

to analyze the distribution of tax burdens across different income groups and small businesses before and after the 2003 and 2004 reforms of local government revenues in Tanzania.

Although the PSIA study falls short from determining whether the local revenue system in Tanzania is progressive or regressive, the study clearly reveals that the ability-to-pay principle is adhered to by the system of local government taxation in Tanzania (World Bank 2005; Table 3.4). Before the 2003 reforms, an average high-income taxpayer paid six times more in local revenues than an average low-income taxpayer. The PSIA study further reveals that the local revenue reforms of 2003 have increased the relative progressivity of the local revenue system; after the 2003 reforms, an average high-income taxpayer paid twelve times more in local revenues than an average low-income taxpayer.

2.4. A profile of intergovernmental grants

Over time, the budgetary resources allocated for intergovernmental grants in Tanzania have steadily increased in nominal terms. This trend was documented already in the Intergovernmental Transfer Study (GSU, 2003), and that trend has continued in recent years.[8] Table 2.12 reflects the profile of intergovernmental grants over time; recurrent sectoral grants (including the administration grant) climbed from TSh 179 billion in FY 2000/2001 to TSH 362 billion in FY 2004/2005. These recurrent transfers are expected to increase further to TSh 437 for the coming fiscal year.

The composition of recurrent sectoral grants is quite stable over time. The main component of intergovernmental grants is education grants, which holds steady at around 69% across the five-year period. Similarly, the share of local health allocations as well as other allocations hold surprisingly steady over time. The stable composition may either indicate the relative constant prioritization of local government activities across sectors, or could reflect the incremental nature of Tanzania's central government budget process.

A picture of stability over time also emerges when considering the proportion of local government spending as a percentage of the central government's recurrent budget. Consistently, intergovernmental grants account for 17-18% of the national

[8] Section 2 of the GSU study presents a detailed quantitative analysis of Tanzania's system of local government transfers..

recurrent spending. Although resources allocated to the local government level rose slightly over the period under consideration (from 17.62% in FY 2000/01 to 18.60% in FY 2004/05), it is hardly possible to conclude that there is a discernable upward trend.

However, it is possible that the numbers in Table 2.12 do not fully reveal the size of the transfer system and in fact may understate the extent of expenditure decentralization in Tanzania, since the table narrowly focuses on local government resources provided to LGAs through the regional votes. In fact, over the period under consideration, local governments may have increasingly been the beneficiary of other funding sources, including PEDP, the Health Basket Fund, ministerial subventions and other parallel funding mechanisms. If donor-funded programs such as PEDP and the Health Basket (which are accounted for in the Development Budget, as opposed to the recurrent budget) indeed disproportionately benefited local governments, then it might be the case that (a) in total, local governments received an increasing share of budgetary resources over the period considered, and/or (b) that the percentages in the bottom-panel of Table 2.12 understate the importance of local government transfers in the national budget.

Thus, in an attempt to more accurately portray the resources available at the local government level, Table, 2.13 integrates not only the budgeted sectoral block grants for FY 2004/2005, but also reports transfers from known sectoral (basket) funds and other known sources; the table further shows the realization of intergovernmental transfers.[9] While additional work may be needed to reveal all government resources flowing to the local government level, a preliminary conclusion that we can draw from this table is that significant resources flow to the local government level outside the regular recurrent grant system.

While it is indeed true that local governments are the beneficiary of other recurrent resources outside the regional budget votes (Votes 70-95), it would be unwise to simply sum up the two different types of resources to the local government level. First, the level of control that local governments have over parallel-funded activities may differ greatly between programs. Particularly in the case of ministerial subventions to LGAs, it is quite unlikely that LGAs in fact have any degree of discretion over the resources in question. In this case, it is highly debatable whether such resources should be counted as “local” resources.

[9] Since budget years were not synchronized until July 1, 2004, we are unable to fully compare the central and local government data. For comparative purposes, we display reported actual figures for January-June 2004 (the latest data available), along with annualized estimates for 2004. The problem with data synchronization will no longer be a problem for future years.

Second, in many cases, the central government budget actually fails to break out the size of ministerial subventions actually provided to the local government level. More often than not, such local government subventions are combined in votes together with resources intended for the central ministry, making it impossible to quantify the amount of the subventions actually provided. In no case does the budget plan provide any indication how such resources are allocated among local government authorities, thereby making it impossible for LGAs to plan for these resources. Third, given the non-transparent nature of these parallel funding mechanisms, no budget reconciliation ever takes place to assure that these resources were indeed provided to the local government level. As such, we simply cannot be sure that these resources indeed ended up at the local government level.

Furthermore, it is not a foregone conclusion that an increase in local government resources from these alternative funding streams would increase the overall degree of expenditure decentralization in Tanzania. Since these resources are accounted for in the Development Budget, it would be appropriate that if adjustments are made in the numerators for additional recurrent local government spending contained in the Development Budget that similar adjustments are made in the denominator as well. In fact, if one were to take into account the central government's budget in its entirety, it is quite likely that the overall degree of expenditure decentralization would be substantially lower, due to the highly centralized nature of the development budget.

An important conclusion that we can draw here with respect to the quantitative analysis of parallel funding mechanisms is that –in order for us to get a more accurate picture of the role of these funds to local government finance- the central government, as part of the budget process, should more carefully quantify the financial resource provided to local governments outside the context of the regional votes. A related policy question that needs to be resolved in the emerging system of local government finance is whether there are valid reasons for these parallel mechanisms to exist outside the realm of the regular recurrent grant system in the first place (particularly now that the government's recurrent transfer system has been put on sound footing).

Based on the consistent data available for recurrent sectoral allocation, there are a number of interesting observations that can be made regarding the profile of intergovernmental fiscal transfers in Tanzania. Table 2.14 presents descriptive statistics for local government allocations over time, showing how intergovernmental grants have been distributed to the local government level. A first obvious trend visible in the table (confirming the trend revealed in Table 2.12) is that the nominal level of transfers is increasing over time. Perhaps just as

interesting, or maybe even more interesting, is what the table show about the allocation of transfer resources across local government jurisdictions.

One of the conclusions of the Intergovernmental Transfer Study (GSU, 2003) was that there were large variations among (per capita) local government allocations to different LGAs, and that in fact grants were being allocated in a counter-equalizing manner, so that wealthier, urban councils were receiving greater resources than poorer, rural councils. This trend was later confirmed by additional research (Boex, 2003). Table 2.14 confirms the significant variations between different local government councils. Table 2.15 confirms the results reported by GSU (2003) that these variations are worse for some sectors (especially agriculture, local roads and water) than others (primary education and health care).[10]

Table 2.14 further reveals the initial impact of the increased attention to the pro-poor allocation of resources to the local government level in recent years. Based on the coefficient of variation, we observe the inequality in budgeted resource allocations to the local government level steadily increasing prior to the release of the transfer study in January 2003. However, the variation in transfers declines starting from fiscal year 2003/2004 onward, suggesting a more equal allocation of local government resources. For FY 2004/05, the further decline in the variations may be the result of the initial (albeit imperfect) introduction of formula-based sectoral grants for the primary education sector and local health services. The statistics consistently indicate a progressively more pro-poor allocation of local government resources in FY 2003/04 and FY 2004/05.[11]

This trend –increasing disparities over time in the allocation of transfers before 2003, and decreasing disparities since then– is generally mirrored by the other inequality measures. Prior to the completion of the intergovernmental transfer

[10] The fact that these variations are more severe in certain sectors signifies that different approaches may be needed to assure convergence between the historical allocation patterns and the formula-based allocation approach. See LGRP/GSU. 2005. Technical Notes on Local Government Finance Reform in Tanzania: The implementation of the formula-based grant system in Tanzania: Convergence of phasing-in and holding harmless provisions (Technical Note 2005-2).

[11] The preliminary budget frame figures for FY 2005/06 indicate a significant further decline in local disparities in the allocation of transfers (with an expected coefficient of variation of 0.27). While the introduction of formula-based transfers should greatly reduce variations in transfers, differences in (per capita) grant amounts between districts will continue to exist, as determined by the allocation factors included in the respective transfer formulas. Furthermore, the existence of phasing-in and hold-harmless provisions contributes to a gradual transition to the more equitable formula-based system.

study in 2003, the ratio between the local governments that received the highest transfer to the district that received the least was extremely high. In FY 2000/01, the ratios of maximum to minimum amount of transfer were 6.51, and increased steadily to 8.09 and 9.52 over the next 2 fiscal years. This ratio significantly improved starting FY 2003/2004, when the best-endowed LGA only received 5.32 times the amount received by the worst-endowed LGA. The ratio declined further for FY 2004/2005, although it is again expected to increase slightly based on preliminary budget data for FY 2005/06.[12]

The same overall trends are revealed by the other inequality ratios in Table 2.14, including the ratio of maximum to average, and the ratio of minimum to average transfer. However, these ratios reveal a further detail: the more equal allocation of resources is predominantly the result of efforts to "pull up" the poorer districts, rather than of an effort to "push down" the wealthier districts. Consistent with the policy choice to hold LGAs harmless against declines in resource allocations (and policy decisions outside their control), the maximum resource allocations shows an upward trend (albeit with a spike in 2002/03). While this suggests that wealthier local governments continue to receive larger transfers over time, the ratio of maximum to average has been declining (albeit only gradually) since 2003. At the same time, the ratio of minimum to average transfers has been increasing steadily, and has made much more significant improvements since 2003. For the coming fiscal year, the poorest-endowed district in Tanzania is expected to receive basically half of the average per capita transfer in Tanzania; this is almost double the amount that the worst-off district received in FY 2000/01(when the worst-off district only received 34 percent of the average district's resources).[13]

The trends displayed in Table 2.14 suggest an extremely positive development in local government finance in Tanzania: despite large historical variations and counter-equalizing patterns in local government resource allocation prior to 2003, the allocation of recurrent grants since 2003 appears to have occurred in a

[12] Based on the formula-based allocations provided to LGAs as part of the Budget Frame in January 2005, the variations in transfers between different local councils was expected to decline even further. However, the preliminary budget figures reflect a much greater variation in resources as a result of modifications made to the Hold-Harmless Baseline (largely in response to changes in PE resulting from staffing decisions made by PO-PSM without considering the formula-based funding framework) .

[13] As eluded to in the previous footnote, the pro-poor effect of the local government budget guidelines issued in January 2005 would have been even greater, with the poorest council receiving 61 percent of an average district's resources. However, the failure of the government to hold steady the "hold-harmless baseline" caused a significant worsening of disparities in transfer allocations vis-à-vis the figures contained in the local government budget guidelines.

systematically more equal and pro-poor manner. In particular, as the formula-based transfer system is being phased in, the transfer system allocates additional resources to the previously under-resourced regions, without pushing down the allocations to the more developed (and previously advantaged) local governments. The major improvements in pro-poor local government allocations -while fully holding wealthier councils harmless- has been possible in part due to the rapid increase in the real size of allocations available to the local government level.

2.5. The special role of DSM City Council

The Dar es Salaam City (DSM) Council takes a special position in the system of intergovernmental fiscal relations in Tanzania. The City Council (CC) covers the entire DSM Region, which is comprised of the three constituent municipalities of Ilala, Kinondoni and Temeki. The local expenditure assignments which are normally carried out at the district level are divided in DSM between the City Council and the Municipal Councils. For instance, the City Council provides no primary education (this is all done at the municipal level), while both the CC and municipalities deliver certain health care services. Similarly, revenue collections are divided between the two local government types.

To the extent possible, it is worth reviewing the preceding tables to the extent that they specifically identify trends in Dar es Salaam region. Table 2.2 is particularly useful in this regard. This brief section is not intended to take the place of a much more comprehensive and detailed analysis of fiscal trends in DSM; the purpose of this section is merely to highlight the unique fiscal role of DSM in Tanzania's system of local government finance.

A first observation from Table 2.2 is that DSM is by far the wealthiest region in terms of own source revenues: local governments in DSM collect an average of TSh 4300 per (official) resident, which is four times the level of an average region. Even compared to the next wealthiest region (Arusha), DSM collects almost three times more own source revenues per person. In fact, in this respect the local tax system appears to be less "progressive" than the central government tax system: TRA collections data for 2002/03 (not tabulated here) indicate that taxpayers in DSM contributed more than ten times the amount in central government taxes per person than an average tax payer. Whether this is good or bad (or whether the tax system is progressive, regressive or proportional) depends on the distribution of economic activities and tax bases across regions. There data are extremely hard to come by. It may be interesting to note, however, that

according to the household expenditure survey (2002), per capita household expenditures in Dar es Salaam were only twice greater than the national average and only 50% above the household expenditure levels in other urban areas.[14]

Another interesting observation that can be extracted from Table 2.2 regarding Dar es Salaam region is that the region receives substantially less than the average amount of intergovernmental transfers. One reason is that the demographic composition of DSM region is different from most of the country; whereas according to the census 19% of the population of an average region is of school-age, the corresponding figure for DSM is only 14%. Given that primary education is the predominant local government service funded by transfers; this would result in lower overall per capita transfers for the DSM municipalities. Other allocation factors included in the transfer formulas (based on the number of clients or relative cost of providing local services) may have a similar impact.[15]

A second possible reason why DSM's local councils may be receiving relatively fewer transfers is the argument that DSM has disproportionately more own resources, and therefore it simply does not need as much in the way of intergovernmental transfers. However, using Dar es Salaam's high own source revenue collection as justification for its low transfer does not seem to be valid. First of all, this argument is conceptually flawed, since own source revenues are intended to cover different types of local expenditures than sectoral grants (as discussed further in Section 3 of this report). While it is true that the local governments in DSM have relatively higher own source revenue collected from various economic activities in their jurisdictions, the local governments in DSM are also expected to provide a much higher level of public service to their constituents. If DSM's local councils had to divert their own resources to pay for sectoral services (that are elsewhere fully covered by transfers), this would substantially reduce their ability to provide local public services. Such failure of local public service delivery would in turn discourage tax payers and restrain economic development. In the end, such an approach (basically excessive fiscal

[14] If this were to be an accurate proxy for the tax base in each jurisdiction, this would suggest that local governments in DSM in fact may be exerting above-average fiscal effort in collecting own source revenues, and that the central government's tax system is biased to collect a disproportionately large amount of taxes in DSM.

[15] At the surface, this in fact seems to be an important part of the explanation. In almost all instances, the formula-based amount for DSM councils is either very close to the hold-harmless amount (which is based on last year's allocation) or the hold-harmless amount actually exceeds the formula-based amount. This would suggest that under the previous system, local councils in DSM in fact received at least their fair share of resources, thereby dispelling the notion that the seemingly lower transfers were due to a negative bias against DSM.

equalization) would likely not only harm Dar es Salaam, but may in fact reduce overall economic growth in the entire country.

The rationale that transfers to DSM should be lowered because of their higher revenue collections would be inconsistent at best, because there are other regions with high own source revenues that actually receives relatively above-average transfers. As shown in Table 2.2, excluding DSM, Arusha and Pwani regions are among those with the highest own source revenue collection, but these regions also receive above-average transfers.

Finally, Tables 2.16 and 2.17 reveal the composition of own revenue sources in DSM region. In general, the municipalities in DSM region reveal the same trends as other urban areas as far as their revenue collection efforts and the impact of the revenue rationalization reforms of 2003 and 2004. However, we can remark the following with respect to Dar es Salaam's unique position in the larger system of intergovernmental finance in Tanzania:

- Despite a sharp overall drop in total local revenue collections from 2002-2004 (from TSh 57 billion to TSh 36 billion), total local revenue collections in DSM declined from TSh 15.7 billion to TSh 13.0 billion over the same period.
- These figures indicate that DSM has a dominant position in local government finance in Tanzania; a significant portion of local government revenues in Tanzania is collected within DSM region.
- In addition, the fiscal significance of DSM region has increased in recent years. In 2002, the region was responsible for collecting slightly over a quarter of all local government revenues. By 2004, DSM accounted for over one-third of all local government revenues. (By comparison, in 2002/03, the TRA extracted 78 percent of all its revenues from Dar es Salaam).
- Although before the local revenue reforms, the tax burden was more equally spread between several types of tax instruments, by 2004 the Service Levy accounted for over 40% of all revenue collections in DSM

Table 2.1
Overview of Local Government Financial Resources in Tanzania

	2001/2002	2002/03	2003/04
		TSh Million	
Local Government Grants	201,119.0	247,027.3	290,973.8
Own Source Revenues	51,214.9	57,752.1	48,267.4
Local Government Borrowing	50.0	225.0	317.5
TOTAL	252,333.9	304,779.4	339,241.2
		As Percentage	
Local Government Grants	79.7	81.1	85.8
Own Source Revenues	20.3	18.9	14.2
Local Government Borrowing	0.0	0.1	0.1
TOTAL	100.0	100.0	100.0

Source: LGFR (2004); Table 1.1

Table 2.2
Local Government Revenue by Sources 2004

	Per Capita (TSh)			As Percentage		
	Transfer	**Own Source**	**Total**	**Transfer**	**Own Source**	**Total**
Arusha Region	11,009.1	1,698.6	12,707.7	86.6	13.4	100.0
Pwani (Coast) Region	13,340.5	1,595.6	14,936.1	89.3	10.7	100.0
Dodoma Region	9,954.0	336.9	10,290.9	96.7	3.3	100.0
Iringa Region	12,190.4	886.8	13,077.2	93.2	6.8	100.0
Kigoma Region	8,077.8	388.0	8,465.8	95.4	4.6	100.0
Kilimanjaro Region	16,089.8	997.2	17,086.9	94.2	5.8	100.0
Lindi Region	12,248.0	659.8	12,907.8	94.9	5.1	100.0
Mara Region	11,662.0	759.8	12,421.9	93.9	6.1	100.0
Mbeya Region	12,316.3	790.0	13,106.4	94.0	6.0	100.0
Morogoro Region	9,981.0	722.3	10,703.2	93.3	6.7	100.0
Mtwara Region	11,559.0	850.6	12,409.5	93.1	6.9	100.0
Mwanza Region	8,119.6	880.1	8,999.7	90.2	9.8	100.0
Ruvuma Region	12,214.5	473.8	12,688.3	96.3	3.7	100.0
Sinyanga Region	7,852.7	512.5	8,365.2	93.9	6.1	100.0
Singida Region	9,885.0	212.1	10,097.1	97.9	2.1	100.0
Tabora Region	8,833.0	836.0	9,669.0	91.4	8.6	100.0
Tanga Region	11,714.5	841.4	12,555.9	93.3	6.7	100.0
Kagera Region	8,742.7	285.4	9,028.1	96.8	3.2	100.0
Dar es Salaam Region	7,752.0	4,299.4	12,051.4	64.3	35.7	100.0
Rukwa Region	9,582.4	505.6	10,088.1	95.0	5.0	100.0
Manyara Region	10,847.7	396.2	11,243.9	96.5	3.5	100.0
NATIONAL AVERAGE	10,210.6	1,028.4	11,238.9	90.8	9.2	100.0

Source: Computed by authors based on Ministry of Finance and PO-RALG data.

Table 2.3
Consolidated Local Government Revenue Collections by Source, 2001 - 2004
(Actual collections, in TSh millions)

	2001	2002	2003	2004(*)
Development Levy	10,994.4	11,212.0	3,179.6	466.2
Property Tax	3,146.4	3,542.8	3,171.5	4,901.2
Agricul. Cess / Livestock Levy	9,321.3	9,209.2	8,977.3	7,147.2
Industrial Cess / Service Levy	5,217.1	9,085.0	7,724.0	9,377.1
Land Rent	620.8	742.7	753.2	369.5
Licenses and fees	10,152.8	11,052.8	11,998.7	6,201.8
Charges	3,141.4	4,041.6	5,042.2	4,389.5
Other taxes and levies	8,620.8	8,866.0	7,421.0	3,583.7
TOTAL	51,215.0	57,752.1	48,267.5	36,436.2

Source: Computed by authors based on PO-RALG data. (*) Annualized estimate, based on collections for January-June 2004.

Table 2.4
Consolidated Local Government Revenue Collections by Source, 2001 - 2004
(As percentage of total)

	2001	2002	2003	2004(*)
Development Levy	21.5	19.4	6.6	1.3
Property Tax	6.1	6.1	6.6	13.5
Agricul. Cess / Livestock Levy	18.2	15.9	18.6	19.6
Industrial Cess / Service Levy	10.2	15.7	16.0	25.7
Land Rent	1.2	1.3	1.6	1.0
Licenses and fees	19.8	19.1	24.9	17.0
Charges	6.1	7.0	10.4	12.0
Other taxes and levies	16.8	15.4	15.4	9.8
TOTAL	100.0	100.0	100.0	100.0

Source: Computed by authors based on PO-RALG data.

Table 2.5
Consolidated Local Government Revenue Collections by Source, 2001 - 2004
(TSh per capita)

	2001	2002	2003	2004(*)
Development Levy	338.1	335.1	92.3	13.2
Property Tax	96.8	105.9	92.1	138.3
Agricul. Cess / Livestock Levy	286.6	275.2	260.7	201.7
Industrial Cess / Service Levy	160.4	271.5	224.3	264.7
Land Rent	19.1	22.2	21.9	10.4
Licenses and fees	312.2	330.3	348.5	175.0
Charges	96.6	120.8	146.4	123.9
Other taxes and levies	265.1	265.0	215.5	101.1
TOTAL	1,574.9	1,725.9	1,401.8	1,028.4

Source: Computed by authors based on PO-RALG data.

Table 2.6

Descriptive Statistics for Local Government Revenue Collections in 2002

(Actual per capita collections, TSh per person)

	Development Levy	Property Tax	Agricultural Cess/Livestock Levy	Industrial Cess/Service Levy	Land Rent	Licences and fees	Charges	Other taxes and levies	Total Local Revenues
Average	283.86	95.88	306.37	177.50	21.45	310.58	162.76	239.95	1,598.35
Standard Deviation	245.62	239.36	373.84	773.06	76.57	425.76	314.84	379.57	1,494.00
Coefficient of Variation	0.87	2.50	1.22	4.36	3.57	1.37	1.93	1.58	0.93
Minimum	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	266.57
Maximum	1,537.99	1,361.88	2,555.18	7,283.60	595.35	3,605.31	1,734.25	2,225.56	11,186.85

Source: Computed by authors based on PO-RALG data.

Table 2.7
Descriptive Statistics for Urban Local Government Revenue Collections in 2002
(Actual per capita collections, TSh per person)

	Development Levy	Property Tax	Agricultural Cess/Livestock Levy	Industrial Cess/Service Levy	Land Rent	Licences and fees	Charges	Other taxes and levies	Total Local Revenues
Average	182.20	414.07	142.44	755.65	48.98	817.92	381.58	621.01	3,363.86
Standard Deviation	128.06	397.31	220.53	1,600.19	135.25	666.46	470.64	648.84	2,465.43
Coefficient of Variation	0.70	0.96	1.55	2.12	2.76	0.81	1.23	1.04	0.73
Minimum	30.12	41.67	0.00	3.26	0.00	280.44	0.00	0.00	862.99
Maximum	588.85	1,361.88	855.75	7,283.60	595.35	3,605.31	1,465.64	2,225.56	11,186.85

Source: Computed by authors based on PO-RALG data.

Table 2.8

Descriptive Statistics for Rural Local Government Revenue Collections in 2002

(Actual per capita collections, TSh per person)

	Development Levy	Property Tax	Agricultural Cess/Livestock Levy	Industrial Cess/Service Levy	Land Rent	Licences and fees	Charges	Other taxes and levies	Total Local Revenues
Average	309.28	16.33	347.36	32.96	14.57	183.74	108.06	144.68	1,156.97
Standard Deviation	261.43	40.30	393.48	155.00	51.80	195.91	235.58	181.21	584.72
Coefficient of Variation	0.85	2.47	1.13	4.70	3.56	1.07	2.18	1.25	0.51
Minimum	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	266.57
Maximum	1,537.99	259.52	2,555.18	1,434.80	389.98	1,342.57	1,734.25	826.19	4,241.11

Source: Computed by authors based on PO-RALG data.

Table 2.9
Descriptive Statistics for Local Government Revenue Collections in 2004
(Actual per capita collections, TSh per person)

	Development Levy	Property Tax	Agricultural Cess/Livestock Levy	Industrial Cess/Service Levy	Land Rent	Licences and fees	Charges	Other taxes and levies	Total Local Revenues
Average	26.38	114.93	239.13	201.25	11.34	155.34	131.70	120.05	1,000.12
Standard Deviation	14.34	359.87	280.80	856.97	36.60	325.36	196.13	121.56	1,576.14
Coefficient of Variation	0.54	3.13	1.17	4.26	3.23	2.09	1.49	1.01	1.58
Minimum	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Maximum	2,502.38	1,867.46	2,543.01	3,763.16	237.30	1,519.85	1,285.79	2,764.13	7,552.72

Source: Computed by authors based on PO-RALG data.

Table 2.10

Descriptive Statistics for Urban Local Government Revenue Collections in 2004

(Actual per capita collections, TSh per person)

	Development Levy	Property Tax	Agricultural Cess/Livestock Levy	Industrial Cess/Service Levy	Land Rent	Licences and fees	Charges	Other taxes and levies	Total Local Revenues
Average	12.12	516.85	134.34	774.53	18.69	376.94	340.61	378.45	2,552.52
Standard Deviation	59.38	523.52	239.80	1,020.11	49.11	378.10	338.46	690.11	1,751.82
Coefficient of Variation	4.90	1.01	1.78	1.32	2.63	1.00	0.99	1.82	0.69
Minimum	0.00	0.00	0.00	0.00	0.00	53.15	0.00	0.00	664.66
Maximum	290.88	1,867.46	1,037.26	3,763.16	237.30	1,519.85	1,285.79	2,764.13	7,552.72

Source: Computed by authors based on PO-RALG data.

Table 2.11
Descriptive Statistics for Rural Local Government Revenue Collections in 2004
(Actual per capita collections, TSh per person)

	Development Levy	Property Tax	Agricultural Cess/Livestock Levy	Industrial Cess/Service Levy	Land Rent	Licences and fees	Charges	Other taxes and levies	Total Local Revenues
Average	30.10	10.08	266.16	51.70	9.42	97.14	77.20	52.61	594.42
Standard Deviation	260.85	48.33	428.18	107.26	24.98	180.66	104.90	128.57	589.64
Coefficient of Variation	8.67	4.79	1.61	2.07	2.65	1.86	1.36	2.44	0.99
Minimum	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Maximum	2,502.38	458.00	2,543.01	747.28	165.00	1,390.17	546.03	777.34	2,990.76

Source: Computed by authors based on PO-RALG data.

Figure 2.1
Consolidated Local Government Revenue Collections by Source, 2001 - 2004

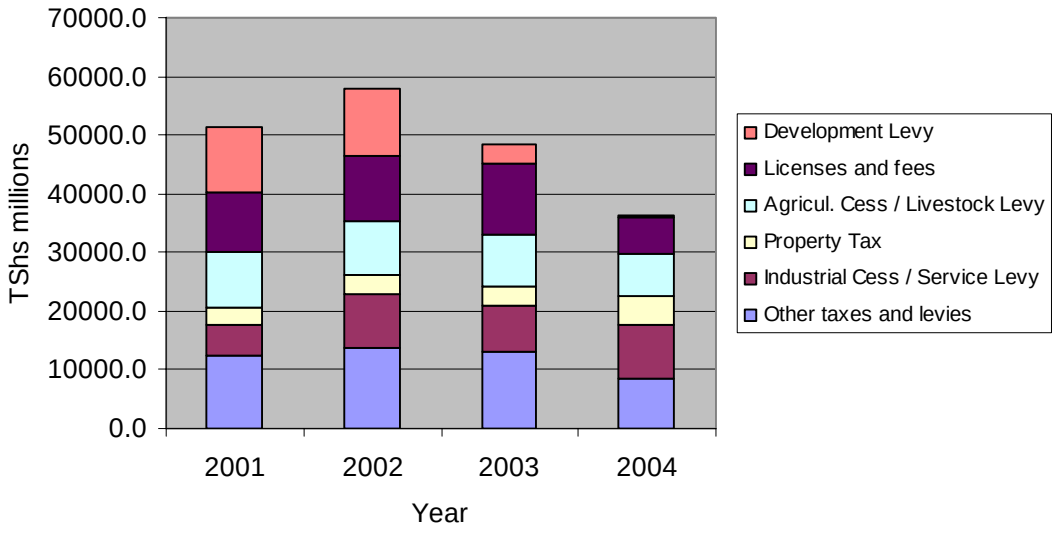
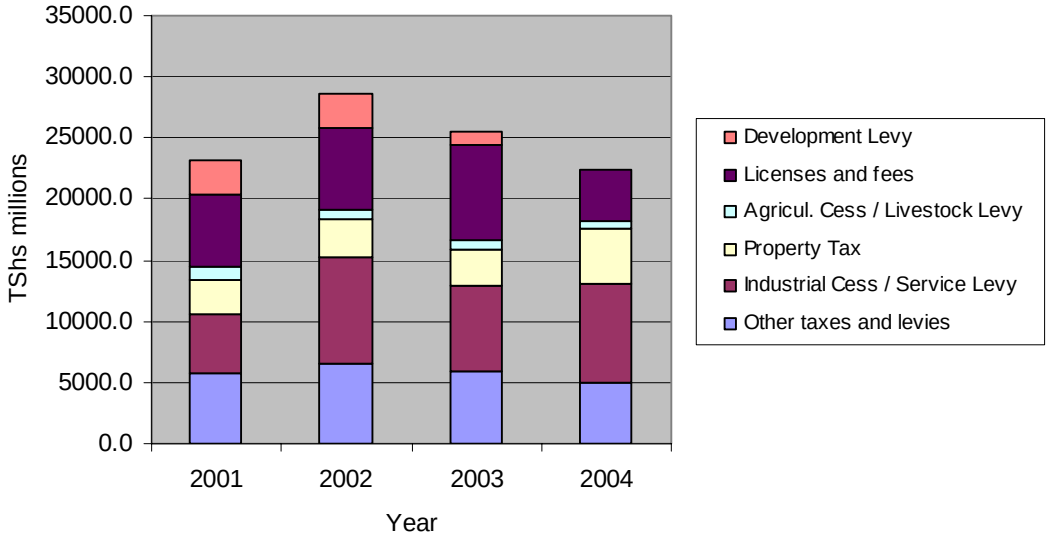


Figure 2.2
Consolidated Local Government Revenue Collections by Source for Urban Districts, 2001- 2004



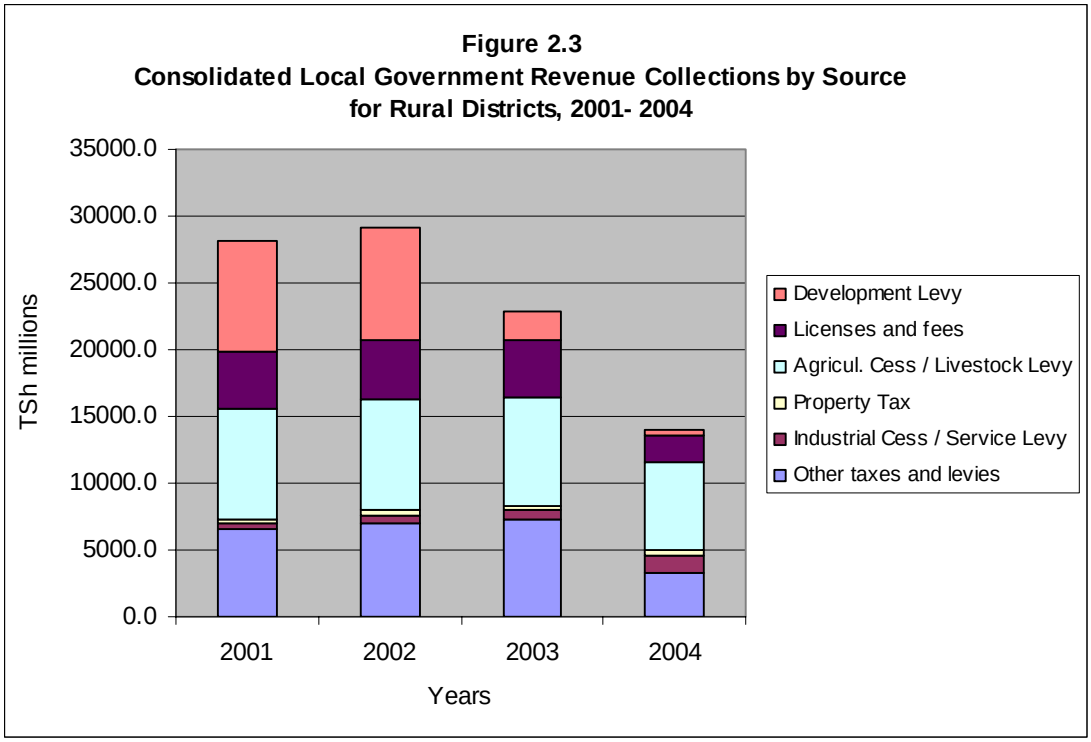


Figure 2.3
Consolidated Local Government Revenue Collections by Source
for Rural Districts, 2001- 2004
35000.0
30000.0
25000.0
20000.0
15000.0
10000.0
5000.0
0.0
TSh millions
2001
2002
2003
2004
Years
Development Levy
Licenses and fees
Agricul. Cess / Livestock Levy
Property Tax
Industrial Cess / Service Levy
Other taxes and levies

Table 2.12
Aggregate Budgeted Local Government Allocations by Sector

	2000/2001	2001/2002	2002/03	2003/04	2004/05
	TSh Million				
Education	129,804	137,914	170,242	202,240	245,945
Health	29,112	35,468	43,685	48,856	63,574
Other	20,638	27,737	33,100	39,878	52,248
TOTAL	179,555	201,119	247,027	290,974	361,768
	Percent of Total				
Education	72.3	68.6	68.9	69.5	68.0
Health	16.2	17.6	17.7	16.8	17.6
Other	11.5	13.8	13.4	13.7	14.4
TOTAL	100.0	100.0	100.0	100.0	100.0
	Percent of Recurrent Spending Budget				
Education	12.7	12.3	11.4	12.6	12.6
Health	2.9	3.2	2.9	3.0	3.3
Other	2.0	2.5	2.2	2.5	2.7
TOTAL	17.6	17.9	16.6	18.1	18.6

Source: LGFR (2004); Table 4.2

Table 2.13
Budgeted and Actual Block Grant, 2004
(TSh Million)

	Budgeted 2004/2005		Actual, Jan-Jun 2004	Annualized 2004
Education Block Grant	245,945.4	Education Block Grant	104,911.4	209,822.9
Health Block Grant	63,574.1	Health Block Grant	22,258.5	44,517.0
Roads Block Grant	4,991.9	Roads Block Grant	5,402.3	10,804.5
Water Block Grant	11,215.2	Water Block Grant	3,698.9	7,397.8
Agriculture Extension Block Grant	13,939.1	Agriculture Extension Block Grant	2,549.6	5,099.1
Local Administration Block Grant	22,102.0	Local Administration Block Grant	12,984.8	25,969.5
General Purpose Grant	25,000.0	Compensation Grant	10,422.6	20,845.2
Fuel Levy / Roads Fund	21,804.0	Other Government Grants	23,275.4	46,550.8
PEDP Capitation Grant	66,229.5	Basket Funds /Donor Funds	39,103.7	78,207.4
Health Basket Fund	17,807.1			
TOTAL	472,608.3	TOTAL	224,607.1	449,214.3

Source: Ministry of Finance and PO-RALG data.

Table 2.14
Variations in Local Government Allocations Between Districts
(TSh per person)

	2000/01	2001/02	2002/03	2003/04	2004/05	Budget Guidelines 2005/06	Budget 2005/06
Average	6,563	7,215	8,594	9,718	11,770	14,209	14,666
Standard Deviation	2,504	2,877	3,815	3,498	4,066	3,537	4,429
Coef. of Variation	0.382	0.399	0.444	0.360	0.345	0.249	0.302
Minimum	2,251	2,604	3,152	4,330	5,805	8,662	7,167
Maximum	14,650	21,054	30,002	23,024	26,545	28,849	36,150
Ratio max to min	6.51	8.09	9.52	5.32	4.57	3.33	5.04
Ratio min to average	0.34	0.36	0.37	0.45	0.49	0.61	0.49
Ratio max to average	2.23	2.92	3.49	2.37	2.26	2.03	2.46

Source: Computed by authors based on Ministry of Finance data.

Table 2.15
Descriptive Statistics for Budgeted Sectoral Transfer 2004/2005
(TSh per person)

	Agriculture	Education	Health	Works	Water	Administration	GPG
Average	425.41	7,179.38	1,882.80	153.56	360.73	663.45	704.21
Standard Deviation	208.72	1,368.43	472.28	58.34	181.65	184.25	193.17
Coefficient of Variation	0.49	0.19	0.25	0.38	0.50	0.28	0.27
Minimum	146.94	5,185.12	1,131.26	58.10	142.00	354.92	308.11
Maximum	868.56	11,117.85	3,172.52	288.22	792.72	1,110.67	1,204.11

Source: Computed by authors based on Ministry of Finance data.

Table 2.16
Consolidated Local Government Revenue Collections by Source for Dar es Salaam Urban Districts, 2001 - 2003
(Actual collections, in TSh millions)

	2001	2002	2003	2004
Development Levy	2,045.4	2,018.8	859.3	0.0
Property Tax	1,514.0	1,663.3	1,583.7	2,394.1
Agricul. Cess / Livestock Levy	530.0	570.0	499.5	310.1
Industrial Cess / Service Levy	3,839.7	4,345.9	5,317.7	5,608.3
Land Rent	0.0	0.0	0.0	0.0
Licenses and fees	3,621.1	4,314.5	4,923.0	2,680.0
Charges	394.9	431.1	1,759.5	1,102.8
Other taxes and levies	1,660.1	2,342.1	513.1	978.3
TOTAL	13,605.3	15,685.7	15,455.9	13,073.5

Source: Computed by authors based on PO-RALG data.

Table 2.17
Consolidated Local Government Revenue Collections by Source for Dar es Salaam Urban Districts, 2001 - 2003
(Actual collections, as percent of total)

	2001	2002	2003	2004
Development Levy	15.0	12.9	5.6	0.0
Property Tax	11.1	10.6	10.2	18.3
Agricul. Cess / Livestock Levy	3.9	3.6	3.2	2.4
Industrial Cess / Service Levy	28.2	27.7	34.4	42.9
Land Rent	0.0	0.0	0.0	0.0
Licenses and fees	26.6	27.5	31.9	20.5
Charges	2.9	2.7	11.4	8.4
Other taxes and levies	12.2	14.9	3.3	7.5
TOTAL	100.0	100.0	100.0	100.0

Source: Computed by authors based on PO-RALG data.

Section 3
Expenditure assignments as the foundation for the system of financing local governments in Tanzania

The logical starting point for the exploration of any system of local government finances is to determine what functions and activities that should be funded at the local government level. With respect to expenditure assignments, the study's TORs request the current study to:

- Review any documentation of the functions and responsibilities of each level of government authority, including the lower-level local governments. (TOR 2.2 [iii])
- quantify the total revenue required by each level of Local Government Authority in order to fulfill its obligations and perform its assigned functions. (TOR 2.2 [v(a)]).

As already noted in Section 1 of the Final Report, we believe that a broad consideration of expenditure assignments in Tanzania should be an integral component of the study. In fact, expenditure assignments play a more important role in creating a sound framework for local government finance than made apparent by the TORs. Reflecting the importance that we attach to assuring that the expenditure assignments are right is that the first fundamental principle which we believe is needed as a foundation for a sound local government finance system is that expenditure assignments form the foundation for a framework for local government finances, and that "finance should follow function." In other words: it would be impossible to get the system of local government finance "right" if the expenditure responsibilities that the system should be funding are improperly assigned. In fact, failing to consider the expenditure assignment question in a comprehensive manner as an integral part of the local government finance system would perpetuate numerous problems in the realm of local finance which cut across the various dimensions of the intergovernmental fiscal structure.[1]

In many developing countries –including those that are pursuing decentralization reforms-, local governments often have few *de facto* expenditure responsibilities. However, the evolution of decentralization reforms in Tanzania since 1982 has given local authorities a true role in the expenditure and delivery of key public services, in the

[1] For instance, having an ineffective and incomplete assignment of expenditure responsibilities contribute to reduced revenue performance for local governments. Likewise, a comprehensive and clear assignment of expenditure responsibilities is needed as the basis for a sound system of intergovernmental fiscal transfers.

context of a relatively sound legal framework. Section 3.1 will review the local government structure and assess the appropriateness of expenditure assignments in Tanzania. Once the appropriateness of the expenditure assignments has been determined, Section 3.2 will consider in principle how different types of locally-provided government goods should be funded. Next, Section 3.3 explores the resource requirements for local governments in Tanzania. Section 3.4 contains concluding remarks and recommendations.

3.1 The local government structure and expenditure assignments in Tanzania

3.1.1 Local government structure: the context for considering expenditure assignment

Before we can assess the appropriateness of expenditure assignments in Tanzania, we should consider Tanzania's current structure of subnational government, including the number of government levels, the size of subnational jurisdictions, and so on. Although we consider the local government structure as part of our broader evaluation (e.g., see the first row of Table 1.4), the subnational government structure was considered an exogenous factor during the formulation of the local government finance framework.

Nonetheless, we believe that the current local government structure in Tanzania provides an appropriate basis for moving forward. As the most important level for provision of local government services, district and urban councils are generally of an adequate size and have sufficient administrative capacity to operate as local government jurisdictions and to assure the delivery of the range of public services assigned to them. The facilitative role of the Regional Administrations (as opposed to their previous more hierarchical role) is appropriate and is seemingly allowing local governments greater control over their own affairs in recent years without regional interference.

Like many developing countries, Tanzania is facing tension between providing local government services by jurisdictions that are generally too large on one hand (thereby risking a lack of correspondence and local accountability) and providing local government services by jurisdictions that are generally too small (thereby risking inefficiencies due to scale economies and inadequate administrative capacity) on the other hand. Along this spectrum, Tanzania has made the prudent choice to assign the bulk of local responsibilities to the district level, while the village/mtaa level currently plays a minor role in the delivery of services and local infrastructure; the role of the village level is likely to increase in the future.[2]

3.1.2 Principles of a sound expenditure assignment

[2] The Mtaa committee will become legal entity (body corporate) with the Budget Law for next year, allowing it to take on a stronger role within the overall local government system in urban areas.

The main principle of a sound expenditure assignment is the concept of "subsidiarity", which requires that government services are provided at the lowest government level that is able to do so efficiently.[3] Although there is no single "best" manner in which to assign expenditure responsibilities across different local government levels, there are a number of steps that should be followed in the assignment of expenditure responsibilities (Martinez-Vazquez, 1998):

1. Determine the appropriate roles of the public and private sectors.
2. Establish a formal assignment of expenditure responsibilities - and do this before determining the other components of the system of intergovernmental fiscal relations. The lack of a clear, formal (legislated) expenditure assignment –or conflicts in the legislative framework- is a common shortcoming of fiscal decentralization reforms.
3. Follow the subsidiarity principle in assigning the allocation function:
   - Assign the responsibility to fund distributive programs to the central government.
   - Assign the responsibility to provide the stabilization function to the central government.
   - The subsidiarity principle and the nature of market failure should determine which level of government is best situated to ensure the efficient provision of other government services.
4. Assure that the expenditure assignment recognizes the multi-dimensional nature of expenditure responsibilities, including the responsibility to set policy norms and regulations; to finance; to provide; and to produce a certain government service.
5. Assure that the legislative framework is consistent and is clear in assigning the responsibilities of the various government levels, especially when different aspects of a functional responsibility are shared by different government levels. Then assure that the legislative framework is followed in practice.
6. Ensure that minimum standards of local service provision are assured via penalties and rewards, and make sure that local governments operate in a framework in which they are accountable.

3.1.3 Assessment of expenditure assignments in Tanzania

According to the legislative framework, local governments in Tanzania play an important role in the delivery of government services, as they are assigned the responsibility to deliver key public services such as primary education, basic health services, and other typical "local" public services. In addition, the *de facto* expenditure assignments closely match their legislated expenditure responsibilities. As a result, 20 percent of public expenditures are made at the local government level.

The responsibilities that are assigned to the local government level in Tanzania are typically "local" services, and the assignment of expenditure responsibilities generally

[3] See Martinez-Vazquez (1998) for a discussion on the sound assignment of expenditure responsibilities.

follow the subsidiarity principle and broadly coincide with sound principles of expenditure assignment. Nonetheless, there are a number of shortcomings in the current assignment of expenditure responsibilities in Tanzania.

Perhaps the most important shortcoming of expenditure assignments in Tanzania is that the current assignment of expenditure responsibilities in the Local Government Acts is one-dimensional. By failing to consider the multi-dimensional nature of expenditure assignments, the legislative framework does not distinguish between national functions for which the provision is devolved to the local government level; functions that are fully devolve to the local government level; and functions that are merely delegated to the local government level. In the absence of this distinction, it is unclear which level of government is responsible for funding the various responsibilities for which provision is assigned to the local government level (see Box 3.1).[4] As further discussed in Section 3.2, the exact nature of the expenditure assignment determines how a function or activity should be funded.

Box 3.1
Feedback from the Second Stakeholder Workshop (May 2005)

The second stakeholder workshop on the development of a strategic framework for local government finances –held in Dar es Salaam in May 2005- was presented with the following statement for discussion and debate: "The assignment of expenditure responsibilities in Tanzania should be clarified. The legislative framework should clearly state for each local responsibility which level of government is responsible for (1) policy/regulation, (2) financing, (3) provision, and (4) production."

<u>Unanimous agreement and consensus exists with regard to this statement.</u>

The discussion group that focused on this statement came up with a classification of expenditure responsibilities based on a number of key functions, such as primary education, basic health services, and so forth. It was noted that the assignment of functions requires a great deal of specificity, certainly beyond the main functional level. This study team believes that the legislative framework indeed should be clarified in this manner.

A point was also raised that there exists confusion surrounding the assignment of secondary schools, to the extent that currently LGAs are required to fund the development of secondary schools, while this is not currently a local government function.

The assignment of responsibilities in the DSM region requires greater attention in the expenditure assignment framework. While the DSM CC is intended to represent all constituent municipalities, in fact, it does not play this role. For instance, while the CC sits on the water board, the municipalities have significant issues.

[4] In practice, there appears to be a relatively widespread degree of consensus about which local government activities are "truly local activities" (local markets, and so on), which functions are national functions where provision is devolved to LGAs (primary education, basic health, and other priority sectors) and functions that are delegated (e.g., contagious diseases).

A second important concern with the current expenditure assignments in Tanzania is the role of local government administration. In the current system, local government administration is a burden predominantly borne by LGAs themselves. At the same time, the Local Government Finance Act provides for a central government matching grant for local government administrative staff above a certain pay grade, although it appears in reality that the cost of personal emoluments for local administrative staff are in fact fully funded from central government resources. While there is no comprehensive picture of local government spending patterns, the available evidence from various selected LGAs suggests that local governments in Tanzania spend somewhere between 50-60% of their own source revenues on local administration. The fact that these own resources have to be generated locally for local administration without translating into services that directly benefit local residents has been identified as a major area of concern for local residents and taxpayers. In fact, based on survey evidence, certain studies have placed the blame for the low value-for-money at the local level from own resources on local officials; local officials are essentially accused of wasting local resources on administrative functions. However, it may simply be the case that in the absence of adequate funding for administrative tasks from alternative resources (e.g., intergovernmental transfers), local governments have no choice but to spend a large proportion of own revenues towards the cost of operating the local authority. If the latter is the case –and local communities are asked to bear a disproportionate share of the cost of local administration- then this would have significant negative reverberations throughout the system of local government finance that is beyond the fault of local governments themselves.[5]

Another set of concerns with the current expenditure assignments in Tanzania regard a number of secondary issues; although these problems in expenditure assignments may be serious in their own right, these problems are not likely to have system-wide effects on local government finances. Such concerns include the following:

- A real question should be raised whether the delivery of secondary education is appropriately assigned to the central government level. Given the prior failures of centralized primary education and the relative success of decentralized delivery of primary education, it is hard to justify the centralized provision of secondary education directly by the Ministry of Education and Culture. This debate should take on special prominence given the recent ramping up of funding for the Secondary Education Development Program. In fact, to the extent that as part of the budget formulation process for FY 2005/06 funding is actively being diverted away from primary education at the local level towards secondary education to be controlled by MOEC, one cannot help but wonder whether political motives have overtaken true policy objectives and concerns about service delivery.

[5] To some extent, the introduction of the unconditional Compensation Grant / General Purpose Grant in the aftermath of the local revenue rationalizations of 2003 and 2004 should have offset this problem. This issue will be pursued further in Sections 4 and 5 of this report.

- Although the principle of decentralization by devolution is clearly articulated in the legislative framework and local governments receive a significant portion of their funding through the sectoral allocation mechanisms under the regional PO-RALG votes (Votes 70-95), this does not mean that there is universal acceptance of the role of local governments in the providing government services assigned to the local government level. Central government line ministries continue to assert a role for themselves within the responsibilities assigned by law to the local government level, often citing weak local government capacity as a reason for continued central government involvement. Within the health sector, the Ministry of Health continues to provide in-kind transfers of medicines to LGAs rather than devolving greater flexibility to local health authorities. The decentralization of local water services envisions the production of potable water by the private sector (water corporations, local water board, and/or local user groups), although the sector's *modus operandi* appears to be more one of deconcentration than devolution; for instance, the majority of local water board members are appointed by the sectoral minister as opposed to the relevant local council.[6] Likewise, the highly discretionary "hands-on" role played by PO-RALG in managing the local share of the Roads Board Fund also seems to contravene the assignment of the responsibility for maintaining local roads to the local level. The disbursement of the roads funds to PO-RALG rather than directly to the local governments clearly and unnecessarily diminishes local governments' role in exercising their functional responsibilities. The same concern (central micro-management of local government affairs) is raised by the earmarked provision of funding for urban fire-fighting services through the Administration Grant.

- A final issue of concern in expenditure assignments in Tanzania is the special role of the Dar es Salaam City Council vis-à-vis the three municipal councils in the DSM region. In order for "finance to follow function" it is imperative that the functions of the City Council relative to the municipalities are more clearly defined in the legislative framework.

3.1.4 Achieving expenditure autonomy and accountability at the local government level

One of the biggest challenges in the realm of expenditure assignment has been the ongoing struggle to assure greater local government control over the actual delivery of services. Although local governments have been legally responsible for delivering key public services since the mid 1980s, until recently, the central government was able to micro-manage local government expenditure decisions through the highly discretionary transfer system. The center's control over local finances is now slowly being diminished as formula-based recurrent sectoral grants are being introduced. Instead, the center is improving its ability to properly exercise regulatory control over local budget decisions (i.e., in a less discretionary manner) through the local budget guidelines.

[6] The intrusion of central government in the management of residential water supplies in Dar es Salaam in May 2005 certainly seems to be inconsistent with a decentralized approach to service delivery in the water sector.

Possibly the last bastion of excessive central government control over local administration and delivery of services is through its control over the placement of local public servants. The fact that the center continues to exercise control over the placement of teachers and other local staff has major implications for the system of local government finance.[7] Despite the revision of the Public Service Act in 2004, PO-PSM continues to approve local staff positions without consideration as to whether local governments are able to afford the staff in the context of their formula-based grants. This is a major hindrance in fully implementing the formula-based transfer system. Therefore it is a key priority for the Ministry of Finance and PO-RALG to engage PO-PSM and bring local government staffing issues in compliance with the formula-based grant system.

Of course, in order to secure the benefits from local budget autonomy, local governments should operate in a transparent and accountable manner in a way that responds to local needs and preferences. Yet, many critics of decentralization have argued that local governments have insufficient capacity and lack accountability to ensure the sound delivery of public services. The available data do not support this conclusion; as a result, we strongly disagree with this contention. A series of recent opinion surveys suggests that there is a lack of public trust in local governments, which leads the author's to be highly critical of local governments' role in public finances (e.g., Fjeldstad 2004; REPOA/CMI, 2004). However, none of this work provides comparative data for the quality of services delivered by the central government, so we are simply not able to conclude whether the alleged poor performance of local governments is any different from the quality of central government services, or whether the shortcomings of local government services are simply caused by a broader lack of public resources (which potentially reduces the quality of services at both the central as well as the local government level). Nor do the studies isolate the negative impacts of shortcomings in the design of the overall local government finance system (for instance, the inadequate assignment of expenditure responsibilities for local administration as discussed above) which are simply beyond the control of the local government level. Although there is surely an ongoing need to build the capacity of local governments to be able to better plan and budget for the delivery of local government services, when properly financed, local authorities are clearly in a position to deliver services in a relatively effective manner. In fact, this assertion is supported by the survey data produced by the aforementioned studies. For instance, in a recent survey, an overwhelming majority of local residents (70.1%) expressed satisfaction with the local delivery of primary education services (Fjeldstad, 2004: Table 15). Although comparable data are not available for central government services, it is unlikely that citizens are equally satisfied with any public service provided by the central government. It is therefore simply untenable to suggest that local governments have insufficient capacity or are insufficiently accountable to effective deliver key local government services. Institutional and administrative aspects of assuring a participatory

[7] If local staff are placed without local consent, then local governments cannot necessarily be expected to pay for these staff from their formula-based sectoral grant. This issue is discussed by LGRP/GSU. 2003. Technical Notes on Local Government Finance Reform in Tanzania: The design of formula-based recurrent block grant system and the role of personal emoluments (Technical Note 2).

and accountable budget process at the local government level are further considered in Section 7 of this report.

3.2 How to fund different types of local government goods?

When expenditure assignments are understood to form the foundation for a framework for local government finances, in order for "finance to follow function", both intergovernmental transfers and own local revenues should play important but distinct roles in the system of local government finance. Thus, the first key question in designing a local government finance strategy should be: what determines how each local government activity should be funded?

According to a broad consensus among public finance experts and international best practices, the appropriate funding mechanism for any publicly provided good at the subnational level is determined by the subsidiarity principle, which states that government services should be provided (and financed) at the lowest level of government that can do so efficiently.[8] Following this principle, we can broadly classify four types of local government expenditures:

- Government services that are provided at the local government level but that are national policy priorities (or otherwise not exclusively local in nature).
- Government services that are provided at the local government level but that are exclusively local in nature.
- Expenditures on local government administration.
- Capital development that is provided at the local government level. Again we can distinguish between capital development spending that is exclusively local in nature, and projects that are not exclusively local in nature.

The appropriate funding mechanism for each of these four categories of local expenditures is determined by the reason why the public sector is providing the good in the first place.[9]

National policy priorities. Local governments in Tanzania are responsible for delivering a number of services that, while they are provided (delivered) at the local government level, these activities are not exclusively local in nature. Examples of such activities include the provision of primary education, council health services, water, agricultural extension, and local road maintenance. Although it is appropriate for these services to be delivered by the local government level (because they are in a better position to deliver these services than the central bureaucracy), it would not be appropriate for these sectoral

[8] See Martinez-Vazquez (1998) for a broader discussion on the subsidiarity principle and expenditure assignments.

[9] While conceptually it is appropriate to say that certain activities should be funded through different financing modalities, this does not mean that local governments should in fact funnel money through a system of different local government bank accounts. Local government financial management issues are discussed later in this section.

services to be funded at the local government level because these are national policy priorities. It is appropriate to fund these sectoral expenditures from central government resources (through some type of conditional transfers) because all these programs either involve (1) a significant element of poverty reduction which justifies central government funding, or (2) significant spillover effects to national policy objectives, such as national economic growth, or both.[10]

For instance, while providing a child with a primary education provides direct benefits to the child and his/her community, in many ways the benefits of primary education are felt nationwide through a better educated workforce and improved economic productivity and a more literate, healthier population, resulting in higher national tax collections, lower spending on poverty reduction programs and health care, and so forth. At the same time, central government funding of primary education assures equal access to primary education to all Tanzanians, an important element of the government poverty reduction strategy. Likewise, health services, water provision, agricultural extension, and local road maintenance can all be justified as having either positive spillover effects or significant redistributional impacts.

Indeed, the stakeholders' workshop held in January 2005 concluded that for the priority sectors, "decentralization by devolution" in Tanzania should be interpreted as devolution of provision, so that the central government will continue to have responsibility for determining sector policies, setting service delivery standards, and providing financing to fund the provision of services at the local government level (see Section 1.4 of this Final Report). As such, the provision in the Local Government Finance Act that provides central government funding for these activities through intergovernmental grants –and the actual provision of funding through formula-based sectoral block grants- is fully consistent with sound decentralization principles and practices. The provision of sectoral block grants is further discussed in greater details in Section 3.3.

Truly "local" government services. In addition to providing a number of national services at the local level, local governments in Tanzania are responsible for delivering a number of services that are not only delivered at the local government level, but are in fact exclusively local in nature. Examples of such local activities include local refuse collection, street cleaning, parks and recreation activities, community activities, and so forth. Such services are provided by the public sector either because they are local public goods (the enjoyment of a local park is neither rival nor excludable) or because they are what economists refer to as club goods.[11]

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[10] The expenditure assignment literature is clear that under the subsidiarity principle, the financing of income redistribution (including poverty reduction activities) generally cannot be achieved in an efficient manner with funding from own local revenue sources. Likewise, to the extent that the benefits from a locally-delivered service are felt outside the local jurisdiction or nationwide, these activities should (partially or wholly) be funded from higher government levels.

[11] A public good is a good or service that is non-rival and non-excludable. Non-rival means that one person can enjoy the benefits of a good without reducing the benefit received by others; non-excludable means that a person cannot be excluded (or it is prohibitively expensive to exclude him/her) from enjoying the benefits of the good. Club goods are private (i.e., rival and excludable) goods and services that are provided by local

Since the benefits of these activities exclusively befall the local community, it would therefore be appropriate for the local community to pay for these activities from its general budgetary resources, which include its own source revenues supplemented by unconditional transfers received from the center. While conceptually it would be best to pay for such local activities through local benefit taxes, there are two reasons why own source revenues may have to be supplemented with unconditional grants. First, the revenue sources assigned to the local level may not yield adequate revenues to fund the "truly local" expenditure responsibilities assigned to local governments; as such, unconditional grants can be used to assure vertical fiscal balance. Second, if exclusively local government services would be exclusively funded from own source revenues, this could lead to horizontal fiscal imbalances.

The issue of horizontal fiscal balance is a valid concern when considering whether local government activities should be funded from general budgetary resources at the local level (which currently consists mostly of own source revenues). There are three arguments that could be made that might mitigate this concern. First, as the local services in question are non-priority in nature (especially when compared to primary education or basic health services), it is in fact not inappropriate to allow variations in service delivery across local government jurisdictions with wealthier local jurisdictions being able to provide somewhat better services than poorer local governments. After all, allowing variations in the mix of local services offered among jurisdictions is required in order to achieve the efficiency benefit of a decentralized system. Second, it is worthwhile to note that the demand for many of the local services under consideration is more closely connected to the economic base of a jurisdiction rather than to the population of the locality. For instance, the need for street cleaning and public refuse collection tends to increase proportionally with the level of economic activity (especially around markets), so that funding these activities from own source revenues assures that there is a correspondence between the demand for this local service and the resources provided by the funding mechanism. A third factor mitigating the equity concern of locally-funded activities is that, as we discuss further in Section 5 of this report, we recommend transforming the General Purpose Grant into a genuine equalizing, unconditional grant scheme. Introduction of an equalizing GPG would assure greater horizontal fiscal balance while ensuring revenue autonomy for local governments that are able to raise adequate own source revenues from local sources.[12]

Local administration expenditures. Another question that has been the source of some concern in Tanzania's current system of local government is whether local administration is in fact a local government affair -and thus should be funded from own local sources-, or whether the cost of local government administration should be considered as part of the national realm of expenditure responsibilities. As noted in Section 3.1, the Local

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governments because they can be provided more cost-effectively when produced for a group of residents instead of a single household.

[12] Note that the current General Purpose Grant is currently (notionally) distributed in accordance with the revenues lost due to the revenue rationalizations of 2003 and 2004. As such, the GPG is currently likely counter-equalizing.

Government Acts determine that local government administration is a local government function, although part of local administrative costs are defrayed by the central funding of local administrative salaries.

There are three problems with the current legislated funding mechanisms used to finance local government administration, concerning both the efficiency and equity of the system. First, since local taxpayers are interested in paying for local services that provide a direct benefit to the local community, their incentive to pay for administrative overhead is extremely low. Thus requiring local governments to self-fund a significant part of their administrative cost reduces local taxpayer compliance, which will ultimately result in suboptimal funding for local government administration and for other local services.[13] Second, the current approach to funding local government administration is potentially inequitable, since matching grants will favor wealthier districts in setting up better (or at least, better funded) local government administration. Additionally, the horizontal allocation of administrative personnel has historically taken place in an extremely discretionary manner, which has resulted in large variations in administrative grants between LGAs. Third, and perhaps most importantly, it would be fair to consider local government administration as an integral part of the national administrative infrastructure, as an important part of its functions is to oversee and provide national public services. In this context, it should be noted that a large majority of expenditures at the local government level (ranging from 80-90 percent in most councils) is spent on national priority programs. Therefore, although local administration is clearly a local government function, there is a strong case for local administration to be financed (in large part or wholly) with central government funds. However, this should be done without rigid earmarked financing tied to existing personnel posts in local administrations.

Since assuring devolved local provision and production of local administration is the best way to safeguard local autonomy, we recommend that local administrative activities should be viewed as local in nature and should be funded from general local resources. However, to prevent local governments from spending an excessively large share of local own source revenues on local administration, and in order to recognize the important role that local government administration plays in the infrastructure of the national public sector, it would be appropriate to assure that unconditional transfers are provided to LGAs in order to cover the cost of local administrative expenditures. By providing local governments with unconditional transfers to cover the basic cost of local government administration, LGAs should be able to provide their residents with much better "value for money" for programs funded from locally raised sources.[14]

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[13] Conversely, local government officials have a bureaucratic tendency to consider administration as a first charge. As a result, a majority of locally collected revenues are absorbed by local administration: for instance, see the studies on local public finances in Mbeya, Mtwara and Singinda (UUAP, 2001).

[14] To some extent, the current provision of GPG transfers already allows local governments to cover most or all local administrative expenditures from this unconditional grant. However, since the local revenue trend has been toward less rather than more revenue autonomy, fewer LGAs have been able to capitalize on the revenue reforms to increase local fiscal compliance.

Local capital development projects. At the present time, there is no systematic financing system for the financing of local capital development expenditures, and only 4 percent of the Development Budget is passed more or less directly through to the local government level. Local capital development is funded through a number of –predominantly donor-driven- sources, including centrally earmarked transfers from the development budget for local projects, sectoral capital development programs (including classroom construction, health facility rehabilitation, and agricultural development programs) and area-based local development programs (ABPs). Many of these funding mechanisms require some co-funding (generally 10-20 percent) by local governments from own sources.[15] Some capital development funding is provided through the Local Government Loans Board (see Chapter 5 of the Local Government Fiscal Review).

There is consensus among economists that financing capital infrastructure from recurrent resources generally results in an under-provision of investment in public infrastructure. Instead, borrowing is an appropriate mechanism to pay for capital expenditures, as it allows the (local) government to restore the match, over time, between the costs and benefits of capital infrastructure (see Section 3.4). Yet, in the absence of well-developed capital markets and a sound framework for local government accounts, private financial institutions such as banks are often unwilling to lend to local governments as the risk of local government authorities defaulting on repayment is often considered high. Thus, in the absence of a well-functioning capital market, alternative mechanisms are needed to finance the capital development needs of subnational governments.

As such, in order to resolve the market-failure in capital markets for local government borrowing, we recommend that local capital development expenditures in Tanzania are funded from two sources. First, we should expect that a majority of LGAs in Tanzania are not in a sufficiently sound fiscal position to borrow and repay money for virtually any of their capital development needs any time in the near future: for these councils, an expanded system of capital development grants will need to be the predominant source of capital funding. Second, to the extent that councils in Tanzania are able to responsibly borrow resources –either through the LGLB or directly from the capital market- the framework for local government borrowing should be expanded appropriately to accommodate for this. To the extent that borrowing might be a feasible option for LGAs in Tanzania, the proposed framework for local government borrowing is discussed in greater detail in Section 3.4.

The first step towards a comprehensive, formula-based Local Government Capital Development Grant (CDG) system was made as part of the preparation for the World Bank credit under the Local Government Support Project (LGSP). It is expected that the CDG system will soon start providing essentially unconditional capital development grants to the local government level. Consistent with PO-RALG's current Letter of Sector Policy -which clearly states that the CDG is to be the main mechanism for funding local capital development infrastructure- the CDG mechanism will be financed from government's "own" resources, contributions from bilateral and multi-lateral donors, as

[15] LGSP/PWC. 2004. Background Paper: Development Funding To Regions and Local Government Authorities.

well as loan proceeds from international financial institutions. The *Local Capital Development Grant System: Manual for the Assessment of Councils Against Minimum Conditions and Performance Measurement Criteria* (PORALG, 2004) provides a comprehensive description of the CDG. Section 3.3 (below) discusses the evolving role of capital grant funding in Tanzania's local government finance system.

3.3 The resource requirement for subnational governments

The TORs (Section 2.2 (v)(a)) request the current study to quantify the amount of resources required by each subnational government level in order to fulfill its obligations and perform its assigned functions in terms of the Constitution, legislation, and national policies, particularly the poverty reduction strategy. Such a costing of each level's expenditure needs is useful to assure vertical fiscal balance in the system of intergovernmental fiscal relations.[16] However, before we proceed to quantify the expenditure needs of each government level for specific activities, it is important to consider the relative nature of public expenditure needs.

The nature of public expenditure needs. Determining the expenditure needs of different government levels in the public sector begins with the explicit recognition that public resources –and by extension, public resources available to the local government level- are always scarce. While it is tempting to believe that the expenditure needs of governments can be quantified in an objective manner, we need to recognize upfront that expenditure needs are, by their very nature, always relative to the resources available and never absolute. Even though a sector ministry may quantify its fiscal needs in terms of the cost of achieving certain desirable sectoral service delivery norms, this does not necessarily mean that the service norms are achievable within the resource constraint within which the government must operate. For instance, despite the desire of the Ministry of education to achieve a 40 to one student-teacher ratio, this does not necessarily mean that this norm is affordable given the other demands on the national budget. As such, any successful public expenditure management process needs to determine expenditure needs on a relative basis, which allows for the prioritization of budgetary resources among competing uses. As part of any budget process that recognizes the relative nature of expenditure needs, the central government will have to decide the most efficient use of any additional budgetary resources given the government strategic priorities.

In a sound budget process, the central government decides the overall size of the public sector through its macroeconomic (taxation and borrowing) policy decisions. As part of the government's broader fiscal policy strategy (which incorporates decisions on the tax system as well as the annual budget processes), the relative expenditure requirements of the local government level are implicitly determined by the revenue sources assigned to

[16] Vertical fiscal balance is said to exist when there is a broad correspondence between the aggregate financial resources assigned to each level of government and relative expenditure responsibilities of each government level. Vertical fiscal imbalance results when one government level receives a disproportionate amount of revenue sources compared to its expenditure responsibilities, and this imbalance is not corrected through the transfer system.

the local level, the vertical allocation of grant resources through the regional votes, and possibly, by the level of transfers from sector ministries and the development budget to local governments.

Box 3.2
Risks associated with absolute expenditure requirements

Not only is a budget process that is anchored on the concept of absolute public expenditure requirements unlikely to produce a balanced budget, but more importantly, a decentralization strategy based on this principle raises the possibility of actually derailing the decentralization process.

When the national budget process quantifies the expenditure requirements of local governments in an absolute manner, this raises the expectations by local residents that these local services will be fully funded (one way or another) by the public sector. While disappointment with the decentralization process will ensue when subsequently the requisite resources for local government services turn out not to be available, it won't be necessarily clear who is at fault and who should be held accountable for this failure. Local government officials will, of course, blame the central government for inadequate funding. At the same time, opponents of decentralization at the central government level can exploit the failure of local governments to deliver public services as an argument to recentralize sectoral activities. As such, a decentralization approach that quantifies expenditure requirements based on absolute norms is unlikely to produce a sound and consistent basis for decentralization reform.

The previous National Minimum Standards approach. The National Minimum Standards approach to financing local governments previously used in Tanzania failed to recognize that local expenditure needs are never absolute. Under the NMS approach, the resource needs of each local government sector were determined based on "national minimum standards" (NMS) for local service-delivery.[17] These NMS generally reflected a desired level of service delivery (for instance, a desired student-teacher ratio of 45:1), without considering whether the service level was actually fiscally affordable from a budgetary viewpoint.[18] Since under the previous NMS system the quantification of expenditure needs was developed outside the context of the regular budget process, the formulation of the standards did not consider the overall affordability of the service delivery standards. As such, the NMS reflected policy goals that were not necessarily obtainable by local governments, rather than budget norms for which local governments could be held accountable.

[17] See PWC. 2000. *Local Government Finance Reform: A System for the Financing of Local Government* for a description of the NMS approach. See LGRP Technical Note 2003-03 (*"Introducing formula-based block grants as an alternative to national minimum service standards")* for a critique of the NMS approach.

[18] To further compound the problem, some standards may not even be objectively quantifiable in terms of expenditure needs.

While the use of budget norms or minimum standards is not uncommon, an ill-conceived NMS approach can be seriously detrimental to the decentralization process. On one hand, if the minimum standards are set too low, local services received by residents end up being poor and the nation will fail to achieve its national policy priority objectives. On the other hand, if the minimum standards set by the central government are in fact set too high and become unaffordable to local governments, this would set local governments up for failure. Excessively high NMS would also allow local government officials to pass the blame for inadequate local service delivery to the central government's inability to pass down adequate resources.

The current national budget process and local resource needs. As part of the current system of formula-based sectoral block grants in Tanzania, the relative policy importance of the six main recurrent local government functions -and the associated level of funding made available to each local government function through the transfer mechanism- is determined at the Cabinet level as part of the annual Budget Frame based on the government's national policy priorities. By determining the sectoral budget envelopes for local government sectors up-front in the budget process, the process assures that local governments are able to develop realistic budget plans that fall within the resources available to the local government sector. As noted elsewhere in this report, sectoral allocations for local governments have grown over the past years in proportion to the rest of the national budget.

In practice, the budget formulation processes in Tanzania combine the realization that expenditure requirements are relative with the desire to achieve a well-defined absolute minimum level of public services. The relative prioritization of budget resources is achieved in the context of a cross-sectoral medium-term expenditure framework (MTEF) by first computing the absolute cost requirements for achieving desirable standards of service delivery across all sectors. As the next step in the budget formulation process, the Ministry of Finance determines how much of each sectoral expenditure requirement can be funded within the public resources available. Aggregate local government allocations (sectoral transfers) for primary education and other local government sectors are treated in a similar fashion. This allows policy makers to establish budget priorities based on how much of each sector's requirement is being funded. Although such comparisons may be helpful in identifying budget priorities between central government agencies as well as between central and local government programs, one has to interpret such analyses with extreme caution since the absolute expenditure requirement are determined in a very subjective manner. For instance, based on expenditure norm for primary education based on a student-teacher ratio of 45 students to 1 teacher (and other similar norms), one could conclude that Tanzania is currently fully funding its primary education requirement. However, if the Ministry of Education would redefine the expenditure norm for the student-teacher ratio to 30:1 or even 20:1, the very same analysis would show that the sector is grossly under-funded.

In addition to the analysis of expenditure requirements in the cross-sectoral MTEF, the Ministry of Finance rolled out a budget planning software in late 2004 that integrated a performance-based dimension into the central budget formulation process in the context

of the new poverty reduction strategy (PRS II/NSGRP). Whereas the previous poverty reduction strategy exclusively focused on poverty priority sectors, PRS II moves away from the sectoral approach by recognizing that not all expenditures within the priority sectors necessarily contribute to poverty reduction. Instead, the new PRS focuses on a cluster strategy approach. The major clusters of poverty reduction include (i) Improvement of quality of life and social well being; (ii) growth and reduction of income poverty; and (iii) governance and accountability. The new cluster-based approach does not mean that the sectoral nature of expenditures becomes irrelevant altogether, but it does mean that spending within sectors is further scrutinized to identify whether the resources are used to fund pro-poor activities. As part of the performance-based budget approach, line ministries need to indicate in the budget planning software to which extent specific budget items address pro-poor priority cluster activities. This will then assist the Ministry of Finance and Cabinet in prioritizing proposed sectoral expenditure programs. See Section 5 for a further discussion of the inclusion of intergovernmental transfers in the central government's budget formulation process.

In contrast to expenditures in the national priority sectors, which are predominantly funded from intergovernmental transfers, local non-priority budget expenditures are almost exclusively funded from own local revenue sources. As such, in practice the fiscal priority of these expenditure responsibilities is implicitly determined by the yield of the local revenue instruments that are made available to the local level, plus the amount of unconditional grants which are provided to the local government level. In this regard we should note that a substantial share (about 50-60%) of own local revenues are needed to cover local administrative expenses, thereby greatly limiting the amount of resources available for “truly local” expenditure activities. However, the under-funding of local expenditure programs does not necessarily give rise to unfunded mandates as local governments are able to respond by reducing the quality and level of local government services. (see Box 3.3)

Box 3.3
Alternative approaches to addressing the vertical resource needs of subnational governments

Reaching vertical balance in a decentralized system is always a challenge, as international experience indicates; functions and revenues are provided to local governments in different combinations and with varying relationships between these two building blocks of local fiscal autonomy. Some countries address this challenge of achieving vertical fiscal balance by providing local governments with autonomous revenue sources and some clarity on expenditure functions. Local governments can then, for example, increase or decrease the tax rates of some significant taxes to raise adequate revenues for their stipulated expenditure responsibilities. Such a “revenue first” approach, with little follow-up on expenditure assignment, avoids vertical imbalances by definition, but this construction potentially can make it difficult for the national government to realize national interests and priorities through local government service delivery.

Other countries choose not to provide local revenue autonomy, and rely on alternative mechanisms to reach vertical balance at the local level. For instance, vertical fiscal imbalances

could be avoided by not defining in any concrete way the expenditure responsibilities of local governments or leaving quite open, that is subject to the availability of resources, the level at which concrete physical expenditure norms could be fulfilled. In essence, these approaches mean that local expenditure choices are made at the level and quality that available local resources allow in accordance with local priorities. This has been largely the experience of most transition countries in Central Europe and the former Soviet Union and it is also a common practice in Latin America.

Source: Jorge Martinez-Vazquez, Jamie Boex and Gabe Ferrazzi. 2004. Linking expenditure assignments and intergovernmental grants in Indonesia. ISP Working Paper Number 04-05 (September).

Absolute resource requirements based on current national standards. There are two sources that provide guidance on the budgetary implications of an absolute approach to budget requirements. The first source is the report produced by PWC (2000) on a system for the financing of local governments based on the national minimum standards approach; the second source is the cross-sectoral MTEF produced by the Ministry of Finance for 2002.

The PWC report costs out, at a very high level of detail, the exact resource requirements for the delivery of local government services. For instance for the delivery of primary education, the proposed NMS approach costs out the fixed costs of running a District Education Office as well as the variable costs of primary education based on projected teacher costs (salaries and benefits) and the normative student-teacher ratio of 45 to one; their projected cost of material and equipment (including slates, books, and science kits); as well as the projected cost of in-service training of teachers (at local Teacher Resource Centers). Likewise, the report produced NSM estimates for the administrative cost of non-priority sectors based on national input requirements. Based on the computations by PWC (2000), local governments faced a substantial budget shortfall (of almost 50%) based on an absolute costing of their expenditure requirements, as shown in Table 3.1.

Table 3.1
Local expenditure requirements based on national minimum standards for service delivery (Tsh millions, 1998/99)

Grant	Funding Required	Budget amount	Shortfall	Shortfall as % of Budget
Education	126,240	81,910	44,330	54.1
Health	58,506	32,470	26,036	80.2
Roads	63,445	15,314	48,131	314.2
Water	2,030	1,755	275	15.7
Agriculture	6,111	4,200	1,911	45.5
Total Conditional	256,332	135,649	120,683	89.0

Unconditional	5,414	4,596	818	17.8
Total Grant Costs	261,746	140,245	121,501	86.6

Source: PWC (2000): Page A6.

A more optimistic picture is shown by the cross-sectoral MTEF for 2002. The MTEF summarizes the expenditure requirements for activities in the priority sectors in the public sector (for both the central and local government level), indicating that the expenditure norms for almost all sectors were fully funded. For instance, the budget plan suggests that the budget allocations made in the national budget for primary education cover 99% of the sector's expenditure needs, while the resources set aside for local health-care cover 96% of expenditure requirements. The fulfillment rates for the other local government sectors (including agriculture and livestock, water and local roads) are only slightly lower (Table 3.2). This means that unless the minimum standards are modified, in principle, local governments are currently receiving adequate amount of resources. If this were truly the case, the only adjustment that would have to be made from year-to-year would be to increase the transfer pool for local governments at the annual rate of inflation.

Table 3.2
Summary Of Funds Requirement And Proposed Allocation
For Priority Activities In Priority Sectors
(TSh millions, FY 2002/03)

	Funding Requirement	**Proposed Allocation**	**Proposed Allocation as Percent of Requirements**
Education	403,979	396,067	98%
o/w Basic Education	*203,560*	*202,515*	*99%*
Health	192,226	171,848	89%
o/w Primary Health	*160,232*	*154,263*	*96%*
Water	100,228	93,978	94%
Law and Order	182,715	106,948	59%
Agriculture	85,512	71,548	84%
Roads	286,806	250,744	87%
o/w Rural Roads	*185,018*	*161,754*	*87%*
Other Sectors	246,340	201,383	82%
TOTAL	1,497,806	1,292,516	86%

Source: MOF. 2002. Cross-Sectoral MTEF 2002 (Table 5).

Local resource requirements based on revealed policy preferences. Although estimates of absolute expenditure requirements are helpful in determining local resource

requirements, their use is limited, as they fail to take into account the availability of resources for the public sector. Instead, a more practical approach considers that the policy decisions that are made as part of the central government budget process implicitly reveal how policy makers consider the priorities and needs of central government ministries, as well as local government authorities. Under this assumption, historical expenditure levels provide a useful guide in determining the relative resource requirements of the central government versus the local government level for the various expenditure responsibilities.

- *Expenditure requirements for priority sectors.* As discussed earlier in this section, sectoral block grants should provide the mainstay of funding for the delivery of local public services in the priority sectors in order to assure an "adequate" level of service delivery. In fact, no local contributions should be expected from own sources in order for local governments to achieve the desired "minimum service level". If the local government financing framework would allow central government ministries to claim any part of a local governments own resources for sectoral purposes, this would quickly result in different sectoral ministries, laying competing claims over a local governments resource base, without any safeguards to the local authorities that anything will be left for their own purposes. Although at times, attempts are made by sector ministries to lay claim to local resources, in fact the Local Government Finance Act is clear that local services delivered within the priority sectors should be fully funded through the recurrent transfer system.[19] As such, the level of funding provided to the priority sectors in the national budget (as detailed in Section 2.2) gives an indication of the relative expenditure requirements for the local priority sectors (including primary education, health, agriculture and livestock, water, and roads). Survey evidence suggests that over two out of every three residents are satisfied with the quality of primary education services provided by their local authorities, whereas satisfaction with the other priority sectors is substantially less (Fjeldstad, 2004: Table 15). The government's success in improving the quality of services for primary education is, no doubt, in large part due to the additional resources made available under the Primary Education Development program (PEDP). This success notwithstanding, the relatively low levels of satisfaction with other priority sectors may signal that future marginal resources should be shifted more towards the other priority sectors.[20]

[19] For instance, some stakeholders in the roads sector recently suggested that district and village governments should contribute to the maintenance of local roads from their own resources. Others have proposed that perhaps intergovernmental transfers should be limited only to the PE portion of local government spending, and local governments should bear the cost of Other Charges. Another common opinion is that wealthier, local governments (for instance, the municipalities in Dar es Salaam) should receive fewer transfers for the priority sectors because they can contribute more from own resources. None of the suggestions would be consistent with the view that own resources should be used for general purpose local government activities outside the priority sectors.

[20] In addition, public expenditure tracking surveys have suggested that some of the resources earmarked for primary education and local health services are in fact being diverted for other purposes. To the extent that these resources are being used for legitimate local government expenditures, this would indicate that local governments believe that other priority sectors are being underfunded.

- *Expenditure requirements of local government activities outside the priority sectors.* Local governments have numerous expenditure responsibilities that fall outside the central government's priority sectors, which have to be funded from general purpose resources. These activities include the cost of local government administration; the cost of delivering "truly local" government services (such as refuse collection, community development activities, and so on); as well as the (co-)funding of local capital development projects. In the emerging framework for local government finance, local general purpose activities would be funded from two sources: unconditional grants, as well as own revenue sources. If we were to combine the general purpose resources currently available to the local government level, they would add up to approximately TSh 85 billion for FY 2004/05 (namely about TSh 45 billion in administration and general purpose grants combined, and approximately TSh 40 billion in own source revenues).

  However, the degree of public satisfaction with truly local services (such as garbage collection or local markets) is among the lowest for all local delivered services, suggesting that the services are proportionally under-funded by the current system. Data from sample local governments indicate that local governments currently use approximately 60% of own resources for local administration alone (including staff salaries, sitting allowances for councilors, as well as other overhead costs), therefore leaving extremely few resources for the delivery of local services or for the funding of local capital development. Based on local collections for 2002, this would indicate that local governments spend approximately TSh 30 billion of their own resources on administrative costs.

  Since in the absence of adequate untied grants local governments are forced to use most own local resources for local administration. The poor "value-for-money" received by local residents for their local taxes has contributed to extremely high rates of local tax evasion. This problem could be mitigated in the future by providing additional general purpose resources through the transfer mechanism, which would allow local authorities to use a higher proportion of own source revenues directly for services and infrastructure projects that benefit the local community.

- *Expenditure requirements for local capital development.* As noted in Section 1 of this report, local governments in Tanzania receive only extremely limited direct resources from the Development Budget for the purpose of local capital development. Similarly, local governments have been unable to rely on borrowing for the purpose of funding local capital development. As such, the historical spending levels for local capital development would provide limited guidance on the relative expenditure needs for local capital development spending.

- *Village-level expenditure responsibilities*. Likewise, very little is known about historical spending patterns at the village level. In fact, before we can truly engage in an informed discussion regarding the expenditure requirements for village level activities, we would have to clarify the expenditure responsibilities that are in fact assigned to the village level. However, based on the apparent practical division of

responsibilities between the districts and the lower-level local governments, and based on previous resource sharing arrangements between the two local government levels, one could infer that the aggregate expenditure requirements of the village level broadly fall in the range between 20-50 percent of all general-purpose local spending.

3.4 Recommendations

Assuring that the assignment of expenditure responsibilities to LGAs in Tanzania follows sound principles and international best practices is a critical first step in a sound system of local government finance. A sound expenditure assignment is also needed to prevent a variety of cross-cutting problems in the system of intergovernmental fiscal relations. As part of the "next steps" in transforming the system of local government finance in Tanzania, a number of expenditure assignment issues should be addressed:[21]

Overall policy stance and policy effectiveness.

Generally, Tanzania's policy stance of "decentralization by devolution" is the appropriate basis for expenditure assignments. Although there is an increasingly broad acceptance of devolved delivery of service through LGAs, not all sectoral policy programs are consistent with this government policy stance. On a sector-by-sector basis, PO-RALG, MOF, and the relevant sector ministries should review the *de facto* expenditure assignments (especially within the priority sectors) to make sure that the expenditure assignments are consistent with the policy paper on local government reform and the subsidiarity principle (see Section 3.1.3). Part of this review should consider whether the provision of secondary education should in fact be devolved to the local government level. On a sector-by-sector basis, recommendations should be made on how to move forward by transforming improper expenditure assignments in accordance with the principle of "decentralization by devolution."

Constitutional and legal framework.

The legislative framework needs to be reviewed and revised as needed to assure that the legislative framework for local government (finance) recognize the multi-dimensional nature of expenditure assignments, since "decentralization by devolution" means different things for different locally-provided services. For every expenditure function assigned (in part) to the local government level, the legislative framework should indicate which level of government is responsible for policy and regulation; finance; provision;

[21] These "next steps" are organized in accordance with the categories used in Table 1.4.

and production.[22] Whenever the central government is responsible for the financing of government services provided at the local government level, the Local Government Finance Act should also clarify which mechanism ought to be used to provide the local government level with the necessary resources.

Central government institutional and regulatory framework.

Next, the regulatory framework and central government's budgetary practices should make sure that "finance follows function". This means that:

a. To the extent that the provision of national (priority sector) functions is devolved to the local level, these sectoral activities should be funded through sectoral block grants, and not through earmarked parallel funding mechanisms in ministerial budgets. Unfunded mandates should not be created by establishing "minimum required services standards" which are unaffordable based on the total level of funding provided through the sectoral block grants.

b. The responsibility for local government administration should be assigned to the local government level, and should be fully funded from unconditional grants.

c. Functions that are fully devolved to the local government level should be funded from general local budgetary resources, which include locally generated revenues (own source revenues) plus unconditional grants provided by the central government. Since these functions are assigned fully to the local government level, such local services should not be subject to mandatory minimum service standards by the central government.

d. Functions that are delegated to the local level (i.e., that are explicitly not devolved to the local government level) should be funded through earmarked ministerial subventions.

In order to assure that the regulatory framework and central government's budgetary practices assure that "finance follows function", two concrete actions need to be taken.

First, PO-RALG, MOF, and the relevant sector ministries should produce a comprehensive mapping of finances that flow to the local government level. This mapping should identify every funding stream (including in-kind transfers) that flows to the local government level, as well as the purpose of each funding mechanism. Such an

[22] Alternatively, the legislation may classify which functions are delegated to the local government level; for which functions only provision is devolved; and which functions are fully devolved to the LGA level (as classified in Table 1.3).

inventory of local financing instruments is needed to verify that local government expenditure assignments are funded through the correct funding modality.

Second, it is essential that the regulatory framework and administrative arrangements at the central government level assure that LGAs have adequate administrative control over the functions assigned to the local government level. In practice, the largest obstacle to local administrative control over the delivery of local services is the excessive control by central government ministries over local staffing decisions. While legislative steps have been taken to revise the Public Service Act in line with a decentralized framework, proactive coordination is needed between PO-RALG, PO-PSM and Ministry of Finance to assure that in practice local governments are indeed able to make local staffing decisions within the context of the resources available to them (see Section 5).

Local government institutional and regulatory framework; participation by civil society and private sector

In order to realize the benefits from decentralization, a sound (transparent and accountable) local expenditure management is needed. Improvements are needed in the local budget processes and the monitoring and reporting of local government finances to assure greater transparency and accountability. The institutional and administrative dimensions of local government finance –including the need for participatory and accountable local government budget processes- are further addressed in Section 7 of this report.

Section 4
A review of revenue assignments and own local revenue source options

The concept that in a sound framework for local government finances "finance should follow function" (as developed in Section 3) provides a certain level a guidance regarding the extent to which local government activities should be funded from local taxes or other local government revenue sources (as opposed to, for instance, funding from intergovernmental grants).[1] In particular, Section 3 raised the concern that given the current assignment of expenditure responsibilities and revenue instruments, it would be inappropriate to require LGAs to fund the delivery of national priority programs and centrally mandated services (such as primary schooling or basic health care) from own source revenues. Another cross-cutting concern identified in Section 3 with an impact on local government revenues was the high share of local government administration that is self-funded by LGAs, which greatly reduces the value-for-money received by local residents from their local tax payments. Instead, own source revenues should be used to the maximum extent possible for public services (and infrastructure) that are purely local in nature, in response to the needs and demands from the local community.

Despite this basic guidance, the previous section is silent on the revenue instruments that should be assigned to the local government level in order to raise adequate revenues to fund the delivery of local government services and the development of local infrastructure. In accordance with the TORs (item v(b)), the current section provides a clear description of options, pros and cons, and recommendations, for Government to consider in regard to revenue-generating capacity of Local Government Authorities.

It is important to recognize that the scope of the current report is to assess the overall *structure* of local government finances (including local government revenues) and to recommend improvements to the overall local government finance system. Prior to determining the structure of the overall framework, it would be impossible to develop detailed proposals for the reform of specific local government taxes and revenue instruments. For instance, it would be premature at this stage to discuss the tax rates at which specific local taxes should be levied as part of a future local revenue structure;

[1] Public revenues can be formally divided into tax revenues as well as non-tax revenues, which include user fees and other revenue sources. Unless specifically noted, we use the term "taxes" loosely to broadly cover both tax and non-tax revenue instruments.

such details should only be determined after the overall local government revenue structure has been decided upon. Although it would be impossible to assess the overall framework for local government finance without discussing local government revenue sources in some detail, the "nuts and bolts" of transforming specific local government revenue instruments as part of a sound local revenue system should be determined in a follow-up to the current study. It would probably also be appropriate to note at this stage that from a taxpayer's point of view (or from a politician's view point) there is no such thing as a "good" tax. While we can and will suggest improvements to the local revenue instruments currently used in Tanzania, we will simply not be able to come up with local taxes that people would enthusiastically pay.

This section on revenue assignment and local revenue administration is divided into five subsections. First, Section 4.1 conceptually explores the characteristics of a sound revenue assignment, recognizing that public finance theory and international practices suggest that some taxes are best collected at the national level, whereas other revenue sources are good candidates to be administered at the subnational level. Subsequently, we turn our attention to revenue assignments in Tanzania; Section 4.2 provides an assessment of the current local government revenue system in Tanzania, considering both the issues of tax assignment and tax administration. Section 4.3 provides policy recommendations on reforming the current system of local taxation, whereas Section 4.4 considers the concept of national "fiscal space" and identifies several potential sound local revenue sources that are currently not being used at the local government level in Tanzania. Section 4.5 provides concluding remarks and discusses likely next steps. This section is further supplemented by a series of annexes.

4.1 Sound principles of revenue assignment

In order for local governments to exercise a degree of fiscal autonomy consistent with a fiscally decentralized government structure, local governments must control some own sources of revenue. In this regard, the key policy questions are: which taxes should local governments levy and how? This question is commonly referred to in the decentralization literature as the "revenue assignment question" (McLure, 2000).

4.1.1 Objectives of revenue decentralization/ local taxation

The assignment of taxes in a decentralized system of finance must decide three types of issues. First, what level of government will be granted legal powers to introduce new taxes or change their structure in terms of the definition of tax bases and the determination of tax rates? Second, how will the revenues from different taxes be shared, if at all, among the different levels of government? Third, what level of government will be responsible for the administration and enforcement of the different taxes? This section mostly focuses on empowering local governments with the discretion to introduce own source taxes and other revenue instruments, including setting their rates and bases. Of course, revenue assignments are not a stand-alone issue; it should be seen as an element

that must interact and be compatible with the rest of the design of a decentralized system of finance and more generally with the design of the entire fiscal system of a country.

Criteria that should guide the assignment of revenue sources across different government levels in a country reflect a dual role of taxes. First, taxes provide means to pursue government expenditures so that the generated revenues can be spent on provision of public goods and services. Second, taxes can also be used as a policy instrument to achieve the more direct realization of certain government policy objectives, so that the imposition of taxes themselves leads to actions and outcomes desired by the government. For instance, a tax may be used as a tool for income redistribution by introducing a progressive tax.

Before we move on to a more detailed discussion of revenue assignment criteria, let us broadly outline the scope of government functions, for which taxes can either be the means or the end, as noted above. Musgrave (1959) argues that the economic objectives of the public sector can be defined as, first, assuring a stable economic environment in which the market is able to function, second, achieving a more equitable distribution of income, and third, assuring a more efficient allocation of resources in case the market fails. While, generally, the knowledge of circumstances of time and place make decentralized market forces superior to a centralized allocation of economic resources, there are a number of areas where the market fails (Hayek 1945). Market failure can be due to a number of factors, including the existence of (natural) monopolies and other non-competitive market structures (local public utilities); impossibility to exclude from consumption of the good those who do not pay for it (e.g., street lighting); and the presence of spillover effects or externalities (e.g., vaccination).

According to the economic principles, policy decisions on economic stabilization and income distribution are best assigned to the central government, while some of those related to allocative efficiency (how to best use the resources available to provide goods and services) may be assigned to local governments (as guided by the subsidiarity principle). Otherwise, when decisions on economic stabilization and income distribution are left to the local governments, wrong incentives and conflicts may arise, and policies may be ineffective and unsustainable.

Because taxation does not only provide the means for government activity but also has an impact on the areas of government concern outlined above, Musgrave's (1959) "three-roles" classification of government activities can also be used to guide the assignment of revenue sources across different government levels. After all, different tax instruments have varying impacts as to the three functions of the public sector: macroeconomic stabilization, redistribution of income, and resource allocation.

This conceptual framework can be used to identify characteristics of a good revenue source by identifying specific attributes of a tax instrument that makes it a desirable element of any national tax system. Then we identify additional requirements for a tax instrument that makes it appropriate for being assigned to the local level of government within the national system of public revenues.

4.1.2 Characteristics of a good revenue source

Characteristics of a good revenue source are very intuitive and have been known for many centuries. In 1776, Adam Smith, a classic economist, formulated some of these principles in his seminal *The Wealth of Nations*:

> *"The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."*

This single sentence carries the seeds of what is today known as the "ability to pay" principle and the "benefit principle." The first principle, states that taxpayers with a greater ability to pay should pay more. The second guiding principle of taxation states that those who benefit more from government services should pay more. Today these two fundamental principles of taxation are perceived by some as mutually exclusive. However, when Adam Smith wrote these canons, long before the era of the welfare state, the range of services provided by government might indeed have benefited the wealthier more. Indeed, in the same paragraph Smith went on:

> *"The expence of government to the individuals of a great nation is like the expence of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate."*

Thus, by saying that citizens should be taxed "in proportion to the revenue which they respectively enjoy under the protection of the state," Adam Smith probably meant that to be in proportion to benefits from government services.

> *"The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person… Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it… Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."*

In other words, a good revenue source should minimize the costs of compliance by taxpayers as the latter represent a pure waste to the society being a loss of time and efforts for the taxpayer without any associated gains for the state budget.

In addition to the Smith canons, the modern public finance literature generally recognizes the following principles as commonly acknowledged characteristics of a good revenue source:

- ***Adequate revenue yield***: The revenue yielded by local taxes should be adequate. Among others, revenue adequacy should be considered relative to the funding needs of the local government level and relative to the size of the economic base of the local community.
- ***Revenue buoyancy***: Overall, revenues should change roughly in proportion to the economic base. This does not mean that government revenue should follow short-term economic fluctuations. Rather, as the long-term economic development makes taxpayers demand a wider range and a better quality of services from the government, this trend should be matched by increasing yield of the tax system applied to the growing economy.
- ***Equity***: Good revenue sources are "fair" or equitable. Economists consider two dimensions to fairness in a fiscal system:
    - The notion of horizontal equity suggests that taxpayers in similar circumstances should be treated similarly by the tax system. The tax should be fair not only in terms of definition but also application. Thus, for instance, tax assessments should be uniform and comprehensive. A perception of the tax as being "fair" is believed to contribute to the probability of voluntary compliance.
    - In addition to horizontal equity, the tax system should also display vertical equity, or fairness between taxpayers at different rungs on the income ladder. The determination of what is "fair" is subjective, but at a minimum, most people believe that wealthier tax payers should pay more in taxes. As noted earlier, this principle is known as the "ability to pay" principle. The other notion of vertical equity often considered (particularly at the local level) is the benefits principles. As discussed above, the benefits principle suggests that taxpayers should pay taxes in (approximate) proportion to the benefits received from public services.
- ***Efficiency***: An efficient revenue source minimizes administration and compliance cost, and in particular generates an amount of revenues well above these costs. Good taxes should not give taxpayers incentives to change their behaviors and discourage productive activities in the economy. Good taxes should be difficult to avoid and evade.
- ***Politically acceptable***: A good revenue source is politically acceptable and sensitive to the historical and institutional framework in a country.

4.1.3 Principles of a good revenue assignment to the local level

Besides satisfying the outlined above criteria of being sound revenue instrument, a revenue source needs to meet some additional conditions to be a good local revenue source. First of all, some taxes while satisfying the criteria of sound revenue instruments when applied at the national scale, may be not so when levied by individual local governments. For example, payroll taxes collected "at source" (at the firm's location) might satisfy the benefit principle when levied at the national scale, in the sense that such a tax is borne by workers who benefit from the central government's healthcare and unemployment programs that would be funded with such revenue. However, the benefit

principle would be violated if commuting workers had to pay such a tax in the locality where they work while consuming local government services in the locality where they reside.

Second, recall the dual role of taxes as both the sources of revenue and tools of government policy. To the extent that local governments are responsible for policies different from that of the central government they might need different tools. Thus, Musgrave's (1956) "three-role" classification of government activities is not only useful in considering the assignment of expenditure responsibilities, but can also be used to guide the assignment of revenue sources across different government levels. It has been argued by many experts (e.g., Oates, 1972; McLure, 2000) that macroeconomic stabilization and income redistribution should for the most part be a central-level responsibility. Hence, tax instruments that can significantly affect macroeconomic stabilization and income redistribution should be assigned to the central government.

For instance, most economists would argue that progressive income taxes should generally be assigned to the central government level, owing to its redistributive nature as well as to the economic stabilization that results from applying higher rates on growing income. However, the same reasoning does not apply to flat-rate surcharges on the national income tax. By the same token, in order to pool the cyclical fluctuations in revenues, revenue sources that are highly sensitive to general economic conditions should be assigned to the central government. If local government revenues (and therefore expenditures) follow closely the fluctuations of local economy, this pro-cyclical local government spending would exacerbate economic fluctuations by cutting public works in the time of recessions. Thus, subnational governments should turn to more stable tax bases such as property taxes and consumption taxes. In addition to helping survive economic downturns, stable sources of revenue are also important for budgetary and financial planning.

As subnational governments are mostly prescribed to engage in activities ensuring a more efficient allocation of public resources, they should be assigned revenue sources for which it is easier to establish a link with the benefits received by residents from local government spending (Bird 1999). The most obvious example of a revenue source satisfying this "benefit principle" is charging for specific services provided by local governments (the cost of issuing driver's licenses, and so on) and for goods and services provided by public enterprises (utility charges, museum admission, and so on). Besides generating revenue for local governments, user charges also have a great economic value of providing demand information to public sector supplier. This ensures that publicly provided goods are valued by citizens at least what it costs to produce them. Whenever it is possible to do so in an efficient manner, local governments should rely on user fees to raise revenues for the delivery of a local service.

Unlike user fees paid based on a free consumer choice, benefit taxes are compulsory contributions to local governments that are nonetheless related in some manner to benefits received by the taxpayer. As such, for benefit taxes there is either a specific or general link between the amount of taxation and the benefits from a specific government

service. For example, the size or value of a residential property relates quite closely to an individual taxpayer's benefits received from street improvements on which the property is located. By contrast, general benefit taxes can be exemplified by charges levied on motor vehicles and motor fuels, whose revenues can be used for the construction and maintenance of roads and highways and thus benefiting road users as a class. Likewise, property taxes are often considered a good benefit tax to finance local collective public goods.

Unlike user charges, benefit taxes do not give a choice to local residents and thus do not provide local governments with information whether local government services are demanded by the citizens and valued at least at what it costs to produce them. Nevertheless, relating taxes to the benefits of public spending has the major advantage of helping increase the accountability of subnational governments to their own constituencies. In jurisdictions where the level of taxation exceeds the value of the benefits of public spending, high-income individuals and investors could threaten to leave or never to come or invest there.

Besides neutrality with respect to income distribution and economic fluctuations and adherence to the benefits principle, public finance theory and practical policy wisdom provide other desirable characteristics for local government taxes. Some of these characteristics are just corollaries of the principle stated above.

- ***Correspondence***: A sound local tax should establish a link between the jurisdiction in which a tax is levied and the area in which the benefits are received from the local services funded with that revenue source. Thus, the tax base should be readily identifiable with the local authority area. Adherence to the correspondence principle gives local governments the right incentives to fund an optimal amount of locally provided goods (where marginal costs equal marginal benefits).

- ***Geographic neutrality.*** Taxes assigned to local governments should not interfere with internal commerce nor distort the location of economic activity. Thus local governments should not levy production-related sales taxes or source-related income taxes, except where justified by benefits provided to businesses and commuters.

- ***Visibility***. Local taxation should be clearly perceived by local residents. That is, local taxpayers should be aware they are paying the tax, of its amount, and whom its payable and for what purpose. This enables local residents to evaluate the efficiency of local government services as to how much value they get for the money they pay.

- ***Fiscal autonomy***: Subnational governments that lack some control over (at least the rate of) one or more significant sources of revenue can never truly enjoy fiscal autonomy. They cannot be responsive to the demands of their constituency as they cannot expand services when there is higher demand and cutback otherwise.

Neither do local governments have flexibility for fiscal adjustment in response to rising costs.

- ***Local tax administration***: Certain revenues are inherently better administered at the local level (e.g. property taxes), while local governments have a relative disadvantage in collecting others taxes (e.g., corporate profits tax). Local governments should be assigned taxes for which there are information and enforcement advantages at the local level. For example, it is commonly argued that in the case of property taxes a more decentralized tax administration may have superior knowledge of local circumstances and ability to tailor procedures to local conditions and therefore be more effective in tax enforcement. The capacity to administer taxes is an important factor in the assignment of taxing powers to lower levels of government and should explicitly to be taken into consideration.

- ***Vertical fiscal balance***: Vertical fiscal balance exists when there is a broad correspondence between the expenditure responsibilities assigned to each level of government and the fiscal resources available to each government level to carry out those responsibilities.

- ***Horizontal fiscal balance***: Horizontal fiscal balance refers to the existence of balance in fiscal needs and resources between different government units at the same level of government. Although horizontal fiscal balance can be achieved through intergovernmental transfers (equalization grants), the revenue assignment should be made cognizant of the resulting fiscal disparities. Thus, good local revenue sources have a tax base that is relatively evenly distributed across jurisdictions.

Sometimes it is argued that local revenue sources should have an immobile base, so that local taxpayers are not able to move to avoid the local tax. However, in reality this is only a requirement if the local tax system fails to satisfy some of the principles for a sound local revenue assignment. For instance, if the benefit principle is preserved in assigning local taxes, the potential mobility of taxpayers would not necessarily bring about economic distortions, since taxpayers would be receiving local benefits in accordance with local taxes paid. Meanwhile, the potential mobility of taxpayers and tax bases can actually increase efficiency in the delivery of subnational government services by forcing local officials to provide a balanced basket of subnational services and subnational taxes.

However, if non-benefit taxes are applied to mobile bases, inefficiencies can arise from tax avoidance costs, as taxpayers could try to reduce their subnational tax liability by moving between subnational jurisdictions without affecting the benefits received from publicly provided goods and services. Equally distorting, and therefore to be avoided, are local taxes that can be "exported" to taxpayers in other jurisdictions. Such local "tax exporting" is a practice that violates the correspondence principle.[2] It is not only unfair

[2] "Tax exporting" is a situation in which the burden of taxes imposed by one subnational government is

but also encourages over-expansion of public services. Although clearly tempting and attractive to individual local governments, the assignment to local governments of taxes that can be exported lead to inefficient and irresponsible behavior of local governments at a national scale.[3]

In summary, the characteristics required from a good local revenue source follow logically from the goal of decentralization and the role that local governments are expected to play. To the extent that economic rationale for decentralization is to improve efficiency, the benefit principle is pursued to link the costs of public services to the benefits delivered to local residents. Similarly, horizontal or political accountability of subnational officials requires the ability of subnational governments to affect at the margin the level of their revenues by choosing tax rates for some of the most important taxes assigned to them.[4] Limited subnational taxing authority and dependence on the revenue decisions of the upper-level government (including decisions concerning revenue sharing and most other forms of transfers) undermines the accountability of subnational governments to their constituency. Inadequate revenue autonomy offers an easy "scapegoat" for poor local performance ("we do not get enough resources from the central government") and by generally weakening local taxpayer awareness of taxes and interest on the quality and level of local services delivered.

A number of recent studies (e.g., Ter-Minassian 1997; Ebel and Yilmaz 2002) suggest that outcomes of decentralized spending depend on the form of financing used for these expenditures, with a crucial aspect being the extent of control that local governments can exercise over the sources of their revenue. Revenue autonomy is important for subnational governments for higher accountability of public officials and efficiency of expenditures, or for the ability to mobilize revenues and expand or contract the budgets at the margin; in addition, a healthful degree of revenue autonomy at all levels of government is the only certain way to address vertical fiscal imbalance.

4.1.4 Applications of correspondence and the benefit principle to local revenue structure

A consistent theme throughout our discussion of revenue assignments to the local level is that the appropriate type of funding mechanism for any publicly provided good is determined by the reason why the public sector is providing the good in the first place. In principle, the best public funding mechanism will provide the closest possible

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borne by the residents of other jurisdictions who do not benefit from services provided by the government levying the tax.

[3] Examples of taxes that are likely to be exported in large part include local taxes on production, when the products are consumed or utilized outside the local jurisdiction levying the tax. This is particularly the case for excises levied on the production of alcohol or production taxes on local mineral resources. In these instances, although the revenue is collected in the jurisdiction in which the production occurs, the tax burden is typically passed on (mostly) to the consumer through higher prices. As a result, most of the local tax burden is "exported" outside the locality, and paid by consumers outside the local jurisdiction.

[4] Other forms of local tax autonomy, including the ability to change tax bases or the ability to introduce or eliminate some taxes, are generally less desirable since they can easily lead to increases in compliance and administration costs.

correspondence between the level of benefit received by the local user and the cost of providing the good or service. Thus, if an individual resident receives all the benefits from a good or service provided to him or her by a local government (for instance, electricity consumption or access to a local public swimming pool) the beneficiary could simply be charged a user fee (or quasi-user fee) based on the cost of service provision. We earlier identified this principle –that taxpayers who benefit from a publicly provided service should pay taxes roughly in proportion to the benefits received- as the "benefits principle."

Table 4.1
Appropriate funding mechanisms for local government expenditures

	Local government expenditure (local service delivery and/or local infrastructure)	**Examples**	**Appropriate funding source**
1	Local government services that are excludable and that do not have any spillovers or equity implications	Excludable club goods such as public swimming pools; local utilities	User fees or quasi-user fees
2	Local government services that are not locally excludable or those that have local spillovers ("truly local" services)	Local parks, minor local roads; refuse collection in urban areas	Local taxes
3	Local government services that have spillovers between local jurisdictions	District roads; mosquito control	Local taxes combined with intergovernmental (matching) grants
4	Local spending on national priority programs (i.e., national priorities where the provision is delegated or devolved to local governments)	Public education, public health care	Sectoral/conditional intergovernmental grants (supplemented by local revenues as demanded by local priorities)
5	Local spending on programs that have important equity implications, or national spillover benefits	Social welfare programs, public education, pure public goods	Sectoral/conditional intergovernmental grants, equalizing general-purpose grants
6	Local spending on local capital development	Capital development programs	Borrowing (if possible); intergovernmental grants

However, there are four cases in which the link between the cost of service provision and the benefits received by a resident are weakened or non-existent, notably: spillovers (externalities), non-excludable goods (public goods), redistributive programs, and capital development projects. For the purpose of this study, it suffices to say that in each of these cases, the weaker the correspondence between benefits received by individual residents and the cost of service delivery, the smaller the opportunity to rely on the "benefits principle" to pay for the cost of service delivery. As Table 4.1 shows, the most

appropriate funding source depends on the exact nature of the local government expenditure.

4.1.4 Poverty reduction and revenue assignment: the incidence of local taxes

An important policy issue related to local taxation is its impact on inequality and poverty reduction. In some African countries local taxation is found to be regressive in the sense that these taxes require lower-income taxpayers to pay a greater percentage of their income in tax than upper-income taxpayers (see Bahiigwa et al, 2004, on Uganda). Although a recent study in Tanzania found that wealthier taxpayers pay a substantial larger amount in local revenues, it is unclear from the preliminary results whether local revenues in Tanzania are actually progressive, proportional or regressive. However, we argue that the impact of taxes on poverty should not be viewed in isolation from the entire tax system of the country, the impact of services provided with these funds, and other benefits of local taxation. In fact, fifty years of economics literature (from Musgrave, Buchanan and Oates, to McLure, and Bird) suggests that local governments have a very limited role indeed in income redistribution, as this is a functional responsibility that should be generally assigned to the national level. As a result, we should not expect local taxes to be collected on a progressive basis in order to pursue the objective of income redistribution.

Instead, as was argued above, the benefit principle should be the main guidance in assigning revenue sources to the local level of government. Thus, if local taxes meet this criterion, then the amount of money paid in local taxes by a local resident should be proportional to the benefits received by this taxpayer from local government services. In this case, the relationship between the amount of taxes paid and the income (or wealth) of this taxpayer would depend on the distribution of benefits from local government services across different income groups. For instance, police and fire protection is likely to provide greater benefit to owners of larger properties and, if financed with a benefit tax, would require wealthier households to pay more. Thus, the primary determinant of the incidence (i.e., the progressivity or regressivity) of benefit taxation at the local level is the benefit incidence of the services provided by local governments.[5]

Although it falls beyond the scope of the current study, it is useful to consider the incidence of public services delivered at the local government level. Based on a recent study conducted by Sahn and Younger (1999), Figure 4.1 shows the concentration curves for benefits from public education and health services in Tanzania; these curves show who benefits more from selected local public services (poor or wealthy households). In general, the further the curve falls below the 45-degree line, the more benefits are concentrated among the high-income individuals in absolute terms. According to the figure, for most services wealthier households benefit more in per capita terms than the poor. The only exceptions are primary education, which is wealth-neutral and post-

[5] See Martinez-Vazquez (2001) for a detailed discussion of the concept and measurement of (net) fiscal incidence.

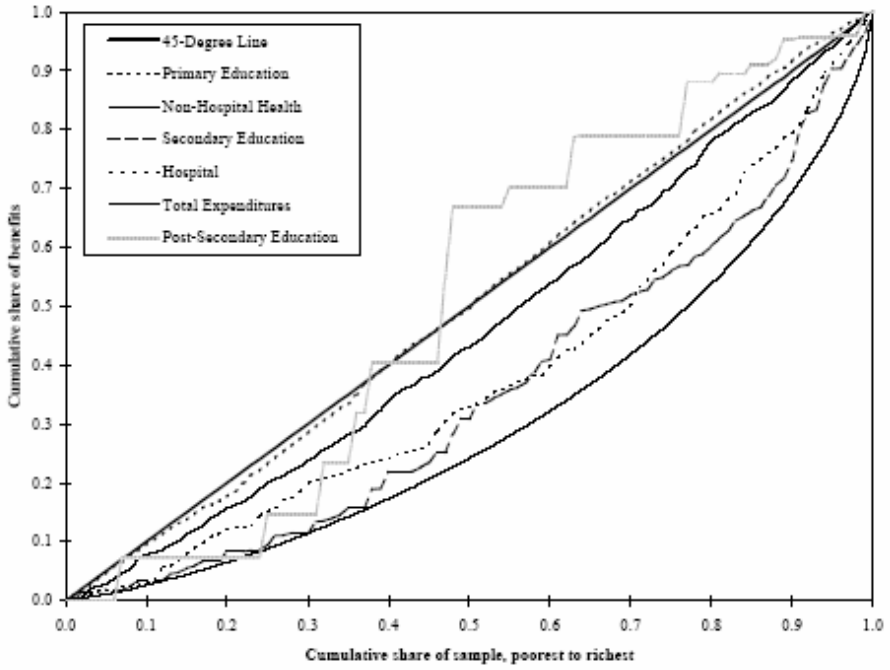
secondary education, which benefits more upper-middle class than the poor and the rich. The most pro-rich services are secondary education and hospital services. At the same time, all the concentration curves lie above the total expenditures curve, meaning that social services are more pro-poor than other government services not represented in the figure.

Table 4.2
State and Local Taxes Plus Federal Income Tax for Washington State as a Percentage of Household Income

	$25,000 HH Income	**$50,000 HH Income**	**$75,000 HH Income**	**$100,000 HH Income**	**$150,000 HH Income**
State and Local Taxes	8.5%	6.3%	6.3%	6.0%	5.8%
State, Local and Federal	12.3%	15.5%	17.8%	20.5%	23.3%

Source: Prepared for the Washington State Tax Structure Study Committee by the Department of Revenue (September 13, 2002)

Figure 4.1
Concentration curves for health and education in Tanzania



Source: Sahn and Younger (1999).

Even if the rich benefited more from local government services and paid more in local taxes than the poor, the amount of local taxes paid by the rich could still account for a smaller fraction of their total income than that of the poor. This is because the rich might spend more income on other categories of expenditures. Thus local taxation would not reduce income disparities. Nevertheless, this should not be seen as a flaw of local taxation because, as was argued above, income redistribution should be left to the central government. Even if local taxation might be regressive, the ultimate income distribution is determined by the entire system of taxes both local and central. For example, Table 4.2 shows that state and local taxes in the State of Washington are regressive. However, when federal income taxes are added, the total tax burden in Washington is progressive.

In summary, even when adhering to the best principles, local taxation cannot guarantee reduction in income inequalities. In part, this might be due to the fact that some local government services are enjoyed more by low income households, who cannot afford privately provided services. It is known that other necessities such food and water consume a larger portion of poor households' income than that of higher income households.

It is important to recognize that despite the possible regressivity, local taxes bring many benefits such as enhancing the accountability of subnational governments to their constituency, and by generally strengthening local taxpayer awareness of taxes and interest on the quality and level of local services delivered.

Furthermore, despite their apparent regressivity, local taxes are important especially when some local government services would not be available in a particular community without these funds. For instance, although user fees are generally regressive, residents regardless of income would be better off in a community with safe public water sources funded by user fees when compared to a community where no safe drinking water is available, and all households would have to rely on more expensive private provision of potable water.

Nonetheless, the regressivity of local taxes can be mitigated by provisions for relief of hardship and other measures to protect those on the lowest incomes. This might include graduated user fees schedules (by which low-income households pay lower fees than higher-income households), tax deferrals programs, tax rebate schemes aimed at low income groups, or local tax relief for the elderly or pensioners (such as property tax exemptions for certain classes of tax payers).

4.2 Assessment of the current local government revenue system in Tanzania

The previous section (Section 4.1) provides an overview of what features combine to form a good tax instrument and what characteristics are desirable for a good system of local taxation. These factors include an adequate revenue yield (and buoyancy); horizontal equity; adherence to the benefits principle and correspondence; adherence to

the ability-to-pay principle; easy administration and compliance; economic efficiency (the revenue source should not distort economic activity); and political acceptability.

Building on this knowledge, the current section pursues the review and assessment of local government taxes in Tanzania. This assessment and analysis leads to our recommendations in Section 4.3 on transforming Tanzania's current poorly structured and incoherent system of local taxation into a coherent, efficient and standardized local government finance system.

For the purposes of the current discussion, it is fair to say that there are three basic things wrong with the current revenue assignment and local taxation in Tanzania. First, there are a number of significant shortcomings of the overall local government revenue system (Subsection 4.2.1). Second, there are problems with the manner in which local taxes are administered in Tanzania (Subsection 4.2.2). Third, there are a host of problems specific to virtually each of the revenue sources assigned to the local government level (Subsection 4.2.3)

4.2.1 General shortcomings of the local government revenues system

Brief synopsis of the current local government revenue system in Tanzania. Until 2003, Tanzania followed a "permissive" approach to local government taxation, meaning that local governments were essentially allowed to come up with their own local tax structure. As noted elsewhere in this report (among others, in Section 1), this open approach to local revenues was a major contributing factor to a highly fragmented local tax system. It was felt by many that the fragmented local tax structure imposed an excessively high burden on local taxpayers (through high cumulative rates and high administrative costs) and caused an environment not conducive to economic growth. In addition to the collection and taxpayer compliance problems caused by the lack of a uniform local revenue system, the absence of a uniform local revenue system also has hindered the systematic collection of data on local government revenues.

The system of local taxation in Tanzania was significantly reformed in 2003 (and further modified in 2004) by proclamation of the Minister of Finance during the Budget Speech. The reform effort known as the "rationalization and harmonization" of local revenue sources eliminated the Development Levy,[6] abolished eight fees (for bicycles, culture, health facility registration, health inspection, business premises inspection, water connection, land, hides and skin),[7] eliminated two types of licenses fees (for *application* of licenses on Intoxicating Liquor and Local Liquor), and abolished the local brew cess and the livestock cess. Subsequently, in 2004, local business license fees were virtually

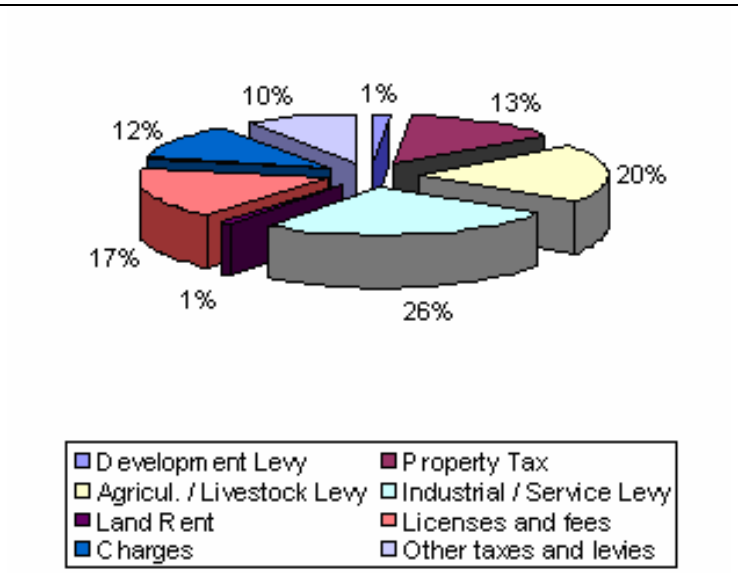
[6] From 2001 this was levied at TSH 3,000 per head. Before 2001, the Development Levy had some graduation in it. Everyone was subject to a minimum of TSH 3,000, but employees had to pay a levy between TSh 3,000 and TSh 8,000 according to their skills and employers were subject to a surcharge of 30 percent of their license fees.

[7] The market fee of TSh 100 charged to peasants bringing their agricultural products to the market was also abolished.

eliminated (see LGFR 2004; Chapter 3).

Figure 4.2 shows the relative breakdown of local revenue collections for 2004; greater details on local government revenues may be found in Section 2 of this report (e.g., see Table 2.3-2.5).The only *de facto* income tax at the local level –the Development Levy- was abolished in July 2003, although a few LGAs still report collecting trivial amounts of it in 2004 (accounting for less than 1% of local revenues). Property taxes and land rent – typically a mainstay of local tax systems in other countries- account for only about 15% of local collections.[8] In contrast, turnover taxes (on agricultural products and the turnover of larger businesses) account for over 45 percent of local revenues. Turnover taxes are taxes on goods and services (i.e., consumption taxes), which generally have undesirable efficiency effects through the cascading or pyramiding of tax burdens. Non-tax revenues are reflected to account for 30 percent of local collections, although this amount should be expected to be overstated, since business licenses were drastically reduced in July 2004, which basically also eliminated them as a revenue source for local governments. The remaining 10 percent is accounted for by other taxes and levies.

Figure 4.2
Consolidated Local Government Revenue Collections by Source, 2004
(Annualized collections, as percent of total)



The Local Government Finances Act -as reformed in 2003 and 2004- provides LGAs with a list of taxes, levies and fees that local governments are allowed to collect (Table

[8] As reported in Table A.4.1.3 in Annex 4.1, on average property taxes represent 3.6 percent of all tax revenues for a large sample of countries in 2000.

4.3).[9] In contrast to the permissive approach to local taxation that prevailed before 2003, this current list is a so-called "closed list": local governments are not allowed to levy any taxes, levies or fees, which are not on this list. Thus local governments are now required to set their own revenue policy within the limits set by the central government. In principle, local revenue sources in Tanzania are administered by the local governments and they are fully retained by them. The rates applicable to these local levies and fees can in many cases be determined by the local governments although in practically all cases there is a maximum rate determined by the central government. It is unclear to what degree local governments strictly adhere to the new "closed list" and the maximum rates. In practice, it appears that local governments tend to focus their revenue efforts on one or a few local tax instruments to maximize yield relative to collection effort. As a result, LGAs do not pursue all the taxes assigned to the local government level with equal effort. The tax rates applied to many smaller local revenue sources (or revenue sources that are considered a "nuisance" locally) tend to be lower than the maximum.

Table 4.3
Closed List of Revenue Sources for Local Government (2005)

Taxes on property • Property rates *Turnover Taxes* • Service levy *Taxes on Goods and Services* • Crop cess (maximum 5% of farm gate price) • Forest produce cess *Taxes on Specific Services* • Guest house levy *Motor Vehicles, Other Equipment and Ferry Licenses* • Vehicle license fees • Fishing vessel license fees	*Business and Professional Licenses* • Commercial fishing license fee • Intoxicating liquor license fee[10] • Private health facility license fee • Taxi license fee • Plying (transportation) permit fees • Other business licenses fees *Other Taxes on the Use of Goods, Permission to Use Goods* • Forest produce license fees • Building materials extraction license fee • Hunting licenses fees • Muzzle loading guns license fees • Scaffolding/Hoarding permit fees

Whenever possible, the most straightforward way to raise revenue in accordance with the benefit principle is by charging user fees to cover the cost of providing specific local

[9] To a large degree, the nomenclature and division of local revenue sources in tax revenues and non-tax revenues (and between various categories) is rather arbitrary. A tax is an involuntary payment to the government (by households and business firms) that does not involve a *quid pro quo* (Latin: "this for that") benefit.

[10] Note that in 2003 the fee for the "application for the license" was abolished, but not the fee for holding the license itself.

government services, such as the cost of issuing driver's licenses or marriage license, as well as for goods and services provided by public enterprises (utility charges, museum admission, and so on). Besides generating revenue for local governments, user charges are able to function as a pricing mechanism, thereby ensuring that locally provided goods are only used by local residents as long as their benefits exceed the cost to the user. The continuation of Table 4.3 below presents the list of non-tax revenue sources that is contained in Schedule 1 of the Local Government Finance Act. Given that many of these non-tax revenue sources should be used to cover the cost of providing specific local services, it is important to distinguish these non-tax revenue sources from "regular" local tax revenues. In particular, revenues raised from user fees and other non-tax revenue sources are generally not available for general-purpose funding of local services.

Table 4.3 (continued)
Closed List of Revenue Sources for Local Government (2005)

Administrative Fees and Charges	*Administrative Fees and Charges (Cont'd)*
• Market stalls/slabs dues • Magulio fees • Auction mart fees • Meat inspection charges • Land survey service fee • Building permit fee • Permit fees for billboards, posters or hoarding • Tender fee • Abattoir slaughter service fee • Artificial insemination service fee • Livestock dipping service fee • Livestock market fee • Fish landing facilities fee • Fish auction fee • Health facility user charges • Clean water service fee • Refuse collection service fee • Cesspit emptying service fee • Clearing of blocked drains service fee	• Revenue from sale of building plans • Building valuation service fee • Central bus stand fees • Sale of seedlings • Insurance commission service fee • Revenue from renting of houses • Revenue from renting assets • Parking fees *Entrepreneurial and Property Income* • Dividends • Other Domestic Property Income • Interest • Land rent *Fines, Penalties and Forfeitures* • Stray animals penalty • Share of fines imposed by Magistrates Court • Other fines and penalties

It is important to recognize that unlike narrowly-defined user fees used for cost-recovery, licenses or fees can be used as a mechanism to collect general-purpose revenues (rather than as a fee to recover the cost of a specific service or as a regulatory tool *per se*), in which case the issuance of licenses or permits in fact predominantly functions as an administrative tool in the collection of local general-purpose (i.e., tax) revenues. For instance, in many countries the existence of local business licenses often exclusively (or

predominantly) serves the purpose of ensuring the payment of local business taxes. It is a generally accepted international practice that the issuance of local business licenses (or business permits) is an appropriate method of ensuring a tax handle on local businesses (see Kelly and Devas, 1999). This stands in stark contrast to current practices in Tanzania, where the Ministry of Finance is adamant that licenses should be used for regulatory purposes only, and not as revenue instruments.

Fundamental principles of a sound local government finance framework in Tanzania. The local revenue reforms of 2003-04 were basically inspired by the two sound objectives, notably (1) reducing the administration costs and compliance costs faced by local taxpayers and, (2) rationalizing the system of local government revenues by getting rid of "nuisance taxes." These latter type of taxes were roughly defined as local revenue sources with noticeable compliance costs, or local revenue sources which raised limited revenues compared to the cost of collecting them.

While the premise and direction of these reforms were generally sound, there are two general issues that have been now repeatedly raised regarding these reforms. First, most importantly, the reform did not provide autonomous revenue substitutes for the abolished taxes. Thus, although local governments were held harmless for the lost revenues through transfers, revenue autonomy and therefore government accountability at the local level was decreased. An important theme for the future local government financing strategy is how best to address this issue and restore local revenue autonomy to an adequate level. Second, although there was a clear need for the simplification and rationalization of the local tax system, the selection of some of the local taxes and fees for elimination was not always a fortunate one. In addition, the current local government revenue sources available to LGAs continue to provide them with a highly fragmented set of local revenue sources. As such, in many ways, the future local government financing framework should reshape the system of local government revenues to provide LGAs with a truly harmonized and rationalized set of local government revenue sources.

As noted during the inception phase of this study (and as reflected in Section 1 of the current report), there was a prevailing skepticism in policy circles in Tanzania with respect to the policy relevance of own local revenues as part of a viable system of local government finance. The prevailing mood in Tanzania, in this regard, mirrored trends in neighboring Kenya and Uganda. However, to some extent the elimination of local revenue sources were based on a number of common misconceptions held about local taxation in Tanzania, which were identified during the inception phase of the current study (Section 1.3). After clarifying these misconceptions, the study team set forth a number of fundamental principles of a sound local government finance framework, including two principles regarding the role of local government revenues (Section 1.4). During a stakeholders' workshop in January 2004, consensus was reached that these two principles should be an integral part of the foundation of the strategic framework for local government finance in Tanzania. Two of the four principles (notably Principles 2 and 3) directly related to the role of local government revenues:

Principle 2: The role of taxation in the public sector is more than maximizing revenue yield. If structured appropriately, local taxation empowers communities, enhances accountability, helps improve vertical imbalance problems, and overall, it improves the efficiency of the public sector.

Principle 3: Each government level requires control over at least one good revenue source. The deficiencies in local tax administration should not be addressed by eliminating local taxes without consideration of their revenue impact; rather, deficient local taxes should be transformed into sound revenue instruments. There is a need for a limited "closed list" of local taxes that captures the diverse circumstances of local government authorities in Tanzania. Revenue autonomy should be separated from the issue of tax administration; local taxes can be administered by the central tax administration as needed.

Although this policy stance lays the foundation for a sound future local government financing framework, there are a number of other challenges in the realm of the assignment of revenue sources to the local government level. These issues are identified in Table 1.4 in Section 1, which provides a "big picture" overview of the current local government financing system. The revenue assignment issues identified include:

- ***Legislative issues***: Although the Local Government Finance Act was reformed in 2003 and 2004 to introduce a "closed list" approach to local revenue, the Act appears to have been amended in such a way that it appears contradictory. The Act ought to be reviewed and revised in such a way that it is wholly consistent with the new "closed list" vision of the local revenue system.
- ***Central government regulatory and institutional issues***: No single central government institution is responsible for local government revenues. Whereas the Ministry of Finance has jurisdiction over tax policy, it has no specific expertise on local government taxation or local government revenue. The same is true for the Tanzania Revenue Authority. Furthermore, neither PO-RALG nor LGRP have specific expertise in formulating local tax policy or guiding local government revenue collections or local tax administration.
- ***Local regulatory and institutional issues***: Given the historical fragmentation of the local tax system, there is no standard framework for local government revenues or local tax administration. Local governments' capacity to collect local government revenues is generally very weak.
- ***Civil society and private sector issues***: One of the potential benefits of local revenue autonomy is that it allows communities to determine the mix of private and public (local) services that it desires. Control over the local resource envelope would allow communities that want greater public services to tax themselves more than other local governments. However, if there would be no corresponding benefit to higher local taxes, local revenue autonomy would actually create inefficiency rather than efficiency. The limited input of local civil society organizations in the local budget process (including the determination of local tax rates) is disconcerting, as local

involvement in the budget process, through community groups and local business organizations, is critical to assure efficient use of own source revenues.

General shortcomings of the current local government revenues system. Until recently, the "rationalization" of local government revenues was largely equated with the elimination of local taxes. Although the lost revenue was replaced with a general-purpose compensation grant, little attention was paid to the positive role that local taxation plays as part of a local government finance system. While a period of study and analysis by PO-RALG preceded the local revenue reforms (as collected in "*Guidelines for Rationalization and Harmonization of Local Government Sources of revenue, Tanzania Mainland*" 2002), these guidelines did not recommend the wholesale abolition of any local revenue sources. Instead, these guidelines provided a list of suggested measures (including the targeted elimination of certain taxes) to be adopted selectively by individual LGAs. Furthermore, the local revenue reforms were adopted without consultation of local government officials, and no preparations were made for the implementation of the reforms. As noted in Section 2 of this report, these reforms would appear to have reduced own revenues at the local level by somewhere between 40 and 60 percent.

The realization that a significant overhaul of the local revenue system needed to take place –and the realization that this reform should take place in the context of the broader local government finance system- was an important impetus for the current study. As such, detailed discussions on the current assignment of revenue sources to the local level in Tanzania –along with proposals for reform- are contained in this section. These discussions show that the main shortcomings of the current local revenue system are as following:

1. <u>LGAs are mostly assigned low-yielding taxes</u>. It is a fact that the central government has reserved itself the most important and elastic tax bases in the economy, making so much harder for local governments to have any substantial revenue source of their own. Unfortunately, Tanzania is not an exception in the international experience in this sense. However, critics of local revenue performance should duly take into account the quality and nature of revenue instruments assigned to the local government level.

2. <u>Fragmentation causes horizontal inequity.</u> Because no single tax assigned to the local government level consistently yields any significant revenues, the local tax system has seen a proliferation of small taxes. Even though many of these taxes intrinsically tax similar or related activities or tax bases, these instruments are often structured quite differently in terms of base and rates. This type of fragmentation has led to significant horizontal inequities between local taxpayers. For instance, different businesses often bear quite different effective rates of local taxation. Such horizontal inequities have recently been used as an argument for the further elimination of local government taxes (e.g., Fynn, 2004).

3. The benefits principle is misunderstood or missing as a conceptual foundation for local government revenues. We believe that the benefit principle should be an important guiding concept in determining Tanzania's local government revenue structure. However, the benefit principle of taxation (especially as applied to the local level in Tanzania) seems to be poorly understood by some stakeholders. Some stakeholders have interpreted the benefit principle in its narrowest sense, in which case they argue that "unless I receive local government services, I should not have to pay local taxes".[11] Although this interpretation can be quite correct in the case of user fees for specific services, there are many other services at the local level that cannot be financed by user fees. Rather, many local services need to be financed by local taxes that reflect a broader interpretation of the benefit principle, particularly when it is impossible to exclude non-paying residents from receiving benefits. For instance, upgrading street pavement would benefit all adjoining properties, and it would be appropriate to pay for such expenditure through a mandatory local property tax, as it would be impossible to withhold the benefits of the improved infrastructure from those taxpayers that refuse to pay. Likewise, because we know that car owners use local roads more than other people, a local tax on motor vehicles would be well justified under the benefit principle in order to help fund local road maintenance. As such, there is a need in Tanzania to reinforce the benefit principle through a clearer correspondence between the taxes local residents pay and the benefits they receive.[12]

4. Excessive focus on redistributive impact of local revenues. There appears to be an excessive focus in Tanzania on the redistributive impact of local government revenues. Often times, the system of local taxation has been attacked and even reformed under the pretense that it may be regressive. Although policy makers must not lose sight of vertical equity issues, there are several conceptual errors in the ordinary political discourse of this issue in Tanzania. First, the most recent estimates of tax incidence at the local level in Tanzania (World Bank, 2005) show that as a whole, local taxes actually conform to the ability-to-pay principle. As a matter of fact, it is quite possible that local government revenues in Tanzania are in fact slightly progressive. Second, as noted in Section 4.1, there is ample consensus among public finance experts that, for practical and conceptual reasons the goal of income redistribution through taxes or other means should not be left to local governments. Instead, the function of funding redistributive activities should be assigned to the central authorities. Third, the incidence of taxes should not be looked in isolation of other taxes or even more important in isolation of the incidence of public expenditures. From a vertical equity viewpoint it can be desirable to have a mildly regressive local tax system (but one that yields revenue adequacy and accountability) when this is offset by highly progressive expenditure incidence at the local level.

[11] Of course, this statement presents a chicken-and-egg problem: after all, unless taxpayers pay their local taxes, they will not receive local government services.

[12] For example, the perception that locally raised revenues are mostly used to finance a local bureaucracy that primarily occupies itself with the management of delegated central government functions has contributed very little to the voluntary compliance of local taxpayers.

5. Most taxes currently assigned to the local level are hard to administer and hard to enforce. It is often disingenuously argued in Tanzania that local governments should not be provided with any more tax handles until they prove that they are capable of effectively administering the taxes they now have. Such statements ignore that fact that many of the taxes currently assigned to local governments (such as the property tax) are notoriously hard to administer and may be highly unpopular and therefore hard to enforce. A sound revenue assignment (and well-designed local taxes) should take into account the relative ability of local governments to administer local taxes. Local tax administration is discussed in greater detail in subsection 4.2.2 and Annex 4.1

6. Compliance costs for local taxes are high. Anecdotal evidence suggests that compliance costs for local government revenues are quite high, among others due to the fragmentation and lack of uniformity of the local tax system. Because the high compliance costs for local taxpayers have a potential negative impact on economic growth, the reduction of such compliance costs should weight heavily in the design of future reforms.

7. Local governments are assigned the least politically acceptable revenue sources. It must also be recognized that local governments have been handed down the task of implementing and enforcing sources of revenue that tend to be particularly unpopular, such as the (now abolished) Development Levy or the current property tax. Unless local government taxes are specifically designed in such a way that takes into account this political dimension and proactively mitigates their lack of "popularity" as part of their design, it is unlikely that local governments will be able to effectively rely on such unpopular revenue sources.

8. Cross-cutting problems with the system of local government finance. It is broadly accepted that the poor local revenue performance in Tanzania is not only caused by a poor revenue structure, but also by failures in other dimensions of the local government finance system. For instance, as noted in Section 7 of this report, poor financial management practices at the local level and the lack of trust that local residents have in their officials are leading factors in poor revenue performance at the local level. Similarly, the absence of hard budget constraints further reduces the incentive for local governments to collect own source revenues. These issues are discussed in greater detail in Annex 4.1.

Objectives for transforming the local government revenue system. Despite the many shortcomings of the current system of own source local revenues in Tanzania, we made the case at the outset of this report (Section 1) that the presence of own revenue instruments at the local governments level was a critical element of a sound framework for local government finance. In addition to raising revenues for local spending, when structured appropriately, local taxation has the potential to empower communities, enhance accountability, improve vertical fiscal balance, and improve the overall

efficiency of the public sector.

We further noted that as a guiding principle in the transformation of the system of local government finance system, the deficiencies in the local structure and local tax administration should not be addressed by eliminating local taxes without consideration of their revenue impact; rather, deficient local taxes should generally be transformed into sound revenue instruments. In accordance with these principles, we believe that the transformation of the local revenue system should take on board the following objectives:

- Local governments in Tanzania fundamentally require a certain level of revenue autonomy in order to assure correspondence between the costs and benefits of local government services and to enhance the accountability of local officials to their constituents. Local revenue autonomy also helps to address existing vertical imbalances and provide local governments with some degree of creditworthiness. In the shorter term, the goal should be to at least recover the level of self financing that local governments had before the "rationalization and harmonization" reform of 2002. This would mean restoring local revenue collections to about 5 percent of national revenue collections or about 15-20 percent of total local government resources. In the longer term, revenue autonomy at the local level should be high enough to allow richer better-off local governments to self-finance their own expenditure responsibilities (see Box 4.1). The increased fiscal disparities that will inevitably accompany higher revenue autonomy, especially between rural and urban areas, should be addressed through a system of formula-driven unconditional equalization grants.

- Tax autonomy should be pursued via a "closed list" of local taxes. This closed list should provide local governments with the discretion to change local tax rates (within centrally established limits) but with no discretion to change any other features of the local tax structure. As such, the tax base as well as the administrative processes of local government taxes would be centrally defined and monitored. Imposing a clear structure and regulatory framework for local government revenues is critical, since unregulated authority of the local level to create local revenue instruments (or the lack of enforcement of the "closed list") would contribute to a return to an overly complex and non-transparent local tax system.

- The reform of the local government tax system should allow for asymmetries in revenue assignments. Different tax instruments might be appropriate for use by urban and rural local governments. To ensure the appropriate use of local tax instruments in the context of accountable local governments, the right to collect certain local revenues might be subject to certain objectively determined minimum conditions.

- The reform should focus on the simplification of the current structure by combining several fragmented local taxes and levies into a small number of tax instruments with a more significant revenue potential.

- Furthermore, the local tax system should be simplified by harmonizing the local

government tax system as much as possible with the central government's tax system to reduce compliance costs by taxpayers and to allow leveraging TRA administrative apparatus to support revenue mobilization at the local level.[13]

- The revenue assignment of revenue sources to the local government level should primarily be guided by the benefit principle, thereby reinforcing the correspondence between local government revenues and local government expenditures. Although income redistribution is not an appropriate activity to be financed by local governments, the local revenue system should be sensitive to the redistributive incidence of local taxes whenever possible.

- The reform of the local system of taxes should seek to provide local governments with revenue sources that have an appropriate local tax handle. In addition, the policy-level reform should be accompanied by a strong commitment by the central government to support the development and modernization of the system of local tax administration, so that both existing as well as possible new local taxes can be used effectively.

Box 4.1
The desired size of own local government revenues in Tanzania

In Tanzania, in aggregate, local revenues play only a very minor role; a detailed quantitative analysis of local government revenues is contained in Section 2 of this report. Based on annualized figures for the first six months of 2004, local revenues will be about TSh 36 billion, or roughly TSh 1000 per person. There is no hard and fast rule to answer how big local government revenues should be. Rather than deciding on an absolute benchmark, it is important to consider the size of local government revenues, first, as a share of the national revenue pie, and second, as a share of total local budget resources.

Over the past few years, local government revenues in Tanzania have represented between 3-5 percent of national (central plus local) revenue collections, and have only provided between 10-20 percent of the total amount of resources spent at the local government level (i.e., intergovernmental transfers and own source revenues combined). Due to the recent revenue rationalization measures, both trends have declined rapidly. Thus the 2004 figures represent a precipitous decline from previous years, and amounts to only 2 percent of domestic revenue collections.

Even before the "revenue rationalization" reform of 2003/04, Tanzania's degree of revenue decentralization to the local level of 3-5 percent was well below the average degree of revenue

[13] For instance, it may be appropriate to consider harmonizing the threshold for the Service Levy with the turnover threshold for the VAT, which was recently revised upward. A disconnect between these threshold levels would complicate the local administration of the Service Levy. However, imposition of the higher threshold should be done while taking into account the local revenue impact of such a move, along with possible alternative taxing mechanisms for businesses below the threshold (see the discussion of the Unified Local Business Tax below).

decentralization of 9.3 percent for developing countries. However, there are a number of factors that would support a high degree of revenue centralization, including the need for the public sector to improve the nation's revenue performance, the relative efficiency of the TRA, and the presence of appropriate transfer mechanisms to assure vertical fiscal balance. At the same time, if local government revenues imposed a disproportionate efficiency burden on local taxpayers, this would be another argument to limit revenue decentralization. However, in the policy range of revenue decentralization that Tanzania is currently in, it is unlikely that any of these arguments present a binding constraint; from an efficiency or macroeconomic stability view point, there certainly should be no concern for excessive revenue decentralization as long as local revenues remain less than 5 percent of national revenue collections.

A more worrisome picture is revealed when we look at the share of local government budgets covered by own source revenues. Whereas the average share of local expenditures covered by own sources was approximately 20 percent in 2002, this figure is likely to fall below 10 percent during the current fiscal year (2004/05). In fact, for many poorer, rural districts, the share of own source revenues is in fact much lower, often-times approaching zero. As such, the sharp reduction in own budget resources spells potential trouble for the ability of local government revenue instruments to assure a minimum degree of revenue autonomy and to function as an accountability mechanism. Even if local authorities had control over the tax rates of all local revenue sources, they would only be able to affect a 10% deviation in local spending. We certainly would not want this ratio to fall any further. In contrast, local government budget autonomy could be enhanced by increasing the prominence of local revenues as a share of the local budget without posing an imminent risk of resulting in excessive revenue decentralization.

In the short-to- medium run, a contribution by local revenues to the local budget of 10-20% (i.e., the situation in 2002) might be a desirable target to aim for. However, the upper range of this target is unlikely to be achieved in the short term. With an estimated recurrent sectoral grant pool of TSh 474 billion for FY 2005/06, a 20% budget share would imply the need for local authorities to collect approximately TSh 100 billion in own source revenues compared to TSh 36 billion of the annualized total for the year 2004. As such, a more realistic (albeit still ambitious) revenue target for the short term would be to assure a minimum 10% aggregate contribution (TSh 53 billion) to the local budget from own local revenues. How such an increase (or actually, rebound) in local government revenues could be achieved through a stronger revenue assignment and better local tax administration practices is discussed in greater detail further in this section.

4.2.2. Local tax administration and efficiency of the local government revenue system

Two of the most prominent arguments that have led to the rationalization and elimination of local government revenues in Tanzania are, first, that local government taxes cause inefficiencies and are an obstacle to local economic growth, and second, that local government revenue administration is sufficiently inefficient to result in a suboptimal allocation of public resources at the local level. Proponents of these arguments largely base their case on conceptual arguments and anecdotal evidence; unfortunately, little hard evidence is available about the efficiency or inefficiency of the local tax system as a whole, or the (in)efficiency of local tax administration in particular. Although we concur that revenue assignments and local tax administration are quite likely the weakest dimension in the intergovernmental fiscal system in Tanzania, we do not believe it

prudent to accept the inefficiency arguments at face value.

There is a broadly shared assumption that local tax administration in Tanzania is consistently poor, and the study team certainly proposes that strengthening of the local capacity to administer taxes and revenues should be a central theme of future local tax reforms. However, it may be a mistake to singularly focus on local tax administration as the culprit for the dysfunction of local government reveneues.

Much of the evidence to support the contention is based on taxpayer surveys. For instance, 45.7 percent of survey participants agree that dishonest collectors form a major problem in tax collection, whereas harassment by tax collectors is considered a major problem by 38.2 percent (see REPOA, 1994; Fjeldstad, 2004). However, caution is needed in interpreting these studies, since survey results are notoriously sensitive to the exact formulation of questions. In fact, it can be hard to distinguish based on survey results to what extent we are measuring actual problems in local tax collection, or whether we are merely measuring the perceived problems.[14] In fact, opinions regard local tax administration may also simply be biased by a strong preference not to pay local taxes.

One potential indication that perception and negative bias may play an important role in the survey evidence is given by variations in perceptions across LGAS. While many councils in Tanzania have introduced new methods to increase revenues from existing sources by outsourcing some of the revenue collection to private collectors to increase revenues from existing sources, all own revenues in Iringa DC are collected by the council staff (REPOA, 2004). If outsourcing of tax collections were to improve the efficiency of collection, we would expect Iringa residents to have greater concerns about tax administration than elsewhere; in fact, survey results suggest that Iringa DC has the most honest tax collectors and have the least problems with harassment. Thus, even where local tax collection is outsourced, there is a negative attitude towards local taxes.

Another argument offered in support of the inefficiency of local tax administration is the relatively low degree of local revenue performance, measured as actual tax collections as a share of "potential" tax collections. However, as discussed in Annex 4.1, there might be a number of good reasons why local governments prefer not to maximize local revenue collections, especially considering the onerous nature of many of the tax sources assigned to the local level. As such, low revenue yield or poor revenue performance should not a priori be assumed to indicate poor local tax administration.

A point of concern raised by many stakeholders is the low "net tax take" at the local government level, which is defined as the share of revenue collections that remains available for spending on public services after subtracting the cost of tax administration. We should recognize that an inherent inefficiency of the public sector is that due the cost of revenue collection, outlays on public services will always be less than 100% of

[14] For instance, it appears that Fjeldstad (2004) asked respondents "What are major reasons why people pay taxes?" rather than "What are major reasons why YOU pay [(or do not pay) taxes?"

revenue collections due to the cost of collecting revenues. In an efficient local tax system, collection costs represent only 1-2 percent of total collections, meaning that 98-99% of public resources is available for the delivery of services. Unfortunately, to our knowledge, there is no empirical study available that attempts to quantify the net tax take of local governments (or the central governments) in Tanzania. While it is likely that the net tax take is substantially higher at the central government level, a valid question that yet remains to be answered is whether the cost of local taxation is indeed so prohibitive that it would cause serious suboptimal public finances.

While it is certain that efficiency gains can be made in the cost of local tax administration, we do not believe that local tax administration *per se* is the most significant source of inefficiency or perverse incentives in the local government finance system. In our view, a much more significant problem is the fact that a huge proportion of local revenue collections is actually used for local administration rather than the delivery of local services: sample evidence suggest that anywhere from 40% to upwards of 60% of local revenue collections are spent on local administration costs (Kobb 2001; REPOA 2004). As such, we can quantify that out of every TSh 100 paid by local taxpayers, 40-60 shillings is basically diverted to general local administrative overhead and therefore simply not available for funding of direct local government services. In Section 3 of this report we conclude that this is a fundamental shortcoming in the assignment of expenditure responsibilities.

A final potential source for inefficiency arising from local tax administration is in the compliance cost (including both time and actual outlays) needed to comply with local tax regulations in order to do business in a locality. Again, although compliance costs and bureaucratic hurdles are surely an obstacle for local economic growth, the actual efficiency impact of compliance costs is hard to quantify. Furthermore, if we were to argue that the high compliance cost for local taxes is a reason to centralize revenue collections, we would also have to show that the compliance costs at the central government are substantially lower.

4.2.3 Shortcomings of specific revenue instrument assigned to the local government level

The place to start for a detailed evaluation and reform of the local tax system is with a critical examination of the strengths and weaknesses of the taxes currently being used at the local level.[15] Instead of listing each one of the current local taxes separately we believe it is helpful to group them in several general categories, which among other things may point the way toward some possible consolidation and simplification of local taxes. These general categories are: taxes on personal income and business activity (including the Service Levy and agricultural taxes); property taxes; other local taxes and levies; non-tax revenues; and contributions and voluntary contributions.

[15] Recall that a quantitative analysis of local revenues is contained in Section 2 of this report.

Local taxes on personal income and business activity

There are a number of reasons why local taxes on the income of households and businesses are sound local revenue instruments. First, the direct nature of local income taxes provides a strong link between the tax instrument and how the money is spent at the local level: direct taxes tend to be more visible and therefore provide the strongest incentives for local participation and local accountability mechanisms.[16] Second, local income taxes have the potential for being somewhat adjusted in accordance with the ability-to-pay principle.[17] Third, local income taxes (both on households and firms) can be interpreted to some extent as benefit taxes in the sense that wealthier taxpayers typically benefit more from the public services provided by the local government level. Fourth, to the extent that taxpayers are nationally registered and the tax base is already nationally defined or clear (for instance, for households paying personal income tax at the central government level; or businesses paying VAT), local income taxes should be relatively easy to administer (possibly even as a piggy-back tax by the central tax administration authorities).

Development Levy (abolished). As we discuss later in the review of central government revenues (Section 4.4), the part of the national "fiscal space" that covers the taxation of incomes of households and smaller firms is a sound realm for local government taxation. However, with the abolition of the Development Levy and the virtual abolition of business license fees, LGAs essentially do not have currently any direct taxing instruments.

Local income tax for minor settlements. The only local income tax which currently still appears on the books is the local income tax for minor settlements, which is currently collected by the TRA (Section 9(a) of the Local Government Finance Act). This provision involves the taxation (at a fixed amount) of a number of small productive activities (such as retail, milling, butcheries, and so on) "within the boundaries of villages and non major trading centers." It is unclear to the study team whether this provision has survived the reforms of the LGFA and the Income Tax Act (2004), or whether the collection of these revenues has already been ceased at this time. Either way, this provision contributes to the unnecessary fragmentation of the local tax structure; this business tax on these selected activities could easily be integrated in a more comprehensive local business tax (as discussed further in Section 4.3).

Service Levy. The Service Levy is an important revenue source for local governments in Tanzania, particularly for urban local governments. The rate of the Service Levy is set by

[16] The phrase "no representation without taxation" would be appropriate here. A clear example of this concept is the loss of voice and legitimacy that was experienced by many taxpayers (particularly from marginalized groups) after the abolition of the Development Levy.

[17] This is particularly true for a local (graduated) income tax on households. However, it should be noted again –as suggested in Section 4.1- that the redistribution role of the public sector should be assigned to the national level, making it a secondary concern in the system of local government taxation. The issue of progressivity should be considered from the perspective of the entire tax system (central and local) and more correctly, from the perspective of overall fiscal incidence, combining the overall incidence of taxes with the overall (benefit) incidence of public expenditures.

central government directive and currently it equals 0.3 percent of the turnover of producers with turnover in excess of TSh 20 million.

A turnover tax is a type of a consumption or sales tax, which is imposed on the total turnover or sales of a company. However, the turnover tax has often been criticized as a poor (local) tax instrument. For instance, by definition a tax on consumption must be applied only to sales to households and should not be applied to sales to business, including sales of capital goods. Moreover, to comply with the benefit principles, local consumption taxes should be destination-based: that is, they should be paid to the jurisdiction where consumption takes place as opposed to the jurisdiction of production. The Service Levy is typically collected by the jurisdiction of production, although the lack of uniformity in Tanzania's framework means that a business that produces its product in one jurisdiction and sells it in another is potentially subject to taxation by both local governments.

By comparison to the VAT or a retail sales tax, a turnover tax applies to all sales, including those to business. This is because the turnover tax does not have the mechanism of removing taxes on business transactions through invoice-crediting (as with the VAT) or the use of suspension certificates (as with the RST). Taxing each transaction could potentially result in "cascading", with taxes compounding at each stage of production. Turnover taxes are notorious for their distortions of economic decisions and tax experts and international organizations, such as the IMF, frown upon their use. However, the ultimate degree of distortion depends on a number of factors, including the tax rate and the levels of production at which the tax is applied.

On one hand, the Service Levy provides an attractive revenue source for local governments with a high yield. A very attractive feature of the Service Levy is that its collection can be coordinated with the collection of the VAT by the TRA. This means that local governments can readily identify the taxpayers, as well as the turnover subject to the Service Levy. Such coordination is not possible for smaller enterprises, because many smaller firms are not subject to central government taxes.

On the other hand, a number of concerns have been raised with regard to the Service Levy:

- First, as noted above, turnover taxes such as the Service Levy have the potential to be perversely cascading. However, given that the Levy is only imposed high in the productive process (only for firms with a turnover in excess of TSh 20 million) and at a very low rate, the possible distortions and inefficiencies caused by potential cascading should be relatively limited.
- A second concern that has been raised is the notion that the Service Levy introduces the form of double taxation because the firms that are subject to the Service Levy are also subject to the national VAT. However, there is in principle nothing wrong with different levels of government sharing a tax base, as long as the combined tax rate is

not excessive.[18] Given the extremely low rate of the Service Levy, it is unlikely that the Service Levy will cause a reduction in economic efficiency.

- A third concern with the Service Levy is its limited scope, which contributes to the further fragmentation of the local tax system. The previous Industrial Cess (which was replaced by the Service Levy) was levied on the unit cost of finished goods of certain industries (aluminum products, cigarettes, beer, Konyagi, soft drinks, cement, wall tiles, etc), which made this tax arbitrary and discriminatory. While the uniform Service Levy is a step in the right direction, the Service Levy is still only applied to larger firms, thereby requiring a separate taxing mechanism for smaller productive enterprises. As argued in the next section, it would make a lot of sense to address taxes on business production and turnover in a more comprehensive fashion.

Box 4.2
"Ideal" approaches to subnational business taxation

In theory, the best form of business taxation is a broadly-based levy neutral to factor mix. Conceptually such a tax, sometimes called a business value tax (BVT), resembles VAT but has several important distinctions. Unlike VAT, BVT is origin-based and therefore taxes exports and not imports. This is because a local business tax is supposed to compensate local governments for services reducing costs of businesses, which accrue at the place of production and not consumption. Second, this tax is assessed by addition of payroll, interest, rents, and net profits (or subtraction of the cost of intermediate goods and services from gross receipts) based on annual accounts rather than on transaction (invoice-credit) method as in the case of VAT. This way it treats all factors of production equally and does not distort investment decisions. In the real world the closest approximation of BVT had been Italy's regional business tax (IRAP) before labor costs were partially excluded from the tax base in 2003.

Because BVT requires sophisticated accounting and record keeping and therefore developed tax administration capacity, it might be suitable only for regional (and larger metropolitan) governments. In addition, the costs associated with record keeping would discourage compliance by smaller businesses. Therefore, for lower-level local governments it would be more appropriate to tax businesses with fixed charges varying by type, size, and location. Broadening the tax base by reaching smaller businesses would restore the benefit principle by spreading the costs of government services to all businesses that benefit from it. Such a tax— called the Single Business Permit— was introduced in Kenya in 1999 to replace the preexisting license fees, which had been burdensome to businesses and conducive to corruption. A middle ground between BVT and fixed charges would be a low-rate gross receipts levy as in Tunisia.

Source: Bird (2003)

Taxes on agricultural production. The produce cess (previously reported together with the

[18] There are many examples internationally of tax base sharing among different levels of government. However, there are a number of countries that prohibit the share of tax bases, some times as a constitutional mandate.

livestock levy) is the highest yielding source of local revenues for most rural local governments in Tanzania. Rather than imposing the tax directly on agricultural producers, the crop cess (as well as a buyer's license fees) is collected indirectly from the crop buyer. Although the collection of the crop cess as an indirect tax (rather than as a direct tax collected from the grower, or at marker from the seller) is arguably intended to facilitate the administration and enforcability of crop cess collections, the indirect nature of the tax may also provide political acceptability (although local producers likely bear the lion share of the tax burden).

However, in reality, it is not altogether clear whether the archaic licensing, registration and transaction procedures currently used to assure compliance by the buyer indeed improve local revenue performance. It might in fact be much simpler (although probably much less popular) to collect a tax on the value of agricultural production directly from the farmer rather than the buyer. Shifting the legal incidence back to the farmer would re-establish the link toward the produce cess as a local benefit tax.

Indeed, Tanzania's approach to taxation of agricultural production has long been criticized as inefficient and impractical (for instance, see Bird 1971). In fact, agricultural producers (for instance, cashew nut producers) have been lobbying for further reductions in the Produce Cess by arguing that the tax imposes a high tax burden and is horizontally inequitable, as it disproportionately singles out the production of specific crops for taxation (Fynn, 2004). To the extent that the effective rate of taxation of certain businesses in certain LGAs may be quite out of line with the average effective rate for all businesses there is a valid argument in these positions, but it is simply not the case that the local tax system tax as a whole applies excessive tax rates to agricultural production. Although the effective tax rate surely varies between districts, total crop cess collections for cashew represent a mere 3.54 percent of the turnover value of cashew nut at the farm gate price.[19] As such, the argument of efficiency and horizontal unfairness should not be used as a pretext for the abolition of additional local taxes such as the crop cess; instead, improvements of horizontal equity should be addressed through a more uniform system of taxation.

However, often these arguments tend to suffer from a narrow perspective, failing to take into account the larger system of local government finance. In particular, it is frequently overlooked that taxes on agricultural production can be interpreted in essence as a local benefits tax, since agricultural producers benefit broadly for local services and local infrastructure both as residents of the local community as well as economic producers.

While the presence of a separate tax on agricultural production contributes to the appearance of an arbitrary and overly fragmented local tax system, it is important to note that taxes on agricultural production are in essence simply another form of turnover

[19] Computed by authors based on the data reported by Fynn (2004) for the cashew nut sector.This percentage contrasts starkly with the "effective tax rate on farmers" reported by Fynn (2004; Figure 10) in the range of 20-40%. Fynn's numbers are inflated by the inclusion of central government taxes, a license fee paid to the Cashew Nut Board of Tanzania, a charge covering the operational costs of Primary Societies as well as the purchase of certain inputs.

taxation, which is levied at the point-of-sale of agricultural products, with a maximum rate of 5 percent on the farm gate price. As such, the integration of the produce cess as part of a unified local tax on production or business tax would be a major step towards a more integrated local government tax system and toward improving the perception of fairness across different groups of taxpayers.

An additional element of local revenues on agricultural production that is often overlooked is the collection of license fees that are collected from wholesalers and purchasing agents of agricultural produce. To the extent that these license fees are set too high (e.g., TSh 60,000 per district per buyer per year), this licensing structure may actually limit competition in the agriculture sector by encouraging purchasers of agricultural output to only operate in a few local government areas. This has the potential for creating a series of local monopsonies for agricultural output (a situation in which there is only one purchaser for a crop in each district), which would have the potential of lowering the prices received by agricultural producers and inflating the profit margins of intermediaries. While this issue should be looked into further on a product-to-product basis (as this could form an important barrier to local economic growth), it falls beyond the scope of the current study.

Local property taxes and land rent

Currently, the local property tax is grossly underutilized in Tanzania as a local revenue source. Whereas in some countries property taxes contribute up to 30-50 percent of local revenues, the property tax in Tanzania only yields 13 percent of total local revenues. Even to the extent that property is being taxed, revenue performance for the property tax remains quite low. For example, in Dar es Salaam, collection rates remain less than 30-50 percent (Kelly 2004). Rural property is essentially untaxed.

Local property taxes. Property taxes are a good and commonly used local government source. First of all, taxes on real property (i.e., land and buidings) are a visible type of tax and thus are conducive to political accountability. When both property and population are generally homogeneous and ownership of property is widespread, a property tax complies with the benefits principle.[20] In other situations, property taxation can weaken the benefit link by moving the tax burden on to a few classes of property such as non-residential property. However, taxation of property in an equitable way requires costly revaluation of property on a regular basis. Property taxes further follow the ability-to-pay principle, although some liquidity problems may be present for those homeowners with valuable real estate assets and low income.[21] In principle, the property tax should be easy to administer since property is very visible and immobile across local jurisdictions, which

[20] The balance between the services received by property owners and the property taxes they pay on their real estate typically can be capitalized into property values. That is, property taxes do not have to reduce the market value of dwellings in the market if the general perception is that the quality of services provided by the local government is good.

[21] Being "house rich and income poor" can be a problem for elderly people. Some countries use special exemption schemes ("homestead exemptions" or "circuit breakers") to increase equity in the implementation of property taxes.

should give local officials a strong “tax handle”.

The property tax applies only to buildings in Tanzania, with distinctions made between urban and rural LGAs. Although legally the base of a property tax should be the market value of the property, the Local Government Finance Act (1982) authorizes all local governments to levy a flat amount per building with possible adjustment for size location and use. For instance, the current flat rate for the property tax in Ilala Municipality is TSh 10,000 for residential properties and a standard rate of TSh 200,000 for businesses. Urban and township authorities are also authorized to impose an ad valorem property tax on buildings according to the Urban Authorities Act of 1983. However, individual valuations are costly and time consuming and so far have covered only selected properties in Dar es Salaam and selected other municipalities (which received specific project support for this purpose under the Urban Authorities Partnership Project, UAPP). Due to the lack of open market property transactions (and the separation of land and buildings), the depreciated replacement cost approach is still the most commonly used method of valuation. Since most of the properties are not valued, a differentiated flat rate is used in most cases.

Despite its potential as a local revenue source, property taxation seems to face a number of specific challenges in the context of Tanzania (for instance, see McCluskey et al 2003), which means that there is no simple and quick answer to fixing the property tax problem. A first issue facing property taxation is the separation of taxation on land and structures: while property taxes are assigned to the local government level, the collection of Land Rent is assigned almost completely to the central government (as discussed further below). Another part of the challenge may simply be administrative: local governments may lack the administrative capacity to produce an accurate cadastre of taxable structures and appropriately value these properties. Yet another issue may be the enforcement of the tax and the political viability of enforcement. If property taxes are enforced stringently, non-compliant taxpayers should be subject to forfeiture of their property for failure to pay their local property taxes. However, this enforcement mechanism may not be a viable option for local authorities, either for social, legal, political, or practical reasons. However, if property tax collections are not enforced (or indeed, not enforceable) then the property tax is essentially reduced to a voluntary contribution mechanism.

Although there are numerous challenges to be overcome in the structure, administration and enforcement of the property tax in Tanzania to make it a viable and substantial local government revenue source, there is no reason why property taxation (on both land and buildings) should not be the mainstay of local revenue through out Tanzania in the medium to long run. This is especially true for urban local governments (where most structures are located), but as well as for rural areas, where a simple flat rate on the occupancy of land and huts should be possible as well. The challenges with the administration and enforcement of the property tax could be resolved in part by separating and/or outsourcing the development of the cadastre, the valuation of

properties, and also potentially the billing and collection of the tax.[22] Outsourcing the administration of the property tax may limit the ability of local politicians to undermine its effectiveness by doling out politically-motivated exemptions.

Whereas local authorities are responsible for the entire administration of property taxes except for appeals, there is an important role for the central government. In many countries, the central government protects local taxpayers from local government arbitrariness by clearly defining the regulations for property valuation and ensuring that local governments accurately and fairly engage in valuations and collections.[23] The central government can also develop and maintain the fiscal cadastre for local governments lacking the adequate level of administrative capacity. Ultimately, there are a variety of approaches in the international experience to making the property tax work (see Box 4.3).

Box 4.3
International experience with property taxation

Taxes on property and land exist in virtually every country. Most countries tax both land and structures, usually together but sometimes separately. Some countries tax only land (e.g., Jamaica, Kenya, Bermuda and some parts of Australia and South Africa). Even fewer countries tax only structures (e.g., Ghana). Some countries also tax machinery and other tangible assets. There is a theoretical case for the taxation of only land, which would fall on location rents and have no discouraging effect on the development of property. At the same time taxing land alone based on market values is problematic because market prices capture both the structure value and its location. However, this argument is less relevant for developing countries, where due to the lack of property transaction information, valuation is done separately for land and structures based on land value map and replacement costs respectively.

International experience presents several approaches to determining the value of the taxable base— be it land or structures or both. Under an *area-based approach*, a charge is levied per square meter of land area, per square meter of buildings, or combination of the two. The assessment rate per square meter can be adjusted to reflect location, quality of the structure, or other factors. This approach is used in central and Eastern Europe, China, Chile, Kenya, and Tunisia. An alternative to an area-based approach is *value-based assessment*, which can be subdivided into capital and rental value approaches. Capital value assessment estimates the price that would be struck between a willing buyer and a willing seller in an arm's-length transaction. Under the rental value approach, property is assessed according to estimated rental value or net rent. In theory, a tax on market value is equivalent to a tax on rental value as the discounted net stream of net rental payments is approximately equal to market value. However, in practice the equivalence does not hold when the rental value does not allow for

[22] Note, however, that the ultimate enforcement of the tax (using fines, forfeiture, etc) is a public domain attribute, which fundamentally cannot be privatized.
[23] For instance, local governments in the State of Georgia that fail to maintain professional standards in the valuation of property and collection of property taxes (as determined by the State Department of Revenue) lose the right to collect the property tax.

deduction of all relevant expenses (e.g., maintenance, insurance, etc) or when the rental value is based on the current use rather than the highest or best use.

Source: Bird and Slack (2004)

In Tanzania, local councils (with the Minister's approval) may levy a special property rate to cover the costs of special capital works schemes which only benefit a limited number of properties in the ratable area. This is known in the local finance literature as a "betterment or improvement levy."[24] For instance, this could mean that LGAs could impose an additional surtax on properties in a certain neighborhood in exchange for localized benefits from a specific capital development (e.g., road improvements or street lighting). Despite the potential for increased correspondence offered by this local tax instrument, this option has not been used extensively by local councils in Tanzania up to now.

Land rent. As noted above, the local property tax is applied to structures only. The taxation of land is done through the payment of Land Rent. However, the taxation of land is greatly influenced by Tanzania's post-independence history of "common" (i.e., nationalized) land ownership. Although the 1995 Land Policy reintroduced the notion of private property and legalized market alienation of land, land ownership continues to be a highly politicized issue.[25]

Based on two separate Land Acts, there are essentially two systems of land tenure in Tanzania (Shivji 1998). First, there is a formal system of land registration and the issuance of land titles which is administered by the Ministry of Lands. Second, at the local level, there is an informal land tenure system which is administered at the village level, whereby village authorities are able to provide households the right to occupy and use land that is not nationally registered, typically against a nominal fee.[26] However, the informal land tenure system does not provide the same degree of protection as the formal registration of land.

For officially registered land, land charges are collected through a system of annual Land Rents administered by the Ministry of Lands.[27] The level of the rent is set by the central government but collected by local authorities, who are subsequently credited 20 percent of collections on a derivation basis as compensation for collecting the land rent. In Dar es Salaam region, the Ministry of Lands collects the land rent directly and thus local

[24] See Annex 4.5 for a discussion of the practice with betterment levies around the world.

[25] For instance, land ownership by foreigners is still prohibited. Furthermore, title to land is not indefinite; instead, owners are given occupancy rights for a number of years (for instance, 30 years). Strengthening land ownership is a fundamental ingredient for future economic growth and development in Tanzania, well beyond its implications for property taxation. (For instance, see Hernando de Soto, 2003). However, this broader issue falls beyond the scope of this study.

[26] Since these payments are made at the village level, they are not captured by the local government financial management system.

[27] Interestingly, the Ministry of Finance lists Land Rent as a non-tax source, but rather as property income.

authorities do not receive any share from the collections in the capital region.

The justification for the existence of the Land Rent harks back to the period of nationalized land ownership, with the land rent essentially serving as a lease payment for the land's full economic rent. In a way, land rent thus provided compensation to the community at large for excluding them from using the land. However, this justification is no longer valid under the current land policy, since the government has moved away from the notion of exclusive national land ownership.

Instead it would be a lot more appropriate in the current framework to assign the Land Rent (largely or exclusively) to the local government level. There are several basic reasons in favor of doing that. First, under the logic that formally registered land prevents other individuals from using the land, the greatest share of the opportunity cost is borne by people in the local community. Therefore, the compensation that is paid for the exclusive right to use the land (i.e., the Land Rent) should predominantly flow to the local community as well. Second, to the extent that local landowners benefit from local government services and infrastructure (including roads that provide access to the land), assigning revenues from the land rent to the local government level increase the correspondence in the tax system. Third, the current system of land rent collections only provides local governments with a weak incentive to collect the land rent, as they only get to keep 20% of the revenues collected. Local governments would have a much stronger incentive to collect land revenues if they would be entitled to keep a higher share of the collections.

Other local taxes

Many of the other taxes assigned to the local government level are appropriate local revenue sources, where a strong argument can be made based on the correspondence principle. For instance, this is the case for the guesthouse levy, as well as for other local taxes and license fees on specific types of local productive activities, such as plying fees, taxi licenses, and licenses on intoxicating liquors. Likewise, professional license fees are often a type of local income tax on professionals in the form of a license fee (see the discussion in the next sub-section) where there is a broader correspondence between the payment made and the benefits received from local services and infrastructure. Although these revenue sources are typically not among the highest yielding local revenue sources, the revenue potential from these taxes should not be underestimated.

Local non-tax revenues

To the extent that the main purpose of "real" licenses and user fees is to recover the administrative costs of issuing the licenses or the cost of providing the public services, it is important to price the service right. Requiring local governments to set the fee level below the actual cost of provision will cause a fiscal burden on the locality, and would give local governments an incentive, or actually force them for lack of cost recovery, to provide poor services. Setting fees above the costs for services provided would be suboptimal as well because of the induced lower consumption below optimal levels, and

would raise fairness issues to the extent that the public sector has a monopoly over certain services (e.g., the issuance of marriage licenses).

While user fees provide important efficiency benefits, it is important to balance the cost of collecting and administering user fees with the amount of revenues collected; since certain types of user fees involve many small transactions, such fees may be relatively costly to collect. In addition, the payment of user fees provides many opportunities for petty corruption (either through embezzlement of payments or through the need to provide informal "co-payments" in order to obtain services.) However, similar to the case of excises on utilities, it is possible to collect service fees together with other local government taxes that have a similar benefits incidence in order to reduce the administration cost. For instance, market fees may strictly be used for recovering the cost of operating the market. However, in addition to the costs of maintaining the market structures, there are costs of collecting the garbage generated at the markets, provision of water, latrines, and other measures to ensure some standard of hygiene. Given that the market fees provide a good tax handle (since failure to pay the market fee results in exclusion from the market), this offers a good opportunity to collect other legitimate local revenues in one harmonized instrument. Likewise, it is possible to collect refuse collection fees as a surcharge on property taxes.[28]

Contributions and Voluntary Contributions

The term "contribution" or "voluntary contribution" is used in a number of different ways for widely different local revenue instruments in Tanzania. The concern about voluntary contributions was raised after the abolition of the Development Levy, the abolition of the so-called nuisance taxes and the introduction of a 5 percent cap on the agricultural produce cess. In response to the slashing of the local revenue base and the introduction of a "closed list", some local authorities introduced several new contributions (i.e., surcharges or local taxes) on agricultural produce under heading that they are "voluntary" contributions.

The introduction of such (so-called) voluntary contribution is seen by the central government (especially the Ministry of Finance) as an attempt by local authorities to circumvent the closed list. Although some LGAs may in fact have introduced strictly voluntary contribution schemes, this should not be considered a sustainable approach to financing local services and infrastructure. It is a well-accepted principle by economists that unless there is some type of payment requirement or compliance pressure is imposed to fund a non-excludable good, taxpayers will generally become "free-riders" and rely on other residents to make contributions. If left unaddressed, this free-rider problem would result in a significant under-funding of local public goods, as all residents would count on the payment of their neighbors to pay for the good or service.

[28] There is no single "right" way to charge individual households for certain services, such as refuse collection. For instance, funding could be provided through separate user fees, or this service could simply be funded from general-purpose resources (e.g., funded from property tax collections). However, it appears that currently the law allows a special property rate (or betterment tax) only in areas where a certain capital work scheme has been undertaken by the authority and has benefited the people who own the properties in the area.

As such, in order to be practically viable any type of "voluntary contribution" must be something less than fully voluntary. It is likely that in most cases, voluntary contributions simply refer to *ad hoc* local taxes collected at the district or village level that were introduced for a specific purpose.[29] If communities want to engage in self-funded activities and you believe in decentralization, then such local initiatives should not be discouraged by the higher-level government. Instead, the collection of such "contributions" (whether in the form of a betterment levy or property tax surcharge, as a separate income tax, or in any other form) should be properly regulated to make sure that local governments do not over-tax their residents, and that the local tax instruments used by local governments are sound and fair. In contrast to the reduction in local revenue autonomy over recent years, this suggests that district and village authorities should be given *increased* revenue autonomy, particularly through greater rate discretion as well as greater access to new, sound local revenue sources.

Yet, an official definition of permissible voluntary contributions is currently lacking. As such, one could simply argue that any tax introduced by a District Council on its own accord –as the democratically elected representatives of a local government area- is in fact a voluntary contribution scheme, thereby rendering the entire closed list irrelevant. Alternatively, would a contribution scheme approved by a Village Council be considered a "voluntary" contribution? If the latter definition of "voluntary contribution" is applied, this would either result in double-taxation of residents by district and lower level local governments, and/or require significant coordination between the District and Village levels, since the district and village would have to jointly collect district taxes (e.g., crop cesses) along with the surcharges intended for the village level.

Finally, in some cases, the term "contributions" is applied to contributory payments made by households or firms for non-local government activities. For instance, in the case of the production of certain crops, LGAs act as collection agents for the local Primary Societies or grower's associations (Fynn, 2004). It is extremely important to recognize, however, that these "contributions" are fundamentally very different from other local taxes and contributions, as these resources do not fund local public goods or services. Although the collection of such contributions should be reflected transparently in the local government books of the government that acts as the collection agent, it is critical that such collections are accounted for in separate trust accounts (rather than through the local government's own revenue accounts).

4.3 Policy recommendations: Transforming the current system of local taxation

The TORs for this study task us to identify the most effective and efficient current

[29] This would be consistent with finding by the World Bank's PSIA study (2005), which suggested that development contributions had actually increased since the abolition of the Development Levy.

sources of revenue for Local Government Authorities, and what measures could be taken to optimize the revenues from each of these sources. To a large extent, this is accomplished in the discussion of the current revenue assignments in Section 4.2 and their shortcomings. In addition, the TORs request us to identify any current sources of revenue for LGAs that are reasonable candidates for elimination as inefficient or ineffective, or that require substantial reform in order to optimize their revenue potential. Finally, we are also asked to identify any significant and efficient taxes, fees and charges that as potential sound local revenue sources that are currently not being used at the local government level. Based on our assessment of existing local taxes provided in section 4.2 we identify those sources of revenue that require substantial reform in order to optimize their revenue potential.

The first step in the reform of the local tax system should be to clean and clarify the terminology and concepts currently being used. From the terminology currently in use it is not always clear what is a local tax, a cess, a fee, or a license, and what may be the differences between these concepts. Similarly, the categorization of local revenues in the Local Government Finance Act (as reflected in Table 4.3) is not particularly helpful in understanding the difference between different local revenue instruments. The interest of clarifying these concepts lies in making the system easier to understand for taxpayers and local government officials alike, thereby contributing to greater legitimacy of the system of local government revenues. Greater clarity and greater legitimacy should help to improve the administration of local government revenues and also to facilitate the monitoring of the performance of local tax systems.

In Table 4.4 we present a proposed set of standard terms –based on common internationally used definitions- that could help to clarify the different types of revenue instruments available at the local level. We specifically distinguish between four types of local revenue instruments: local taxes, local levies,[30] local fees and charges, and contributions.. Table 4.4 specifies defining characteristics for each of these terms and further provides examples for each of these revenue types. There may or there may not be agreement with this precise set of definitions that are presented in Table 4.4; what is important is that a clear and consistent set of definitions is adopted and used in formulating the local government revenue system in Tanzania.[31]

In addition to clarifying the nomenclature and classification of local government revenues, we believe that a sound local government revenue system in Tanzania has the following features:

[30] Many of the local revenue instruments that would fall in the category of "local levies" are currently referred as licenses (e.g., motor vehicle license or Liquor license). However, this current practice is not consistent with the concept of licensing adhered to the by the Ministry of Finance.

[31] In the remainder of this section, we will use this new terminology where appropriate, especially when referring to new local revenue sources. However, in order to prevent confusion, we will largely stick the terminology currently used in Tanzania to refer to existing revenue sources.

1. The mainstays of local government taxes should be the Local Property Tax and a Unified Local Business (ULB) Tax. These are broad-based local taxes collected from households and businesses that adhere to both the benefit principle as well as to the ability-to-pay principle. As described below (in subsection 4.3.1), the ULB Tax is envisioned as an amalgamation of the various general local business taxes, fees and charges imposed on local business activity. Efforts to strengthen and improve the Local Property Tax should continue (subsection 4.3.2).

Table 4.4
A consistent categorization of local government revenues in Tanzania

Category	Defining Features	Examples of local revenue sources included
I. Local Taxes	▪ Broad-based local revenue source ▪ No *quid pro quo* involved ▪ Primary function is to raise revenues	▪ Local Property Tax ▪ Unified Local Business Tax
II. Local Levies	▪ Local revenue source levied on a specific tax base ▪ Although levies may be used for regulatory purposes, primary function is to raise revenues (i.e., tax revenues should exceed cost recovery) ▪ No *quid pro quo* involved, although proof of payment may be needed to engage in specified activities	▪ Hotel / Guest house levy • Levy on motor vehicles and plying • Levy on fishing vessels • Levy on liquor establishments • Market levy
III. Local Fees and Charges	▪ There is a specific *quid pro quo* ▪ Fees and charges are collected exclusively for cost recovery of the provided service	▪ User fees ▪ License fees
IV. Contributions	▪ Payments that do not flow to the accounts of District-level LGA for the purpose of funding local government activities	▪ Village Contributions ▪ Cash or in-kind contributions to community projects ▪ Primary society contribution

2. In addition to broad-based local taxes, there is a role in the local revenue system for a variety of Local Levies that are imposed on more narrow bases. Typically, these Levies are imposed on activities for which additional taxes are justifiable based on the correspondence principle (e.g., motor vehicle license/levy; plying fee/levy; local levy on the extraction of building materials, etc.) or for regulatory reasons based on negative externalities (e.g., local liquor license/levy).
3. A third broad category of local government revenues are local user fees and charges. Like Local Levies, fees and charges are imposed on a specific basis, but fees and charges are collected exclusively for cost recovery of the provided service. As

discussed further below, we believe that many of the current fees and charges which local governments are permitted to collect are appropriate sources of local government revenue.

4. Finally, we recommend that the legislative and regulatory framework for local government finance carefully defines the concept of "contributions" to prevent abuse of the current perceived loophole in the local revenue structure. We believe that the central feature of a "contribution" should be that the payment is not intended and may not be used for the funding of district-level government activities. Instead, contributions are payments that are made to fund village-level or community-based activities. Although Contributions may be collected by the district-level LGA on behalf of village authorities or a Primary Society, Contributions should not be considered as local government revenues and must flow directly into a Trust Account specifically set up for this purpose. Within this context, we further propose a standardization of the Village Contributions (subsection 4.3.3).

Box 4.4
Feedback from the Second Stakeholder Workshop (May 2005):
The "true" rationalization and harmonization of local government revenues

The second stakeholder workshop on the development of a strategic framework for local government finances –held in Dar es Salaam in May 2005- was presented with the following statement for discussion and debate: "True rationalization and harmonization of the current local government revenue system should focus on (1) unifying the various different business taxes; (2) continuing to strengthen the property tax; and (3) formalizing the framework for village-level contributions"

General agreement and consensus exists with regard to this statement, although support for this statement is qualified by a number of considerations.

Stakeholder feedback suggested that there was general agreement on the need for a unified business tax, as well as for a continued strengthening of the role of property taxation at the local government level. The role of formalized village contributions as part of the formal system of local government revenues was debated in greater detail. In addition stakeholders identified a number of additional issues to look at in the context of the further rationalization of local government revenues, including the need to assure a harmonization of the fiscal space of local governments and central government; potential mechanisms for revenue sharing; as well as a more detailed consideration of revenue administration issues. It was noted that the way forward for the transformation of the local government revenue system would include the detailed identification of specific local revenue sources (as part of the finalization of the local government financing framework); the determination of the appropriate tax rate levels for the identified taxes; careful consideration of the revenue administration; and the rolling out of these transformed local taxes. It was suggested that the identification of appropriate local tax rates should be determined among others by the desired revenue yield, the desire to minimize distortions, and the need to attain Pareto-optimality between central and local government revenues.

Concern was expressed regarding the degree to which village contributions could in fact be

transformed into a more formal local government revenue source at the village level. There was general agreement that it is appropriate for the central government to regulate the mechanism for contributions at the village level in order to prevent abuse, and the need to assure participation, fairness, and consistency in the administration of village level revenues. However, it was also noted that the use of the term "voluntary" created substantial confusion regarding the nature of village contributions, and that an excessive formalization of village contributions could hamper true bottom-up participation. For instance, careful consideration needs to be given to the decision whether or not village contributions should be formalized into an annualized budget cycle, or whether it should remain more *ad hoc* in order to be able to fund specific community projects as the need arises.

4.3.1 Harmonize the plethora of business taxes into a Unified Local Business (ULB) tax

We recommend introducing a Unified Local Business Tax which would absorb (eliminate) the following current local taxes: the Service Levy, taxes on agricultural production (including the crop cess and the forest produce cess), business income taxes for minor settlements, fees on extractive production, and any other local taxes on productive activities. The ULB will basically also absorb (eliminate) the Stamp Duty on receipts which until recently was assigned to the central level for firms below the VAT threshold.

The ULB is envisioned to be a broad-based presumptive tax on business income based on gross turnover. For smaller businesses or businesses that cannot produce turnover information the local government will assess fixed charges according to a centrally legislated schedule that will allow variations by type, size, and location of the business. These fixed charges by construction will make it a more expensive alternative for taxpayers than the general regime based on turnover. Tunisia's local gross receipts tax and Kenya's Single Business Permit provide examples how the ULB might be formulated.

Given that the introduction of the ULB would be a major reform of the local tax system, a first step would be to pull together the various existing business taxes and turnover taxes under a single "umbrella" tax instrument and to broaden the tax base to include all businesses and productive enterprises at the local level, including any business currently not taxed locally.[32] Broadening the local tax base by reaching smaller businesses would improve horizontal equity in accordance with the benefit principle and would allow the rate structure to be set low by spreading the costs of local government services to all businesses that benefit from it, rather than by burdening only a narrow base of local

[32] The concept of the ULB Tax as an "umbrella tax instrument" is similar to the Income Tax. The Income Tax Act recognizes different types of income (wage income, interest income, and so on), and uses different collection techniques (including withholding at various stages of income generation or income transfers) for different types of income. Different rate regimes are also applied depending on the type of income and type of taxpayer (e.g., presumptive rates versus the graduated rate schedule).

businesses. Even at a small rate, such a broad-based tax is expected to have considerable revenue yield thus enhancing revenue autonomy of local governments.

The introduction of a single, standardized ULB tax across all LGAs would allow the key features of local business taxation to be harmonized across all local government jurisdictions. Regulations and definitions –including the definition of the taxpayers subject to the tax, in which jurisdictions firms should pay the ULB tax, a general definition of the tax base, the general collection procedures, and sanctions for local tax evasion- would be uniform across the national territory. However, as a broad-based tax on business activity, the specific procedures for estimating the tax base and collecting the ULB tax could not be "one approach fits all". The presumptive methods to estimate the value of the firm's tax base would likely vary between firms of different sizes and different sectors. Likewise, the actual points of collections would likely vary between industries in order to maximize the different respective tax handles. This would allow the introduction of a standardized business tax across all LGAs, while maintaining sufficient flexibility for LGAs to collect local taxes in a manner that assure compliance and revenue yield.

A subsequent step in the introduction of the ULB tax would be to harmonize the effective tax rates (and the schedular charges) applied to gross turnover across the different business activities and categories. Currently, the main tax rates range from 0.3 percent of turnover for the Service Levy and 2 percent for the Stamp Duty to 5 percent for agricultural products. However, given that the relationship between gross turnover and net income may vary across industries and sectors, it is not necessarily the case that the tax rate imposed on turnover for each type of productive activity under a presumptive local business income tax is necessarily the same. As part of the harmonization of local tax rates applied to different business types and activities, it would also be appropriate to take into account the fact that the central government imposes different tax burdens on different types of local business activity; for instance, larger businesses above the VAT threshold already face a significant central tax burden (and probably withholds income taxes for its employees), whereas a small agricultural producer likely pays no central taxes whatsoever. Further study will be needed to determine the appropriate relative tax rates between different types of business activity in order to assure a reasonable degree of horizontal equity within the ULB tax.

It will not be easy to construct such a tax right without improved tax administration. For enforcement purposes, the local authorities could issue an annual "*business permit*" as proof of payment of the ULB tax which businesses would be required to display on a permanent basis within their premises.

4.3.2 Continue to pursue strengthen and reform of the local property tax.

The property tax has been identified by many previous studies as one of the local taxes in Tanzania that has not lived up to its revenue potential. Numerous improvements should be made to the structure and administration of the property tax over time, across all facets

of the tax, including valuation, assessment, administration and collection, as well as enforcement.

With respect to the manner in which the tax base for the property tax is defined, we propose allowing local government's to select an approach for the valuation of properties that it deems most appropriate for the conditions at hand, from the legal assessment at market value, and the use of flat rates for all residential and business properties, to adopting an *area-based* methodology for assessing values, according to square meters of built space and neighborhood location of the building. An area-based assessment schedule could differentiate between rural and urban areas and within urban areas could distinguish between three to four value categories. In this case, the assessment tables would be determined by the central government but local governments would have authority to set the property tax rates between minimum and maximum rates to be applied to the area-based assessed values. The range of permissible rates should be legislated at the national level, while local governments would be allowed to select the tax rate and the valuation approach from the legislated options, and could choose to outsource the development of the fiscal cadastre and their classification of properties for valuation purposes, as well as the billing and collection of the tax.

Alternatively, under contract between the TRA and the local authority, the central administration can also develop and maintain the fiscal cadastre for local governments lacking the adequate level of administrative capacity or unable to outsource these activities. Failure to comply with the property tax will subject taxpayers to forfeiture of their property provided the local governments obtain the proper court order. Such enforcement mechanisms need to be applied consistently in order to be effective. The new property tax will replace the existing property taxes, including the current *ad valorem* property tax on buildings in the Urban Authorities Act of 1983.

We suggest two additional measures should be pursued in the realm of property taxation. First, assign the Land Rent exclusively to the local government level or shift revenue sharing from the current 80/20 sharing (in favor of the Ministry of Lands) to 20/80 in favor of district. Second, strengthen the environment for imposition of Betterment Levies by allowing local councils, without the Ministry of Finance approval but subject to rules and conditions set in the reformed Local Government Finance Act, to levy a special property rate to cover the costs of capital infrastructure developments with identified localized benefits for a limited number of properties in the ratable area, such as street lighting, sidewalks, and so on.

Box 4.5
Existing efforts to reform property taxation

Our recommendations on the continued strengthening of local property taxation should not be considered in a vacuum. Substantial work on property taxation was done under the UAPP, and more recently under the World Bank's Local Government Support Program, with the latter being aimed at revenue enhancement in Dar-es-Salaam. The key work done so far is reflected in Mcluskey et. Al (2003); Franzsen and Semboja (2003; 2004); and Faber (2004).

While the work on Dar-es-Salaam emphasizes common themes of simplification and rationalization, there are points of agreement as well as points of disagreement between the previous work and the current study's recommendations. Nonetheless, it will be important to ensure alignment between the reform of the local tax system in general and revenue enhancement in Dar es Salaam in particular; as such, the next steps in the work on developing a local government fiscal framework for Tanzania should work closely with the Dar-es-Salaam project.

With respect to property taxation in Tanzania, Franzsen and Semboja focus considerably on valuation, arguing that the current dual system whereby a flat rate system is maintained in some areas alongside assessments based on valuation of parts of the residential sector is not optimal. They argue for a single, integrated system based on individual valuation and assessment of all non-residential property based on mass valuation. In contrast, McCluskey (2003) identifies that the cost of developing even rudimentary local property cadastres would basically be unsustainable given the current revenue yield from property taxes. We concur that the complexities of mass appraisal (even only for non-residential properties) are likely to be excessively complex in Tanzania's context and run contrary to the theme of simplification. While the valuation techniques chosen may vary from council to council, the cost and complexity of the valuation approach should certainly be taken into consideration in the selection process.

In contrast to Franzsen's work, Faber focuses more on maximizing revenue yield from the property tax, suggesting an approach whereby higher valued residential properties are prioritized in valuation and collection enforcement, with more accurate data being collected in these cases to enable more accurate valuation. Accordingly, Faber recommends that the lowest 30% of properties be exempted from paying property taxes, although properties would still need to be identified and valued sufficiently in order to identify them as falling below the threshold. While we are sympathetic to Faber's focus on administration and revenue yield, we are concerned that exempting 30% of the lowest-value properties would be viewed as inherently unfair by the wealthier taxpayers, who might respond by further reducing their compliance. Certainly, separating the valuation function from the collection function (which might be achieved by contracting out the collection function under tight contractual arrangements) would be consistent with Faber's on revenue yield.

One area that has received relatively little attention is the low effective property tax in Tanzania. For instance, the work on Dar es Salaam refers to the very low tax rate that is effectively applied - ranging between 0.2% and 0.15% of value. While the link with service provision is crucial it should be possible to envisage higher rates alongside better services. Taxation at these very low levels results in administration costs accounting for an overly large proportion of total revenue. A doubling or even tripling of rates could result in a major increase in revenue collections.

While sharp rate increases would likely no be politically feasible if all else is held constant, such a move might be politically acceptable if the urban local governments simultaneously announce popular public works projects and improved public services that they will be able to fund from the increased resources. The introduction of neighborhood-specific "betterment levies" and sensitization campaigns (i.e., marketing) could further boost voluntary compliance.

Additionally, the horizontal equity of the tax should be improved by assuring more consistent valuation, consistent administration, and consistent enforcement with credible and consistent penalties and consequences in case of evasion. In fact, the failure to achieve consistency in the administration of local property taxes is an important factor in the lack of credibility of the local property tax. While it is ultimately a local responsibility to assure the sound collection of local

property taxes, the central government may have a responsibility here as well. In many developed countries, it is in fact the central government that monitors the valuation and collection of local property taxes. In fact, in order to protect local taxpayers, some countries punish the failure by local governments to systematically and fairly assess all property values or local failure to enforce tax collections adequately by removing the locality's authority to collect local property taxes altogether.

There are three basic administration components that affect the revenue yield, efficiency and equity of the property rates systems, (Kelly, 1999) notably collection and enforcement (collection ratio: CR), the property information (coverage ratio, defined as the share of taxable land captured by the cadastre) and the valuations (valuation ratio: VR, measured by the total valuation of the tax rolls relative to the total market value of the properties on the roll), where we can define Tax Revenue = Tax Base * CR * VR * TR * ClR. TR indicates the local tax rate, while ClR represents the collection ratio (tax revenues collected divided by billed tax liabilities). Although further work is required on strengthen the property tax subsequent to adoption of the overall local government finance framework, the study team believes that the key to increasing revenue buoyancy in Tanzania is largely improved administration, and possibly higher effective property tax rates.

Since the different administrative features of the property tax are multiplicative, it is essential to get every administrative step right in order to assure revenue collections; the failure of any one step has the potential to result in drastic revenue losses. Thus, the government must ensure that all property is captured on the tax rolls, that property is valued based on transparent and objective valuation mechanism, that tax is assessed accurately, that revenue is collected and enforcement undertaken against noncompliance. Thus, the coverage, valuation and collection ratios are the critical administrative variables that ultimately determine effective tax rates, the tax burden for each property, the total revenue yield, economic efficiency and overall equity.

Annex 4.1 discusses local tax administration issues in Tanzania in greater detail, including the administration of the local property tax in Tanzania.

4.3.3 Consider the introduction of a formalized Village Contribution scheme

During the 2003 Budget Speech, the Minister indicated that the abolished Development Levy would be replaced with a more appropriate village-level revenue instrument. However, as of yet, no formal village-level revenue sources has been introduced. Instead, village councils rely on all sorts of informal and "voluntary" village contributions (which are permitted –but not well-defined- under the current "closed list").[33] A formalized Village Development Contribution scheme could have the following features:

- The administration of an annual Village Development Contribution (VDC) tax would be guided by an official (yet simple) administrative manual issued by PO-RALG.

[33] Given that village-level contributions currently exist, we classify this revenue source as an existing local revenue instrument. However, given that current contributions schemes are not formalized, one could also consider the Village Development Contribution as a new local revenue source.

- The VDC would have a simple, graduated structure. Village councils would have discretion over the rates, within the limits set by the guidelines. The contribution scheme would be optional; instituted only on the action of the Village Council.
- The collection, administration and use will be fully entrusted to the village level (VEO). As a condition to use this funding source, villages would be required to follow basic participatory procedures in determining the VDC tax rate and keep a book of accounts. The District Treasurer would annually audit the village accounts.
- The VDC would have a simple, three-tiered structure. The Village Council could set the standard VDC charge per adult of working age in a pre-determined range (e.g., from TSh 100 to Tsh 1000 per person). In addition, the contribution would be subject to a maximum of, say, TSh 2000 per household.
- For poor households, a zero-rated tier would be introduced. Qualification for this rate would be based on a "pauper certificate" issued by VEO with public notification and Village Council approval. Those with a "pauper certificate" may be required to provide an in-kind labor contribution (based on pre-determined criteria).
- The Village Council will optionally be able to impose a higher rate on wealthy household based on assessment of "conspicuous consumption". Conspicuous consumption would be assessed by the VEO based on a list of specific criteria (ownership/use of automobile or motorcycle; children attending a private school; salaried employees above certain threshold, and so forth). The higher rate for the VDC would be set at twice the standard VDC rate (subject to a per-household maximum twice higher as well).
- Certificates (or tokens that could be affixed to residences) could be provided to households to signify compliance. While village tax collectors would have discretion to collect the tax in a discretionary manner, the enforcement of the tax would be community-based.

A village-level tax with aforementioned features could bring increased transparency and fairness to the present system of "voluntary" contributions. Requirements of participatory procedures will enhance autonomy and accountability at the village level. However, it does not need to be done in a way that is too formalistic, so as not to stifle village traditions

4.3.4 Non-tax revenues, including business and professional license fees

Of all the business and professional license fees currently on the books, we propose that the Government reconsider the implications of imposing a license fee on private health facilities. Given the trend in public health provision in Tanzania to move away from user fees and given the desire to assure broad-based access to health care services, it might be appropriate to eliminate the license fee on private health facilities. The study team recommends keeping the following Business and Professional License Fees:[34]

[34] Depending on the exact formulation of the ULB tax, some of these license fees/levies might actually be integrated into the ULB tax instead of continuing as separate Local Levies.

- Commercial fishing license fee
- Intoxicating liquor license fee
- Taxi license fee
- Plying (transportation) permit fees
- Forest produce license fees
- Building materials extraction license fee
- Hunting licenses fees
- Muzzle loading guns license fees
- Scaffolding permit fees

Depending on the prevailing sentiment, the new system of local government revenue might wish to move away from the terms "license" and/or "license fee" since these terms imply a regulatory tool and/or a charge that is intended to cover the cost of issuing a license. Instead, the nomenclature of these revenue instruments may be adjusted to be consistent with the categorization presented in Table 4.4.

The fee for billboards and posters (which is currently listed as a user fee) should be considered a Local Levy instead, as the fee charged for the permission to mount billboard and posters is not intended as a cost-recovery device. The regulations for the Billboard Advertising fee should allow for graduation by type of billboard and size.

With the exception of the billboard fee (as noted above), we recommend keeping the current administrative fees listed in Table 4.3.[35] The fee schedule imposed by each local government for these user fees should be guided by the principle of cost recovery for the specific activity. While this means that LGAs might set different rates for these local administrative fees and charges based on cost variations, these local fees may not exceed levels necessary for cost-recovery.

Given that the closed list approach to local revenues (including administrative fees and charges) is not intended to limit the size and range of local services funded by user fees, the central government (through the Director of Local Government, PO-RALG) should duly consider requests from local governments to expand the list of permissible local administrative fees and charges for the funding of additional appropriate local government services.

4.4 Potential new revenue options

If the Government of Tanzania decides to expand local revenue autonomy, there are two ways to do so. First, local revenue yield and autonomy could be achieved by increasing the yield of existing instruments assigned to the local level by optimizing their structure and administration. As discussed in subsection 4.2.3, whereas improvements in tax administration may result in some revenue improvements, it is unlikely that

[35] The fees should be reviewed on a case by case basis whether they are eligible to become levies.

administrative reforms alone will be sufficient to cause a significant reversal in local revenue trends. The second way to achieve greater local revenue yield and autonomy is to expand tax instruments available to local governments. Thus, in addition to the reform or elimination of current local taxes, the TORs also request us to identify any significant and efficient taxes, fees and charges that are potential sound local revenue sources and are currently not being used at the local government level.

Therefore in this section we broaden our "universe" of options beyond the current local revenue sources. It would be inappropriate to consider alternative local revenue options without considering the concept of "fiscal space" (subsection 4.4.1) and without discussing the revenue sources currently assigned to the central governments and assessing whether each of these revenue sources is assigned to the central government in accordance with the conceptual principles of sound revenue assignment and best international practice (subsection 4.4.2). In order to explore all options for potential reforms, we subsequently consider other revenue sources that are currently not being collected in Tanzania but that hold promise as local revenue sources (subsection 4.4.3).

4.4.1 The concept of "fiscal space" and the division of fiscal space in Tanzania

The structure of any local tax system is determined within the context of the revenue assignment problem: how are different taxes assigned among different levels of government? There are two general approaches to revenue assignment in the international practice. In the first approach, different levels of government are assigned exclusive fiscal spaces, defined by tax bases or even full tax structures. This approach would give each level of government exclusive authority to tax certain tax bases. These fiscal spaces can be specified in a law or, as is the case often times, in the country's constitution. In the second approach, different levels of government are allowed to use the same fiscal space, in which case different government levels could "share" tax bases. In this case, limitations on local government taxes tend to be the prohibition of taxes that would restrict internal or domestic trade. [36]

Although these two approaches go back many years in different countries, in principle, there is nothing wrong about two levels of government levying a tax on the same base as long as the combined tax rate is not excessively high (McLure 2000).[37] In this case, local fiscal space would mean, for example, some room for a supplementary rate for local governments. Potential fiscal space can be also identified when the current application of the legal definition of a tax base does not reach a certain class of economic activities, for example those below a certain threshold.

The general principle that has been followed in Tanzania for revenue assignments has been that of largely separate fiscal spaces for the central and local government. The central government has almost exclusively been given the right to tax larger taxpayers

[36] Such is the case with the "commerce clause" in the United States Constitution.
[37] The use of the same tax base by different levels of government nevertheless can be associated with some externalities at one level of government.

that are part of the formal economy (importers and exports, VAT-registered businesses, salaried employees, and so on), whereas LGAs have predominantly been assigned the fiscal space to tax smaller businesses (mostly outside the formal economy) and poor households. There are some limited areas of overlap between the realms of fiscal space occupied by the different government levels. For instance, local governments are allowed to impose Service Levy on VAT-paying enterprises (albeit at a very low rate), whereas the central government has started "intruding" on local governments' fiscal space by introducing a presumptive income tax on smaller businesses below the VAT threshold, which was historically more the fiscal realm of local authorities.

In our opinion, the application of this principle of exclusive fiscal space in Tanzania (and frankly, the disregard for the need to create minimally viable fiscal space for local governments) has introduced unnecessary rigidities in tax assignments. We also believe that this is the right time to carefully examine the fiscal space occupied by the central government in Tanzania and how some of this fiscal space may be shared with local governments.

4.4.2 An assessment of the fiscal space occupied by the central government in Tanzania

The proper place to start for an assessment of revenue assignments in Tanzania is to review the quantitative significance and relative importance of the revenue instruments currently used at the central and local levels, and whether or not some of the fiscal space exclusively held by the central government at the present time offers some advantageous possibilities for it to be shared with local governments.

The level of revenue mobilization. One particular issue in the discussion of fiscal space (at the different levels of government) is whether the overall tax pressure in the country is already too high or conversely whether some of the identified fiscal space may actually be used because the overall level of tax effort in the country is relatively not that high .In this section we discuss what it is meant by these concepts and how they are quantified for the case of Tanzania.

Domestic revenue is targeted to reach TSh 1,739.3 billion in FY 2004/05.[38] This represents about 13.8 percent of the Gross Domestic Product (GDP). An important background question is whether this is an adequate level of revenue mobilization for Tanzania. In general terms, this is not an easy question to answer. Tanzania, or any other country for that matter, is sovereign to decide what share of GDP should be channeled through the public sector via taxes and what should be left in the private sector.

However, Table 4.5 suggests that Tanzania's degree of tax effort (13.3%) is quite low by international standards when considering the tax-to-GDP ratio compared to selected countries in Eastern, Central and Southern Africa (average 18.5%). Yet, the more relevant question is whether Tanzania has enough resources to finance the desired level

[38] See *Budget Digest for 2004/05*, (Ministry of Finance, 2004)

of public expenditures without sustained fiscal deficits. From this perspective, with fiscal deficits of around 6 percent of GDP (before external grants) and with a dependency of external funding of around 3.5 percent of GDP, it would seem that revenue mobilization in Tanzania might be lower than needed (or else that public expenditures are too high). From a different perspective, the level of revenue effort is related to the questions of whether the international competitiveness of the Tanzanian economy is weakened by high tax burdens or by expenditures that are too low to provide adequate levels of infrastructure and public services. These are much harder questions to answer.

Table 4.5
Tax Effort in Tanzania and Across Selected African Countries, 1990s

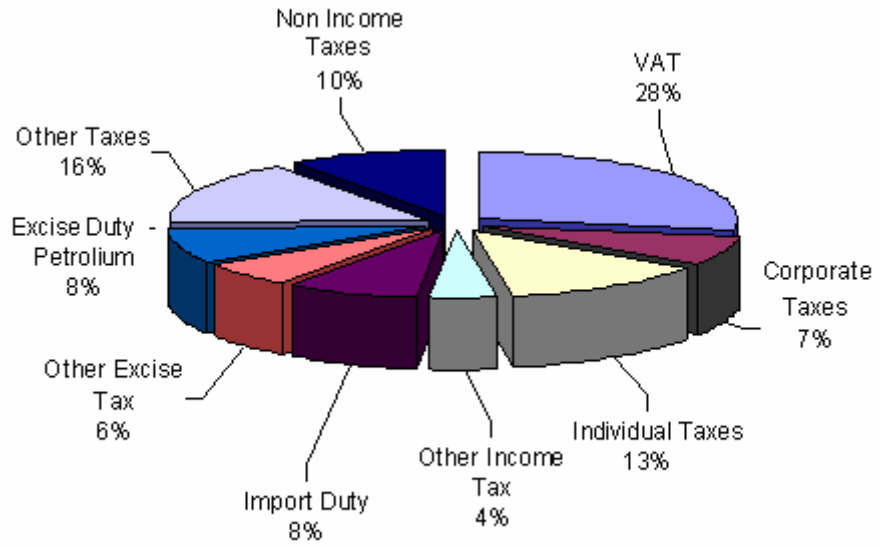
Country	Actual Tax Ratio to GDP
Botswana	33.8
Burundi	15.2
Central African Republic	8.4
Congo	13.3
Ethiopia	10.4
Kenya	22.6
Malawi	15.5
Mozambique	18.0
Namibia	30.2
Rwanda	8.0
South Africa	27.7
Swaziland	29.7
Tanzania	**13.3**
Uganda	8.8
Zambia	17.5
Zimbabwe	23.6
Unweighted Average	**18.5**

Source: Annex 4.2

One piece of evidence that might be brought to bear on these questions has to do with whether Tanzania taxes are at a high level relative to other countries, particularly relative to other countries that have similar per capita income levels and other characteristics. To answer this question we perform a comparison using a regression method, which allows us to go beyond simply comparing the tax-to-GDP ratio (see Annex 4.2). In a summary fashion, the analytical method used in Annex 4.2 consists of comparing the actual revenue collections in Tanzania with the country's "expected" revenue effort predicted from a regression equation. In this last step for predicted revenues, we use features of

Tanzania's economic structure and coefficients from a regression based on data for 115 countries that tell us how on average (for all those countries) those features of the economic structure could be exploited to raise tax revenues. The results in Annex 4.2 show that Tanzania squares well with a tax effort coefficient of 1.2 (Table A.4.2.1). This can be interpreted as saying that Tanzania raises revenues that are above the average, after we take into account income levels and other economic characteristics. However, these quantitative results need to be taken with a grain of salt. It is likely to be the case that tax liabilities are high for some and low for others. In fact, as shown in Annex 4.2, the available estimates are that the shadow or informal economy in Tanzania represents more that half of GDP around year 2000, and that the relative size of the shadow economy has been significantly growing in the past years. By the estimates in Table A.4.2.2 the size of the shadow economy as a percent of GDP was 45.6 in 1990-1991 and reached 58.3 percent in 1999-2000.

Figure 4.3
Central government revenue collections, 2004-05



Source: Budget Speech 2004/05 (MOF, 2004)

The composition of central government revenues. Moving from the overall level to the composition of revenues in Tanzania, a breakdown of central government revenues expected for FY 2004/05 is provided by type in Figure 4.3 (Budget Speech 2004/05). The revenue structure at the central government level shows a similar pattern as the local level, with a limited reliance on income taxes, and more extensive reliance on indirect taxes. At the central level, consumption taxes (VAT and excises) account for 42 percent of central government revenues, with the VAT by itself accounting for 28 percent, and excises the remaining 14 percent. Corporate and individual income taxes are expected to

account for 24 percent of central tax revenues, more than half of which derives from taxes on individuals' income. Import duties are still expected to account for 8 percent of central tax collections. The remainder of collections (24 percent of revenues) derives from other smaller taxes or from non-tax revenues (other sources of income).

Tanzania's tax structure is pretty much in line with the norm in other countries, although there is less dependence on income taxes than is generally the case in the international experiences. Tanzania's reliance on indirect consumption taxes and taxes on international transactions is closer to the international norm (although also a bit below the norm), while the role of other taxes and non-tax income tends to be more prominent in Tanzania.[39] Table A.4.1.3 in the Annex 4.2 shows the international experience for a large number of countries using IMF (2003) data for 2000.[40]

Review of Individual Taxes. We now proceed to examine in more depth the different tax sources as they are currently assigned to the central government. Since the focus of the current report is the implications of the overall revenue assignment for the local revenue structure of taxes currently assigned to the central government, in particular from the perspective of whether there is some fiscal space available for local governments. Therefore our discussion focuses more on aspects and features of central government taxes related to local taxation either as potential revenue sources or how indirectly they relate to local revenue issues, and much less on structural issues concerning those central government taxes.[41] We must note that virtually all central government revenues, as discussed below, are collected by the Tanzania Revenue Authority (TRA).

Personal income taxes

A new Income Tax Act was introduced in June 2004, which in some ways simplified the previous income tax. Tanzania's personal income tax is levied on the world-wide annual income of residents and Tanzania's source income for non-residents. The taxable base includes wages and salaries, profit dividends, capital gains and interest income. The basic rate structure is progressive with four brackets starting at 18.5 percent for incomes over TSh 600,000 and ending at the maximum marginal tax rate of 30 percent for incomes in excess of TSh 6,480,000. In many cases taxes are withheld at source. Employees' incomes are subject to monthly withholding by their employers, while the self employed have to file annual returns and quarterly estimated payments. Besides the withholding of taxes on salaried income, there are a number of other withholding taxes, including on interest income; dividends royalties, and other types of income. [42]

Although there are several issues that we could discuss on the current structure of the

[39] Note that the fact that taxes on international trade are lower in Tanzania than the norm in other developing countries is a positive factor because of the continuing need for trade liberalization.

[40] The table divided taxes into four groups: income taxes, property taxes indirect taxes and taxes on international trade. The category "other" includes both other taxes and those that could not be allocated. Social security taxes have been excluded from this computation. Mean values are reported in the last row of the table.

[41] Information on the structure of current taxes is available from the Tanzania Revenue Authority website.

[42] See TRA. 2004. *Taxes And Duties At A Glance 2004 / 2005*, for a complete picture of all income tax provisions and withholding rates.

personal income tax, the most significant one from the perspective of local revenue mobilization is the relatively high threshold for exempted income. In effect, a threshold of TSH 600,000 leaves most individuals exempt from the central government's personal income tax. Even though there are many angles to this policy -such as reinforcing progressivity or reducing administration costs- we believe that it sets a bad precedent in trying to establish a good tax culture where everyone contributes to financing public services no matter how little. Narrowing the pool of potential taxpayers (while effective in maximizing revenue yield) promote tax avoidance by higher-income taxpayers, and more important from the perspective of this report, it tends to preempt the possibility of using some form of personal income taxation as a source of local revenues.

To some extent, with the introduction of the new Income Tax Act (2004), the TRA is starting to pursue a presumptive type of income taxation for individuals below the regular income tax threshold. While on a positive note this broadens the tax net for the personal income tax, on the downside this development may be considered a further incursion by the central government on the already-limited local tax space of local governments.

Before we explore what possibilities may exist at the local level with respect to that "fiscal space," it must be left clear that the current progressive income tax is rightly assigned to the central government level and it must remain there. In accordance with the normative principles of taxation, a progressive income tax should be assigned to the central government owing to: (i) its redistributive nature; income redistribution is a central government objective and in general should not be pursued by local governments given the mobility of taxpayers; and (ii) its automatic economic stabilizer nature; again, macroeconomic stability is a central government objective and in general should not be pursued by local governments given the porous nature of local economies.

Yet, now that the Development Levy has been abolished, basically no local personal income tax exists.[43] But given that most individuals below the income tax threshold are not taxed by the central government personal income tax, this creates a "fiscal space" with possibilities for a new instrument for local governments financing. There are several possibilities for the taxation of personal income at the local level relevant to Tanzania. The most commonly used one in the international experience is a flat-rate income tax as a surtax or "piggyback" tax on the central government personal income tax, which is collected by the central government tax administration. (See Box 4.6 for a general description of piggyback taxes). To enhance revenue autonomy, local governments may be allowed discretion in setting the flat rate between minimum and maximum rates, which are centrally legislated.[44] Because, local governments may be quite diverse in terms of tax bases and levels of economic development, it is also possible to have an asymmetric implementation of this type of tax, so that only larger cities or only urban areas are assigned such a tax.

[43] It must be recalled here that prior to being made a poll tax, the Development Levy had a progressive nature akin to a rudimentary or simplified personal income tax.

[44] Other forms of tax autonomy, such as the ability to modify the base of the tax by providing more or less deductions, exemptions and so on do take place in the international experience but they are much less attractive because they make tax administration and enforcement so much harder.

Box 4.6
Local piggyback taxes

In the most common practice piggy-back local taxes are collected by the central government as a surtax to a central government tax, but local governments are allowed to set the rate for the surtax and receive the proceeds from the subnational surtax on a derivation basis.

The most common type of piggyback taxes is a flat rate local income tax. However, the international practice also shows cases of piggyback sales taxes and piggyback excise taxes. Consistent with the principles of revenue assignment, the overall attractiveness of piggy-back taxes as a fiscal policy tool can be summarized by its three main benefits: (1) Piggyback taxes allow a relatively high degree of centralized control over revenue sources.; (2) Piggyback taxes with rate setting give local governments an excellent degree of tax autonomy; (3) Piggyback taxes are administratively simple and feasible.

Some tax practitioners object to the notion of imposing multiple taxes based on the same tax base. The main argument is that imposing multiple tax rates on the same tax base could lead to excessively high tax rates. Of course, this could easily be prevented by coordinating the range of tax rates that can be applied by the different government levels. Given that tax payers (both households and firms) receive services from various levels of government, there is conceptually nothing wrong with taxing the same tax base, particularly when this can be done in an efficient and effective manner through a piggy-back style tax.

A flat rate local piggyback income tax is a good local tax because it satisfies the benefit principle and being quite visible it promotes political responsibility and accountability. This is also an elastic tax with revenues increasing commensurable with income, so that as the demand for local services increases with income, so do tax revenues.[45] Most international examples of a local income tax represent piggy-backing on the central governments income tax. (See Annex 4.3 for a discussion of the international practice.) The problem with following the conventional practice is that in Tanzania the central government income tax has a rather narrow base, due in large part to the high minimum exemption currently in the law. There is also the issue in Tanzania of the schedular final withholding taxes on dividends, interest, and rental income. Should the piggyback tax include these incomes or should instead fall exclusively on the general withholding and return filing regimes for wage and other labor income? Technically, there should be no difficulty by adding small flat piggyback rates for local governments to the schedular

[45] There is one technical issue that we need to mention and will probably be of not much importance in Tanzania. Conceptually, a local income tax should be levied at the place of residence where the taxpayer receives most of the local government services. However, for administrative reasons the piggyback tax is withheld at source at the place of work. Therefore there needs to be a mechanism through the tax administration to allocate revenues to the jurisdictions where the workers reside. This is done reasonably well in many countries and it is only an issue in large metropolitan areas where individuals may reside and work in different jurisdictions.

taxes on dividends, interest, and rental income, and have the current withholding agents for the central government to also withhold the piggyback tax for local governments. But because these types of income are likely to be concentrated in a small number of local jurisdictions and because the taxation of capital income involves many other considerations beyond the benefit principle applicable to local financing (capital mobility, international competition for foreign direct investment and so on), it may be desirable to limit the local piggyback taxes to wage and salary incomes.

The first avenue, perhaps the most desirable in technical terms but not the easiest in political terms, would be to reform the current national personal income tax by significantly lowering the exemption threshold. Alternatively, an alternative presumptive income tax (for individuals below the regular threshold) may be able to expand the tax net for the national income tax. Either way, expanding the income tax net would help a local piggyback personal income tax become a more significant source of revenue for more local governments. Without this change a local piggyback personal income tax would likely generate a significant level of local revenues in only a very small number of local governments. A major advantage of this approach is that the introduction of a local piggyback personal income tax would not require any tax administration effort on account of local governments, and would involve little administration effort by the Tanzania Revenue Authority.

Even without expanding the national income tax base, a flat-rate local surtax on income could generate significant local revenues. Based on reported national income tax collections for 2002/03, we informally estimate that a uniform 2 percent flat-rate local surtax on PAYE income would have yielded approximately TSh 14 billion.[46] This compared to actual Development Levy collections in that year of TSh 11.2 billion (see Table 2.3). However, when compared to the Development Levy, the municipalities in Dar es Salaam would likely receive a much greater share of a piggy-back income tax than under the Development Levy. Whereas LGAs outside of the Dar es Salaam regions collected TSh 9.2 billion from the Development Levy (almost 90%), they would likely only receive TSh 3 billion if they imposed a 2-percent piggy-back personal income tax on PAYE income (less than 30%).

A second, much harder alternative to occupy the fiscal space left by the current absence of income taxation on lower and middle-income households would be the introduction of a strictly local flat-rate income tax, again with nationally legislated minimum and maximum rates, but fully administered by the subnational governments. But clearly, without administrative assistance from the central government, assessment of individual income represents a significant challenge for local government. Given the current challenges with local tax administration (and the absence of a good tax handle at the local government level), this would not likely be a practical local revenue option.

A third alternative would be the re-introduction of the old Development Levy into a graduated tax on the basis of profession or some other visible characteristic of taxpayers'

[46] This assumes that all LGAs in Tanzania would choose to select a 2 percent local surtax rate.

income. This is not likely to be a politically acceptable option in the current policy climate in Tanzania.

Corporate income taxes

Tanzania's central government corporate income tax (CIT) is a conventional tax. It is paid at a flat rate of 30 percent on all corporation taxable profits of all companies carrying out business in Tanzania, with deductions of operation costs, depreciation allowances for capital investment, and bonus investment allowance in the priority sectors of hotels, industry and agriculture.

Currently the corporate income tax is appropriately assigned to the central government level. First of all, the corporate income tax affects macroeconomic stabilization and, to the extent that corporations are owned by wealthy individuals, this tax also affects income redistribution. These two characteristics alone suggest that corporate income tax should be levied by the central government. In fact even when levied by the central government, the corporate income tax hardly meets sound principles. There are no reasons to believe that incorporated businesses benefit more from public services than unincorporated ones or that the benefits received vary with profits. The main reason for existence of CIT is to prevent avoidance of individual income tax through incorporation and to withhold tax on foreign shareholders, who otherwise only may have to pay tax in their countries of residence. Clearly, it is administratively easier to tax profits at source rather than as individual income after being distributed among shareholders. But using this facility means that there should be adequate integration of the corporate income tax and the personal income tax. In many cases this integration is non existent, or as in the case of Tanzania only partial.

This imperfect tool to tax individual income becomes even more problematic when levied at the local level as it would be very difficult to attach corporate profits to the residence of shareholders or to apportion profits among several localities where a multi-jurisdictional business might operate. Some countries that allow corporate income taxes at the subnational level attempt to divide or apportion the nationwide profits of a corporation among subnational jurisdictions using a formula. These apportionment formulas tend to use a weighted index of several factors such as payroll, assets, or sales. But even with these formulas the allocation of profit income tends to be quite arbitrary. In some other countries central governments share corporate income tax revenues with subnational governments through either a formula or on a derivation basis. The formula approach, which is more correct, still presents the same issues just mentioned above. In the case of sharing on a derivation basis, the apportionment of profit income among jurisdictions becomes much more arbitrary and in some cases it stays in the very few jurisdictions where companies have their headquarters. See Box 4.7 for a discussion of revenue sharing issues.

Box 4.7
Revenue sharing as an option

A way in which many countries provide subnational governments with unconditional resources is through revenue sharing. This means that revenues generated at one level of government are transferred to finance a portion of expenditures carried out by another level of government. This is common in Germany, Russia, and in many other countries, particularly transition countries.

Two basic options exist in revenue sharing: sharing on a derivation basis, and sharing on a formula basis. Although there can be some advantages to derivation-based revenue sharing, excessive reliance tends to cause horizontal fiscal imbalances in developing economies and require extensive fiscal capacity equalization. To the extent that we would want to provide general-purpose resources (as opposed to sectoral grants, etc.), sharing on a derivation basis would not be a good option in Tanzania; it would unnecessarily worsen local fiscal inequalities. As such, we recommend against derivation-based revenue sharing as an option for funding local governments in Tanzania at this stage. Sharing on a formula-basis would be possible, but then this takes on the nature of a transfer. (For instance, the pool for the General Purpose grant in Tanzania could be defined as X% of VAT collections).

In summary, a corporate income tax is not an option for local governments either in the forms of a separate local corporate income tax, nor as a piggyback corporate income tax, nor a shared tax source.

However, a good case can be built for having some sort of local business tax or business license fees at the local level. Conceptually there are two major justifications for local governments to tax businesses. First, it represents an indirect but administratively easier way to tax income of business owners. In particular, local business taxes could be a feasible way of taxing non-wage income of individuals. The other rationale for local business taxes is that to the extent that businesses benefit from the services and infrastructure provided by the local government, which reduces the costs of doing business, local governments should be compensated according to the benefit principle. Ideally, businesses should be charged specific user charges for specific public services benefiting businesses. However, where it is not feasible to recoup costs of local government services through user charges, some form of broad-based levy on general business activity is warranted. To avoid economic distortions this broad-based levy should be neutral to the factor mix (meaning that the tax should apply both to labor (payroll) and capital (assets), in order to avoid distortions).

One challenge to be overcome for a local business tax in Tanzania would be the administration of such a tax, particularly given the limited coverage of productive activity by smaller firms under the central government's tax system. A presumptive local business income tax based on simplified measures of profitability or business value could be appropriate in this regard, as discussed in Section 4.3.

As a matter of fact, Tanzania just recently practically eliminated the business license fees, which in some ways acted as a local business tax (with the local business license as an effective enforcement tool). Without going back in those reforms, there are two ways to make sure businesses continue to contribute to local government revenues. The first

would be to increase the existing turnover taxes. This is not a desirable plan given that these taxes tend to be distortionary at high rates and the fact that there is already the perception by some that the rates of these taxes are already too high. A second more desirable approach would be to introduce a simple, broad-based, low-rate local business tax to at least replace the income lost by license fees as we propose in subsection 4.3.2.

Value-Added Tax (VAT)

Tanzania relies quite heavily on consumption or indirect taxation.[47] The VAT accounts for the single-largest revenue source at the central level, and collections from VAT and other major indirect taxes (import duty, excise duty on petroleum, and other excises) represent half of all central government revenues.[48] Likewise, at the local level, turnover taxes account for almost half of local revenues.

The current VAT falls on imports and on most domestic transactions by registered business at a single rate of 20 percent. The tax base for VAT on imports is the CIF value plus customs duty and excise duty and for domestic transactions the sale price or the open market value of the goods and services. Exports are zero-rated, thus they are exempted from VAT and registered traders can reclaim a credit for the tax paid on inputs. Most basic goods and services with a high representation in low-income household budgets are exempted from VAT.

The VAT in Tanzania is appropriately assigned to the central government level. The VAT is not generally speaking a good tax to assign to the local government level or to share by the central government with local governments on a derivation basis. The introduction of subnational VATs to provide subnational tax autonomy is a complex issue. Basically, only a number of large federal countries have attempted to introduce a subnational VAT (e.g., Brazil, Canada and India) and the international experience shows that it can easily lead to chaotic situations, as the experience of Brazil has shown in recent years (see Annex 4.4 for a discussion of international practices with subnational VATs). In pure technical (administrative) terms, the VAT is also a poor tax to be shared with subnational governments on a derivation basis. The crediting and debiting of VAT in different jurisdictions make it absolutely unsuitable for direct revenue sharing on a derivation basis. Besides the arbitrariness of crediting and debiting the VAT across jurisdictions, the tax in this case tends to be paid according to the place of registration or the location of the headquarters of business firms.

However, the proceeds of a central government VAT can be perfectly shared with

[47] Originally the term "indirect taxes" was introduced to denote taxes whose burden is expected or intended to be ultimately shifted to someone other than the subject who pays these taxes. In practice this term is used to denote charges on occasional and particular events (e.g., purchases) regardless of the ultimate incidence of the burden.

[48] The import duty will not be discussed in this section any further. Import duty is levied on imported goods usually at an ad-valorem rate on CIF value. There are five rates ranging from 0 percent (for fertilizers etc.) to 30 percent for consumer durables. Tanzania has adopted the Harmonized Tariff System for classification of goods for tax purposes as well as for trade statistics compilation. Imports from COMESA states are generally charged lower rates. Currently, import duty revenues are properly assigned to the central government level.

subnational governments according to some formula, ranging from a pure per capita or population criterion, to estimates of aggregate consumption, or according to an equalization formula that takes into account fiscal capacity and expenditure needs of subnational jurisdictions.[49] The sharing of VAT proceeds according to a simple formula (e.g., population) may be an option for Tanzania (see Box 4.7). However, it must be recalled that revenue sharing, although it can effectively address the issue of vertical imbalances, it is not a solution for the question of how to build revenue autonomy at the local level.

Excises

Tanzania levies excise taxes on traditionally excisable goods (for imports and domestic production) with negative externalities to society, such as alcoholic beverages, tobacco and petroleum products. There are also excise taxes on soft drinks and the import of cement, consumer luxuries, vehicles and cosmetics for pure revenue raising reasons. Excise duties are levied at specific and/or ad-valorem rates ranging from 10 percent to 30 percent.

Excise taxes, in general, are appropriately assigned to the central government. However, unlike in the case of the VAT, excises have potential as piggyback taxes or special taxes at the subnational level. The main reasons are that excises tend to be more politically acceptable, can be easily administered in coordination with national wholesalers as withholding agents, and allow for rates differentiated by region. For example, many OECD countries allow subnational government surcharges on excises.[50] Moreover, the benefit principle accords with the assignment of (destination-based) excises on alcohol and tobacco to the subnational level (to the extent that the latter is responsible for health care) and on vehicles and fuel (to the extent of subnational governments' involvement in road construction and maintenance). The ability to charge differential rates across subnational jurisdictions is of course limited by the possibility of cross-border trade and smuggling. Also what extent excise piggyback surtaxes can be used at the local level depends on the technology of product distribution and points of sales.[51]

Tanzania does engage in the sharing of the Fuel Levy between different government levels through the Roads Board. While the majority of the Fuel Levy (70 percent) is

[49] Policy options and international experiences regarding such transfer mechanisms was discussed as part of the Intergovernmental Transfer Study (GSU, January 2003).

[50] For example, in the Netherlands, provinces impose a surcharge on the motor vehicle tax levied by the central government. Provinces are free to set the rate of the surcharge, subject to a ceiling imposed by the central government.

[51] For example, a surtax on the fuel levy generally is thought not to be feasible because this excise tax is typically levied on fuel supplied in bulk from bonded warehouses or refineries to fuelling stations. Since collection is usually made at source, the geographical incidence of revenue is not related to the benefits provided with these funds, that is, road repairs and construction. However, this tax may be suitable for piggy-backing or even revenue sharing on the derivation principle if the technology exists for the wholesalers to withhold the tax for the local governments on the product shipped to their jurisdictions. Obviously this can be much simpler for a few regional governments than for a myriad of local governments.

retained by central government for expenditure on trunk and regional road maintenance and rehabilitation, the remaining 30 percent is transferred (supposedly by formula) to local authorities for expenditure on district and local road maintenance and construction. Given that the Fuel Levy takes on the nature of a special transfer program, it is discussed in greater detail in Section 3 of this report. While the revenue sharing of the Fuel Levy provides local governments with additional resources, it does not provide local governments with the ability to increase or decrease the excise tax. Given the administrative complications that differing local fuel excise rates would introduce, combined with the geographical distribution of fuel sales across the national territory, it would likely be an undesirable complication to introduce variations in local fuel excises at this point in time.

An interesting aspect of excise taxation in Tanzania is that there are apparently no excise taxes on the provision of public utility services imposed either at the central or at the local level. However, there is significant revenue potential in some of these services and these taxes should be easy to collect from the utility companies, especially in the cases of electricity and phone services (possibly including mobile phones). The rationale for these taxes goes beyond revenue potential and administrative ease. If we invoke the benefit principle, there is a strong correlation between electric consumption and phone services and general economic activity, which are good proxies for the demand of local public services by both households and productive enterprises. Compared to other commodities, taxation of public utilities would be associated with relatively low distortions, as most utilities have been shown to have relatively low price-elasticity of demand. Also, the demand for public utilities has been shown to be income elastic, which brings two additional benefits: progressivity and revenue buoyancy (Linn 1983).

The big attraction of excises on public utilities at the local level is that generally they are easy to administer as utility enterprises are already engaged in collection of consumption fees, so that adding local excises to the utility bill should be relatively easy. The inclusion of a surcharge on utility consumption also provides a very convenient and effective enforcement mechanism; consumers who fail to pay their utility bill are subject to immediate termination of services. In fact, local governments in a variety of developing countries (especially in Central and South America) collect some other local taxes by attaching their bills to the public utility (most often, electricity) bill. The same is the case in South Africa, where until recently municipal revenue collections were piggy-backed onto electricity bills. In summary, assigning excise *ad valorem* taxes at the local level on the consumption of electricity, and possibly phone services, is an option that should be considered by the Tanzanian government.

Stamp Duty

Although a VAT was introduced in 1998 for larger enterprises, until 2003 the central government collected a Stamp duty on receipts, which essentially was a substitute tax for the VAT on small businesses (below the VAT threshold). The Stamp Duty was levied on businesses which are not VAT registered, with duty collected at a rate of 2 percent of the turnover for the traders with a composition agreement with the TRA, while those using adhesive stamps affixed on cash receipt pay 3.6 percent of the sale value.

More generally, the former Stamp Duty on business receipts could be considered a form of a presumptive tax on small businesses (see Box 4.8 for a discussion of presumptive taxation). The stamp duty on receipts is a tax that has significant potential for being assigned to local governments although still administered by the TRA. There is also the possibility of transforming the Stamp Duty into a more general presumptive tax for small businesses covering not only the VAT but also other taxes, in particular income taxes.

Box 4.8
International experience with presumptive taxation

Developed tax systems involve relatively complex structures which utilize sophisticated accounting, record keeping, and tax administration. In many cases, it is easier for individual taxpayers and small enterprises (versus large corporations) to remain outside of the tax net for the simple reason that they can remain inconspicuous to the tax administration. For these types of entities, complicated and administratively burdensome tax systems further discourage compliance with the tax laws. Additionally, complicated tax systems make it difficult and expensive for start-up firms (particularly small enterprises) to act in good faith in terms of tax compliance due to the costs associated with record keeping and the need for specialized information to comply with complex tax laws. In many countries, simplified regimes based on imputed or presumptive taxation has traditionally been used as a way to get some tax revenue from these taxpayers, which might otherwise go completely untaxed (see Annex 4.5).

There are about as many different simplified systems as countries that have used them. Differences are due to taxes that are folded into the system (in some countries only income and wealth taxes are rolled in, in other countries consumption taxes are also part of the simplified system); tax bases (some countries use assets, others turnover or gross receipts, others simply define by the type of business and industry); tax levies (lump-sum, or flat or even progressive rate structures); and eligibility requirements (size of taxpayer defined by assets, turnover, gross sales or receipts, number of employees, etc.). It is difficult to conclude a set of consistent lessons from countries that have used simplified tax systems. One of the primary benefits exhibited by presumptive tax systems on small entrepreneur is bring these taxpayers into the tax net, which besides yielding additional revenue, increases perceived fairness of the system and thus compliance in other sectors. However, one important lesson from the international experience is that there should be a clear eligibility requirement associated with an enterprise's scale of operation. If this is not done, then the presumptive or imputed scheme becomes a hard-to-eliminate alternative tax structure.

Source: Wallace (2002)

Motor vehicle taxes.
Tanzania has a wide array of taxes and fees on motor vehicles and none of them assigned to local governments. Apart from taxes on importation, motor vehicles are subject to various other taxes collected by the TRA. These include:

- *Motor vehicle registration* collected on the first registration of motor vehicles in the country. After the one-time registration fee (levied at a flat rate of TSh 95,000 per registration for motor vehicles and TSh 32,000 for motor cycles), there is an annual fee of TSh 10,000.
- *Transfer tax* which falls on the transferring the ownership of a motor vehicle with the new owner paying a transfer fee of TSh 55,000.
- *Car Benefit tax* paid by all commercial private companies not involved in transport business at TSh 100,000 per vehicle owned per annum.
- *Foreign Motor Vehicle Permit and Transit Charges* paid by all non commercial foreign motor vehicles temporally imported into Tanzania.

Generally speaking, the assignment of vehicle taxes to the central government is incorrect because there is typically a strong link between the ownership of vehicles on one hand, and the use of local services and infrastructure (particularly roads) on the other hand. In addition, local taxes and charges on vehicles can counteract the negative externalities associated with local traffic congestion and local air pollution. Although local governments in Tanzania are notionally assigned some revenues from vehicle registration, we believe that vehicle taxation is an area that calls for a reassignment of revenue sources among different levels of government in Tanzania.

Taxes on extraction of natural resources

Mining taxes and taxes on extraction of natural resources provide a potential solid source of revenues for the public sector in Tanzania. Other than the sharing of hunting fees, local taxes on extractive activities are basically nonexistent in Tanzania. However, there is a good rationale for this type of taxation at the local level.

There is at least a partial link of taxes on natural resource extraction with the benefit principle at the local level. This type of taxes can be justified at the local level to the extent that extraction activities use local infrastructure (e.g., roads needed to transport heavy machinery and mined resources), place stress on other local infrastructure (temporary worker camps, hospital facilities required to treat injuries incurred by those working in this industry, and so on), and –depending on the type of extraction- may be polluting or cause other negative externalities increasing health costs of local residents even those not engaged in the extractive industry. There is an extensive literature in the theory and practice of fiscal decentralization on the pros and cons of the assignment of natural resource revenues to subnational governments. Notwithstanding the arguments for some form of local taxation of natural resources, there are two major arguments against local taxation of natural resources. Firstly, in the case of geographically concentrated natural resources, local taxation could cause extensive horizontal fiscal imbalances (e.g., the recent cases of Indonesia, Nigeria, and Russia). Secondly, given the high volatility of world commodity prices, local taxation of natural resources would not constitute a stable source of revenue. These two arguments are more valid in the case of the very political issue of oil and gas production and less valid in the case of common natural resources.

Although excessive reliance of local governments on extractive revenues should be

avoided, sharing different forms of mining-type revenues with local governments, especially in the presence of negative externalities of the extraction process, could be considered in Tanzania.

4.4.2 Potential new local revenue sources

Based on our appraisal of the appropriateness of the entire spectrum of revenue assignments in Tanzania and identification of fiscal space not currently occupied by any level of government, we suggest a number of possible local revenue sources. In considering whether the introduction of new local revenue sources are needed as part of its strategic framework for local government finance, the government should carefully balance the additional local revenue yield and increased local revenue autonomy with the political and administrative costs that the introduction of new local revenue instruments would hold both for central and local governments alike.

Local Personal Income Tax Surcharge. A possible appropriate new local revenue source is the introduction of a local surcharge (or piggyback tax) on the central government's personal income tax. Such a surcharge would be collected by TRA and would be credited regularly (e.g., monthly) to the respective local government accounts, desirably on a residence basis (as opposed to the place of work). The local surcharge income tax would be levied on the exact tax base of the central government personal income tax, although local governments would have discretion to set a flat (proportional) rate. National legislation would set the minimum and maximum rates that can be applied by the local governments. Such a surcharge would provide local government with a sizeable and buoyant source of revenue. Moreover, being administered and enforced by TRA, it would be easy to implement. However, Tanzania lacks a tradition of piggyback taxes. Uneven distribution of tax base might warrant asymmetrical assignment of such a surcharge, depending on the level of tax base development. Consideration must be given to reforming the current national personal income tax by significantly lowering the exemption threshold. This would bring revenues to smaller communities and at the same time would enhance revenues for the central government. In effect, this tax would likely end up being a local withholding surtax on PAYE income.

The primary advantage of a piggyback local income tax would include the sizable and elastic revenues that such taxes could yield. A secondary advantage of the tax would be the low administrative cost, as its collection would be piggybacked unto the collection of the national personal income tax by the TRA. A (piggyback) local income tax generally adheres both to the ability-to-pay principle as well as to the benefit principle. Disadvantages of this option include the lack of tradition in Tanzania with tax base sharing and piggyback taxation; in fact, the central government may simply be unwilling to share this tax base with the local level. Another potential disadvantage of this potential new local revenue source would be the urban bias in its incidence. However, this would be an unlikely feature of most local revenue sources (particularly ability –to-pay taxes) and could be mitigated by the introduction of an equalization grant.

Local excise tax (Levy) on utilities. We recommend considering the introduction of a Local Excise Tax on Electricity Consumption (and/or telephone service, potentially for both land line and mobile services). Such an excise tax would conform to both the benefit principle as well as the ability-to-pay principle. The tax would be collected by the utility companies at rates set by the local governments from a range with maximum and minimum rates determined by central government regulations or legislation. This would provide a good tax handle and potentially a high yielding and elastic source of revenues used in other countries. However, given that electric tariffs are already considered too high in Tanzania, there are certain limits to the usage of this tax both in terms of political feasibility and efficiency concerns.

Local Motor Vehicle Fees. We recommend reassigning the Motor Vehicle Registration and Annual Permit that are currently collected by the TRA to the local government level. This would be a good benefit tax for local governments. Given that new cars are registered centrally, it may be expedient to leave the first time registration centralized, with the annual renewal fee (which is collected by the TRA district office) reassigned to the local government level. The *Transfer tax,* the *Car Benefit tax,* and the *Foreign Motor Vehicle Permit and Transit Charges* would remain assigned to the central government.

Revenue sharing from extractive industries. A final recommendation -if the government wishes to explore new potential local revenue sources- is to consider some degree of revenue sharing of taxes on extractive industries with local governments. Whereas this option is not likely possible in the near future, its adherence to the benefit principle and correspondence as well and its potentially high revenue yield make it an option that cannot be ignored in the medium-term. Further discussion and analysis would be needed to determine whether this option is both administratively feasible and fiscally desirable in the future, as the distribution of natural resources across the national territory may result in undesirable horizontal fiscal imbalances.

4.5 Recommendations and the way forward

The objective of this chapter has been to offer a comprehensive examination of the local tax system; based on this assessment, we suggest what reforms need to be implemented to enhance the contribution of local government revenues to the broader system of local government finance, including revenue adequacy and accountability at the local level. Our approach has been first to focus on what is now in place and how it can be reformed and improved in the pursuit of increased local revenue adequacy in an efficient and accountable manner. Second, we have also examined the issue of whether there is some additional fiscal space for local governments within the context of centrally assigned taxes and if so, what new taxes could be introduced or reassigned to local governments if the Government considers it desirable to increase the revenue capacity of local governments.

Overall policy stance and policy effectiveness.

On the issues of local government revenues, the policy stance of the Government of Tanzania has been somewhat ambiguous. While there was a recognition that the local revenue system performed poorly, stakeholders within the central government lacked consensus on the way forward. On one hand, the Ministry of Finance was greatly troubled by the impact of local taxation on economic development and was eager to rationalize the local revenue system through a process of eliminating local revenue sources. On the other hand, PO-RALG emphasized the importance of local revenue autonomy, and was hesitant to forcibly restrict revenue discretion at the local government level. Given that both concerns are valid in the design of a local revenue system, the government's policy stance should combine the desire for a clearly structured, transparent and efficient local revenue system on one hand with the desire for local revenue autonomy on the other hand in the context of a well designed local government revenue system.

Our assessment concludes that multiple factors contributed to the shortcomings of the current local government revenue system, excessive local discretion in defining the framework for local government revenues; the resulting excessive fragmentation of the local revenue system; significant horizontal inequities; the lack of legitimate, standardized processes and procedures in collecting local revenues; limited tax administration capacity at the local level, and poor incentives for local governments to collect own revenue sources caused by a variety of cross-cutting local government finance issues (faulty expenditure assignments; lack of correspondence; soft budget constraints, and so on).

The first step in the reform of the local tax system should be to clean and clarify the terminology and concepts currently being used. The interest of clarifying these concepts lies in making the system easier to understand for taxpayers and local government officials alike, thereby contributing to greater legitimacy of the system of local government revenues. Greater clarity and greater legitimacy should also help to improve the administration of local government revenues, improve taxpayer compliance, and also facilitate the monitoring of the performance of local tax systems.

As a second step in transforming the local revenue system, local revenue autonomy should be pursued within the context of a "closed list" of local taxes in order to achieve both objectives (a standardized, more efficient framework for local taxation, as well as local revenue autonomy and flexibility),. The existence of a "closed list" would ensure the overall legitimacy of the local government revenue system and would prevent onerous local taxes from re-emerging. Yet, the closed list approach would nonetheless provide local governments with the discretion to change local tax rates (within centrally established limits); the closed list approach should be defined in such a way that it provides flexibility to LGAs by allowing them to select from various different options how to administer local taxes. As such, the reform of the local government tax system would allow for asymmetries in revenue assignments. For instance, the right to collect certain revenues might be subject to certain centrally-defined minimum conditions.

The reform should focus on the simplification of the current structure by combining several fragmented local taxes and levies into a small number of broad-based local tax instruments with a more significant revenue potential; the prime sources of local revenue would be the Unified Local Business Tax and a Local Property Tax. Compliance costs and horizontal inequities would be further reduced by the introduction of a nationally standardized framework for local revenue administration, which would assure that taxpayers across the country would face the same administrative processes and procedures, including the same local tax forms. Additional local revenues would also be collected from a number of Local Levies (local taxes with a specific tax base) as well as from User Fees. The framework for local government revenues would further be tightened by clearly defining the role of Contributions in the local government finance system, and providing additional context for village-level revenues.

In addition to the transformation of the current local revenue framework, the Government should also consider enhancing the fiscal space of local governments, which have the capability of providing considerable room for enhanced revenues and accountability at the local level. Possible new local revenue sources could include a "piggyback" Local Personal Income Tax Surcharge; the introduction of local excise taxes on utilities; or reassignment of annual Local Motor Vehicle registration fees to the local level.

Adopting and implementing the new policy framework

Building broad understanding and policy-level consensus for the recommended transformation of the local government revenue structure is a critical first step in the process of transforming Tanzania's local government revenue framework. Upon the formal adoption of a broader framework for local government finance (a draft of which is presented in Section 8 of the report), a concerted effort will be needed to ensure that the transformation of local government revenues proceeds in a deliberate manner. The FDTF, in close collaboration with the TRTF, should instigate a participatory process to finalize the "closed list" structure of the new local government revenue system; this process should include central government stakeholders, local government representatives, as well as private sector stakeholders and civil society. After a consensus reform package is attained, LGRP should take the lead in implementing the reforms, including (1) revising the legal framework; (2) strengthening central government institutional and regulatory framework; (3) strengthening of the local government institutional and regulatory framework; and (4) ensuring participation by civil society and the private sector.

- Constitutional and legal framework. After achieving policy consensus of the final shape of the fiscal space for local governments, the LGFA needs to be revised to reflect the more structured environment of local government revenues. While the Local Government Finance Act was revised in 2003 and 2004 to introduce a "closed list" approach to local revenue, the closed list appears to have been introduced "through the backdoor" (as a footnote to a Schedule) rather than by consistently revising the key sections dealing with local revenues. As such, the Act ought to be

reviewed and revised in such a way that it is wholly consistent with the intent and practice of a new "closed list" approach of local government revenues.

- Central government institutional and regulatory framework. Two key reforms are needed at the central government level in order to assure a sound local government revenue framework.[52] First, the central government should develop a nationally standardized set of local tax regulations and a local tax administration manual. The regulatory framework should provide definitions of the universe of taxpayers that are subject to local taxes (and in which jurisdictions), a general definition of the tax base for each tax, the general collection procedures for local revenues, and sanctions for local tax evasion, to assure uniformity in practices across the national territory. At the same time, the regulations for individual local taxes should be sufficiently flexible to allow different LGAs to follow different administrative approaches (within options set forth in the regulatory framework) as may be dictated by local circumstances. For instance, different property valuation approached may be appropriate for local governments under different circumstances, so that the regulations should specify several permissible approaches. Substantive technical support –as well as extensive interaction and possible piloting- will likely be needed to develop the regulatory framework and administrative manuals.

  Second, in order to provide an enabling institutional framework for local government revenue collections, the central government needs to align its institutional framework by introducing a focal point within PO-RALG (ultimately within the LGA Finance Section) for local government revenues. It would be the job of this unit not only to monitor local government revenue practices, but also to support local governments on an ongoing basis in improving their local revenue administration practices.

- Local government institutional and regulatory framework. As already noted, in order to assure that the regulatory and administrative framework for local revenues is appropriate for the variety of local conditions in Tanzania, involvement of local finance officials from a spectrum of LGAs across the country will be needed to assure the development of a sound regulatory framework. In fact, as part of the development process, the new regulatory framework should be rolled out and tested in a select number of LGAs first. This will allow the fine-tuning of the framework itself as well as the development of explanatory materials that will accompany the roll-out of the new regulations.

  Rolling out of the new regulatory framework for local government revenues should be accompanied by an intensive series of seminars and capacity building workshops for local government officials. The transformation process should involve every LGA going through a process by which they identify gaps between their current local revenue structure and the new permitted list of local revenues, as well as any gaps between their local revenue administration practices and the regulatory guidance

[52] This is in addition to resolving any cross-dimensional issues with the local government finance system that may be effecting local government revenues. These issues are addressed in the other sections of this report.

contained in the nationally standardized regulatory framework for local revenues. Local governments should then be provided sufficient time (and possibly limited external support) to develop and implement reforms to come into compliance with the new local government revenue system. In order to assure the orderly introduction of the new local revenue system, sanctions should be put in place for LGAs that fail to comply with the new revenue system after a transition period. Appropriate sanctions should include loss of the privilege to collect (certain types of) local government revenues and/or loss of the privilege to receive (or reductions in the allocation of) the Local Government Capital Development Grant.

- Participation by civil society and private sector. A final element that cannot be overlooked is the role of civil society and private sector in the transformation of the local revenue system. In order for a transformed local government revenue system to work, the new local tax system needs to be well-understood by taxpayers across the country. The sensitization of civil society and the private sector will require a broad range of sensitization activities, including the development of brochures explaining the new local tax system to all citizens; communications about the reforms through the media; as well as requirements for local governments to hold information sessions for local businesses, CBOs and other local stakeholders.

Annex 4.1
Local tax administration and revenue management capability in Tanzania

Revenue administration (which government level collects a revenue sources and how) is an important dimension of a good revenue assignment. If Local Government Authorities are not capable of administering a revenue source in an efficient manner, then either the ability of local governments to administer this source should be strengthened; the revenue instrument should be transformed or rationalized in order to make it easier to administer; or the revenue source should be considered for elimination or reassignment to the central government level.

Local tax administration patterns and local revenue performance

There are a number of studies as well as anecdotal references that discuss the administration of (specific) local revenues in Tanzania. In all this literature, there is a clear consensus that the quality of local tax administration is extremely poor and that local governments only collect a fraction of the local tax liabilities that they are owed.[1]

The current failure of local revenue administration is highlighted in a number of comprehensive studies and government documents over recent years. For instance, the Ministry of Finance's Budget Guidelines for 2004/05-2006/07 estimate that less than 40% of potential revenues from local governments' own revenue sources are actually collected (Steffensen, Tidemand and Mwaimpopo, 2004). This state of local revenue administration is highly unsatisfactory. Not only does this imply a large revenue shortfall in comparison to the revenues that should be available to the local government level, but the low revenue performance also raises the possibility of vertical and horizontal inequities, where the actual tax incidence is determined as much or more by the pattern of collections rather than by the design or structure of the tax instrument itself.

A series of studies on local government finances performed under the UAPP in Singida, Mtwara and Mbeya (Kobb 2001a; b;c) broadly confirm the observation of poor revenue administration and low fiscal effort in these three specific locations. Overall revenue compliance was estimated at 47% in Singida, 54% in Mtwara, and 30% in Mbeya. In Singida and Mtwara property tax compliance rates were reported as low as 18.5%, while in Mbeya taxpayer compliance for the industrial cess was approximately 9%. A similar impression is given from a recent study of finances in six councils conducted between

[1] The latter concept is known by economists as local revenue performance. This concept is also referred to in the public finance literature as "local tax effort" or "fiscal effort," that is, how much revenue is actually collected vis-à-vis overall potential revenue collections.

2000 and 2003 (Fjeldstad, 2004a) and re-iterated in other work by the same author (e.g., Fjeldstad 2004b). Likewise, estimates by Franzsen and Semboja (2003) of the potential additional revenue that could be raised from the three local revenue sources in Dar es Salaam indicate a similar order of failure.

What are the reasons for such poor local revenue collection effort and poor revenue performance in Tanzania? The work by these and other authors indicates a pattern of local tax administration that is characterized by a wide range of shortcomings, driven by poor tax design on the one hand and low administrative capacity on the other. Specific contributing factors to the patterns of local revenue collection in Tanzania include:

- *The fragmentation of local tax structures.* The proliferation of small taxes has clearly been an underlying problem in achieving sound local tax administration and revenue performance. Compliance and administration costs are often unrelated to the amount collected; thus in many cases the collection of a large number of low tax payments costs as much, if not more, than the revenue collected. Given the inefficient nature of such a fragmented local tax system, it may, in fact, be the case that overall efficiency is improved when local governments cease to collect many of these taxes. The decisions by central government in 2003 and 2004 to abolish the Development Levy and a wide range of other 'nuisance taxes' was partly driven by this phenomenon. However, the reforms in some ways may not have actually resolved the fragmentation of local revenue structure.

- *The absence of local "tax handles"*. Whereas central government occupies the part of the "fiscal space" that is populated by large taxpayers with high revenue yield, local governments are assigned taxes that heavily fall on smaller taxpayers that are typically considered as "the hard-to-tax".. As such, local tax administration officials in Tanzania, which often tend to have low administrative capacity to begin with, are often required to collect administratively onerous taxes. In contrast, tax administration is facilitated when the collector has a "tax handle" that provides the collector with an effective instrument whereby collection of the revenue source can be enforced. There are two important types of tax handles. The first way in which a tax handle can be assured is by inserting the tax collection processes into transactions at the stage where money is changing hands. Often this is enhanced where the party to the transaction which is not paying the tax is required to withhold the revenue and pay it to the government Thus taxation of goods being bought and sold at a market, or taxation of incomes done at the point of remuneration, is easier to enforce[2]. The second type of tax handle is provided when there are realistic sanctions for non-payment of the tax. If the chance of non-payers being identified is weak, or the sanctions are weak, or not implemented, tax administration will be seriously compromised.[3] Having a tax handle can greatly reduce tax avoidance and evasion, and reduces the cost of administration and enforcement. Yet, in the case of most local taxes in Tanzania, such as the property tax (or until recently, the Development Levy)

[2] This is also the case with VAT, for example, where, in addition, the system of invoice based credits creates a system of automatic audit of payment

[3] There is a danger in making sanctions too onerous as this makes them politically less feasible to enforce.

good tax handles are absent. In the case of property tax, the tax handle is weak since property owners are often absent and in many cases it is not even clear who the property owner actually is, and thus who is liable for the tax.[4] In fact, the central government has imposed restrictions on local tax administration that further weaken their tax handle. For instance, the (virtual) abolition of local business licenses has eliminated a substantial local tax handle on business revenues, as an important function of licenses (in addition to their regulatory functions) is to assure tax compliance. Likewise, the restriction imposed by the Ministry of Finance that no local taxes may be collected at the market place jointly with the Produce Cess (intended to promote adherence to the "closed list") has greatly reduced the legitimate tax handle of many rural local governments.

- *Political pressures*. Many of the Tanzanian studies pertaining to local revenue administration cite political pressures (both from local officials as well as from national politicians) to relax collection as a contributing factor in the low levels of local revenue collections. While political pressures to lower revenue collections are by no means unique to Tanzania, there tends to be greater scope for this at the local level, particularly where taxes are generally unpopular and poorly designed.

- *Aggressive collection methods*. The generally low local tax compliance levels have resulted in a tense and adversarial relationship between tax collectors and citizens. This was most evident in the case of the Development Levy before it was abolished in 2003. Anecdotal evidence suggests that road barriers would be established where citizens were required to show tax receipts to the local militia and members of the judiciary.[5] Particularly with the late payment of the Development Levy carrying a fine of 50 percent, there were numerous reports of citizens hiding from the authorities to avoid payment. A survey of local residents by Fjeldstad (2004b) finds that a key reason for payment of local taxes is the desire to avoid "creating a disturbance".

- *Excessive revenue discretion and revenue corruption.* Many of the local taxes imposed in Tanzania require assessment processes which entail significant discretion on the part of tax officials and direct contact between tax administrators and taxpayers. The resultant subjectivity involved leads to high scope (incentives and opportunity) for corruption, or, even where this is not the case, perceptions and accusations of corruption or nepotism. Discretion could be reduced in part by more closely regulating the assessment process (based on objective criteria) and/or by separating the assessment function from the collection function. To reduce corruption it is important to address current incentives for evasion,[6] and opportunities.[7]

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[4] This is one reason why many property taxes around the world make the property and not the owner the subject of the property tax; therefore whoever is occupying the property is liable for the tax subject to forfeiture.

[5] Of course, it is legitimate for local authorities to enforce the collection of local taxes in accordance with the law. However, when the enforcement of local taxes degenerates to such an extent that it causes economic and social disturbances, the effectiveness and legitimacy of the local revenue instrument has to be questioned.

[6] These include lack of moral and ethical behavior by tax officials, low probabilities of detection, weak

- *Incentives and the outsourcing of collections.* Many local government authorities have appeared to increase their collection rate through outsourcing tax collection. For instance, Fjeldstad (2004a) notes that of the six councils studied only in Iringa was collection done exclusively by council officials; in the other five councils there was some degree of outsourcing. The rationale behind outsourcing is that the incentives provided by the profit-motive result in a more effective collection process. However, it is often not clear how effective outsourcing actually is, since overall revenue estimates are often very inaccurate and the amounts retained by the collecting agent are generally not known. Thus, regardless of whether taxes are collected by council officials or outsourced, a significant part of the revenue yield has to be set aside for creating the incentive for efficient collection. For instance, until the Development Levy was abolished, the Ward and Village-level Executive Officers that collected the Levy retained 20% of collections, from which their salaries were paid.

- *Low value-for-money.* A common theme in the debate surrounding local fiscal performance is the high proportion of revenue absorbed by local administration and the concomitant low levels of service delivery. Fjeldstad and Semboja (2000) found, for example, that in Kilosa District Council the wages of revenue officials and ward officers was 80 percent and 64 percent of reported collections of own revenues in 1995 and 1996 respectively. Many other more recent studies confirm these findings across the country. Fjeldstad's (2004a) study of six councils estimates that between 50 percent and 60 percent of locally collected revenues are spent on administration. This finding is confirmed by the local government finance studies conducted in Singida, Mtwara and Mbeya (Kobb 2001a;b;c). In the absence of the central government providing local governments with unconditional funding which could be used for this purpose, one cannot hold LGAs responsible for this structural failure of the local government finance system. As noted in Section 3 of this Final Report, we suggest that the manner in which local government administration is currently being funded violates the principle of "finance following function". Instead, we suggest that an unconditional, equalizing General Purpose Grant should be introduced, so that local governments are free to use their own local revenues to fund local government services and infrastructure (see Section 5.3).

- *The presence of soft budget constraints in the transfer system.* The incentive for local governments to collect own source revenues is greatly reduced whenever the local government is able to obtain financing from alternative sources without imposing any burden on local taxpayers. As such, the presence of a soft budget constraint in the transfer system could have a significant negative impact on local revenue performance. We believe that the ability of LGAs to divert OC resources from primary education and health sector grants - which was uncovered by several public expenditure tracking studies- potentially provides local governments with an abundant and "cheap" alternative funding source for spending on own local

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penalization and prosecution and inadequate wages and incentive compatible compensation for officials.

[7] Opportunities for corrupt practices increase with the absence of basic oversight and control of tax administration, complexity of the tax instruments, and discretionary power of tax and customs officials.

activities. Similarly, the discretionary nature of the General Purpose Grant and the presence of other parallel funding mechanisms (including donor funds) also provides a potential entry point for local governments to negotiate grants rather than raising local revenue effort. As such, imposing a more comprehensive, structured, and formula-based transfer system is needed in order to improve local revenue effort.

- *Absence of central government role.* Although local taxation is predominantly a local government affair which improves the (accountability) link between local residents/taxpayers and local officials, there is an important role to be played by the central government in order to assure the legitimacy of the local tax system. However, at the current time, no central government institution (PO-RALG, Ministry of Finance, or TRA) has dedicated staff or expertise to guide local governments in the collection of own revenues. The new LGA Finance Unit within the reorganized structure of PO-RALG (which falls under the Director for Local Government) would be the right place to build this capacity

  Whereas the presence of local taxes encourages residents to participate in the local budget process and to hold local officials accountable, local residents and CBOs lack the technical expertise and the access to assure that their local tax officials follow sound tax administration procedures. Thus in order to increase the legitimacy of the local budget process, the central government should monitor certain aspects of local tax collections and certify that local authorities are adhering to sound tax administration practices. For instance, the central government might wish to monitor property tax valuation techniques applied at the local level in order to assure local taxpayers are being treated fairly in the valuation of property. Likewise, the central government might impose a minimum collection ratio in order to prevent selective collection of taxes, which may result into horizontal iniquities.[8]

Variations in local government revenue administration capabilities

While the local capacity to administer local revenues is generally weak in Tanzania, there are clear variations in local tax administrative capacity. The context for local tax administration differs significantly across the country, with Dar es Salaam a clear contrast to the rest of the country in terms of scale and proportion of revenue raised locally. Yet nowhere could it be claimed that the current administration processes are satisfactory. In this light, it is relevant to explore how administrative capacity varies between different local governments. This will offer a clearer picture of the work to be done, as well as valuable information about what reforms may be feasible in the shorter term and the possible convenience of asymmetric policy approaches.

At the local level, despite the poor design of own revenue instruments there have been

[8] It does not uncommon -even in developed countries- for central governments to monitor local tax collections in order to assure a sound system of local government finance. For instance, in the State of Georgia, the state Department of Revenue monitors local property valuation practices; if local governments fail to adhere to professional standards in valuation, their authority to collect the property tax is taken away.

some notable improvements in revenue collection in recent years. For example, Steffensen et al. (2004) reports that contrary to the experience in neighboring countries own revenue collection increased -albeit modestly- between 1999 and 2002, until the abolition of the Development Levy and the so-called nuisance taxes. The authors attribute this trend to "professional administration raising revenue despite political interference", the use of incentives, outsourcing, and the fact that local government authorities had so few discretionary resources that they were forced to raise their own revenues.

Steffensen et al (2004) also reports some improvement in financial management in recent years, especially when comparing reports for 2001 with reports in 2003/04. There has been a 'slight improvement' in audit reports and a 'marked improvement' in the follow-up on audit queries. In addition, there have been some improvements in staffing. Whereas several years ago there were substantial vacancies in key local finance positions, the key positions of local treasurers as well as accountants are now filled in most of the urban and rural councils.

Another reason for variations in local government revenue administration capabilities is the differential degrees of computerization at the local level._The introduction of computerized Integrated Financial Management Systems (IFMS) for local authorities has been generally slow. Initially, LGRP planned to roll out a local IFMS software package known as Platinum/Epicor in a three-phased approach (one-third of all councils during each phase). While Epicor was introduced in 28 councils in 2000 and extended to all 38 first phase reform councils, significant problems were encountered in the roll-out and the phased approach was abandoned in 2002. Steffensen et al. (2004) notes that as of June 2003 there were 10 councils with a stable, fully operational computerized accounting system. Despite the slow speed of progress, the fact that 10 councils had by 2003 bedded down the new systems indicates that it can and is being done. As experience is gained in implementation it can be expected that the speed of computerization will increase. But capabilities differ greatly across districts.

Specific attention to revenue collections has been paid in the urban areas, particularly under UAPP and now under LGSP (for Dar es Salaam). Franzsen and Semboja (2003) show how revenue collection in Dar es Salaam improved markedly after the degeneration of local government in the city and the subsequent establishment of the City Commission to drive reforms from 1996. Over the last five years own revenues in Dar es Salaam have increased at a much faster rate than inflation despite no tariff increases since 1997.

It appears that there have been different responses across districts to the recent "rationalization and harmonization" of the local tax system. Data being used for a report currently being compiled for a World Bank Poverty Analysis and Social Impact (PSIA) study examines the response to the abolition of the Development Levy and the so-called 'nuisance taxes' in 2003 (ODG and REPOA 2005). Remarkably it shows that aggregate local tax payments in Ilala Council actually rose 5.5%, whereas local revenue payments in other local governments declined.

While all these developments are piecemeal, what emerges is a sense of gradual progress

and responsiveness to change, although with markedly different capabilities to do so across the country. However, if these improvements, even when they are isolated, can be made in the context of the current poor framework for local finances, then there is room for optimism that the councils and other designated agencies (such as private tax collection agencies and potentially the Tanzanian Revenue Authority) will be able to better implement and administer a well-designed system of local revenues.

What is crucial is that the transformation of the local revenue system is designed while keeping in mind the "implementability" of the proposed reforms, and that the implementation process is driven both by key stakeholders at the central government level (PO-RALG and MOF, but also with support from TRA) in combination with continued support for these reforms from the private sector, civil society, as well as local government officials.

Strengthening local revenue administration in Tanzania: The way forward

Any approach to strengthening local tax administration in Tanzania must be consistent with the current and emerging nature of decentralization in the country. In this context it is crucial to recognize the 'concurrent' rather than 'exclusive' nature of many of the responsibilities of local governments. In particular, the strategy to strengthen and modernize local tax administration should be consistent with this approach. Thus, there is scope for greater involvement of TRA in the collection of local taxes. There should be greater interaction and exchange of information between local tax administrations and the TRA with local government tax collection feeding constructively into TRA operations and vice versa, and greater involvement of the TRA in the training and upgrading programs of the local tax administrations. What follows is a discussion of the main policy thrusts needed for the strengthening and modernization of local tax administration.

The need for a standardized local tax administration framework

One of the main principles argued in this report (see Section 1) is the need for a "closed list" of local taxes in order to assure there is a comprehensive, but consistent tax structure in all LGAs. There are several advantages to this. Uniformity will reduce compliance cost to taxpayers and especially firms, which, in turn, will increase the legitimacy of the entire system of local taxation. Furthermore, consistency would facilitate more effective support by the CG and outside experts to help LGAs to improve local tax administration and collection.

Correspondingly, it is important to assure that there is a standardized local tax administration process, which is fundamentally the same for all LGAs in Tanzania. This means that every LGA would use the same revenue administration manual, use the same local tax forms, as well as processes and procedures. This further uniformity would again reduce compliance costs for taxpayers, and increase the ease with which LGAs could be supported by central government officials or external consultants to improve their local

tax administration.

The need for simplifying, rationalizing, standardizing and computerizing processes and procedures more widely

There are significant gains to be had in simplifying, rationalizing, standardizing and computerizing administrative approaches. Not only are costs reduced for government, and efficiency enhanced, but compliance costs imposed on taxpayers are also greatly reduced. However, sometimes complexity tends to linger in the face of simplification efforts because of inertia and comfort with old procedures.[9]

Simplifying. As complexity increases, the resources and skills required to manage it grows exponentially. The evidence is reasonably clear that a key driver of the administrative inadequacies of the current local fiscal system is complexity. Complexity dissipates focus and leads to uncertainty. Simplicity makes for much greater clarity and ease of administration. An example of complexity is where slightly different activities are required to be taxed in different ways at different rates. This results in all related activities having to be classified as one or the other, which in turn leads to disputes which take time and effort to resolve. Were all the activities taxed at the same rate the issue would never have arisen. One of the greatest contributors to complexity is the existence of parallel systems. Typically, parallel systems develop where the tax laws allow for overlapping potential taxes on the same economic activity.

Rationalizing. Different taxes and their enforcement can sometimes work in a contradictory manner because the legislation and implementation processes may have been developed separately, without proper coordination. A good example of the need for rationalization in the current Tanzanian system is in the treatment of property tax and land rent – at least in urban areas. The former is a local tax while the latter is a national revenue source partly shared with local governments. The two are administered separately, yet both entail managing very similar activities. In both cases there is a need for geographical mapping to identify and record land and buildings. Generally the taxpayer is the same person. The value of the one is closely related to the value of the other. While there are significant historical issues to the 'ownership' of land in Tanzania which need to be accommodated, there is no fundamental reason why this cannot be done in a manner which is integrated with the treatment of buildings. A rationalization of these two revenue sources so that they are treated in an integrated way, at least in urban areas, would have significant advantages.[10]

At a more general level, rationalizing the administration of local taxes will entail treating each of them as part of system, thus taking advantage of synergies and economies of

[9] For example, Fjeldstad (2004a) notes in the study of six councils that while they are all moving to implement the Epicor and Platinum financial systems there continues to exist a myriad of other manuals and handbooks, while much of the financial management is still done manually.

[10] The need to rationalize the land and property tax systems into a single system is recognized by a number of commentators, including ODG and REPOA (2005) and Franzsen and Semboja (2003).

scale in their enforcement.

Standardizing. The lack of standardization can considerably increase administration and compliance costs. Where there is no standardization, transparency tends to be greatly reduced since outside parties need to be familiar with the nature of the particular instance at hand. In particular, the compilation of a national data base on local finances, which is a key component of an effective system of decentralization, is impossible without standardization. Some attempts have been made to standardize financial procedures. For example, there is now a 'Local Authorities Accounting Manual'. Yet there remain many different instances at the local level where standardized processes are lacking. In respect of taxes, there appears to be large variations in how local taxes are enforced and administered by different local authorities. The abolition of certain business licenses and 'nuisance taxes' was partly aimed at reducing this variation, yet indications are that it continues to exist to a large degree.[11]

Computerizing. Computerization brings with it massive gains in the efficiency of tax administration, where large numbers of transactions need to be managed. Many of the local government authorities in Tanzania are still run on manual systems. While there are constraints to the introduction of computerized systems in remote areas, as has been discussed, these can and are being overcome. Standardization is a key prerequisite to computerization.

Accommodating asymmetry

While the urban and rural councils provide a single administrative tier comprehensively across the entire country, as indicated, there are huge differences between different parts of the country which any new approaches to administration should recognize and accommodate. These differences are recognized in the differences between the categories of urban and rural councils and the different types of councils within the urban category. In line with the emerging reform approach of the GoT, even though a single system of urban and rural council administration is required, this must be sufficiently flexible and robust to accommodate a continuum of different capabilities while still maintaining a high degree of consistency and standardization. In some instances special legislation has been rightly passed to accommodate the very profound differences that occur in the case of Dar-es-Salaam vis-à-vis all other local governments. This accommodation of asymmetry is not only appropriate but also quite desirable.

Creating synergies between central and local government tax administration

Beyond tailoring solutions to the nature of decentralization in Tanzania as well as simplifying, rationalizing, standardizing and computerizing, there is scope for designing

[11] Donors can hinder standardization because of different reporting needs amongst different donors. This problem does appear to be recognized and addressed in Tanzania through greater co-operation amongst donors.

solutions so that synergies are created between centre and local in tax administration. There is much greater scope for this in the Tanzanian environment where there is a significant degree of concurrent responsibility.

Currently there is a tendency towards competition and a lack of co-operation between the Tanzanian Revenue Authority and local government authorities. However, with appropriate tax design there are many ways in which the two could support one another even while pursuing their own interests. Achieving this is possibly the key to hugely enhanced tax administration since there are significant economies of scale and scope to be captured, while the costs of tax compliance for tax payers could be greatly reduced.

Two examples of how this might be done in the Tanzanian context are suggested in the next sub-section. Even without any shared or complementary operations, co-operation is possible and very desirable in the development of administrative capacity, the marshalling of technical assistance and various types of information exchanges, including on delinquent taxpayers. However, the important gains are harnessed when co-operation shifts to an operational level, as for example in the case of: (i) coordination of registration for national and local taxes to ease business development and to facilitate information exchange for administration; (ii) the use of a single taxpayer identification number to the greatest extent possible; (iii) the exchange of audit and other compliance data to the fullest extent permitted by law; (iv) locating taxpayer services offices together to the greatest possible extent; and (v) coordinating payment mechanisms for central and subnational taxes.[12]

Developing a cooperative approach requires both parties to recognize that each has comparative advantage in the gathering of different types of information. For example, local governments can play a key role in bringing small businesses into the VAT system once they reach the designated threshold, whereas the TRA has the authority and capacity to make assessments based on access to business accounts in a manner which is unlikely to be achieved by local governments.

Many examples in the international experience of co-administration between central and local government concern the property tax, especially in the area of valuations. Central technical skills in areas such as computer aided mass appraisal are combined with local knowledge and information gathering. Design of tax forms and procedures, and training of specialized staff is often also done centrally while administration of the valuation within a local area is managed locally.

It must be recognized, however, that poorly designed attempts to create synergies can result in greater confusion and bureaucracy; so great care should be taken here. The key is not to make the actions of one body dependent upon the other but rather to find ways where the independent actions of each can support and complement the other.

[12] See Martinez-Vazquez and Timofeev (2004) for a fuller discussion of the coordination and cooperation vehicles among different levels of tax administration.

Collecting revenue and ensuring enforcement

The critical test of a tax system lies in whether revenue is actually collected. In the absence of revenue collection all activity around tax design and assessment for liability is meaningless. As already stressed, actual tax systems are represented by actual amounts of money collected. It is remarkable the degree to which analysts (and policymakers) tend to confuse intended tax systems with actual tax systems, analyzing, for example, the progressivity of a tax on the basis of what is intended to be collected, rather than what is actually collected.

As has been stated already, it is far easier to collect revenue at a point where money is changing hands than where it is not, or where there is some other type of tax handle. This may be in the case of income tax at the point at which wages and salaries are paid, or in the case of VAT, where trade takes place. In the case of many local taxes, such as property tax, this phenomenon is absent.

Many successful local governments in the international experience integrate the collection of taxes with the collection of user charges. User charges are sometimes regarded as more legitimate than taxes because there is a clear service to the individual property received in exchange for what is paid. By presenting user charges on an integrated account along with taxes not only are billing and collection costs saved, but readiness to pay is enhanced. As mentioned in Section 4 and is further discussed below, local governments in some countries effectively collect their taxes by linking their payment to the services account and disconnecting services in the case the bill is not paid in full.

A significant problem in revenue collection is finding appropriate sanctions in cases of non-payment. In the case of wealthier tax payers, where larger amounts are in arrears using court orders to attach property is more feasible and incurs reasonable costs in relation to revenue collected, although it can be time consuming. Where smaller amounts are involved the situation is often more complex; although a large number of small defaults can reduce total revenue collection and compromise the legitimacy of a tax system dramatically.

In many cases the only options for enforcement are somewhat, or may appear to be, draconian, and include eviction from property or possession of moveable property through obtaining a court order. Because of the severity of the implications there is often a reluctance to enforce payment until arrears have become significant. At this point there is often an inability to pay. This process then tends to become easily subjected to political pressures where politicians understandably are reluctant to see severe and unpopular sanctions imposed against voters. This further complicates enforcement.

Recently, pre-payment systems have become much more widespread as a means of collecting user charges where consumption can be metered, driven initially by the electricity distribution industry, but more recently by the cell-phone industry. The

technology for water pre-payment systems is not yet matured, but is developing fast. Pre-payment systems have huge scope for improving revenue collection where there are large numbers of small scale consumers and the identification and billing of such consumers is administratively complex, quite apart from enforcing payment.

Where municipalities are involved in electricity distribution, there are instances where the pre-payment systems for electricity have been linked to the management of other accounts payable to the municipality. In the absence of payment of the tax bill the purchase of electricity is limited to a basic amount per month. Most consumers who are in a position to pay taxes tend to seek to consume above this basic level and so tend to pay their outstanding bill in order to consume desired amounts of electricity. In some instances arrears from other accounts are piggy-backed onto the electricity purchases creating an automatic payment of taxes as electricity is consumed. These mechanisms are particularly suitable in the case, for example, of large numbers of urban residential account holders who do not hold bank accounts that enable debit orders to be implemented. They are particularly effective where postal services and other formal systems critical to billing and collection systems are not present. In essence the pre-payment system is used as an 'entry point' where money changes hands to ensure collection of other taxes.

Significant scope also exists for enforcement around the impounding of motor vehicles in cases where motoring taxes are imposed. Relatively cheap electronic number plate recognition technology now exists which enables vehicles to be easily identified and impounded where motoring taxes have not been paid. Such a system may potentially be of use in Dar-es-Salaam. Instances where these systems are linked to other taxes as a means of enforcement could possibly be explored.

Many of these types of technologies are fairly recent, and many other new, cheap, and effective – but as yet unexplored – mechanisms based on information technology are now possible for use in tax administration and enforcement. The constraints lie not in the technology itself, but in using the technology in a manner which is appropriate to local conditions and embedding them into local systems. The growth of the cell-phone industry in Africa in general, and in Tanzania in particular, demonstrates the feasibility of using information and communication technology in new ways even in contexts where the overall level of technological development is low.

Often the constraints to developing new ways of administering taxes are founded upon legal issues which are not easily changed. The reform of the system of local finances in Tanzania offers a good opportunity to tailor new legislation to enabling effective use to be made of modern technological advances.

Providing positive incentives for collection and payment

The new paradigm for tax administration reform and modernization all around the world is characterized by the emphasis placed on creating appropriate incentives to enhance

collection on the one hand and payment on the other. This trend has developed globally as administrative systems and relationships based on hierarchical control and a "catch and punish" strategy have lost currency and legitimacy. In intergovernmental fiscal relations, the emphasis on incentives has led to the broader use of revenue sharing. The argument here is that if an authority has a stake in the revenue collected it will ensure collection takes place. Conversely, if the taxpayer sees at least some of the revenue being used locally it enhances the readiness to pay.

The extent to which revenue sharing arrangements are feasible in the case of reformed local taxes will depend to some degree on the nature of the new taxes agreed upon, but there is clearly scope for it in certain instances. Particularly in some more rural areas there is evidence of a tendency to expect local businesses to make sometimes quite substantial *ad hoc* contributions to local coffers. Mining and other extractive industries and agricultural enterprises are a case in point. It is best that the major contributions of such entities are marshaled through an explicit tax system (revenue sharing legislation and administration) rather than through ad hoc contributions. Designing tax sharing mechanisms around these industries so that part of the revenue accrues locally is key to developing a more appropriate relationship between such businesses and local government authorities.

Another common approach to incentivising collection is outsourcing of collection. This can have very positive results under certain circumstances but could also lend itself to corruption and the accrual of inordinately large benefits to the outsourcing agent. Any outsourcing of revenue collection needs to attend carefully to the design of checks and balances on abuse. Where the outsourcing agent has power to assess liability as well as collect taxes the scope for abuse is very high. In principle it is important that assessment is managed separately and taxpayers are clearly informed of their tax liability. It is also important that the amounts payable to the collecting agents are transparent.

A critical point to keep in mind is that outsourcing becomes difficult to manage properly when the total tax liability is not known. Outsourced collectors can then sometimes pay to the authorities far less than they are able to collect and make very substantial profits. It can work well, on the other hand, where the liability is known, but the authorities have been unable to collect the money due. By bringing more efficient methods to bear and based on increased motivation through the incentive of earning a portion of the amount collected substantial increases in revenue collection can be achieved. Under such circumstances it is also critical that the collection methods are agreed upon and revenue collectors adhere to acceptable practices.

Specific steps to improving local revenue administration in Tanzania

In this subsection we seek to lay out how some of the above administrative approaches might be applied in respect of the newly designed taxes already discussed in Section 4 of the main report. The precise nature of the envisaged taxes is still to be agreed upon; the intent here is to demonstrate what types of synergy are possible.

In previous sections the need for a closed list of local taxes has already been emphasized. Furthermore, to ensure standardization, for every tax on the list the tax base and the administrative procedures should be clearly and uniformly defined nationally. While allowing for an appropriate degree of local variation, national legislation should govern (i) the administration of local taxes, (ii) definition of the tax base, (iii) mechanisms for assessing the base (iv) processes for objecting to a tax assessment, (v) collection procedures.

Unified Local Business Tax

The unified local business tax is intended to replace all other business taxes, such as business license fees, various business levies, and in particular, the Service Levy. This substitution and consolidation of taxes will be quite delicate because some of the taxes being consolidated are now very important sources of revenue at the local level. For example, the Service Levy is currently a key source of revenue for Dar-es-Salaam municipalities budgeted to collect more than 40 percent of own revenues in 2004.

In order to maximize enforceability, the Unified Local Business Tax should be defined in such a manner that it can be linked to the Value Added Tax. At levels below central government's VAT threshold only the local tax should be payable and it should be administered by local government. At these levels, unless statements are available for making an assessment, the tax should be levied on a presumptive basis, as discussed in Section 4. However, once the VAT threshold is reached administration could shift to TRA and be integrated with the nationally administered VAT.

In this manner the local authority would support TRA in the identification of tax payers as they reach the VAT threshold, while TRA would collect the local business tax on behalf of the local authority once the tax liability reaches a level which requires returns based on formal books of account, for which municipal access is less appropriate.

Property taxation

As mentioned previously, various work done already on the property tax has indicated the significant untapped potential of this revenue source for Tanzania. However, also noted, is that the Property Tax is one of the more difficult revenue sources to administer successfully. This appears to be the experience in Tanzania too, with Fjeldstad and Semboja (2000) reporting that Property and land taxes were rated the second most difficult (next to the development levy) to collect in Kibaha and Kilosa. However, because of the fixed nature of property and the link between the value of property and the local services provided to it, it does remain an appropriate local tax.

In Tanzania, the success of the property tax has been compromised by unnecessary complexity. Firstly, two completely different systems are maintained in the land rent system run by the central government and the property tax system run by local

government. Secondly, overly complex valuation systems have been used in attempting to value urban residential property in places such as Dar-es-Salaam.

Land rent is paid to the state for leases on registered commercial, industrial and residential land occupied under non-traditional tenure. Revenues are collected by local authorities, deposited in the bank account of the National Treasury and 20% is supposed to be sent back to the local authority of origin. An integration of the land rent system with the property tax system does not need to be based on a fundamental overhaul of the approach to land tenure, although some administrative adjustments would be required. Different land has different value, be it for ownership or rental from the state. The determination of the value of the land could most successfully be done in conjunction with the determination of the value of the buildings upon it; thus this should be an integrated process. Similarly, there are significant synergies in collecting revenue for land rent and property tax; this should also be a single process.

One of the most fundamental areas for co-operation is in the establishment of a robust and pragmatic way of identifying and coding parcels of property that is able to accommodate the reality of different forms of land tenure in Tanzania, and can be used by all institutions. This is an area that needs urgent consideration, given the resources currently being spent on building new systems and databases. It is important to embed this properly in Tanzanian law.

The taxation of agricultural land – be it in the form of 'rent' for the use of land which is owned by the state – or a more conventional 'tax' of land which is privately owned, has different characteristics from urban land, which might suggest a different approach, contingent upon how agricultural activity in general is to be taxed. However, within urban areas the integration of the current two systems into a single system under the control of local government is clearly advisable. If different systems are maintained between urban and rural land the division between the two needs to be carefully conceptualized and managed.

Valuation is an area where different methods are appropriate to different contexts. Particularly at low tax levels, as is the case in Tanzania, it is inappropriate to use complex valuation techniques for valuing property – particularly relatively low value property. A simple banding system or area assessment would be much more appropriate. Apart from valuation, the key issues are to identify each property sufficiently clearly for the purpose of administering the tax, identifying who is responsible for the property (or, at least, benefiting from the property) so that he or she can be held liable, delivering the account successfully, providing convenient payment facilities, ensuring that payment is properly recorded and receipted and finding practical ways of enforcing payment in cases of default. The valuation of the property is only one of these many steps; the failure of any one of these steps will lead to the tax not being collected. It is better to establish a simple valuation system which is legitimate and robust and can be quickly implemented, while simultaneously focusing resources on these other steps, than to focus on valuations to the exclusion of the other steps. The hardest decision will concern steps to ensure the enforcement of the tax, including potential forfeiture through the court system.

All providers of services to individual properties should ideally be encouraged – or even required – to use the same coding system for their databases, or at least to cross reference their own database to the common coding approach. There may be scope under certain circumstances, especially bigger urban areas, for the entity which collects electricity through the pre-payment system to contract to collect property tax and even water charges, too. Use of a common identifier for each property would be a pre-requisite for that.

Taxes administered purely at local level

There are purely local taxes which lend themselves to being entirely locally administered, just as most central government taxes do not lend themselves to local involvement. An example of a purely local tax is the taxation of billboards and advertising. Taxes on billboards and advertising are a relatively minor, but not insignificant source of revenue for some local authorities. Often local systems for generating revenue from this source could be easily improved at little expense through simplifying and rationalizing local administrative processes.

The relationship between district-level LGAs and sub-district (village) councils

The discussion in Section 4 on Village Contributions raises the key administrative-institutional issues concerning the relationship between district-level LGAs and sub-district (village) councils, in particular, how to decentralize to the lower local level – particularly in the rural areas.[13] There are significant advantages in developing governance arrangements which involve these levels. However, care should be taken to focus on building upon the strengths rather than the weaknesses of such a level.[14]

The strengths of the sub-district (village) councils lie in the extent to which individuals can engage with government around their very local needs. Government can understand people's needs more intimately and be held more directly accountable. On the other hand, this level tends to be weak in managing formal administrative processes. Unreasonable expectations of formal administrative processes at this level can be disempowering; those who are less literate, for example, lose influence and access to those who are administratively attuned. Similarly, in the realm of taxation and the raising of revenue, a system that becomes too formal and administratively driven will lose the scope for engendering contributions in kind in favor of only monetary contributions.

Given the huge variation in skills and resources across the country different degrees of

[13] See, for example, the discussion on this issue in Steffensen et al. (2004).
[14] A particularly useful discussion of this issue is in the revenue sharing study of Kragh, Mangweha and Kadebe (2003).

administrative complexity will be feasible in different contexts. Some lower local government authorities may be well able to handle quite complex administrative procedures in a formal manner. Others may struggle even with simple formal procedures.

The urban and rural council level offers the key level for formal administrative procedures at the sub-national level. Basic systems and guidelines should be established which allow the lower local level to operate at the level of administrative sophistication best suited to it, with the council level providing the basis to enable this to happen.

Thus in some cases, for example, the village level could have its own bank account, collect revenues, receive funds into its account from other sources and procure services. In other cases these activities could be absent. However, this does not mean that the village level cannot organize local activities, including making decisions around the allocation of local resources and contributing in-kind to the creation of local infrastructure such as local school buildings or roads.

A focus is thus required not on determining a single way of operation for all villages and other lower local bodies across the country, but rather on a system which works in conjunction with the urban and rural council level whereby the lower local level operates in a manner most appropriate to enhancing local democracy, common purpose and participation in each local context. The recommendations of Kragh et al (2003) offer a good basis as a starting point for dealing with the more able lower local authorities. The criteria that village and other such authorities should meet in order to qualify for their proposed approach needs to be developed further and consideration given to how such lower local authorities should be dealt with where these criteria are not met.

Thus the principle of a single national framework that permits for local variation according to local capacity should be maintained.

Annex 4.2
Tax Effort in Tanzania

In this annex we use IMF data to compare the tax ratio (tax as a share of GDP) for 115 countries for several years during the 1990s.[15] These data show the tax ratio for Tanzania to be 13.3 percent of GDP. In comparison to many other countries in the sample or the average for all countries one could easily concluded that Tanzania has a low level of taxation. But raw comparisons even with the averages can be misleading because countries are very different from one another in terms of their capacity to tax. In order to explain the variation among these countries we use a regression analysis with a set of explanatory variables that reflect country differences in taxable capacity.[16] These independent variables and the hypotheses about how they should effect tax revenue mobilization are as follows:

- The level of per capita GDP should be positively related to the tax ratio, because higher GDP suggests a greater capacity to tax.

- The degree to which the economy is open to trade is a determinant of the tax ratio. The greater a country's propensity to trade with other countries, the easier it is to raise revenues, because the (administrative) tax handles are in place.

- The size of the agricultural sector relative to GDP should dampen taxable capacity and be negatively related to the level of the tax ratio. Countries with a larger agricultural share have fewer good (administrative) tax handles. Moreover, the agricultural sector can be politically hard to tax.

- The rate of population growth is also related to the level of revenue mobilization. Faster growing places tend to lag behind in the amount of revenue they raise per dollar of GDP, in part because of the lag in moving the increased population and economic activity into the tax base.

We have estimated an OLS regression against various combinations of these explanatory variables, with all variables measured in logarithms. The results for the 1990s shown at

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[15] The tax ratio is measured as an average for all of the years of the 1990s for which we have data.

[16] The limitations of cross section analyses of tax effort are worth remembering (Bahl, 1971; Bird, Martinez-Vazquez, and Torgler, 2004). These are no more than comparative empirical studies, and do not allow us to conclude that taxes are "too high" or "too low." Moreover, the results of the statistical analyses vary depending on the specification of the estimating equations. What we look for in such an analysis is a general pattern.

the bottom of the table, indicate that the estimated coefficients for the explanatory variables are statistically significant and have the expected signs. It turns out that the tax ratio is significantly higher in countries where per capita GDP and openness are higher, and where the agricultural share of GDP and the population growth rate are lower. We are able to explain 62 percent of the variation.

Now we can use this equation to estimate an "expected" level of the tax ratio for Tanzania and all other countries. From the equation at the bottom of Table A.4.2.1 and actual data for Tanzania for the explanatory variables, we would predict that Tanzania should raise 10.9 percent of GDP in taxes.

The actual ratio of taxes to GDP in the 1990s was 13.3 percent (column 1 of Table A.4.2.1). The ratio of the actual to the estimated is the "tax effort" coefficient. Thus, as we can see from Table A.4.2.2, by the cross country equation, Tanzania's tax effort coefficient is 1.20. This can be interpreted as showing that Tanzania was making a 20 percent above the international average tax effort in the 1990s.

Based on these international comparisons, we cannot come to the conclusion that Tanzania is a low taxing country. However, there are important reservations to this conclusion. Our results show that *collections* in Tanzania are not low in relative terms. But it may well be the case that liabilities are high for some and low for others, and that Tanzanians who comply with the tax laws face tax burdens that are internationally high while others pay little or no tax. As discussed in the text and shown in Table A.4.2.2 there are good reasons to believe that the burden distribution is unevenly distributed given the large and growing presence of the shadow or underground economy estimates.

There is another qualifier. An argument could be made that the rate of revenue mobilization in Tanzania is actually lower than that reported, because Gross Domestic Product is under-reported. However, Tanzania, like most other countries, is probably using a methodology such that the informal economy is counted in the GDP estimates.

Table A.4.2.1
Tax Effort in Tanzania and Across Selected Countries, 1990s

Country	(1) Actual Tax Ratio to GDP	(2) Predicted Tax Ratio to GDP	Tax Effort: (1) / (2)
Albania	20.5	19.6	1.0
Argentina	19.1	21.5	0.9
Australia	28.8	29.0	1.0
Austria	42.4	38.0	1.1
Azerbaijan	22.4	18.7	1.2
Bangladesh	39.8	13.3	3.0
Belarus	43.7	30.5	1.4
Belgium	44.7	45.1	1.0
Benin	10.0	11.8	0.8
Bhutan	6.1	13.1	0.5
Bolivia	14.5	15.0	1.0
Botswana	33.8	21.0	1.6
Brazil	27.2	19.2	1.4
Bulgaria	33.1	31.2	1.1
Burkina Faso	9.9	12.1	0.8
Burundi	15.2	11.0	1.4
Cameroon	9.6	12.8	0.7
Canada	37.3	33.1	1.1
Cape Verde	16.3	16.8	1.0
Central African Republic	8.4	12.9	0.6
Chad	6.6	11.2	0.6
Chile	19.6	22.9	0.9
China	12.5	16.9	0.7
Comoros	12.2	13.4	0.9
Congo, Rep.	13.3	17.0	0.8
Costa Rica	21.2	20.9	1.0
Cote d'Ivoire	16.7	13.7	1.2
Croatia	44.6	35.3	1.3
Czech Republic	38.5	35.1	1.1
Denmark	48.6	39.1	1.2
Dominican Republic	13.5	19.1	0.7
Equatorial Guinea	12.7	16.6	0.8
Estonia	34.8	39.3	0.9
Ethiopia	10.4	10.1	1.0
Finland	38.5	36.2	1.1
France	43.0	35.5	1.2
Gambia, The	19.9	12.6	1.6
Georgia	8.2	20.3	0.4
Germany	38.1	38.8	1.0
Ghana	13.0	12.9	1.0
Greece	32.1	29.5	1.1
Hungary	40.0	33.3	1.2
Iceland	32.5	32.0	1.0
India	14.5	12.9	1.1

Indonesia	15.8	17.7	0.9
Iran, Islamic Rep.	7.2	17.4	0.4
Ireland	33.3	36.7	0.9
Israel	35.3	24.0	1.5
Italy	41.9	35.2	1.2
Japan	28.1	33.7	0.8
Kazakhstan	14.5	30.6	0.5
Kenya	22.6	13.3	1.7
Korea, Rep.	20.9	28.7	0.7
Kyrgyz Republic	14.0	19.5	0.7
Latvia	32.7	35.5	0.9
Lesotho	39.2	17.1	2.3
Lithuania	30.1	29.0	1.0
Luxembourg	41.1	43.9	0.9
Madagascar	8.2	11.5	0.7
Malawi	15.5	11.5	1.3
Malaysia	21.0	22.4	0.9
Mali	10.7	12.3	0.9
Malta	26.8	36.7	0.7
Mauritania	17.6	14.3	1.2
Mauritius	19.2	27.0	0.7
Mexico	16.7	21.5	0.8
Moldova	26.2	26.2	1.0
Mongolia	24.2	18.3	1.3
Mozambique	18.0	12.5	1.4
Namibia	30.2	19.2	1.6
Netherlands	43.0	39.3	1.1
New Zealand	36.7	28.7	1.3
Nicaragua	25.2	14.0	1.8
Niger	6.7	9.9	0.7
Nigeria	7.8	12.7	0.6
Norway	40.9	38.9	1.1
Panama	18.6	22.0	0.8
Paraguay	9.4	16.3	0.6
Peru	12.8	18.3	0.7
Poland	38.8	27.5	1.4
Portugal	32.6	34.8	0.9
Romania	30.3	25.7	1.2
Russian Federation	30.5	28.3	1.1
Rwanda	8.0	12.1	0.7
Sao Tome and Principe	11.0	14.5	0.8
Senegal	14.9	14.3	1.0
Seychelles	34.4	29.4	1.2
Sierra Leone	11.2	11.9	0.9
Singapore	16.3	39.0	0.4
Slovak Republic	38.6	32.6	1.2
Slovenia	41.8	38.7	1.1
South Africa	27.7	20.9	1.3
Spain	33.6	33.7	1.0
Sri Lanka	17.3	19.0	0.9

Swaziland	29.7	17.6	1.7
Sweden	51.7	38.5	1.3
Switzerland	32.8	38.3	0.9
Syrian Arab Republic	17.6	14.5	1.2
Tajikistan	24.7	16.5	1.5
Tanzania	**13.3**	**10.9**	**1.2**
Thailand	17.2	24.7	0.7
Togo	13.5	12.4	1.1
Trinidad and Tobago	23.2	31.0	0.7
Turkey	24.4	19.5	1.2
Turkmenistan	13.0	16.0	0.8
Uganda	8.8	10.2	0.9
Ukraine	37.0	27.0	1.4
United Kingdom	35.4	36.8	1.0
United States	28.0	28.6	1.0
Uzbekistan	27.9	16.1	1.7
Zambia	17.5	13.8	1.3
Zimbabwe	23.6	15.9	1.5

Source: Government Finance Statistics Yearbook 2001, IMF

Tax /GDP=1.87 + 0.12 GDP per capita – 0.07 Agriculture / GDP+ 0.16 Openness – 0.17 Pop Growth
(2.88) (2.35) (-0.93) (2.65) (-4.94)

R^2 = 0.62
t- Statistics are in the parenthesis

Table A. 4.2.2
The Size of the Shadow Economy in 109 OECD, Transition and Developing Countries

	Shadow Economy [in % of GDP] using the Currency Demand Method		
	Average 1990/91	**Average 1994/95**	**Average 1999/2000**
Albania	32.6	30.6	33.4
Algeria	28.7	31.9	34.1
Argentina	22.1	24.8	25.4
Armenia	43.8	44.3	46.3
Australia	10.3	12.1	15.3
Austria	7.1	8.7	10.2
Azerbaijan	50.3	57.4	60.6
Bangladesh	28.4	32.4	35.6
Belarus	44.2	46	48.1
Belgium	18.4	20.3	23.2
Benin	39.6	42.3	45.2
Bolivia	55.4	60.4	67.1
Bosnia and Herzegovina	28.3	31.9	34.1
Botswana	27.6	30.9	33.4
Brazil	32.5	36.4	39.8
Bulgaria	29.4	33.2	36.9
Burkina Faso	31.9	35.4	38.4
Cameroon	25.9	28.7	32.8
Canada	10.4	12.9	16.4
Chile	13.6	16.4	19.8
China	10.5	12	13.1
Colombia	33.4	36.2	39.1
Costa Rica	22	24.2	26.2
Cote d'Ivoire	33.4	36.2	39.9
Croatia	28.4	30.4	33.4
Czech Republic	15.9	17.2	19.1
Denmark	14.9	16.5	18.2
Dominican Republic	28.4	30.4	32.1
Ecuador	28.9	31.4	34.4
Egypt, Arab Rep.	30.5	32.4	35.1
Ethiopia	33.7	37.4	40.3
Finland	14.9	16.2	18.3
France	11.7	13.8	15.3
Georgia	57.8	62.4	67.3
Germany	10.4	12.9	16.3
Ghana	32.9	35.4	38.4
Greece	22.4	25.9	28.6
Guatemala	41.4	45.9	51.5
Honduras	40.7	44.3	49.6
Hong Kong, China	11.9	13.4	16.6
Hungary	21.4	23.9	25.1
India	20.6	21.8	23.1
Indonesia	15.4	17.6	19.4
Iran, Islamic Rep.	13.7	16.8	18.9
Ireland	10.4	12.4	15.8
Israel	16.3	18.9	21.9
Italy	22	24.3	27

Table A. 4.2.2
The Size of the Shadow Economy in 109 OECD, Transition and Developing Countries

	Shadow Economy [in % of GDP] using the Currency Demand Method		
	Average 1990/91	**Average 1994/95**	**Average 1999/2000**
Jamaica	31.4	33.2	36.4
Japan	8.2	9.6	11.3
Jordan	15.4	17.1	19.4
Kazakhstan	33.7	38.4	43.2
Kenya	28.4	31.2	34.3
Korea, Rep.	22.3	24.9	27.5
Kyrgyz Republic	32.4	36.1	39.8
Latvia	32.5	36.3	39.9
Lebanon	27.4	30.4	34.1
Lithuania	24.7	27.1	30.3
Madagascar	32.4	35.8	39.6
Malawi	33.5	37	40.3
Malaysia	25.1	27.4	31.1
Mali	32.7	36.9	41
Mexico	24.1	27.1	30.1
Moldova	36.4	41.7	45.1
Mongolia	16.2	17.1	18.4
Morocco	29.8	32.7	36.4
Mozambique	35.9	38.1	40.3
Nepal	31.7	35.2	38.4
Netherlands	9.6	11.4	13
New Zealand	8.4	10.4	12.7
Nicaragua	40.1	43.2	45.2
Niger	32.2	37.4	41.9
Nigeria	46.7	51.5	57.9
Norway	12.3	16.4	19.1
Pakistan	28.2	31.4	36.8
Panama	51.4	58.2	64.1
Peru	47.1	52.3	59.9
Philippines	37.2	40.1	43.4
Poland	21.3	24.3	27.6
Portugal	17.2	19.3	22.6
Romania	26.2	30.6	34.4
Russian Federation	37.5	41.3	46.1
Saudi Arabia	14.2	16	18.4
Senegal	35.1	39.1	43.2
Singapore	9.8	11.2	13.1
Slovak Republic	14.3	16.2	18.9
Slovenia	21.5	24.3	27.1
South Africa	22.1	24.2	28.4
Spain	17.2	19.4	22.6
Sri Lanka	36.2	40.1	44.6
Sweden	12.2	16.4	19.1
Switzerland	6.9	7.3	8.8
Syrian Arab Republic	12.8	16.2	19.3
Tanzania	**45.6**	**51.3**	**58.3**
Thailand	43.2	47.3	52.6
Tunisia	30.9	33.6	38.4
Turkey	26.3	29.4	32.1

Table A. 4.2.2
The Size of the Shadow Economy in 109 OECD, Transition and Developing Countries

	Shadow Economy [in % of GDP] using the Currency Demand Method		
	Average 1990/91	**Average 1994/95**	**Average 1999/2000**
Uganda	37.2	40.1	43.1
Ukraine	43.3	47.3	52.2
United Arab Emirates	19.8	22.7	26.4
United Kingdom	8.4	10.3	12.6
United States	6.9	7.4	8.7
Uruguay	41.3	45.3	51.1
Uzbekistan	27.3	30.1	34.1
Venezuela, RB	27.4	30.4	33.6
Vietnam	10.9	12.3	15.6
Yemen, Rep.	20.7	23.4	27.4
Yugoslavia, Fed. Rep.	21.9	25.8	29.1
Zambia	40.7	44.3	48.9
Zimbabwe	47.3	53.4	59.4
Unweighted Average	*26.6*	*29.5*	*32.7*

Source: see Alm, Martinez-Vazquez, and Schneider (2005)

Table A.4.2.3 Tax Structure in International Perspective Percent of Total Taxes

COUNTRY	Income and Payroll Taxes	Property Taxes	Indirect Taxes	Taxes on International Trade	Other Taxes
Argentina	26.3	8.4	35.0	3.8	0.1
Bahrain	36.3	3.8	16.1	43.8	0.0
Belarus	27.1	3.2	62.3	4.9	0.0
Bhutan	53.4	0.4	42.6	3.6	0.0
Bolivia	10.9	10.5	65.1	6.2	0.1
Bulgaria	31.6	1.5	61.2	3.8	1.8
Canada	57.0	11.7	27.3	0.8	0.0
Chile	22.8	4.1	61.3	7.6	4.2
Congo, Dem. Rep.	12.6	0.0	23.8	24.7	38.8[a]
Congo, Rep.	11.3	0.0	64.5	22.9	1.4
Costa Rica	22.4	0.5	68.7	8.4	0.0
Cote d'Ivoire	29.1	1.7	23.3	45.4	0.5
Croatia	22.1	1.8	66.4	8.7	1.0
Czech Republic	40.1	2.4	53.9	3.1	0.4
Denmark	60.8	3.6	34.6	0.0	1.0
Dominican Republic	20.5	1.1	28.5	48.5	1.4
Estonia	39.2	2.2	58.4	0.2	0.0
Georgia	25.9	9.4	54.6	6.1	0.0
Hungary	36.1	2.6	55.6	4.0	1.7
India	37.3	0.1	37.3	25.1	0.2
Iran, Islamic Rep.	53.0	2.5	19.9	23.3	1.3
Israel	53.2	7.7	37.3	0.9	0.7
Jamaica	41.9	0.6[c]	40.5	8.9	8.1[b]
Kazakhstan	52.7	6.0	36.3	4.1	0.7
Latvia	36.9	4.9	56.6	1.6	0.0
Lithuania	40.5	2.7	55.3	1.5	0.0
Macao, China	8.9	6.5	82.1	0.0	2.5
Madagascar	15.7	1.0	29.1	53.5	0.6
Maldives	4.6	0.0	29.7	64.4	1.3
Mauritius	14.6	5.8	46.2	33.4	0.1
Mexico	32.6	1.7	59.6	3.9	0.7
Moldova	17.5	6.1	68.9	7.5	0.1
Mongolia	28.4	0.1	56.2	10.1	1.3
Myanmar	34.5	0.0	58.2	7.2	0.0
Nepal	22.4	3.4	41.6	32.6	0.0
Nicaragua	17.1	-0.2	73.6	9.4	0.0
Pakistan	28.1	1.2	44.7	16.0	10.1[d]
Paraguay	17.9	0.0	59.4	18.2	4.4
Peru	26.8	0.0	67.0	12.4	3.2
Poland	35.5	5.2	55.9	3.5	0.0
Romania	34.5	2.7	54.8	6.2	1.1
Russian Federation	33.2	4.5	44.4	13.0	0.1
Seychelles	26.7	0.1	7.8	63.1	2.3
Singapore	50.2	6.5	31.2	2.5	9.6
Slovak Republic	35.9	2.8	54.3	7.0	0.0
Slovenia	36.3	2.5	57.6	3.6	0.0
South Africa	54.0	5.8	34.8	3.1	0.7
Switzerland	58.1	12.3	28.6	1.1	0.0
Tajikistan	16.0	5.6	63.8	12.6	0.0

Thailand	32.2	2.3	53.1	11.9	0.5
Tunisia	28.5	1.9	51.8	15.5	2.2
Turkey	37.4	4.0	52.1	1.7	4.7
Ukraine	42.3	0.0	52.4	5.3	0.0
United States	66.4	13.2	19.5	1.0	0.0
Uruguay	26.2	9.3	57.1	4.7	3.1
Venezuela, RB	42.5	5.5	39.7	11.4	0.9
Mean	32.6	3.6	47.5	13.4	2.0

Source: Government Finance Statistics, International Monetary Fund (2003). Data for 2000, excluding social security taxes.

a) Some direct taxes are classified as "other".
b) Includes ASD and some SCT revenues.
c) We have assumed that the IMF classified property taxes as "other" and have moved this amount to the "property Tax" category.
d) Includes surcharges on natural gas and petroleum.

Annex 4.3
Some International Experience with Piggyback Income Taxes

Table A.4.3.1 describes the the piggyback arrangement for income taxes in a variety of countries. Other examples of countries with piggyback income taxes include Belgium, Germany, Norway, and Sweden. Piggybacking arrangements provide subnational governments with considerable revenue autonomy because they can set the tax rate, administer the tax, and even limited ability to define the base. Piggy-backing arrangements allow the states and the Centre to exchange information which can increase the effectiveness of enforcement activities. A drawback of piggy-backing arrangements is that state revenues may change whenever the federal tax base is changed.

Table A.4.3.1
Subnational government personal income taxes

Country	Tax Base	Subnational Government's Tax Rate Schedule		Tax base between localities	Assessment and Collection
		Single Rate*	Separate progressive rate schedule		
Canada (excluding Quebec)	Central gov't income tax paid before allowance	38.5 - 59.0 (Av = 47)	-	Residence	Central Gov't
Japan	Centre's tax base and separate tax relief structure	-	4 to 18 + fixed amount	Residence	Local Gov't
Spain	Centre's tax base (but regions can modify personal exemptions for their share) and separate tax relief structure	Split rate between the center and the regions. The regions can increase or decrease their rate	-	Residence	Central Gov't

Sweden	Centre's tax base and separate tax relief structure	26.4 - 33.2 (Av = 30)	-	Residence	Central Gov't
Switzerland	Separate base in each canton	-	5 to 34	Residence	Canton
United States	Separate tax base in most states	-	2 to 14	Residence	States

Source: Timofeev (2002)

Notes: * Minimum and maximum rates levied among subnational governments. Although a given subnational government uses a single rate, subnational governments are free to levy different rates. That different rates are applied by different subnational governments in a given country illustrates the advantage of greater revenue autonomy that can be achieved with a piggyback income tax.

In the United States, many states piggy-back on the federal income tax, but the piggy-backing does not extend to central collection, only to reliance by states, if they wish, on federal tax definitions, structures and reported amounts. Most states levy income taxes separate from, but coordinated with, the federal income tax. There are two major coordination mechanisms in the United States. These mechanisms are complementary not mutually exclusive. First, states may choose to cooperate on tax administration with the higher level government through a regular exchange of information. Work by one level of government can generate revenue for another level at little or no additional cost. For example, at the federal level, the Internal Revenue Service may inform a state of an audit finding regarding an individual residing in that state. Second, states may choose to coordinate their tax base with the higher level government. For example, several U.S. states levy their state individual income tax on a taxpayer's amount of federal adjusted gross income, so that the state income tax form simply begins with a number extracted from the federal income tax form. Coordinating tax bases reduces administration and compliance costs and fosters greater coordination on tax enforcement between levels of government.

Annex 4.4
Some International Experience with VAT at the subnational level

Generally speaking, the VAT is the main source of revenue in many countries. It is considered to be an efficient and buoyant source of revenue when properly designed and administered. The international experience with subnational VAT is very limited.

Brazil has a dual VAT (central and states) and India is currently introducing a similar arrangement. Brazil's federal VAT (IPI) applies to industrial goods; the subnational or states' VAT (known by its Brazilian acronym, ICMS) charges the circulation of goods in general and some services (i.e., interstate and inter-municipal transportation and communication services), In addition, municipalities levy charges (ISS) on a specified list of services. It is noteworthy that the IPI is fully creditable against the ICMS.

Although the states of Brazil obtain nearly 85 percent of their own-source revenues from the ICMS, there are a number of complex technical and administrative problems concerning the application of different VATs in different states. In addition, the tax bases of these three taxes overlap, leading to confusion and inefficiency. Generally speaking, the ICMS is a poorly conceived and inefficient tax.

The major problems with this tax include the following: (i) complexity of each of the 27 states having its own VAT law, resulting in more than 40 rates and different rules for assessing tax credits; (ii) evasion associated with the complexity and treatment of interstate trade; and (iii) fiscal wars, with states offering tax exemptions and refunds. Current proposals to reform the ICMS are currently under consideration.

Canada is the only other country with a dual VAT at the central and subnational levels. While the federal VAT is imposed throughout the country, only a few provinces actually use a VAT. In contrast to Brazil, the provinces of Canada levy a variety of consumption taxes. Quebec levies a VAT and administers both the federal VAT and the provincial VAT. In three other provinces, the federal government administers a joint federal-provincial VAT, which is levied at a uniform rate. Alberta does not have a broad-based consumption tax, and the remaining five provinces apply some form of final retail sales tax (RST). As in Brazil, Canada's VAT is fully creditable.

Although the Canadian system is complicated, lacks clarity, and violates some efficiency and administrative criteria of a good VAT; it works. The main reason is that Canada has achieved a good degree of harmonization of VAT between the central and subnational

governments.

For illustrative purposes, the European Union (EU) can be regarded as a federation running state-level VATs by the member countries. Coverage of the VAT includes both goods and services, and broad guidelines have been established (i.e., common set of rules, exemptions and definitions), and there is a main floor rate of 15 percent. Despite the efforts to harmonize rates, actual rates vary among member countries from 15 to 25 percent. The EU requires that any country wishing to be part of the Union adopt a VAT and must refrain from levying any effective tax on intra-community transactions. Thus sales between member states are zero rated. Although this arrangement was intended as a transitional arrangement, agreement on alternative regimes for tackling interstate trade has not been reached and the discussions still continue.

Table A.4.4.1
Some comparison of general consumption tax regimes

	Canada GST-QST	Canada HST	Brazil	Argentina	India
Good federal VAT	Yes	Yes	No	Yes	No
Federal VAT revenue to states	No	No	Yes by revenue sharing formula	Yes (part of general revenue-sharing)	Yes (CST)
State taxes on destination basis	Yes	Yes	No	No	No
State rate setting autonomy	Yes	No	Yes (except for interstate trade)	Yes	Yes
Good administration	Yes	Yes	No	No	No
Good cooperation between central and state governments	Yes	Yes	No	No	No

Source: Bird and Gendron (2001)

Other countries have opted for centralizing the VAT and then sharing its proceeds with subnational governments according to formula. For example, in Australia, there is a federal VAT levied throughout the country, which is distributed to the states through an equalization grant. Germany also has a national VAT that is shared with subnational governments mostly according to population. Canada (several provinces) and Spain shares a part of the VAT proceeds with subnational governments according to estimates

of aggregate consumption in each of those subnational jurisdictions.

The experiences of these countries show that international best practice is a national VAT administered by the central government. This arrangement greatly simplifies or eliminates many of the complexities surrounding the design and administration of subnational VATs, such as harmonization of tax rates, the need for border adjustments on inter-state trade, and administration of tax credits for input tax paid and zero-rating of international exports.

Annex 4.5
International experiences regarding presumptive taxation [17]

Imputed or presumptive taxes are taxes based on notional income rather than actual income. Imputed systems tend to calculate taxable income based on key factors which are associated with income generation (sales, turnover, number of employees, size of firm, assets of the taxpayer, etc.) Imputed tax bases are typically calculated based on coefficients for different factors applied to specific taxpayers or specific types of taxpayers (certain sized enterprises in particular industries).
By contrast, presumptive taxes tend to be calculated based on more aggregate indicators, such as industry and region, or external indicators of income, with less specific calculations for particular taxpayers. In both cases, the tax bases take advantage of data that are easier to come by than data required to calculate actual taxable income as specified by law.

Based on international experience, presumptive and imputed tax calculations may be classified into four basic groups although there are certainly others (Buotogoli, 1995):

1. Systems which estimate taxpayer income and apply a formula to all taxpayers (by type of taxpayer or by individual taxpayer). Estimation of taxpayer income may be a very simple calculation (such as a lump sum tax based on the average income of a particular profession) or a more complex calculation using information on sales, employees, assets, location, etc;
2. Systems which apply an assets tax (used more generally for all businesses and as a minimum tax);
3. Systems which apply a gross receipts or turnover tax (used more generally for all businesses and as a minimum tax);
4. Systems which base the tax on external indicators of income (personal expenditures, wealth, etc.).

Experience with presumptive and imputed taxes in selected countries

Greece:
Individuals may be taxed according to imputed income when imputed income is higher than actual income declared, and the taxpayer can not substantiate the difference. Imputed income is calculated based on criteria such as: rent of second home, operating expenses of vehicles, planes, costs of domestic servant, assets (cares, boats, ships, planes). Additions to imputed income as of January 1, 1995 include the purchase of enterprise shares, purchase or construction of immovable property (excluding first

[17] This annex draws on Wallace (2002).

residence of up to 120 square meters), and loans to personal enterprises, partnerships, and limited liability companies. (Coopers and Lybrand, 1997 International Tax Summaries).

France:
The forfait (contractual system) has been established for certain taxpayers whose income falls below a set threshold: sole proprietorships, individuals and unincorporated businesses. Those covered include: farmers, unincorporated businesses, professionals whose gross receipts fall below a certain threshold. For small businesses selling goods, the threshold is FF 500,000; for other small businesses (mostly service providers), the threshold is FF 150,000. The income thresholds used under the forfait system have not been adjusted for inflation. Over time, the result is that there has been a natural transition from the forfait as fewer taxpayers fall below the income threshold.

The taxpayer must agree with the tax administration to be taxed based on estimated income versus actual income. The actual estimation of income is well developed in tax administration procedures manuals. The taxpayer must supply the following to the tax administration: purchases, sales, value of closing inventory, number of employees, wages paid, and number of cars owned. Indicators determine income versus checking assessments or reported income. Expenses are estimated by the tax administration. The tax administration calculates income based on a sophisticated and detailed estimation procedure, by industry.

Israel:
The tachshiv of Israel is another widely referred to method of presumptive taxation. Tachshivim are standard assessment guides, produced for a variety of industries. The assessments are based on a variety of factors including physical location, size of store-front, etc. The assessments may be negotiated with industry representatives, but not with individual taxpayers.

Mexico:
Mexico adjusted its tax scheme for small businesses after a major tax reform in 1988. Prior to 1988, there was a Special Basis Taxpayer regime (for transport, primary and publishing enterprises) and a Minor Taxpayers Regime (for all sectors, with a threshold of gross income below $100,000). Under the first scheme, taxpayers were divided into two groups: those below a turnover threshold were taxed based on an asset-based lump sum levy and those above the threshold were taxed based on a profit coefficient on actual turnover. The second scheme applied to all other industries, with the limited threshold. The form of taxation was similar. A variant of these schemes is now in place in Mexico. The base is cash flow, and the tax is a set percent of cash flow. As part of the 1988 Tax Reform, Mexico also introduced a presumptive minimum tax effective since 1989. Business assets were taxed at 2 percent until 1997, and are now taxed at 1.8 percent of gross assets. The tax liability is creditable against regular corporate tax liability.

Bolivia:
Bolivia instituted a number of changes to their tax code in the mid-1980s. In 1986, a simple tax on gross sales replaced direct and indirect taxes on small enterprises.

Additionally, Bolivia introduced a 3 percent levy on net worth, as a form of presumptive final tax. Bolivia's case was fairly unique in that there was no additional corporate income tax. This has since been changed, and the tax is now levied as a presumptive minimum tax.

Russia:
There are two special taxes on small businesses: the Single Tax and the Imputed Income Tax. The Single Tax is aimed at reducing the complexity of the tax system for small businesses by replacing many taxes with one tax, and also reducing accounting and reporting costs. Small businesses qualify for the Single Tax based on thresholds of the number of employees and gross receipts. The system is optional for small businesses and is largely regulated by regional authorities. The current threshold (100,000 minimum monthly wages) is relatively high by international standards. Individual entrepreneurs pay a patent fee, which differs based on industry and region. Legal entities are taxed based on gross receipts or an alternative income calculation (at the discretion of the regional authorities). The alternative income base allows deductions for some inputs, but not all.

The Imputed Income Tax applies to a variety of industries, and imposes eligibility restrictions based on number of employees only for certain industries (public catering, retail trade, and transportation services; taxi cab services were added later). A tax rate of 20 percent is applied to imputed income, which is calculated via a complex formula. The formula is based on the following factors (among others): location, quality of services, quality of premises, distance from highway, inflation, and seasonality. The actual calculation is at the discretion of regional authorities. The tax takes the place of most taxes, with the major exceptions of: state duty and customs duty, land tax, tax on purchase of foreign currency, and withheld income tax and VAT.

Other Experiences:
Uruguay, Angola, Cameroon, and Morocco all have experience with presumptive taxes, specifically on small businesses. In these countries, small businesses are defined by turnover (Uruguay and Angola), or include a large component of the service sector (Cameroon and Morocco). These systems are some of the most straightforward presumptive systems where few calculations are required and administration is relatively inexpensive.

Lessons Learned from International Experience

The results of imputed and presumptive taxes used in various countries are difficult to quantify. However, there are some general lessons which pertain among countries:

- Governments must decide on their goals for presumptive or imputed taxation since the best structure for one goal may or may not be different for others. The goals in general are: reduce tax evasion/avoidance of small, hard-to-tax firms; reduce compliance costs for taxpayers; reduce tax avoidance in general; or reduce tax evasion/avoidance of individuals.
- It is difficult to transition away from imputed or presumptive systems aimed at

capturing the small taxpayers. If a goal is to use such a system to bring a taxpayer into the tax net and then to transition the taxpayer to the regular tax system, the tax laws need to take this into account. This might be accomplished by setting tax rates under the simplified system at a reasonable rate (not too high nor too low) and creating incentives to move to the regular system (for example, allowing certain deductions only under the regular tax), or imposing a limit regarding the number of years that a taxpayer of a particular size--measured by economic activity--may remain on the simplified system. Finally, the French method of non-indexed thresholds may also be a natural way to move taxpayers off of the imputed or presumptive system to the regular tax system.

- Collective assessment is likely less corrupted than individual assessment. Presumptive assessment on a taxpayer-by-taxpayer basis might be more accurate, but it does not outweigh the corruption.
- Taxpayers should be able to appeal their tax assessments which are based on presumptive or imputed means and they should be able to convert to the regular tax system without an ability to move back to the imputed or presumptive tax structure.
- In general, thresholds should be indexed for inflation. Lump-sum taxes should be indexed for inflation to maintain the integrity of the system. The case for non-indexation is when the government allows inflation to transition taxpayers to the normal tax system.
- Presumptive minimum taxes have been relatively effective at raising taxpayer awareness. In some countries (Mexico), these taxes appear to have encouraged an increase in compliance with the regular tax system.

Table A 4.5.1
Presumptive/Imputed Tax Treatment of Small Businesses

Conditions	Conditions	Conditions
Belgium	Small businesses: Flat rate for three years	Forfait scheme applying to small businesses based on profession (1992) for income below BF 100,00
Greece	Small businesses: Flat rate applied to purchases and receipts	1992
Spain	Small businesses: Forfait scheme for twenty-eight industries	Began in 1992
	Other small businesses covered by a standard flat rate tax	Tax base: sales minus limited expenses

Bolivia	Small businesses in two sectors: Transport (no threshold)	Tax Base: Turnover
	Retail and artisans (threshold of $4,000 turnover)	Tax Base: Total income
Israel	Small businesses and professionals (no threshold): Tachiv applies to 140 occupations	Tax Base: a mix of total turnover and inputs
Mexico	Small businesses and professional: all industries at a standard percentage	Tax Base: cash flow
Uruguay	Small businesses: all industries with turnover less than $22,000; taxed as a flat amount (unindexed)	Tax Base: Turnover
Angola	Small businesses: all industries with turnovers less than $20,000	Tax Base: Turnover
Cameroon	Small businesses: service sector	Tax Base: Flat presumptive amount
Morocco	Small businesses: service sector	Tax Base: Turnover, taxed as a fixed percentage

Source: Wallace (2002)

Annex 4.6
International experiences regarding subnational tax autonomy

International experience illustrates the range of possibilities for local taxation and also demonstrates their pluses and minuses and the importance of good design whatever the choice. Advanced countries divide into three groups in regard to the major sources of tax revenue: the property tax reliant countries (most British heritage), countries reliant on income tax, on both individuals and businesses (largely northern Europe and Japan), and the mixed tax – that is property, income and various sales and other forms of taxation – countries (largely southern European countries). Some of the income tax reliant countries, such as eastern European countries, entitle local governments to the local yield from a national income tax, but do not allow them to determine the tax rates. However, in a number of countries (Denmark, Finland, and Sweden) individual local governments set local income tax rates (single rates with the tax collected through a national income tax system). Supplementary business taxation is practiced in Canada, France, Germany and Japan. Local sales taxes are common in Austria, some southern Europe countries and in the US. Local sales taxes are also widely used in less developed countries where other forms of taxation are more difficult to implement.

A first step in considering international experiences with regard to subnational powers of taxation is to determine to what degree subnational governments legally have tax autonomy? To what extent are subnational governments able to choose the tax base of the taxes they collect? To what extent do subnational governments have control over the tax rates of the taxes that they collect? Our review is largely based on OECD countries, which should be considered as the appropriate reference group for the long-term structure of a sound tax system.

Legal provisions for subnational tax autonomy

In most OECD countries, regional and local governments have no legal power to choose or alter the base for their taxes. For example, Article 77 of the Icelandic Constitution declares that the tax system shall be decided by national legislation; local authorities are therefore not entitled to introduce any types of taxes. A second example is Portugal. In Portugal, the tax base and rate limits are set by the national parliament, and local authorities have no power to establish taxes outside those provided for by the national government. Thus similar to Iceland, Portugal's municipalities are not free to fix the tax base or deductions and exemptions applicable to specifically local taxes. Even in Germany's federal structure, Länder (States) have no powers to change tax bases autonomously.

Out of the 28 OECD countries reviewed, subnational governments in only a handful of

countries can legally choose to determine or modify (for instance, through exemptions) the bases for local revenue sources. These countries include Belgium, Finland (Åland region), Japan, New Zealand, Spain, Switzerland, and the United States.

- Theoretically Belgium's Communities[18], regional governments and local authorities enjoy tax autonomy, which allows them to raise taxes and royalties in those areas for which they have competence, unless they are already liable to a federal/regional tax. However, Communities have so far not taken the opportunity to do so. On the contrary, regional and local authorities utilized this opportunity to raise 8% and 13% of their tax revenue correspondingly.

- In Japan, local public entities may levy special taxes on items for which the Local Tax Law contains no particular provisions. However, introduction of new local taxes is subject to the Minister of Home Affairs approval. The Minister must give his approval insofar as such taxes do not impede internal trade and as long as they do not overlap with other taxes imposed by the local public entity or by the national government.

- In New Zealand, the bulk of local government revenues derive from an annual tax on property (so-called "property rates") for which local authorities effectively have the autonomy to set both the base and rates. There are three main classes of rates: general rates, separate rates (for water, land drainage, refuse collection, etc.) and special rates (levied in the event of loan default). The range of allowed tax base option is reasonably comprehensive. Although, there is a maximum rate which caps the total tax revenue from general rates and uniform annual charges, they do not constrain tax revenue as separate rates are not covered by the limits.

- The Spanish constitution provides for certain limitations to the taxing power of Autonomous Regions (states). For example, the Autonomous Regions cannot impose a tax on a tax base that is already taxed by the central government. Also, taxes imposed by the Regions may not introduce barriers to the internal trade. Local authorities can only impose taxes in areas that the national legislation provided for.

- In Switzerland's federal structure, regional governments (cantons) have the initial right to raise taxes from any tax base, except those explicitly prohibited in the Federal Constitution (VAT, custom duties, stamp duties, anticipatory tax, tax on tobacco and certain special consumer taxes). Local governments (communes) for their part can only raise the taxes they are authorized to under the constitution of their canton.

- In the United States, states are subject to very general limitations in levying state revenues (for instance, constitutional clauses on non-interference with inter-state

[18] Belgian official Communities refer to a division of the political linguistic and cultural competencies of the country overlapping with the territorial division into regions.

and international commerce and due process need to be observed). As a result, states have virtually complete discretion over their tax structure at the state level, including the choice which taxes to levy, defining their tax bases, setting the tax rates, and administering the taxes. At the same time, local governments, being legally dependent on the states, generally have a much smaller degree of taxing power.

Composition of subnational tax revenue by tax base

International experience with regard to local taxation depends to a great extent on how a country's revenue sources are assignments among the different levels of government. Table A.4.6.1 shows that subnational governments in general derive a large share of their resources from income and profits taxes (whether as an own source tax or as shared revenues from the national tax) and the property tax. A third source of subnational tax revenue, taxes on consumption, is mostly assigned to the regional level.

Table A.4.6.1 suggests that subnational governments receive revenue from income and profits taxes in 21 out of 28 OECD countries, either in the form of shared revenues or through separate subnational income taxes. Out of the 7 federal countries included in the table, Australia is the only country that fully retains income and profit taxes at the federal level. In the remaining six federations, regional and local governments receive revenue from these income taxes.

Countries where income and profits taxes form a dominant share of local government revenues include Germanic, partly Germanic, or Scandinavian countries. All four Scandinavian countries (Denmark, Finland, Norway, and Sweden) derive a high share of tax revenues from income and profits taxes and allocate over half of the revenue to local governments. Moreover, in Denmark, Finland, and Sweden, local governments can set rates for these taxes. In Denmark, revenue from the national corporate profits tax and capital gains tax is shared with municipalities.

Share and structure of those subnational taxes whose rates are determined autonomously by subnational governments

Regular OECD statistics do not distinguish real local taxes, where local governments set a local tax rate, and revenue sharing. That is why we look separately on the composition of those subnational taxes for which local governments can change the rate (within some statutory limits). While we earlier concluded that only in few countries have subnational governments any discretion over their tax bases, the experience with regard to subnational governments' discretion over their tax rates is decidedly mixed. In virtually all countries reviewed, subnational governments have discretion over the tax rates of one or more subnational revenue sources (Table A.4.6.2).

In fact, the table suggests that in half of the reviewed countries, subnational governments have discretion over the tax rates of revenue sources that generate over 50 percent of subnational tax revenues. However, the table is incomplete to the extent that it ignores intergovernmental fiscal transfers. For instance, while subnational governments in the

Netherlands are reported to have rate discretion over 100 percent of subnational tax sources, in fact, subnational tax revenues only play an extremely minor part in subnational government finance as intergovernmental transfers account for well over 70 percent of revenues for subnational governments in the Netherlands. To account for this fact, Table A.4.6.3 reports the yield from discretionary sources of revenue of local governments as a share of their total revenue. In most countries non-tax revenue (that is user fees) account for a large portion of local governments' own-source revenue.

Income taxes are an important source for tax rate autonomy in the countries surveyed. In nine out of nineteen countries, as much as sixty percent of discretionary subnational tax revenues (taxes over which subnational governments have rate discretion) were accounted for by taxes on income and profits (Belgium, Denmark, Finland, Germany, Iceland, Japan, Portugal, Sweden, and Switzerland). In six countries, subnational governments collect half or more of discretionary subnational tax revenues by means of property taxes (Austria, Czech Republic, Netherlands, Norway, Poland and the United Kingdom). In three countries (Austria, Hungary, Spain), taxes on consumption make up over fifty percent of discretionary subnational taxes.

Table A.4.6.1
Distribution of subnational taxes with discretionary rates, 1995

	Percent of subnational taxes	out of which (percent of discretionary tax revenue)		
		Income & Profits	Property	Consumption
Austria	46	0	50	50
Belgium	55	88	9	3
Czech Republic	5	0	100	0
Denmark	95	95	5	0
Finland	89	94	5	0
Germany	13	63	37	0
Hungary	30	0	11	85
Iceland	92	79	21	0
Japan	90	59	35	6
Mexico	0	0	0	0
Netherlands	100	0	66	34
New Zealand	0	0	0	0
Norway	3	0	100	0
Poland	45	0	81	19
Portugal	8.5	100	0	0
Spain	38	0	42	57
Sweden	100	100	0	0
Switzerland	41	85	15	0
United Kingdom	100	0	90	0

Source: Derived from OECD (1999) and Crédit local de France and Crédit communal de

Belgique (1997).

Overview of international practices by type of tax

Subnational taxes on personal income

Nationally administered income taxes are shared between different levels of government in Austria, Germany, Luxemburg and Spain. Subnational governments actually "piggyback" on the national income tax in Belgium, Canada (except Quebec), Denmark, and Iceland. In Norway, local councils may in principle reduce the local component of the 28 percent flat-rate on the personal income, thus technically making the scheme a piggyback tax. However, since all municipalities and counties in Norway use the maximum rate, the nature of the approach is in fact more akin to a shared-revenue approach rather than a piggyback tax.

In Finland, Japan, Spain, and Sweden, subnational governments can set separate rates as well as the allowance structure for subnational taxes applied to the national income tax base. In the Swedish approach to piggybacking personal income taxes, all income tax revenues are paid to the central government; during the fiscal year, subnational governments receive their revenues based on a forecast. The final tax amount is settled in the following year when total revenue is assessed.

In Quebec, Switzerland, and the United States, regional or sometimes local governments may fix their own bases for income tax. In the United States, most states have state income taxes separate from (but coordinated with) the federal personal income tax. The use of personal income taxation in conjunction with property taxes is well illustrated in many states in the United States where local income taxes are used by 3700 local governments in 14 states. Local income taxes are especially important in a number of US cities. Typically local personal income taxes in the U.S. allow no deductions of personal allowances. The tax is generally simply specified as a percentage of wage earnings, although in some cases capital gains are taxed as well (Norton, 1995). Local income taxes were also used by a variety of Canadian local governments prior to the federal-provincial tax rental agreement of WWII.

Subnational taxes on corporate income

Contrary to the advice from scholarly and policy-advising worlds (for instance, McLure 1983), many countries in fact do rely on various regional and local business taxes - CIT, capital taxes, nonresidential property taxes, and historical levies such as patents or octroi. To the extent that business taxes exceed the tax rates imposed on residents (as *de facto* user charges for local infrastructure and services), in effect cutting the link between taxes and spending which is essential for sound local finances. However, unlike more visible taxes on residential property and personal income, local business taxes are popular because it is easy to assume that someone other than local residents pays business taxes.

In (mostly larger federal) countries that have enacted subnational CIT, the apportionment of corporate income (profit) among jurisdictions is based on an apportionment formula. In the United States, most states have enacted a state-level CIT. A common method that

U.S. states use to determine the level of corporate income taxable within their jurisdiction is an equally-weighted three-factor formula, in which the share of corporate income taxable in the jurisdiction is a function of the share of total corporate property, payroll, and sales within the jurisdiction. In recent years U.S. states have been shifting from the traditional formula that accords equal weights to the three factors (payroll, property, and sales) to double-weighting sales, presumably in order to prevent discouraging economic activity within their borders.

While some Canadian provinces (the largest and wealthiest) implement their own individual and corporate income taxes, others rely on the surcharges on the national taxes. In both cases, tax bases and apportionment formulas are quite similar, if not identical. In Canada the apportionment formula assigns equal weight to payroll and sales.

While the U.S. and Canada have independent subnational, coordinated corporate income taxes, Portugal has a true subnational piggyback CIT. In Portugal, local governments are allowed to levy a surcharge on the corporate income tax. It is collected at municipal level at a maximum rate of 10 percent. This is an optional tax. The decision to levy the tax and its assessment, within the legal limits, are the responsibility of the municipality. It may only be introduced in order to fund investments and/or in connection with fiscal equalization; it is calculated and collected by the central government.

Supplementary business taxation is practiced in Canada, France, Germany, Italy, and Japan. There are three main versions of these taxes: (i) taxes on inputs to a firm or a combination of inputs, profits; (ii) taxes on profits or income of professionals; (iii) taxes on business assets.

In France the tax base is composed of two elements (1) the rental value of fixed business assets and (2) one eighth of the payroll. In Japan, the local inhabitants tax covers businesses with offices and premises in a local authority area. The levy on business has two bases: (i) employees and capital (ii) corporation rate applied to the level of the national corporation tax payable. In Luxemburg, local governments levy business tax based on operating profits.

Originally, Germany's communities determined the rate of the local business tax (Gewerbe Steuer) by applying a multiplier to the statutory rates prescribed for separate components of the tax base. After exclusion of the payroll and asset components, the tax base has narrowed to only business profits (with partial deductibility of interest and lease expenses). Local governments have to share revenues from the business tax with the federal and regional governments, in exchange for which they receive 15 percent from the personal income tax. In 1998, the assets component of this tax was abolished and localities were compensated with a 2.2 percent share increase in the share of VAT collections that flows to the local government level.

In Spain, the tax on economic activities (*Impuesto de Actividades Económicas - IAE*) is a direct tax levied annually on the exercise of a business, professional, or artistic activity. The tax liability is calculated based on various factors such as the type of business

activity, head office location, the size of business premises, and electricity consumption (the number of employees criteria was abolished recently).

Subnational taxes on consumption

Most OECD countries have instituted a value-added tax at the national level, and do not have a general sales tax at the subnational level. Among the few exceptions are the United States and Canada, which have retail sales taxes at the subnational level. There would be significant administrative challenges to introducing a subnational VAT, although several countries (including Brazil, India and Canada) have or are in the process of introducing a subnational VAT.

In the United States, in the absence of a broad-based federal consumption tax, retail sales taxes provide an important source of revenue at the regional (state) and local government levels. In fact, sales tax revenues are the second most important local tax revenue source overall after the property tax. It is levied by l6100 governments in 31 states. While legislated sales tax bases differ from state to state, sales taxes are generally levied on retail sales, although in Hawaii, Louisiana, and Mississippi sales taxes also apply to wholesale transactions.

Ten U.S. states have a piggyback local sales tax or have a coordinated local sales tax approach, where the state's sales tax provides the tax base for local jurisdictions. For example, the "local option sales tax" in Georgia allows localities to raise the state's general retail sales tax rate of four percent by up to three percentage points for a variety of local financing needs. In California, local governments have the choice between a 0.5 or 1 percent surtax, while local sales taxes in New York add another 1-3 percent to the state-level sales tax. Depending on the state's sales tax base, food and other necessities are usually exempt. Public utilities sales are also often exempt from sales taxes (thus simplifying the allocation of their sales across local jurisdictions) but are typically subject to additional forms of state taxation (Aronson and Hilley, 1986).

While sales tax revenues in the U.S. typically accrue to the jurisdiction in which the sale is made (i.e., where the seller is located), exceptions often exist for large purchases, such as automobiles or furniture. Sales taxes for such purchases typically flow to local governments based on a residence principle.

Canada has a rather complex and asymmetric combination of federal and subnational value-added taxes. Several of the maritime provinces of Canada, employ the harmonized sales tax, which combines the federal and provincial VATs. All of the provinces that participate in the scheme must implicitly adopt the same VAT rate. Other provinces have a final retail sales tax. Unlike most other Canadian regions, Quebec has its own provincial VAT, which it administers independently of the federal authorities. Quebec also administers, under contract, the federal VAT in the province.

In most OECD countries, subnational taxes on consumption are represented by subnational surcharges on excises rather than by broad-based subnational consumption taxes. For example, in the Netherlands, provinces impose a surcharge on the motor

vehicle tax levied by the central government. Provinces are free to set the rate of the surcharge, subject to a ceiling imposed by the central government.

Subnational taxes on property

Typically, sound tax assignment calls for property taxes to be exclusively assigned to the local government level. However, there are some limited experiences with sharing of property taxes between different levels of government, or between different types of local government. For instance, there are positive experiences in several U.S. states where several local jurisdictions (counties, municipalities, school districts, etc) tax the same property object, either using close coordination or piggybacking. Moreover, 22 states and the District of Columbia levy their own general property tax in addition to the local property tax.

Table A.4.6.2
Structure of regional and local taxes
(% of total tax revenue of these levels of government)

	Income & Profits		Property		Consumption	
1997	Region	Local	Region	Local	Region	Local
Federal countries	**45.4**	**40.8**	**10.0**	**43.6**	**39.5**	**9.9**
Australia	0	0	30.9	100.0	43.9	0
Austria	53.5	35.5	0.8	9.4	41.3	29.8
Belgium	51.6	82.4	5.4	0	43.0	15.9
Canada	50.1	0	6.4	86.0	37.6	1.4
Germany	47.4	77.1	5.2	21.7	47.3	1.1
Switzerland	75.5	84.4	16.9	15.0	7.6	0.5
United States	39.5	6.0	4.3	73.3	56.2	19.6
Unitary Countries	**--**	**41.8**	**--**	**32.5**	**--**	**17.5**
Czech Republic	--	89.2	--	5.2	--	5.5
Denmark	--	93.4	--	6.5	--	0.1
Finland	--	95.8	--	4.0	--	12.8
France	--	15.5	--	31.4	--	12.8
Greece	--	0	--	0	--	32.9
Hungary	--	0	--	22.2	--	75.5
Iceland	--	78.2	--	14.7	--	7.1
Ireland	--	0	--	100.0	--	0
Italy	--	18.1	--	34.4	--	16.0
Japan	--	52.6	--	30.4	--	16.0
Korea	--	12.3	--	57.1	--	27.2
Luxemburg	--	93.1	--	5.7	--	1.2
Netherlands	--	0	--	62.2	--	37.8
New Zealand	--	0	--	90.6	--	9.4
Norway	--	89.9	--	9.4	--	0.7
Poland	--	59.5	--	32.3	--	8.3
Portugal	--	22.7	--	38.8	--	27.8
Spain	--	26.4	--	34.9	--	25.5
Sweden	--	99.7	--	0	--	0.3
Turkey	--	30.8	--	3.0	--	32.2
United Kingdom	--	0	--	99.1	--	0

Source: Derived from OECD (1999, Tables 132-135)

Table A.4.6.3
Revenue Autonomy of Local Governments in OECD Countries, 1995

	Percentage of own-source revenue	*Composition of own-source revenue (percent)*			
		Non-tax	*Income and profit taxes*	*Property taxes*	*Consumption taxes*
Federal	**53**	**28**	**12**	**10**	**3**
Countries					
Austria	50	42	0	3	3
Belgium	47	8	16	17	5
Germany	55	39	11	5	0
Mexico	22	22	0	0	0
Switzerland	82	33	42	7	0
United States	62	21	2	30	9
Unitary					
Countries	**48**	**20**	**12**	**12**	**1**
Czech Republic	25	20	0	5	0
Denmark	57	10	45	2	0
Finland	67	32	33	2	0
France	71	17	—	21	—
Hungary	29	23	0	1	5
Ireland	37	21	0	16	0
Italy	39	14	0	15	0
Netherlands	28	20	0	5	3
New Zealand	89	36	0	52	1
Norway	18	17	0	1	0
Poland	50	33	0	14	3
Spain	57	15	10	21	6
Sweden	82	12	70	0	0
United Kingdom	28	16	0	11	0

—. Not available.
Source: Derived from OECD (1999) and Crédit local de France and Crédit communal de Belgique (1997).

Table A.4.6.4 surveys local government authority with regard to property taxation in 25 countries recently covered by the WB case study (Bird and Slack, 2004). While in all these countries local governments receive revenue from property taxes (either on the derivation basis or through a redistribution pool), in only half the cases can they determine the tax rate. According to Table 4.1.4 tax collection is usually, but not always, a local government function. At the very least local governments thus almost always have some discretion in determining the size of the ratio of taxes collected to taxes assessed. In a few instances, however, such as Guinea and Tunisia (and likely most of

francophone Africa) as well as Chile, they cannot even do this.

Case studies show that, at present, some of the information required for property identification is held by different government agencies. For example, in Latvia the information is split between the State Land Service, the Title Book Service, and the State Tax Service. The assessment function seems to be essentially local in about half the cases and central or regional in the others. In many cases, however, the detailed assessment methodology is established by the central government even when assessment is a local function. For example, in Colombia the maintenance of the property register and updating the valuation is centrally coordinated, although the billing, filing of payments, and auditing of the property tax are carried out at the local level. However, even the centrally maintained property register can prove to be cumbersome and difficult to update in a rapidly changing environment of property development and escalating values, as has been the case in Colombia.

In Mexico, the assessment of the property tax is made by state governments (setting the base and rate) but collections are enforced by localities (keeping the proceeds). In Chile, the national tax administration (SII) is responsible for assessment since the tax is a national tax. Since all revenues are earmarked to local governments, however, many municipalities are keen to complement the SII teams with local government officials. Over 400 such officials have been trained (by SII) for this task. Chile has a "relatively efficient and equitable property tax system."[19] This state of affairs was not cheap to achieve. In 1985, for example, the property tax was estimated to be the most expensive tax administered by SII, accounting for only 3.5% of revenue but 20% of field personnel and 40% of computer programming maintenance and operations. Another estimate for 1991 put the cost of property tax administration at 2.2% per dollar of tax revenue.

International experience with betterment levies[20]

In Tanzania, councils (with the responsible minister's approval) may levy a special rate to cover the costs of special capital works schemes which only benefit a limited number of properties in the ratable area. Up to now, this option has not been used by any council. Therefore it is useful to study the experience of other countries with such levies. This kind of charge (also known as betterment levies) is levied on property owners (as in Canada, Poland, Columbia, Argentina and Mexico) or on developers (as in Canada, Australia, Mexico). In the latter case, known as development charges, over the long term the tax burden is likely to be borne by new owners rather than by developers who nominally pay them. A related instrument is used to reap 'unearned increments' in property values arising from administrative acts such as rezoning (as in Poland, Columbia and Mexico). Below we provide more detail on the experience of selected countries.

In Canada there are two kinds of special taxes on property aiming at recouping the costs of building local infrastructure. Special assessments (also known as improvement

[19] J.K. Rosengard, *Property Tax Reform in Developing Countries* (Boston: Kluwer Academic Publishers, 1998), p. 85.

[20] This discussion draws on Bird and Slack (2004).

charges) on residential, commercial, and industrial properties are used to recoup the costs of additions and improvements to existing infrastructure that borders those properties. The charge is determined based on particular capital expenditures (street pavement, water mains and sewers, sidewalks, street lighting, etc) in a given year but the costs can be spread over a period of years. The most common base for special assessments is the front footage of properties, size of lot, assessed value of property or location zone.
By contrast, development charges (also known as exactions and lot levies) recoup growth-related capital costs from developers rather than final beneficiaries. The charge is determined by a special rule, for example, based on the forecasted growth in the need for services and the existence of excess capacity. While municipalities in British Columbia use a development-by development approach, elsewhere this charge is levied uniformly for all developments in the municipality.

In Poland, local governments may impose an 'adjacency fee' to partially recover costs of infrastructure investment. The fee cannot exceed 50 percent of the increase in property value attributed to infrastructure improvement. Payment of the fee can be extended over the period of up to ten years (with interest). In addition, within five years of land plan change, a tax of up to 30 percent of the value increase can be imposed on the sale of affected property. At the same time, owners whose property value decreases as a result of land plan changes have a right to compensation.

In Colombia, municipalities have been authorized to impose special charges to pay for certain public works since 1921. According to the present system introduced in 1966 (under the name of 'valorization'), each level of government can levy contributions on any benefit or appreciation of property arising from public works. Such contributions may be imposed before, during, or after the construction of public works. The cost of the works plus 30 percent is divided among affected properties in proportion to the benefit. Property owners can participate in budgeting of the works and assessing contributions.
A related tax was introduced recently (impuesto a la plusvalia) to tax the appreciation of land value arising from administrative decisions related to the use of land included in the master plans. This tax can range from 30-50 percent of the difference between the commercial value of property before and after the change of the master plan. Up to now, this levy has not been utilized by Colombian cities.

In Argentina, provinces and municipalities may finance certain public works by betterment taxes (contribuciones de mejoras) when those works raise land values. Governments identify the group of beneficiaries and share part of the construction costs among them in proportion to estimated benefit. In Australia most states charge fees to developers to compensate local governments for improvements in infrastructure necessitated by development. The United Kingdom have attempted to institute various forms of betterment taxes and other fiscal instruments intended to capture increments in land value attributed to public policy changes. However, these instruments have proved to be both politically highly contentious and administratively complex so that no such taxes exist at present.

In summary, country experiences with betterment levies vary from relatively successful

as in Colombia to a complete failure in the United Kingdom. Potentially such levies can act as a form of marginal cost pricing and hence induce more efficient development patterns and discourage urban sprawl. This requires several important conditions: 1) careful identification of beneficiaries for a particular project and the extent of benefits in terms of incremental property value; 2) careful costing of projects; 3) ensuring that costs do not exceed estimated benefits, which would be indicated by consent to this charge by affected property owners; 4) prompt construction of projects and collection of assessed contributions.

Table A.4.6.4
Property Taxes Around the World

Country	Tax Base	Rate	Identification	Assessment	Billing and Collection	Paid to
United Kingdom	residential property	local	national	national	local	locality
	non-residential property	national	national	national	local	redistribution pool
Australia	land	state	state	state	local	state
	property	local	state	state	local	local
Canada	property	provincial	provincial	provincial	local	province
	property	local	provincial	provincial	local	municipality
Chile	property	national	national	national	national	40% to locality and 60% to a redistribution pool
China	transfer of intangible assets and real estate	national	local	local	local	locality
	Urban real estate	national	local	local	local	locality
Colombia	property	local	national/local	local	local	locality
Germany	real estate	local	state	local	local	locality
Guinea	structures	national	national	national	national	shared
Hungary	structures	local	local	local	local	locality
India	property	local	?	state/local	local	locality
Indonesia	real estate	national	national	national	national	province/locality
Japan	real estate	local	national	local	local	locality
Latvia	real estate	national	national	national	local	locality
Kenya	land	local	national	local	local	locality
Mexico	property	state	state	state	local	locality
Nicaragua	real estate	national	national	local	local	locality
Philippines	real estate	provincial	provincial	provincial	provincial	locality
Poland	real estate	local	national	local	local[21]	locality
South Africa	real estate	local	local	local	local	locality
Tanzania	structures	local	local	local	local	locality
Thailand	real estate	national	local	local	local	locality
Tunisia	housing	national	national	joint	national	locality
Ukraine	land	national	national	national	national	locality
Argentina	property	province	province	province	province	province
	property	municipal	municipal	municipal	municipal	municipality

Source: Bird and Slack (2004).

[21] Unpaid taxes (arrears), except in the largest cities, are turned over to the national tax office for collection. However, this office seldom seems to pursue the collections of "other people's revenue" with enthusiasm.

Section 5
Tanzania's intergovernmental fiscal transfer system

Intergovernmental transfers play an important role in the system of intergovernmental relations. A detailed discussion of the current transfer system is provided in Chapter 4 of the Local Government Fiscal Review. The transfer system is of substantial importance to the central government budget, as almost 20 percent of budget resources are devolved to the local government level through the regional votes (Votes 70-95) in the budget (LGFR 2004; Table 4.2). The transfer system plays an even more important role at the local level, as transfers provide over 80 percent of resources to the local level (LGFR 2004: Table 1.1). In fact, Section 2.4 of this report notes that this figure may in fact even understate the role of intergovernmental transfers in local government finance, since indirect transfers to the local government level are not captured in this figure.

Based on the inception report and the discussion held during the stakeholders' workshop in January 2004, broad consensus was reached on the principle that the intergovernmental transfer system will continue to play a key role in the framework for local government finance. Indeed, it was agreed that there is an important future role for sectoral block grants, equalization grants and capital development grants in Tanzania's system of local government finance (Principle 4).

The Government's initial vision of the country's intergovernmental transfer system is clearly set forth in its Policy Paper on Local Government Reform (MRALG, 1998), although the document fails to provide many details on the exact specification of the transfer system. The Intergovernmental Transfer Study (GSU, January 2003) commissioned by PO-RALG and the Ministry of Finance provided a detailed strategy towards a comprehensive transfer system, which was adopted by Cabinet in February 2004. The GSU study on the recurrent grant scheme took place almost in parallel to the development of the capital development grant system under the preparation for a World Bank credit under the Local Government Support Program.

As for the overall assessment of the current local government finance system, the study team believes that the current intergovernmental fiscal transfer system is on sound footing. In accordance with the big picture assessment of Tanzania's local government finance system in Table 1.4 in Section 1, we come to the following conclusions regarding the role of the intergovernmental transfer system in Tanzania:

- *Overall policy stance and policy effectiveness*: The government is in principle committed to a formula-based grant system that is objective, fair, and results in the efficient delivery of local services. Nonetheless, political and institutional constraints prevent the immediate and full implementation of the formula-based transfer system. The evolving system of intergovernmental grants is fully consistent with broadly agreed-upon universal principles for the design of a sound transfer system.

- *Constitutional & legal framework*: The current Local Government Finance Act (1982, as intermittently revised) provides an adequate legal basis for the transfer system. However, as the Act was modified from time to time, it contains duplicative provisions which may reduce the law's clarity and transparency.

- *Central government institutional and regulatory framework*: Much has been done in recent years to improve the institutional framework for intergovernmental transfers. A Coordinating Block Grant Implementation Team (BGIT) as well as Sectoral BGITs were set up in order to coordinate the sectoral block grants between the various central government stakeholders. On the regulatory side, integrating the formula-based block grants into the national budget processes is still very much a work in progress. The grant system needs to be linked more carefully to the central government's budget processes, including the PER, the MTEF and government's PRS II (now NSGRP). Also, it is critical to assure consistency between the block grant system and the regulatory framework for the administration of local service staff.[1]

- *Local government institutional and regulatory framework:* The budget guidelines which are issued to the local government level are increasingly aligned with the Budget Frame drafted by the Ministry of Finance. As such, these guidelines provide clear guidance on how LGAs are expected to spend these transfers. The monitoring and reporting framework is still inadequate to systematically verify compliance with the budget guidelines.

- *Participation by civil society and private sector:* The current budget arrangements at the local level are not very transparent and do not allow for the consistent monitoring of grant-funded programs, either within or outside the government's financial management structures. Ongoing work is needed to improve the transparency and accountability with which transfer resources are spent at the local government level.

Box 5.1
The legal framework for intergovernmental fiscal transfers in Tanzania

[1] Under the current regulatory processes, central government officials can appoint or transfer local government staff to the payroll of an LGA without express consent of the Council Director. Since such actions are beyond the council's control, councils cannot be forced to pay for such additions from their formula-based grant allotment and require additional grants. This obviously defeats the entire purpose of having a formula-based grant system. Such central government intervention should cease immediately for the formula-based block grant system to become effective.

The current Local Government Finance Act and the relevant regulation provide an adequate framework to proceed with the introduction of a formula-based block grant scheme. The Local Government Finance Act and applicable regulations require the Minister of RALG to allocate earmarked grants for core local government functions (education, health, roads, water, agriculture and local administration), but also provide the Minister discretion to allocate block grants in these same policy areas which "may vary from one local authority to another depending on the grades and standards as may be prescribed by the Minister" (i.e., based on a formula). While in practice no distinction is made between the earmarked grants and the block grant referred to in the legislation, the regulatory framework in place for the block grant system would provide a sound basis for a formula-based block grant scheme. Local Government Finance Act Regulations (Government Notice 281, 2000) specify with regard to block grants that:

- Funds received by LGAs should be used economically, diligently, efficiently and effectively
- Transfers should promote efficient mobilization and use of resources
- The allocation should guarantee equitable access by the population to basic services
- The approach should ensure that there is objectivity, transparency, and accountability in the system of managing public finances

The remainder of the assessment on Tanzania's intergovernmental transfer system is structured as follows. First, we discuss the nature or structure of the overall transfer system: what types of grant programs should the grant system consist of? Should there be a single subvention scheme, or should local governments receive several types of grants? This issue is discussed in subsection 5.1. Then, the remainder of this section discusses the four recommended grant mechanisms that together would constitute the entire system of intergovernmental grants, namely (1) the recurrent sectoral block grant mechanism (subsection 5.2); (2) the unconditional, equalizing General Purpose Grant (subsection 5.3); the Capital Development Grant mechanism (subsection 5.4); as well as transfers from ministerial budgets, donor-financed activities, and other parallel funding mechanisms (Subsection 5.5). Concluding remarks and recommendations are captured in Section 5.6.

5.1 Overall structure of the transfer system.

The first key decision to be made regarding the transfer system is the basic structure of the transfer mechanism: should local governments (predominantly) be funded through a single recurrent block grant, or should local governments receive separate grants for different activities? Different countries have answered this question differently, and the answer depends to a large degree on historical and institutional factors, as well as on the expenditure assignments that the transfer mechanism intends to fund.

5.1.1 A single transfer mechanism, or different grants for different purposes?

As a first approach, some countries provide subnational governments predominantly or exclusively with general-purpose resources (either revenue sharing or equalization transfers) that flow into the general account of each local government in addition to local own revenue sources. Local governments are then required to fund their services from these general resources. For instance, this is the general approach in countries such as Japan, Germany, South Africa, Indonesia, and many transition countries in Eastern Europe and the former Soviet Union. This approach does not mean that local governments are necessarily free to spend their general resources as they wish; it simply means that the transfer mechanism is not used in itself to earmark these resources. However, even though the transfer mechanism provides these funds as general resources, nothing prevents the central government from effectively dictating how local governments spend their resources, for instance, through local budget guidelines or by establishing national minimum standards for the delivery of local government services. This approach has advantages as well as disadvantages. On the plus side, it may be easier to manage and more transparent to provide only a single grant to each local government. If no other conditions are put on the resources provided to local governments, a single unconditional grant scheme would also allow for greater local autonomy, enabling local authorities to move resources between different sectors and programs. On the negative side, it can be difficult to design a grant scheme that assures that every local government jurisdiction receives adequate resources to fund the services that it is supposed to provide, as the single grant scheme is trying to fulfill a number of different objectives. If the transfer system fails to provide adequate resources to the local government level to fund the mandated responsibilities of the local government level, this gives rise to unfunded mandates.

In contrast to the single-scheme approach, under a transfer approach with multiple grant schemes, different funding flows are established for different purposes, so that the different grant schemes are earmarked (or "ring-fenced") for specific purposes (although one of the funding flows typically included in a multi-scheme transfer system is typicallly an unconditional / equalization grant scheme). Although international practices vary widely between countries, the different grant flows may originate from different votes or sections in the national budget, and/or may flow into different accounts at the local level. The stringency of the conditionalities imposed by the central government also varies greatly between countries and in fact even between grant schemes in the same country, from very broad and general (e.g., "these resources should be spent on the provision of primary education") to highly detailed and extremely rigid (e.g., "this grant is being provided to build a bridge at the following specific location with the following specifications: …"). Most countries that rely on multiple transfer programs have separate funds for different sectoral programs (local education; health; social programs; and so on). Almost all grant systems separate recurrent grants from capital development grants.[2]

[2] Strictly from an administrative point of view, it might be even more straightforward to rely on a single subvention to be used both for recurrent and capital purposes. However, there are good economic reasons why a central government might wish to provide capital development funds to the local government level, as separate from local recurrent resources. As such, combining recurrent and capital development grant scheme would thus violate the maxim in local government finance that "finance should follow function" and that a single local government grant scheme would not be practical in assuring that local governments set aside resources for local capital development purposes. Some recurrent grant schemes allow recurrent

Countries that rely on multiple transfer streams with targeted grant programs vary from more centralized countries –such as the Netherlands- to much more decentralized countries such as the United States and Australia.[3] Of course, a transfer system with multiple grant schemes also has a number of advantages and disadvantages, depending on the exact implementation of the system. Among the potential advantages is the closer linkage between specific mandated local responsibilities (such as primary education) and the funding for those activities. A potential negative could be the excessive imposition of conditionalities, which would reduce local government autonomy. Depending on one's viewpoint, the inability to move resources between different forms of funding mechanisms (if local governments play by the rules) could be either a positive or a negative; local governments may see this as limiting their ability to move resources towards their (local) priorities, while the central government may consider that this provides an assurance that each local government will at least spend a certain amount on specific government services.

It is important to note that the choice for either a single grant mechanism or an approach that relies on a number of transfer schemes does not necessarily result in a more centralized or decentralized system. In fact, depending on the conditions imposed on the local level through budgetary regulations and sectoral standards, both approaches could, in principle, be structured to result in exactly the same outcome. However, a more targeted transfer system with multiple transfer schemes may provide a greater degree of central control over local spending, particularly when local governments lack spending discipline and have weak financial management systems.[4]

As discussed further in Section 7 of this report, from a financial management perspective, it is preferable that all transfer funds flow into the general account of the local governments, even if they are earmarked for different uses. Theoretically, a single treasury account is the best approach to managing finances, both at the central as well as at the local government level. In practice, however, multiple fund accounts may be used as a financial management and control mechanism. However, there are ways to reconcile the desire for a single treasury account approach with the desire to have different accounts for different purposes.

The formula-based recurrent grant system proposed by GSU in 2003 and adopted by Cabinet in February 2004 maintained the previous structure of local government grants: the system of intergovernmental grants continued to be separated into five sectoral funding mechanisms. Although, for administrative purposes, each sectoral grant scheme

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resources to be used for capital purposes, but local governments are typically prohibited from using capital grants for recurrent purposes.

[3] Whereas the vertical political structure in the U.S. is extremely decentralized, and revenue sources are highly decentralized (both at the federal-state and state-local levels), the U.S. federal government as well as state governments rely almost exclusively on targeted, conditional transfers.

[4] However, the provision of different grants for different purposes by no means guarantees budget execution in accordance with grant conditions, especially in the case of weak central monitoring. International practice is rife with examples where conditional grants are diverted for practices outside their intended use.

continues to be divided into PE and OC streams, the sectoral formula is applied to a grant pool that combines resources for both PE and OC. As such, the funding which each LGA would receive for each of the six sectors would be strictly determined by formula. Although central government officials would continue to have a role in guiding the local budget formulation process, they would no longer have discretionary control over setting the amounts received by each LGA. Despite the sectorally segregated structure of the transfer system in Tanzania, public expenditure tracking studies (PETS) report significant under-spending at the local level on primary education and health care services, suggesting that substantial resources are diverted from the respective sectoral OC accounts.

Given the financial management challenges at the local level in Tanzania; the different functional assignments at the local level; and the limited capacity of the center to monitor local spending, the study team believes that it is appropriate to maintain the current structure of the transfer system, which includes separate block grant schemes for different sectors. Although –as noted above- using numerous budget accounts is not considered a "best practice" in local financial management, it is felt that the use of different local accounts for different purposes provides a certain degree of budgetary control in Tanzania at the current time. Introducing a singly cross-sectoral transfer to LGAs (even in the presence of minimum sectoral spending guidelines) would not be politically acceptable in Tanzania given the current policy environment.

5.1.2 "Finance follows function" and the recommended structure of the transfer system

The conceptual basis for the "right" system of intergovernmental fiscal transfers is the assignment of expenditure responsibilities; Section 3 set out that there is a need for local government financing to follow the functional responsibilities assigned to the local level. In the context of the expenditure assignments as discussed in Section 3, a combination of transfer schemes is deemed the most appropriate.

As guided by the TORs for the current study, the policy framework for the transfer system fully integrates the work which has already been done by GSU as part of the Intergovernmental Transfer Study (Boex, Bahl, Martinez and Rutasitara, January 2003). In this context, the study team recommends that the overall structure of the emerging transfer system should include the following elements:

1. Formula-based sectoral block grants. Formula-based sectoral block grant schemes should form the primary (and exclusive) mode for funding the local provision of national public services in the five main priority sectors (primary education, local health, agricultural extension and livestock, water sector and local roads).

2. Unconditional grants. Unconditional grants should be provided to the local level to (1) provide funding for local government administration and (2) provides equalizing funding for other, non-priority-sector local activities to supplement own local revenue sources. These objectives may be achieved through the

implementation of a single, unconditional and equalizing General Purpose Grant mechanism.

3. Capital development grants. Given the local government financing framework in Tanzania, it is appropriate for funding of capital development to be primarily provided through a Local Government Capital Development Grant scheme.

4. Earmarked ministerial subventions. While there are currently a number of allocations made indirectly to LGAs –either from donor resources through the development budget or through ministerial votes-, most of these parallel funding mechanisms are providing funding for functions that are devolved to the local level. To the extent that the provision of services is devolved to the local government level (through full devolution or devolution of provision), no funding should be provided through ministerial budget votes. As such, most existing earmarked subventions within ministerial budegts should be integrated into the government's formula-based system of intergovernmental grants with all deliberate speed. The only permissible earmarked ministerial subventions to LGAs should be transfers that are provided for delegated (rather than devolved) functions.

5.1.3. Vertical fiscal balance: expenditure assignments and the vertical allocation of intergovernmental transfers

As explained in Section 3 of this report, we advocate considering a "relative approach" (as opposed to an absolute approach) to establishing local expenditure needs. This means that in determining the size of transfer pools, policy makers should determine the aggregate level of local expenditure needs for a sector by first taking into account the total amount of resources available to the public sector as a whole.

One of the main advantages of relying predominantly on a transfer system that is based on a relative approach to estimating local expenditure requirements is that the resources allocated to the local government level through the transfer system are by definition available in the national budget. As such, the system of local government finance does not run the risk of structurally over-funding local governments relative to the central government level and thereby causing fiscal imbalances and fiscal crisis at the central government level. At the same time, LGAs should be protected from unfunded mandates by assuring that the service delivery standards set for local governments are affordable under the resources made available by the transfer system. This is one of the reasons why the previous National Minimum Standards approach failed in Tanzania.

To the extent that the local government finance system in Tanzania relies on own source revenues and general-purpose funding (rather than sectoral or earmarked funding), vertical fiscal balance is assured to some degree by the absence of binding expenditure norms for local government activities outside the priority sectors (see Box 3.3).

As noted earlier, the central government is currently setting aside approximately 18% of its recurrent resources for sectoral transfers to the local government level. For comparative purposes, it is interesting to note that Tanzania's degree of expenditure decentralization is well above the average level for developing economies (14%), although local authorities in many developing countries have fewer functional expenditure responsibilities than LGAs in Tanzania. In this respect, local governments in Tanzania are much more like local governments in transition or developing countries; the comparative figures for expenditure decentralization in transitional and developed countries are 26% and 32%, respectively (Bahl, 2004). Thus, based on international experiences, we would expect the degree of expenditure decentralization to gradually increase over time as Tanzania's economy continues to develop, as we would expect local government services to play an increasingly important role in the public sector as the economy grows.[5] As such, it would not be unrealistic to expect that the share of local government spending as a percentage of central budgetary resources would gradually increase to around 25% over the coming five to ten years.

5.1.4 The pro-poor nature of the formula-based block grant system

At first glance, it may appear that clinging to a transfer system that has sectoral funding mechanisms runs contrary to the new poverty reduction strategy. The major clusters of poverty reduction included in the NSGPR are (i) promotion of economic growth and reduction of income poverty; (ii) improvement of quality of life and social well being (through responsive and efficient public services); and (iii) governance and accountability. Yet, it is important to recognize that the introduction of the cluster-based approach should be understood to supplement a sectoral break-down of public expenditures, rather than replace the sectoral divisions in the budget.

The logic behind the new PRS approach is that merely increasing spending in a certain sector is not by definition pro-poor, unless it is spent on a pro-poor activity within that sector. While the previous (exclusively sectorally-based) PRS approach failed to recognize this, the new NSGPR approach recognizes that it is necessary to consider whether spending within each sector is "pro-poor" and/or "pro-growth" by determining if the spending falls within one of three clusters of pro-poor/pro-growth activities. In principle, all public services provided by LGAs within the five "priority" sectors (primary education, basic health services, and so on) continue to be critical under the new cluster-based NSGPR classification. In fact, it would be fair to require of LGAs -as part of the local budget guidelines- that sectoral block grants should be spent fully in accordance with the national strategy.

Furthermore, within each recommend transfer mechanism, the process of defining formula-based sectoral block grants is more than "just coming up with a formula". The process of allocating local government grants in a pro-poor manner affects each of the three stages of the design of an intergovernmental transfer scheme:

[5] This is consistent with the notion that virtually all government services currently provided at the local level are considered priority services in the context of the cluster approach of the PRS II.

1. Determination of the size of each sectoral grant pool (to which the formula will be applied). Since the sectoral budget priorities (i.e., the size of sectoral grant pools) are explicitly determined as part of the budget frame informed by the PRS (before dividing grant resources among local governments), the central government budget frame should fund local government activities in a pro-poor manner.

2. Formula-based allocation of resources. The allocation of the sectoral grant pools between local government authorities should occur on the basis of a transparent, objective formula. The formula-based division of resources assures that resources are divided among local government authorities consistent with their relative service delivery needs, again consistent with the PRS II approach.

3. Use of block grant resources at the local level. Local governments are provided with guidelines and conditionalities in order to ensure that they spend the block grant funding in pursuit of PRS objectives. In this context, an adequate monitoring and reporting is being set up to allow the central government to keep local governments accountable for the use of central government resources.

Correspondingly, the discussion of each transfer mechanism in the following sections follows the same basic break-down, where each grant scheme is broken down into its three basic elements: (1) determination of the size of the grant pool; (2) the horizontal distribution of the pool among eligible local government jurisdictions; and (3) conditions or restrictions on the use of resources at the local level.

5.2 Formula-based sectoral block grants

As part of the recurrent grant system, the central government provides LGAs with five formula-based sectoral block grants: one for each of the five main priority sectors (primary education, local health, agricultural extension and livestock, water sector, and local roads). According to the legislated and *de facto* assignment of expenditure responsibilities, local governments have been assigned the responsibility to provide these public services of national significance (i.e., devolution of provision). Local governments do not have adequate revenue autonomy to fund any significant portion of these expenditures, and should be expected to under-fund these programs given their national (rather than local) nature. Since the national government has policy-setting and regulatory control over these sectors, it should provide "ring-fenced" funding for these sectors through sectoral block grants. The level of funding for these sectoral block grants should be in proportion to the service level that the central government wishes to achieve.

As fully developed by the Intergovernmental Transfer Study (GSU, 2003), the horizontal allocation of these sectoral grant formulas should be based on the relative demand for the local government service (for instance, the number of clients for the service) in each LGA (see Box 5.2). The exact sectoral formulas were developed by each sector's Block

Grant Implementation Team, and adopted by the Coordinating BGIT as being consistent with the overall transfer system.

Each recurrent sectoral block grant provides local governments resources jointly for PE and OC in that sector, and allows local authorities to distribute their resources between these categories within that sector, as long as the local authority complies with the constraints imposed by the local budget guidelines.

Box 5.2
Reforming Tanzania's intergovernmental transfer system:
Moving from discretionary, input-driven grants to a formula-based, demand-driven approach

The current formula-based sectoral block grant approach entailed a shift away from the supply paradigm inherent in the previous national minimum standards (NMS) approach. Assuring that funding is driven directly by (a proxy for) the level of demand for government services rather than indirectly through the cost of inputs may seem a trivial difference, but it reflects a major shift in the philosophy of local government service delivery. The NMS approach treated local governments largely as passive agents of the central government, in which success was not defined by the efficient and successful delivery of government services but rather by the degree of conformity to national norms. As such, the previous NMS approach was dogmatic and inflexible.

In contrast, a demand-driven grant system provides an incentive for local governments to respond to local communities' needs in a creative and flexible manner in a way that a more centralized system is generally not able to do (and which the current system discourages).

Size of grant pools. Currently the resources set aside for local government activities are determined on a year-to-year basis in the context of the annual budget process. The amounts determined each year are supposed to be guided by the government's longer-term view of its poverty alleviation strategy, as well as the Cross-Sector Medium Term Expenditure Framework (MTEF) and the Public Expenditure Review (PER). As noted in the Local Government Fiscal Review (2004: Table 4.2), intergovernmental transfers as a percentage of the national budget has remained nearly constant for the past five years. However, if one takes into account the earmarked funds that have been provided to the local government level through ministerial votes, the percent of national budgetary resources that is transferred to the local government level may actually have increased over the past five years (see Section 2.4 for a further discussion).

One potential problem with determining the size of transfer funds on an annual basis is that the budget processes guiding budget formulation (MTEF, PER, NSGPR) are not working in an integrated manner in actually determining the amounts that are being budgeted for specific activities (for instance, see Oxford Policy Management 2005). Since the budget policy documents only give guidance for the upcoming budget year, this

allows sectoral ministries to strategically increase the amount of sectoral funding available to the line ministry at the expense of local government funding. For instance, during the budget preparations for FY 2005/06, the Ministry of Education and Culture sharply reduced the amount of ministerial PEDP funding for local governments that it had set aside for primary education capitation spending; instead, MOEC's budget revealed a sharp increase in spending on secondary education (SEDP). While the government argued that this moving of resources was a "policy decision" made by the government, this policy decision was clearly not made in the context of the MTEF, PER and NSGRP, leading some to believe that the local level was the victim of a politically motivated decision by the central government that effectively resulted in local governments receiving fewer resources for the delivery of a key public service, whereas MOEC increased the share of sectoral resources under its control. This example reveals that local governments are at a distinct disadvantage when their vertical share of resources is not protected by a funding rule, since (unlike sector ministries) local governments lack their own voice at the central government level during the budget process ending Cabinet.[6]

Rather than determining the size of the sectoral block grants from year to year as part of the annual budget process, vertical funding rules may be specified in a number of ways that protect local governments against such opportunistic cuts in the level of intergovernmental grants by the central government. For instance, one could specify a rule that a block grant pool has to be at least a certain percentage of the budget: for instance, the Primary Education Block Grant should receive at last 12 percent of the national budget resources. Alternatively, the funding rule may guarantee a minimum increase from year-to-year, such as the rate of inflation.

While there are many advantages to having a vertical funding rule to determine the pool(s) of resources made available to local governments, introduction of such a funding rule could also be counter-productive in the near future if sectoral transfer pools might possibly increase over the coming years. As such, the study team recommends –for the time being- continuing the current approach of adjusting the size of transfer pools annually as part of the budget process, in line with the budget priorities of the public sector (see Box 5.3). However, it will be critical for PO-RALG and the Ministry of Finance to closely monitor the resources provided to local government level to prevent sectoral ministries from arbitrarily "clawing back" resources provided to the local level in order to increase the ministry's own budget. In this light, the government may wish to revisit the vertical allocation approach every few years, as it may be appropriate to introduce a vertical funding rule at some point in the future.

Box 5.3
Determining government priorities and establishing the size of transfer pools

[6] To be fair, PO-RALG noted the reallocation of education funds during the finalization of the government budget, but was unable to reverse the so-called "policy decision" made by MOEC with the apparent approval of the Ministry of Finance.

The central government's budget process is supposed to drive spending changes from year to year in line with the government's strategic priorities. For central government agencies, the Budget Frame (which is prepared from October-December for the next budget year) determines the relative sectoral policy priorities for the country, guided by the PRS, PER and MTEF frameworks. This process of prioritization is currently being modified with the introduction of PRS II (or the National Strategy for Growth and Reduction of Poverty, NSGRP) to more closely align government spending practices with its policy priorities. GSU (2003) recommended that the Cross-Sectoral MTEF should separately identify sectoral transfer schemes in the multi-year budget estimates.

Even though the activities funded by local government transfers are national priority (both under the sectoral approach of the PRS I, as well as under the thematic approach of PRS II), local government transfers for sectoral programs have not increased as a percent of the national budget (LGFR 2004: Table 4.2). The proportional increases from year to year may reflect the incremental nature of the national budget process in Tanzania.

Under the new poverty reduction strategy (PRS II or NSGRP), sector ministries are supposed to prepare their budget requests in the context of a poverty-focused "performance-based" budget analysis, by which the increased budget request is supposed to be tied to expected increases in public service outputs and, ultimately, NSGRP outcomes. A customized software was introduced by the Ministry of Finance as part of the FY 2005/06 Budget Frame to guide sector ministries in prioritizing their spending programs. Unfortunately, the sectoral block grants were considered in the Budget Frame as part of PO-RALG's programs rather than being considered in the context of sectoral allocations, thereby creating a sectoral disconnect. As such, the budget formulation and its implementation should be fine-tuned, which will enable the size of the sectoral grant pools (i.e., the vertical allocation) to be determined as part of the broader budget frame.

This would lead to a situation where sector ministries –as part of the budget formulation process- would recommend the size of each respective sectoral Block Grant pool in light of their sectoral priorities, with consultation with PO-RALG. This approach is not free of risk: in a constrained budget environment, sectoral ministries might start to behave strategically by down-playing the need for transfers to fund sectoral services delivered at the local government level and emphasize centrally-run sectoral expenditure programs instead. Careful attention needs to be paid by the LG-FA&CG to prevent such vertical fiscal imbalances from arising. If such strategic behavior is noted (as reflected by a declining share of sector transfers as a percent of the national budget), then this would suggest the need to introduce a funding rule to protect the local government's share of the national budget.

Horizontal allocation. On July 1, 2004, formula-based allocations were introduced for primary education and health care, although during implementation some deviations away from the formula-based amounts occurred.[7] Formula-based allocations for all

[7] One of the reasons for the deviations from the formula-based allocations was the fact that line ministries had posted more staff at the local government level than provided for in the budget plan. These discrepancies are discussed in greater detail in a Technical Memorandum. *Strengthening The Allocation Of Sectoral Block Grants Within Tanzania's Budget Process.* (Jamie Boex, September 2004)

remaining priority sectors have been agreed upon (see Table 5.1) and are to be introduced with the beginning of FY 2005/06.

Table 5.1
Sectoral Block Grant Allocation Formulas (FY 2005/06)

Sectoral grant	Grant Pool FY 2004/05	Allocation formula
Primary Education	TSh 245.9 billion	Number of school-aged children: 100% (plus earmarked amount for special schools)
Health Services	TSh 63.6 billion	Population: 70% Number of poor residents: 10% District medical vehicle route: 10% Under-five mortality: 10%
Agriculture Extension	TSh 13.9 billion	Number of villages: 60% Rural population: 20% Rainfall index: 20%
Water	TSh 11.2 billion	Equal shares: 10% Number of unserved rural residents: 90%
Local Roads	TSh 5.0 billion	Road network length: 75% Land area (capped): 15% Number of poor residents: 10%

Even though the benefits of introducing a formula-based allocation mechanism are unmistakable, it would have been a mistake to introduce the new formulaic approach overnight. Instead, a gradual phasing-in of the formula-based approach was put in place to prevent large sudden increases in resource allocations to previously under-resourced districts, which could potentially result in inefficient allocation or even misappropriation of public resources by local governments. Second, during the transition from the previous approach, all districts are held harmless against decreases in their resource allocations. This means that –as part of the computation of the coming budget year's grant allocations-, no single local government authority receives fewer resources than the amount established by the "hold-harmless baseline".

The hold-harmless baseline –which is reviewed and approved by the Coordinating Block Grant Implementation Team-, is based on the previous year's budget allocations, but some adjustments are made, particularly to assure that no PE goes unfunded.[8]

In practice, during the first years of the formula-based budget approach, a number of technical adjustments are made to the baseline against which LGAs are held harmless compared to last years' budgeted allocations. These adjustments reflect changes in

[8] This exact computation of the block grants is discussed further by LGRP/GSU. 2003. Technical Notes on Local Government Finance Reform in Tanzania: How does the new system of formula-based sectoral block grants work? (Technical Note 12).

budgetary allocations made during the budget year, and are predominantly caused by weak budgetary controls and poor budgetary execution at the central government level. For instance, if a local authority is not actually spending the amount of resources allocated to it, it does not need to be held harmless against the higher budgeted amount.[9] Likewise, if local government spending is allowed to increase beyond its budgeted allocation (for instance, since the central government posts additional teacher trainees to each LGA, such deviations need to be accounted for in the hold-harmless baseline. A small proportional increase in the baseline may also be justified in order to assure that all local governments receive a minor year-to-year increase in resources.

A significant problem affecting the hold-harmless baseline was identified during the finalization of the government budget for FY 2005/06.[10] It was uncovered that although PO-RALG and the Ministry of Finance were preparing local government budgets in accordance with the formula, PO-PSM was continuing to engage in "business as usual" by approving staffing positions at the local government level irrespective of the financial resources made available under a formula-based system. As shown in Section 2 of this report (Table 2.14), the fact that PO-PSM was not yet fully on board with the formula based approach significantly reduced the probe toward the nature of local government transfers. Discussions have been initiated between LGRP/PO-RALG and PO-PSM in order to resolve this problem with all deliberate speed, but attention is needed from the highest levels to assure that this problem is indeed resolved in time for the next budget year. As soon as local governments are given veritable control over local hiring and firing, it will no longer be necessary to make such adjustments to the hold-harmless baseline, since it will be possible to hold local governments accountable for assuring that they execute their budgets fully within the context of the formula-based funding constraints.

Finally, with respect to the horizontal allocation of sectoral block grants, we should note that the phasing-in and hold-harmless provisions that were adopted as part of the introduction of the new system of formula-based sectoral block grants should be seen as transition provisions, and it is important for the transparency of the system of local government finance to converge towards a system that is fully determined on a formula-basis. In order to achieve this, the current holding harmless regime may have to evolve in the coming years in order to eliminate any historical imbalances and to assure convergence towards the formula-based approach. The review of current phasing-in and holding-harmless practices, and how to modify them in order to move towards a system

[9] The reader should bear in mind that the "appropriate" allocation to each council is determined by the formula. The "hold harmless" process merely assures that no LGA suffers a decline in service delivery. If the resources are not actually being spent, there is no decline in local services.

[10] Another problem identified as part of the FY 2005/06 budget formulation process was the emergence of a number of small earmarked amounts for sectoral purposes alongside the formula-based grant. In some cases, these earmarked funds are appropriate as they are basically intended to fund delegated functions such as special primary schools). In many other cases, these earmarked funds simply appear to be an attempt by central government ministries to continue to exert control over the allocation of resources to the local level outside the formula based approach.

that is fully formula-driven (without addition transitional provisions) is the focus of a technical note produced by LGRP and GSU.[11]

Active steps will need to be taken in order to assure that the phasing-in and holding harmless provisions are indeed a transitional feature of the new formula-based system of intergovernmental grants. This is particularly and unequivocally true in the agriculture, water and roads sectors. Even in the primary education and health sectors, the phasing-in and holding harmless regimes need to be reconsidered in order to assure convergence towards the formula-based approach and eliminate any structural imbalances in the allocation of local government resources.

Local use of resources. A key feature of the formula-based approach is that the formula-based allocation eliminates the need for budget negotiation between the local authority on one hand and regional and central government officials on the other hand. Since the formula-based allocation is determined objectively, local governments now have greater stability in their budget allocations and should be better able to engage in their financial planning and budgeting processes.

In the budgeting and spending of block grant resources, local authorities have to comply with a number of general conditions; for instance, local authorities shall abide by all financial standards and budget procedures as mandated by PO-RALG in the Local Authorities Accounting Manual, and all local authorities should abide by all technical and professional standards in the delivery of local services as set forth by the respective sectoral ministries. Furthermore, LGAs have to comply with specific sectoral block grant conditions specified by the respective line ministries in the local budget guidelines.

In order to assure the central government and the development community that sectoral block grants are indeed used for their intended purpose (and not diverted to alternate uses), the system of local government finances should be more closely monitored. A first stage in the process is to assure that transfers (both for PE as well as OC) are actually disbursed by the treasury system as planned. Currently, at no stage of the budget process does the Ministry of Finance or PO-PSM actually check whether the disbursement of PE plus OC to each local council match with the budgeted allocations.

Box 5.4
Diversion of sectoral transfers and the lack of a hard budget constraint

A number of public expenditure tracking surveys (PETS) have been conducted in Tanzania to analyze whether sectoral transfers in primary education and health are actually being spent within the intended sector. These studies have generally found that a significant share of OC resources (in the region of 40-60%) is being diverted away from sectoral purposes, especially in the case of primary education.

[11] LGRP/GSU. 2005. Technical Notes on Local Government Finance Reform in Tanzania: The implementation of the formula-based grant system in Tanzania: Convergence of phasing-in and holding harmless provisions? (Technical Note 2005-2).

This diversion of sectoral resources has an impact on the local government finance system beyond merely reducing OC spending for service delivery in the particular sector. In fact, to the extent that local governments are diverting sectoral grants to fund other local government activities, the central government is in fact providing local governments with a "soft budget constraint". This soft budget constraint provides local governments with a disincentive to collect own source revenues, as local government officials apparently find it easier to divert sectoral grants away from primary education and health rather than collecting taxes and other revenues from local taxpayers.

While the results from the PETS have led the governments to take certain steps (such as the publication of grant disbursements to the local level), the response by the government to these PETS results were not as thorough as elsewhere (for instance, in Uganda). For instance, the provision of the unconditional grant or permission to collect certain local revenue sources could be made subject to proof (provided by the annual audit process) that sectoral resources are not being diverted. In addition, local financial management processes should be reviewed to ensure increased transparency of the local budget process (as discussed further in Section 7).

Monitoring and reporting of local government finances –as well as the monitoring of compliance with financial conditionalities- should be facilitated by two local fiscal management tools. First, the introduction of local Epicor (integrated financial management) systems –spear-headed by LGRP- sharply reduces the time-cost and effort for LGAs to prepare the needed monthly, quarterly or annual budget reports. In addition, the LGA Plan-Rep (planning and reporting) system which is currently being rolled out by LGRP is meant to function as a single-channel reporting mechanism from LGAs to the central government level.[12] When fully implemented, Plan-Rep should be able to extract the necessary data automatically from the local Epicor systems, consistent with the mantra of "eyes on, hands off." See Box 5.5 for a more detailed discussion on how local government grants and local government finances should be integrated into the central government budget processes and central government budget documents.

Box 5.5
Integrating the finances of decentralized local governments in the central government's budget process

The manner in which local government finances are currently included in Tanzania's central government budget processes reflects the past practices of a highly centralized, top-down budget structure. For instance, the national budget document (Volume III, Estimates of Public Expenditure Supply Votes (Regional), Details on Urban and District Councils Grants and Subventions) includes highly detailed expenditure estimates for local government allocations.[13]

[12] As noted in Section 3.5, the new organizational structure of PO-RALG includes a data-gathering and processing unit for this purpose.

[13] It is important to note that this volume is actually truly part of the budget estimates voted on by parliament, since the volume is produced after the budget vote. Instead, these local budget estimates are

For FY 2003/04, local expenditure details are included at a GFS sub-item level for every local council.[14] However, this inclusion of local budget expenditures in the national budget documents provides a false illusion of central control: the local expenditure items are limited to centrally-funded spending programs (i.e., it excludes all spending from local own resources) and there is no systematic mechanism in the national budget process to reconcile the local budget plans with actual local spending.

Since significant administrative resources are dedicated to this seemingly ineffective system of monitoring of local government budgetary resources, a technical note was prepared that reviews current practices. This review arrived at five key recommendations for the monitoring and reporting of Tanzania's local government finances:

1. Emphasize the philosophical shift away from centralized control

The current national budget process fails to reflect that under the Government's policy of "decentralization by devolution" local governments have the final responsibility for delivering certain services. As such, the central government (neither the executive branch nor parliament) should micro-manage local government finances in a discretionary manner.

2. Discontinue the practice of including detailed local budget estimates in the national budget

With the introduction of formula-based grants, there is no reason to include a high degree of detail on local expenditures in the national budget. Indeed, the entire practice of disbursing sectoral grants through "regional" votes should be questioned; it would be much more pragmatic that local government resources are included in the budget by assigning a separate vote for each transfer program. Rather than including a detailed breakdown, the budget would include the formula applied to each transfer program, and the resultant allocation of resources among local government authorities. The reform would recognize that once a transfer is released by the national treasury, the central government is no longer able to monitor its usage through the treasury system. As a matter of the central budget accounting, each sectoral transfer to the local government level should be identified as just that: a sector transfer to the local government level (and not as a specific expenditure).

3. Continue strengthening the capacity of local governments to manage local finances in a sound and transparent manner

While Tanzania's central government has a well-functioning Treasury system, local government authorities rely on a local treasury function. While local financial management is currently not as strong as the central treasury function, there are strong reasons not to centralize the administration of local government finances. Nonetheless, we should also recognize that the current weakness of local financial management capabilities (including the lack of local fiscal transparency and the limited degree of local accountability) could jeopardize the potential benefits of a decentralized system of government. In response, Tanzania's Local Government Reform Program (LGRP) is

tabulated by the Ministry of Finance from local budget sources after parliament approves the overall size and distribution of local government allocations among local jurisdictions by sector.

[14] There is some suggestion that the Ministry of Finance includes this high level of detail for local government allocations at the request of –or as a condition imposed by- the International Monetary Fund. It is unclear whether this is a misunderstanding or not. However, as evidenced by the international experiences presented later in this document- the IMF generally does not ask or receive such a high level of local budgetary detail of either developed or developing countries.

working systematically to improve the capacity of local governments to manage their financial resources in a sound, transparent and accountable manner primarily through the introduction of a local integrated financial management system.

4. Strengthen the systems for reporting, monitoring and analysis of local government finances

Current efforts in Tanzania to monitor local government finances are fragmented between the Ministry of Finance and PO-RALG. On one hand, whereas the Ministry of Finance has the best technical capacity to tabulate and to systematically analyze the condition of local government finances, the Ministry lacks the mandate and the institutional positioning to systematically gather the necessary local government budget data. On the other hand, whereas PO-RALG has the necessary institutional set-up to gather local government budget reports (on budget plans and budget outcomes) on a systematic basis, PO-RALG lacks the human resources and the technical capacity to tabulate the data and engage in basic comparative analyses of local financial data. A concerted effort should be made to establish a joint reporting and monitoring system that allows both PO-RALG and MOF to achieve their respective functions: PO-RALG is responsible for monitoring and overseeing the budget execution of each individual LGA on a one-by-one basis, whereas MOF is responsible for assuring the overall fiscal integrity of the local government finance system.

5. Produce an annual Local Government Fiscal Review

The central government has a legitimate interest in monitoring the overall state of local government finances. This effort would obviously be complicated if the national budget would no longer include detailed local expenditure data (although there is currently no assurance that local governments indeed spend their resources consistent with the budget plan laid out in the national budget). Instead, a policy-analytical document (a Local Government Fiscal Review) could be produced by the central government based on more aggregate local revenue and expenditure data (rather than the false sense of detail currently provided by the budget). Such a document would allow national policy makers, local government officials and other stakeholders to track the overall financial status of the local government sector, and would allow stakeholders to compare the fiscal performance (and compliance with grant conditions) of individual local governments. The first Local Government Fiscal Review was produced in 2004, and included a statistical annex, which should evolve in future years to include additional useful comparative analyses.

Source: LGRP/GSU. 2003. Technical Notes on Local Government Finance Reform in Tanzania: Linking local government budget reporting and the national budget process (Technical Note 2003-11).

5.3 Formula-based, unconditional equalizing General-Purpose Grant

In addition to the formula-based sectoral grants, we believe that a formula-based, unconditional equalizing General-Purpose Grant should be an indispensable part of Tanzania's system of local government finance. The General-Purpose Grant (GPG) is intended to provide funding for two purposes. First, the GPG would provide unconditional funding for local government administration purposes. Box 5.6 discusses

why the current funding mechanisms for local administration and general-purpose funding are inadequate and inappropriate. Second, the GPG would provide equalizing funding for fully devolved (purely local) activities for local governments for which own local revenue sources provide inadequate revenues.

Box 5.6
What is wrong with the current funding mechanisms for local administration and general-purpose funding?

Currently, the central government provides local governments with funding for local administration through Local Administration allocations. In addition, the central government provides LGAs with an unconditional grant for general-purposes (in compensation for the elimination of a number of local revenue sources in 2003 and 2004). What is wrong with the current approach of funding local government administration and other (non-priority sector) local government activities?

- Local control over the financing of local administration is needed. Consistent with the subsidiarity principle, the responsibility for local government administration in Tanzania is assigned fully to the local government level. This means that local government administration is best funded by local government's "own" resources, which includes locally-raised revenues as well as unconditional, general-purposes resources. Local control over funding would allow LGAs appropriate control over activities in their own realm of responsibility. Currently, the central government has full discretionary control over the amount of local administrative funding that each LGA receives. It is undesirable to fund local government administration by a grant mechanism over which central government could exert discretion.
- Local administration should not be funded from local revenue collections. Until 2003, local governments were required to spend upwards of 60% of own source revenues on local administrative costs, since the central government failed to provide any unconditional resources to the local level and only provided salary support for local administration. As discussed in Section 3, this is an improper assignment of expenditure responsibilities because local authorities are part of the national public sector and predominantly manage the delivery of national public services. The current assignment provides a major negative incentive for local revenue collections, as local revenue collections are shifted away from funding local services to funding local administration instead. This could be resolved by funding local administration from unconditional grants.
- The local administration grant is currently not allocated in an objective manner and is counter-equalizing. The allocation of the current administration grant is almost exclusively driven by existing local administrative payroll. Current allocation patterns display large variations in allocations between LGAs which cannot be explained in an objective manner. In fact, it appears that the impact of the local administration grant is currently counter-equalizing, with wealthier, urban councils generally receiving greater transfers than poor, rural councils.
- The incidence of the current Compensation Grant/GPG is not objective and not equalizing. To some extent, the introduction of the current Compensation Grant/GPG mitigated the problem that hitherto LGAs had not received any unconditional resources for the funding of council operations and/or for funding local activities outside the priority sectors. However, the incidence of the current GPG (ostensibly in proportion to revenues lost by the rationalizations of 2003 and 2004) is highly erratic and (more likely than not) counter-

equalizing. Instead, it is important that such unconditional funding is allocated in a transparent and pro-poor manner, consistent with the government's policy objectives.

In any system of local government finance, there will be fiscal disparities between local governments. These disparities between local governments arise, first, because the expenditure requirements for delivering a certain standard of local services vary from district to district (due to variations in cost, demographics, and other local factors), and second, because the ability to collect own source revenues tend to vary between different local governments. Attempts by the central government to reduce these horizontal fiscal imbalances are known as equalization.[15] Equalization can be divided into two types: equalization of expenditure needs, and fiscal capacity equalization (equalization based on the ability of local governments to collect revenues).

In countries that rely heavily on own source or retained tax revenues at the local government level (which cause substantial horizontal imbalances), an equalization grant mechanism is often an important component of the local government finance system. The need for an equalization scheme is often much less important in countries such as Tanzania where there is no large-scale derivation-based revenue sharing and where own source local government revenues only play a minor role. The fact that a large proportion of local government expenditures in Tanzania are funded by sectoral block grants already assures a substantial degree of needs-based equalization, consistent with the Local Government Finance Act Regulations (Government Notice 282, 2000) which specifies that "the allocation [of block grants] should guarantee equitable access by the population to basic services." This is a clear mandate for the government to engage in the equalization of local government resources based on local expenditure needs.

Yet, in addition to recommending the reform of discretionary sectoral allocations into formula-based sectoral block grant schemes, the intergovernmental transfer study conducted by GSU in 2002 also recommended the introduction of an unconditional equalization grant in the medium term. The purpose of the equalization grant would be to provide supplementary funding for LGAs in an equalizing manner (i.e., to local governments with higher needs and lower own revenue potential) in order to fund activities outside the priority sectors.

Indeed, according to the Local Government Finance Act (1982), PO-RALG is authorized to allocate equalization transfers in Tanzania that provide equalization grants to local governments with limited revenue-raising capabilities. The vision of the intergovernmental transfer study was to introduce an unconditional, equalizing grant (which would integrate the current administration grant along with additional resources) into an unconditional general-purpose grant in order to provide local governments with greater autonomy over their budgetary resources. In order to prevent local authorities from using these unconditional resources in an inefficient manner, it was originally

[15] This issue is discussed by LGRP/GSU. 2003. Technical Notes on Local Government Finance Reform in Tanzania: The Role of Equalization in Tanzania's System of Intergovernmental Grants (Technical Note 5).

envisioned that only councils who achieved certain minimum access conditions would receive the unconditional grant.

Despite this recommendation, in 2003, the introduction of an unconditional equalization grant seemed far off as the Ministry of Finance did not strongly support the provision of unconditional resources to the local level. However, with the introduction of a Compensation Grant in 2003 as a result of the elimination of the Development Levy and the other so-called nuisance taxes, a *de facto* unconditional grant was introduced. By 2004, this transfer program had been renamed the General-Purpose Grant, and as part of the budget formulation process for FY 2005/06, preparatory steps are being made to introduce a comprehensive, formula-based, equalizing general-purpose grant.

Size of grant pool. The determination of the size of the unconditional grant pool will be one of the major challenges in the specification of the General-Purpose Grant. Unlike the sectoral block grants –where the respective line ministries and PO-RALG have an institutional/sectoral interest in supporting additional funding for local governments-, there is no "natural" coalition of central government champions to advocate for the size of the General-Purpose Grant pool. This means that technical guidance on the appropriate size of the grant pool is essential. As noted earlier, there are several ways to determine the appropriate size of the grant pool:

- The first way to determine the appropriate size of the grant pool would be to look at historical grant patterns, including historical trends in the administration grant and the compensation grant, as well as trends in local expenditures on administration and other local (non-sectoral) activities. In 2002/03 (the year before the revenue reforms), local authorities received TSh 15 billion in Administration Grant and collected almost TSh 58 billion in own source revenues, for a total of TSh 73 billion in general-purpose resources. In 2004/05, local governments were budgeted to receive TSh 20 billion and TSh 25 billion in Administration Grant and General-Purpose Grant, respectively, and are estimated to collect approximately TSh 36 billion in own sources (total of TSh 81 billion). In the budget frame for FY 2005/06, a combined TSh 60 billion is set aside for administration and the general purpose grant.

  In this regard it needs to be noted that -unlike suggestions by many local government officials- the compensation grant in fact provides local governments with equal or more resources than the local revenue instruments that were terminated. In providing general-purpose grants to the local level, we should also bear in mind that requiring local governments to spend a majority of their own resources on administrative activities greatly reduced the willingness of residents to pay local taxes and had a major negative impact on the overall system of local government finance.

- Another way to determine the appropriate vertical allocation for unconditional grants would be to somehow quantify the absolute need for local administration and other

non-sectoral local public services.[16] The required size of the General-Purpose Grant pool could then be set equal to the total absolute local expenditure needs minus total (potential) own local government revenues. In particular, this approach would be possible for the administration component of the general-purpose grant, as a valid argument could be made that those costs should be fully borne by the center. Calculations of this nature were made by the study on local government finances based on national minimum standards (PWC, 2000). In contrast, it would be virtually impossible to compute an absolute expenditure need for "truly local" expenditure functions, such as local infrastructure needs, parks, and so forth.

- A third approach or consideration in determining the size of the equalization grant is the degree of horizontal inequity caused by local government revenues. Obviously, the size of the equalization grant pool needs to stand in some proportion to the fiscal inequities created by own revenues. In this regard, we need to recognize that the size of the current general-purpose grant (currently budgeted at TSh 37 billion for FY 2005/06, excluding the Administration Grant pool of TSh 23 billion) is almost equal to the size of total own source revenues collected by local governments in Tanzania (estimated at TSh 36 billion). In other words, the current unconditional grant would have substantial capacity to equalize for the variations in revenue-raising potential across local government jurisdictions.

The grant pool for both the administration grant and compensation grant are currently determined in a discretionary manner as part of the annual budget process as part of the "regional" budget votes (Votes 70-95). Some additional "general purpose" local resources are set aside through parallel funding mechanisms, including budgetary resources earmarked in the budget of PO-RALG for the funding of salaries of Ward and Village level officials. These resources should also be integrated into the general purpose grant and added onto the size of the grant pool.

When taken together, this would suggest that the General-Purpose Grant should have a transfer pool somewhere in the range of TSh 60-70 billion (for FY 2005/06). The study team believes this to be an adequate starting point for the grant pool of the general-purpose grant. However, in order to safeguard the relative size of the unconditional grant over time, the study team further recommends that the annual increase of the general-purpose grant should be guaranteed to be at least proportional to the increase in the national budget. Alternatively, the size of the GPG specified as a percentage of the national budget (say, for instance, the GPG could equal 1 percent of national budget resources), or the size of the GPG could be linked to the total size of sectoral block grants (for instance, the size of the GPG each year could be determined as equal to 15% of the sum of all sectoral block grant pools). Whatever vertical allocation rule is ultimately chosen, it would be wise to enshrine this principle in the Local Government Finance Act. This would greatly enhance the stability and predictability of the local government

[16] Note that although we could take on board the guidance provided by "absolute" expenditure needs, we realize –and argued earlier in this section- that public needs should always be considered relative to the availability of public resources.

finance framework, and would reduce the potential for shirking or "clawing back" by the central government.

Horizontal allocation. The "horizontal allocation" of a transfer scheme considers the manner in which transfers are distributed between eligible local jurisdictions. In other words, what formula or criteria should be used to apportion the transfer pool among the different local governments? Historically, the administration grant has been distributed in a highly discretionary and unequal manner; to a large extent, the allocation of the administration grant followed proportionally to where the central government decided to post local government staff. As a result, wealthier (typically urban) local jurisdictions generally received a disproportionately greater share of these resources. Likewise, the compensation grant was originally distributed in proportion to the revenue yield of the eliminated revenue sources, so that wealthier jurisdictions received a greater share of these resources as well. Although the Administration Grant and the General-Purpose (Compensation) Grant provide a natural basis for an equalizing General-Purpose Grant, the current incidence of these two grant schemes are clearly inconsistent with the government's poverty reduction strategy and the stated intent of the law about providing equal access to local government services.

Given that the purpose of the general-purpose grant mechanism is two-fold (first, to provide resources for local administration and second, to provide funding for general (non-sectoral) local purposes in an equalizing manner), it is important to design the formula in accordance with these funding objectives. Consistent with the need for transparency and in order to assure that "finance follows function", the GPG could be designed to have two "windows", with a separate window for each objective.

In order to be truly equalizing, the formula would have to include measures of local needs and local fiscal capacity, and to provide greater resources to local governments that have greater expenditure needs and a more limited ability to raise own revenues. However, as suggested by the previous studies, the data to adequately measure local fiscal capacity in Tanzania are currently lacking.[17] As such, a theoretically superior "first best" equalization formula that carefully measures the expenditure needs and fiscal capacity of local governments is unlikely to materialize in the near future. The loss in accuracy due to measurement problems that would ensue if we would try to actually measure local expenditure needs and fiscal capacity with very imperfect data would likely be much greater than the loss in accuracy from pursuing a less sophisticated approach.[18]

As a feasible and more practical alternative (but conceptually as a second-best option), the allocation formula for the general-purpose grant could be built around a number of basic fiscal needs measures for which data is available, such as population, land area, and

[17] In order to come up with an objective measure of fiscal capacity (which measures the revenue raising potential of a local government rather than the actual revenues raised), we would not only need to be able to measure the actual revenue collections of a jurisdiction, but also the size of the local economy or the size of the local government's tax base.

[18] For a fuller discussion of the measurement of fiscal capacity and fiscal needs, see Boex and Martinez-Vazquez (2005).

the poverty incidence, with the knowledge that fiscal capacity in Tanzania is inversely related to land area and poverty. As such, a good starting point for the discussion of the general-purpose grant formula could be the current formula used for the capital development grant system: population 70%, poverty 20%, and (capped) land area, 10%.[19] Introducing such a formula would mean that although the GPG formula would provide additional resources to all local governments, it would assure that poorer, rural local governments would receive a larger allocation from the grant mechanism. Such a formula based approach would be a significant improvement over the current discretionary (and counter-equalizing) allocation of general-purpose resources.

Although the study team believes that the LG CDG formula provides an appropriate starting point for the General-Purpose Grant formula, the exact nature of the formula should be a topic for further debate once the overall strategic Local Government Financing Framework has been agreed upon.[20]

As a final consideration, as better data comes available in the future with regard to the fiscal capacity of local authorities, the formula could be revised to more specifically take into account the revenue raising capacity of local governments as well as the fiscal needs of the local governments.

Box 5.7
Using the GPG as incentive for better revenue collection?

In addition to funding local administration and other local activities, the central government could design the GPG in order to pursue another policy objective as well. Since the GPG in fact replaces the revenue lost from ineffective local revenue instruments, it would be highly undesirable if local governments would further reduce their revenue effort in response to the introduction of to GPG. This raises the question of whether the GPG should be used to stimulate own source revenue collections at the local government level?

In order for the GPG to be part of a sound local government finance system, the first thing policymakers would have to assure is that the GPG does not provide a <u>dis</u>incentive to local revenue collections. Such a disincentive is much more likely when the transfer mechanism is discretionary and not formula-based, as the discretionary mechanism would encourage local officials to reduce own source collections with the expectation of negotiating greater transfers in the future. As such, the most important step in ensuring a sound GPG is to remove the discretionary element in determining the size of the transfer.

As argued in the intergovernmental transfer study (GSU, 2003), the transfer mechanism is not

[19] In principle, the first "window" for financing local government administration would most likely be based predominantly or exclusively on population. Poverty and land area would be appropriate allocation factors to enter into the equalization window of the formula. Further work would need to be done in order to complete the formula, so as to arrive at a sound and well-formulated GPG equalization formula.
[20] The introduction of a formula-based General-Purpose Grant would have to consider appropriate mechanisms to phase-in and hold harmless, particularly as local governments may not yet be able to rationalize their local administration staff.

necessarily an appropriate tool to stimulate revenue effort or fiscal performance by local governments. It is likely that there are numerous reasons that contribute to poor fiscal effort at the local government level, many of which are beyond the control of local authorities themselves. Section 4 of this study recognizes numerous factors that have contributed to the poor fiscal performance of local governments in Tanzania. None of these issues would be resolved simply by a financial stimulus through the transfer mechanism. Furthermore, there is no economic argument why it would increase efficiency or equity for the collection of local revenues to be stimulated in the long run.

Another problem noted by the GSU study (2003) is the challenge of accurately measuring fiscal performance by local governments in the absence of data on local fiscal capacity. The data availability to address this problem has not improved in recent years. Finally, it should be noted that the local capital development grant system (LGCDG) already provides local governments with a number of incentives for sound local governance through the imposition of minimum access conditions.

This being said, using the transfer system to stimulate local revenues can be an effective policy tool to resolve certain problems with local revenue administration in the short run. For instance, it would not at all be inappropriate to link the receipt of (part of the) unconditional grant to certain revenue performance indicators that are specifically designed to improve local revenue collections. For instance, one could imagine that local revenue collections might improve in response to an incentive by which all local authorities with a collection ratio for the property tax above a certain threshold (say, 75%) would receive a 10 percent increase in the size of their GPG grant.

Local use of resources. Although the General-Purpose Grant is intended to be basically an unconditional grant, some restrictions on the use of this funding have already emerged. For instance, the administration grant is currently specifically earmarked for administrative purposes while it also includes an earmarked component for funding firefighting equipment. Likewise, when the Compensation Grant was introduced, the guiding circular instructed local governments that these resources should be allocated in the same manner as the eliminated own revenues, but then proceeded to mandate that a certain share of the grant (currently 50%) should be shared with the Village-Level.

Box 5.8
Feedback from the Second Stakeholder Workshop (May 2005):
The need for an equalizing, unconditional General Purpose Grant

The second stakeholder workshop on the development of a strategic framework for local government finances –held in Dar es Salaam in May 2005- was presented with the following statement for discussion and debate: “The local government finance system needs an equalizing, unconditional General Purpose Grant to complement recurrent sectoral block grants, the LG Capital Development Grants, and own local revenue sources”

Unanimous agreement and consensus exists with regard to this statement.

Recognition was given to the fact that local government authorities face substantial differences in local tax bases (as well as differences in local expenditure needs). However, careful consideration should be given to the exact purpose for which general-purpose funding is provided, and the resulting transfer mechanism should clearly respond to that relevant policy objectives. In fact, to the extent that unconditional funding is provided for two distinct purposes (namely administration and equalization), the horizontal allocation formula might indeed pursue these two different objectives through two different windows. Looking forward, it was noted that measurement of fiscal capacity and local expenditure needs would be an important challenge. In addition, concern was raised that unconditional funding should not end up being a reward for inefficiency in local government administration, and that the further development of the general-purpose grant should potentially provide incentives for improved local administration.

The study team believes that any specific conditions on the General-Purpose Grant should be removed, so that the general-purpose grant takes on the nature of a true unconditional grant. Any general conditions on sound local government administration should be introduced as part of the overall Local Government Financial Management Manual. Likewise, any resource-sharing arrangement between the district and the village level should not be limited to the GPG, but should more widely consider all (non-sectoral) district resources, again, as part of the overall financial management guidelines.

To the extent that the central government ministries seek to encourage the delivery of a specific local government service (e.g., the encouragement of urban fire-fighting service) or to the extent that a central government ministry may wish to rely on local governments to implement a specific central government function at the local government level (i.e. delegating the implementation of a service), the central government ministry should provide earmarked, cost-reimbursement transfers for these purposes in their own budgets. To the extent that the delivery of such central government activities are delegated to the local government level, the ministerial budget should clearly identify the amount of resources flowing to the local government level, as well as how these resources are distributed among local government units. The provision by line ministries to PO-RALG and Ministry of Finance during the budget formulation process of detailed data on how subventions will be distributed among local government councils is critical (a) for local governments to develop comprehensive local budget plans, (b) to monitor that these resource do not get diverted at the central government level and indeed correctly flow to the local government level, and (c) to monitor that these resources are appropriately spent by local government authorities on their intended purpose.

5.4 Formula-based capital development grants

In order for local communities to be fiscally empowered with respect to their development activities, the government is moving towards devolution of the development budget through the introduction of a formula-based system of Local Government Capital Development Grants. The CDG is described in greater detail in Box 4.3 of the Local

Government Fiscal Review (2004). In addition, there are a number of (typically donor-funded) sectoral programs which provide resources for sector-specific capital development at the local level; for instance, PEDP has a separate window for the funding of classroom construction and rehabilitation. As we note below, we believe that such sectoral programs should be harmonized into the broader Capital Development Grant system.

Although Tanzania should be pursuing a unified budget approach (that more closely integrates the recurrent budget and the capital / development budget), it is appropriate to separate the capital development grant funding mechanism from the recurrent block grant mechanism, since the two mechanisms serve different purposes.[21] In principle, the Local Government Capital Development Grant scheme provides a sound and well-integrated element of the overall strategic framework for local government finance.

Size of grant pool. Based on thorough analysis of the investment needs and costs, the LGA absorption capacity, experiences from other programs and grant schemes, and the supply side (the availability of the funds), it is planned to have an average annual allocation of capital grants of US$1.50 per capita. The optimal size of the capital development grant was determined using qualitative analysis based on international experiences, balancing the available resources from the donor community and the government with the expected absorptive capacity of local government authorities.

Once the CDG system is fully rolled out to all districts, the total size of the capital development grant system will be approximately TSh 55 billion. This stands in contrast to sectoral grants of approximately TSh 400 billion and unconditional grants (GPG and Administration Grant) of roughly 60 billion for FY 2005/05. Although this seems like a limited amount, it needs to be kept in mind that hitherto local governments basically did not receive any capital development funding. In addition, there is a serious concern among policy experts, that local governments should have adequate resources (from own resources or transfers) to maintain and operate the capital development infrastructure that is being put in place. In comparison to the current own source revenue base of TSh 36 billion, the current size of the CDG does not appear to be inappropriate for the initial years of the system.

Horizontal allocation. It has been decided that the following formula and weighted elements will be used in distributing the CDG capital grant funds:

- Population (70%)
- Poverty indicator (20%)
- Land Area (10%)

The allocation formula adopted by the CDG is fully consistent with the sound principle of transfer design as laid out by the intergovernmental transfer study (GSU, 2003). The formula advocates greater resources to poorer local government authorities, as well as to

[21] Section 6 provides additional insights into why it is not appropriate or efficient to fund capital development activities with recurrent finances.

geographically larger local government districts (in other words, rural district authorities). This is consistent with needs based equalization. Although the CDG formula is pro-poor, a potential criticism of the formula is that it fails to recognize that some districts already have a greater capital stock than other districts. However, it would be almost impossible to subjectively quantify the value of existing capital stock in different local government areas with the current data available. As the CDG system evolves over time, the allocation formula should be reviewed from time to time to assure that the formula achieves the policy objectives that it is intended to secure.

Local use of resources. The capital grant will cater for a broad range of investments in infrastructure and service provision within the mandates of the LGAs. The grant will be a non-sectoral discretionary capital transfer to LGA for capital investments in new infrastructure and rehabilitation of the existing stock. Councils that do not meet the performance conditions for capital development funding but do meet (lower) minimum conditions will receive a capacity building grant. LGAs can use these resources according to their own priorities for improvement of their performance and enhancement of their capacities.

While the CDG is an important step in the process of arriving at a unified capital development funding mechanism, the current design of the CDG simply lumps together capital development spending for the key priority sectors (e.g., building classrooms, clinics, and so on), and capital projects that are truly local in nature (e.g., minor roads, local markets, other local infrastructure, and so on). While the unconditional nature of the current CDG allows local governments substantial budget autonomy, at the same time the CDG system in its current form does not allow the central government to use the CDG system to steer resources as may be needed to national priority sectors, such as classroom construction, clinic rehabilitation, local roads construction, and so on.

Thus, in addition to the implementation of the current "general-purpose" window to the LG CDG, the study team recommends that the next step for the CDG system should be to widen the CDG system by incorporating potential "windows" for formula-based sectoral capital development transfers under the same overall mechanism. In that case, all capital development funding schemes -including sectoral capital development grants- could be planned and budgeted as part of the comprehensive local budget process, and could flow through the same budgetary mechanisms and accounts at the local level.

Box 5.9
The capacity building component of the CDG

One weakness of the current capital development grant system is the capacity building grant. Although the original design of LGSP envisioned the development of institutions to supply training and capacity building to local governments, this component of local capital development system was never fully developed. As a result, there is an institutional vacuum in the area of local capacity strengthening as part of the CDG system. If unaddressed, the distinct possibility arises that local government capacity strengthening grants will be allocated in an ineffective manner.

This should be addressed in improvements to the institutional framework as discussed in Section 3 .5.

Having a unified capital development grant system should reduce the current fragmentation, duplication and loss of transparency associated with the existence of parallel funding mechanisms. For instance, the current PEDP capital grants are currently routed to the local level through each LGA's Education OC account. Such mixing of funding sources greatly reduces the transparency of the local budget and complicates expenditure tracking, thereby reducing the accountability both of local as well as central government officials. Instead, all capital development grant should be transferred to the local government level through the Local Development Account. Improved budgeting practices should enable the local budget process to identify how much of the various development resources were spent in each sector.

5.5 Transfers from ministerial budgets, donor-financed activities, and other parallel funding mechanisms

Earlier we noted that in some cases, the funding of functional responsibilities which are delegated by central government ministries to the local government level (as opposed to "devolved" to the local government level) may be appropriately achieved by earmarking transfers within ministerial budgets, as long as these resources are clearly identified, the allocation between jurisdictions is done in an objective, fair and transparent manner, and the Ministry of Finance (ACB/RALG) and PO-RALG (through the LG FA&CG) are advised of the distribution.

However, to the extent that intergovernmental transfers are intended to fund devolved delivery of services (such as is the case in primary education, basic health care and so on), these resources should all be provided through (and not around) the sectoral block grant mechanism. One further case in point (as further discussed in Box 5.10) is the local share of the Roads Fund, which is currently funded through the PO-RALG budget. Likewise, it does not make sense to have an earmarked ministerial subvention mechanism in the PO-RALG budget to fund VEOs and WEOs, which is clearly a responsibility assigned to the local government level. This funding mechanism should clearly be folded into the envisioned GPG mechanism.

Box 5.10
Providing funding from the Roads Board / Fuel Levy to the local government level

There are currently two mechanisms by which LGAs receive transfers from the central government for the maintenance of local roads. First, local governments receive a relatively small sectoral block grant for local road maintenance. This block grant is transferred directly from the treasury to the LGA like all other sectoral block grants. Second, local governments also

receive a substantial transfer from the Roads Board, which is funded from the Fuel Levy; the relevant legislation sets aside 30% of Fuel Levy collections for the local government level. However, unlike the sectoral block grant for local road maintenance, the funding from the Roads Board is transferred to PO-RALG, which administers these resources. Although in principle the distribution of these resources among LGAs is determined by a formula, PO-RALG appears to administer these resources in a highly discretionary manner, which opens the door for possible inequity, inefficiency, and possible malfeasance.

Having two parallel mechanisms to fund local road maintenance reduces the transparency of the local government finance system and would potentially allow local governments to double-bill for the same activity. The parallel structure is further inefficient by causing substantial administrative duplication and by necessitating unwarranted administrative overhead at the central government level. The manner in which the Fuel Levy funds reach the local government further unnecessarily interjects central government bureaucrats in local decisions and thus unnecessarily restricts local government control and local autonomy.

As such, the study team argues that the Fuel Levy should be transferred directly to local authorities by standing order based on the actual application of a horizontal allocation formula, without the intervention of PO-RALG. Only in the case that a specific local governments is shown to have misallocated the Roads Board grant or it is unable to account for the resources, should the standing order be revoked for that individual local authority.

The same argument should be made for donor-driven projects: the donor community should avoid creating parallel financing structures (either within the context of the central government budget, or completely around the public budget) that by-pass both central government and/or local government budgets.

There is substantial direct donor support to local governments, both in the form of district-level development aid as well as in donor support for specific local-level projects. Although well-intentioned, to the extent that such aid by-passes the central government's allocation mechanism, this practice risks undermining the existing system of intergovernmental fiscal relations. Indeed, the Letter of Sector Policy encourages donor programs to recognize local governments as legitimate representatives of the people for the purpose of allocating public resources at the local level, and to move away from area-based and sectoral programs as modalities to fund the delivery of local government services. For the most part, donors have been extremely supportive of this policy, and many development partners have integrated their existing ABPs into the LG CDG.

The record on this point is not perfect, however. For instance, with support from the World Bank as well as the Government itself, the Tanzania Social Action Fund II (TASAF II) continues the practice of working basically as an extra-budgetary fund, going around LGAs and working outside local budgetary accounts. Likewise, development initiatives pop up regularly that –typically for purposes of expediency to the donor agency- envision financing structures outside the larger system of local government

finance. A case in point might be an envisioned community-funding mechanism to be provided to the village-level for HIV/AIDS activities.

The obvious concern with such extra-budgetary funding modalities is that direct aid to communities (around their local governments) could bring substantial horizontal fiscal imbalances (with certain LGAs receiving more than others) and also greatly reduces the degree of fiscal transparency at the local government level. Discretionary donor funding (much like discretionary and *ad hoc* central government transfers) also softens any hard budget constraint on local government, may provide negative incentives for local governments to raise their own revenue sources, and could prevent local governments from achieving real local buy-in from their local communities in their service delivery role. Furthermore, such parallel funding mechanisms often ignore the link between capital development activities and the impact for the local recurrent budget.

In many ways, the reforms of the recurrent transfer system that the government has adopted over the past several years combines the positive features (such as objective formulas, transparency, and rule-based conditions) of sectoral programs such as the PEDP and the Common Health Basket Fund. Since the government has applied these lessons by making them a central feature of the entire government transfer system, the time is right to integrate PEDP and Health Basket and other similar funding streams into the government's own transfer system. In fact, maintaining separate parallel funds will reduce transparency and accountability, since LGAs are able to "play" with different funding sources (potentially opening the door for double-counting and other malfeasance). Furthermore, integration of these parallel funding streams into the government's main transfer system reduces duplication in monitoring and reporting, and allows the public sector to reduce the reporting burden on local government by stream-lining the monitoring and reporting system of local government finances.

5.6 Recommendations

Progress towards a formula based system of intergovernmental transfers over the past few years has substantially improved Tanzanian system of local government finance. Although substantial progress has already been made, continued progress is necessary in order to ensure that the current improvements in the allocation of local government resources is consolidated and remain sustainable.

Consistent with the recommendations made as part of the intergovernmental transfer study (GSU, 2003), the study team recommends a further tightening of the intergovernmental transfer system which would limit the ability of central government officials to make arbitrary allocation decisions. Section 5.1.2 recommends a clear four-pronged structure for the transfer system, based on the notion that "finance should follow function". Further streamlining and standardization of the intergovernmental transfer system would make the system of local government finances easier to administer, more

efficient, more transparent, more equitable, and would reduce the opportunity for potential corruption (both the local government level as well as the central level).

Overall policy stance and policy effectiveness.

The first step in further strengthening the transfer system would be the unequivocal commitment by the central government that formula-based grants (as opposed to discretionary grants) should be used for the funding of devolved functions. As noted at the beginning of this chapter, the Government of Tanzania is in principle committed to a formula-based grant system that is objective, fair, and results in efficient delivery of local services. Nonetheless, political and institutional expediency sometimes prevail and prevent the immediate and full implementation of the formula-based transfer system.[22] In order to overcome such obstacles, the President, Cabinet, and all involved stakeholders should reaffirm their commitment to a formula-based system of local government transfers.

Constitutional and legal framework.

While the current Local Government Finance Act (1982, as intermittently revised) provides an adequate legal basis for the transfer system, the Act contains numerous duplicative provisions which reduce the overall clarity and transparency of the local government finance system. The law contains many redundant clauses which provide the minister responsible for local government with excessive discretion over the allocation of transfers. Accordingly, the legal framework should be revised in line with the recommendations made in this section, which will provide for a more carefully structured system of intergovernmental fiscal transfers.

Central government institutional and regulatory framework

Although substantial progress has been made in recent years with respect to the institutional and regulatory framework that guides the allocation of intergovernmental transfers, this area will continue to require substantial attention.

The major challenge with respect to the formula-based sectoral block grants is to resolve how these grants should be properly included in the national budget process. The current structure in which local government allocations are budgeted for is a vestige from a centralized past and makes no sense in the current decentralized framework. Now that local government allocations are determined based on the formulas, the division of sectoral block grants over 21 regional votes hinders proper planning and reduces transparency. Although there is broad consensus that it is ultimately the local government that should determine the balance between PE and OC for government services delivered at the local government level, the current budget process still imposes separate aggregate requirements on local PE and local OC. The extent to which the budget formulation

[22] Examples of such bottlenecks and constraints include (1) the lack of operational convergence by PO-PSM in approving local government staff posts consistent with the formula-based system; (2) the increased practice in the FY 2005/06 budget of earmarking sectoral funds in addition to the formula-based allocations; (3) the apparent strategic re-budgeting of sectoral resources in ministerial budgets away from devolved sectoral functions provided by the LGA level, towards sectoral functions directly under the responsibility of the central government ministry.

process for transfers to local level should be modified should be determined by an inclusive series of discussions between involved stakeholders, which include the Ministry of Finance, PO-RALG, the PER working group, public finance management reform experts, and other stakeholders.

A common objective of the institutional and regulatory forms of the central government level should be the comprehensiveness and transparency with which the central government budget captures transfers to the local government level. A major improvement in the local government finance system would have been made if the central government's budget plans would systematically and transparently reflect the amount of transfer resources that are planned to flow to the local government level.

A more systematic inclusion of local government transfers in the central government's budget process will enable the central government to better monitor the actual spending of transfer resources, both by more closely monitoring of actual disbursements of PE and OC to the local government level, as well as by analyzing (self-reported) local government expenditures, which are largely funded with transfer resources.

Local government institutional and regulatory framework and participation by civil society (CS) and private sector.

As noted throughout this report, the benefits from decentralization will fail to materialize unless local governments spend public resources in accordance to the wishes and needs of the residents in their communities. As such, local financial management that promotes local participation in local accountability is a critical feature of any sound local government finance system. This issue is discussed further in Section 7 of this report.

Section 6
Local government borrowing as part of the system of local government finance in Tanzania

A brief synopsis of local government borrowing is provided in Section 1.2.4 of this report. Although borrowing currently only plays a very minor role in the system of local government finance, the question of local government borrowing is becoming increasingly important in Tanzania. Currently, the only approved borrowing mechanism for local authorities is the Local Government Loans Board, but by all accounts the Board is undercapitalized to meet all the (legitimate) borrowing needs of local governments in Tanzania. While one strong feature of Tanzania's (restrictive) approach to local government borrowing is that it provides local governments with a hard budget constraint (See Box 6.1), the current approach may actually be too restrictive and unnecessary prevent access to capital lending to some fiscally responsible and viable LGAs. Recently, a study was commissioned by LGRP to assess current LGA lending practices and to determine a new structure for the Local Government Loans Board (LGRP, 2005); their recommendations will be taken up later in this section.

Box 6.1
Providing local governments with a hard budget constraint and the "golden rule" of local government borrowing

The "golden rule" for (local) government borrowing states that it is proper for (local) governments to borrow for capital projects but prohibits the use of borrowing to fund recurrent spending (Musgrave, 1959). Instead, government spending on current goods and services should be met by revenue from taxes and other recurrent revenue sources. There is common agreement that borrowing to cover current expenditures is acceptable only in very rare, specific cases—usually for very short periods, to cover deficits arising from uneven cash flows within a budgetary year. (Dafflon, 2002; Swianiewicz, 2004).

Even in these exceptional cases, short-term local borrowing might provide local governments with a "soft budget constraint". The experience of many countries is that local government which receive short-term budget loans are unable to repay these credits at the end of the fiscal year, so that these budget loans end up being transformed into deficit grants. If local governments come to expect that their budget loans will be forgiven at year's end, this gives them a perverse incentive to engage in excessive spending and to reduce their revenue effort.

One on the constraints on the environment for local government lending is the limited degree of local revenue autonomy, which constrains the ability of LGAs to repay loans. While it is unlikely that borrowing will offer a solution for the financing needs of poor (predominantly rural) local authorities, access to borrowing may provide an avenue for wealthier (particularly urban) authorities to make greater investments in urban infrastructure. The reason why the borrowing mechanism may be more appropriate for (some) urban governments as opposed to rural governments is because urban governments have greater own resources and should be better able to repay their loans. Instead, most rural local governments likely have inadequate resources to repay their loans; alternative mechanisms (especially capital development grants) will have to be relied on to fund their capital development needs.

6.1 The rationale for borrowing to provide funding for capital development.

When local governments prioritize their recurrent expenditure needs and their budget decisions, this is accomplished by comparing the expected benefits from the various spending options: for instance, a community may judge the benefit of having additional schoolbooks during the coming year to be greater than the benefit of hiring a new teacher (or vice versa). However, the very nature of capital goods is different from regular recurrent budget items, which complicates the budgetary choices that need to be made.

In fact, if the local government finance system would require localities to fund capital goods from recurrent resources, this would lead to an under-provision of capital infrastructure. According to Petersen (1998), there are four major reasons why recurrent financing of capital development would be inefficient:

1. The amount of resources needed for capital projects is often too large to be raised from regular recurrent sources. Unlike most recurrent expenditures, capital infrastructure is “lumpy” in nature: all the spending must be done before there are any benefits, so that you could not simply decide to build half a bridge and receive half the benefits. If financed from recurrent revenues, taxpayers would be asked to bear the full cost of a capital project upfront, while the benefits from capital projects are spread out over a multi-year period: this concept is known as inter-temporal mismatch. Borrowing would restore the match over time between the costs and benefits of capital infrastructure. This argument is valid both for social types of infrastructure (school buildings, clinics, etc.) as well as productive types of infrastructure (markets, roads, and so on).

2. The absence of certain types of infrastructure may be limiting economic growth: while building a market or a rural road may generate economic activity, the fiscal resources to build the market or road only become available once the investment is in place. As such, the infrastructure that is needed to accommodate future growth is needed today; to delay providing the infrastructure would mean to slow

economic growth. In addition, if user fees or increased economic activity are expected to generate additional local revenues once the capital is in place, the absence of the capital infrastructure would also influence a locality's ability to repay the debt. Of course, this argument is only valid if borrowed resources are invested in economically productive uses.

3. It is more equitable (fair) to have those residents that will receive the benefits of the capital project over time to also contribute to the cost. The equity issue is particularly relevant when considering major capital projects with long-term benefits, where in the absence of borrowing we would possibly ask one generation to pay for the infrastructure used by another generation (intergenerational equity).

4. For countries with high inflation volatility, future increase in construction and acquisition cost can be avoided by building the project now. If loans can be locked in a reasonable, fixed rate, future inflation could also reduce the cost of borrowing, as the future payment would be worth less than the value of the sum that was borrowed.

6.2 Local government borrowing and moral hazard: the lack of incentives for repayment and the risk of a soft budget constraint

If local government borrowing has so many conceptual benefits over funding capital development from recurrent resources, why then is borrowing not widely used for this purpose in local governments around the world? There are in effect two parts to this question's answer. First, in order to borrow money, local governments need to have adequate revenues to repay their debt. Thus if local governments lack own resources (either in the form of own revenue collections or in the form of unconditional transfers), then it would be impossible for them to credibly borrow funds. Second, even if local governments have adequate resources, local government borrowing raises a problem with moral hazard.[1]

The moral hazard problem in subnational borrowing is the following: although a loan between a responsible local government and a (public or private financial institution) could bring benefits to both, once the loan is made, what is the incentive for the local government to repay this debt? In highly developed market economies with an established tradition of local autonomy, the reason that the local government will repay its debt is two-fold. First, in the absence of a solid repayment record on existing loans, local governments know that banks and other financial institutions would refuse to lend to them in the future. Second, in the case of loan defaults by local officials, legal action by their creditors or administrative action by the central government would give financial and political incentives for local governments to respect the loan agreement.

[1] Moral hazard is a situation in which one of the parties to an agreement has an incentive -after the agreement is made- to act in a manner that brings additional benefits to himself or herself at the expense of the other party.

However, conditions in most countries do not provide for such a tight accountability framework. In fact, in most countries the central government is (either implicitly or explicitly) regarded as the guarantor of all subnational government borrowing, so that there is an expectation that if a local government defaults on a debt; it will be repaid (in one way or another) by central authorities.[2] This expectation provides two perverse incentives: first, it gives an incentive to lending institutions to loan resources to local authorities even if these localities are not expected to repay their debts. Second, local governments have an incentive to excessively borrow and spend with the expectation that they will be bailed out by the central government, either by a one-time bailout or by a systematic increase in grants.

This threat of soft budget constraint is one of the most pressing local government finance issues in countries around the world. A review of empirical evidence and international practices reveals regular episodes of severe local debt, fiscal crises, and ultimate central government bail outs of regional and local governments in developed and developing countries alike (Rodden, 1999). Depending on the degree to which subnational governments are able to indebt themselves, the consequences of this problem could be very severe. Subnational fiscal crises caused by excessive subnational borrowing and payment arrears have the potential to snowball into national financial crises and macroeconomic instability.

In order to put into place a viable local government borrowing framework, the risks of moral hazard and soft budget constraints have to be overcome. Very broadly, there are three mechanisms that could contribute to fiscal discipline and responsible borrowing behavior by local governments:

1. Hierarchical constraints. Unless it is absolutely clear to all stakeholders involved (including local officials, local communities and financial institutions) that the central government does not guarantee local government debt and will not bail out defaulting local authorities, the potential for moral hazard arises. This situation motivates central governments to implement rules and administrative controls that constrain and limit local borrowing. Rodden (1999) refers to this set of limitations and rules as a *hierarchical* hard budget constraint. The ultimate hierarchical constraint is the legal enactment of local government "bankruptcy" or financial emergency procedures, which define the central government's response if a local government does default on its loan obligations (see Box 6.2).
2. Horizontal constraints. In addition to central government regulations, local fiscal decisions regarding borrowing are also dictated by local political considerations. If the local borrowing framework is unambiguously clear, any claims that other government levels are responsible for repaying local debt would not be credible. In that case, local government officials who attract excessively high levels of debt risk being punished by local voters who would hold their local officials responsible for failing to assure local fiscal health.

[2] If local governments borrow from an intermediary financial institution such as the LGLB, the mechanism remains essentially the same. Unless the Board has the institutional credibility or legal means to enforce repayment discipline, local governments will lack an incentive to repay their debts.

3. Market pressures. Finally, if local governments borrowing directly from capital markets through bonds or banks (instead of an intermediary financial institution such as a loans board), the fiscal actions of local governments serve as signals to the financial market about their creditworthiness, as the market evaluates local governments based on their capacity and willingness to honor their debts. In a well-functioning capital market, local authorities that have established a greater creditworthiness pose less risk to financial institutions and are able to borrow at lower interest rates. This is known as *market-enforced* hard budget constraint. Tanzania is still quite a ways off from having an appropriate market-based local government borrowing framework.

Box 6.2
Local Government Bankruptcy or Emergency Procedures

Like individuals and businesses, subnational governments sometimes face financial difficulties. Subnational governments can get into financial problems in various ways, sometimes through economic or social misfortune; sometimes through incompetence or malevolence; sometimes through stubborn unwillingness to make tough budgetary choices; and often through a combination of these causes. However, the difference between businesses and subnational governments is that an insolvent business can be declared bankrupt and dissolved (in which case the assets are sold off to repay the firm's debts). This is generally not an appropriate response for local government authorities.

Although the occurrence of occasional local fiscal problems may be inevitable, a sound local government fiscal framework should at a minimum (1) remove any perverse incentive that would reward poor financial management, and (2) provide a clear framework for resolving local fiscal crises when they occur. Many countries have introduced municipal bankruptcy laws or local financial emergency procedures to assure a hard budget constraint in subnational financial management. Municipal bankruptcy laws generally have several components:

- Local bankruptcy laws or financial emergency procedures are generally triggered when a locality meets one or more specific criteria of insolvency (indicating that it is unable to repay its existing financial obligations). It is important to rely on objective, rules-based criteria, to prevent the central government from abusing such emergency provisions to intervene in subnational fiscal issues for political reasons.
- When the statute or regulation is triggered, local control over its finances is limited. In some cases, the local treasurer is subjected to external oversight, either by a centrally-appointed administrator, a supervisory board, or by a court-appointed specialist. In other cases (especially when the crisis is due to inadequate local oversight or malfeasance on the part of the local council), the local council or treasurer may be dismissed. The latter would send a strong signal to ensure local political accountability, and would discourage local politicians from trying to create budget deficits in order to attract supplementary funding from the central government.
- The externally appointed supervisor is given final authority over local budget decisions. It is his or her job to ensure that the local government is returned to financial solvency. In order to do so, the supervisor or emergency manager has the authority to reduce specific local spending items, terminate local staff as needed, require increases in local taxes, and renegotiate the local government's debt.

- Once the local financial crisis is resolved and the locality is returned to fiscal health, control over local fiscal decisions is returned to the local elected council and the local treasurer.

Source: Mikesell (2002)

6.3 International approaches and limitations

Ter-Minassian and Craig (1997) document international practices with respect to subnational borrowing. They group country approaches to the control of subnational borrowing into five broad categories, although some countries use mixed methods. At the extremes, a country could base its borrowing framework on exclusive reliance on market discipline on one extreme, and on a complete prohibition against subnational government debt on the other extreme. Other categories lie between those two extremes: cooperation by different levels of government in the design and implementation of debt controls, rule-based controls for subnational borrowing, and administrative controls on subnational debt.

Reliance on market discipline. As suggested by Lane (1993), there are a number of conditions that need to be satisfied for financial markets to create discipline on subnational government borrowing behavior:

- Markets should be free and open from regulations that place government in a privileged borrowing position
- Availability of adequate information on borrower's outstanding debt status and repayment capacity
- There should be no perceived chance of bailout of the lenders in the case of impending default
- The borrower should have institutional structures that ensure adequate policy responsiveness to market signals before reaching the point of exclusion from new borrowing

These stringent assumptions on market conditions are unlikely to be realized, especially in developing countries. Even some industrial countries place various forms of interventions into financial markets to put government securities at privileged positions. Because of those necessary conditions, exclusive reliance on market disciple as a method to control subnational borrowing is not widely used.

Cooperative approach to subnational debt. Closest to reliance on market discipline is the cooperative approach to debt control. In this approach, the limits on the local indebtedness are not set by law or determined by the central government, but arrived at through a negotiation process between the federal and lower level governments. Under this approach, subnational governments actively participate by formulating macroeconomic objectives and the key fiscal parameters necessary to attain those objectives. Central and local governments then agree on specific limits for financing requirements of individual jurisdictions. This approach has advantages in promoting

dialogue between different levels of government, and is especially common in federal or quasi-federal countries. It also raises consciousness to macroeconomic impacts of subnational governments' borrowing decisions. But this approach works better in the environment of relative fiscal discipline and conservatism, as it may not be effective to prevent debt buildup in countries with weak market discipline, fiscal discipline or central government leadership.

Rule-based approaches to controlling subnational borrowing. A progressively more restrictive approach to local government borrowing is a rule based approach, which puts limitations to local borrowing in the constitution or in the laws. Some of these rules may set limits on the absolute level of indebtedness of a specific local jurisdiction; others specify that credit is to be used only for specific purposes; other rules may determine a maximum allowed debt service relative to total expenditures in order to limit the new borrowing; and others severely restrict certain types of borrowing associated with greater macroeconomic risks (such as borrowing from foreign sources). Many countries use a combination of these rules. In general, a rule-based framework for local government borrowing provides transparency and avoids a bargaining process between local and central governments.

However, a rule-based approach lacks flexibility and may end up encouraging practices aimed to circumventing the rules. To ensure its effectiveness, it needs to be supported by clear and uniform accounting standards for government entities, elimination of off-budget operations, a clear and comprehensive definition of what constitutes debt, and a modern government financial management information system.

Direct central government control over subnational borrowing. The opposite extreme of the market discipline approach –short of an outright prohibition of subnational borrowing- is direct controls by central governments over subnational borrowing. This control may mean that every local borrowing transaction from a private lender needs to be reviewed and authorized by the center, and/or the centralization of all government borrowing with on-lending to subnational governments for special purposes.[3]

In reality, direct administrative control comprises a range of centralized approaches, from complete central discretion over local borrowing decisions (where a central government body decides on local government loans on a case-by-case basis), to a centrally-organized financial intermediary for local governments. Direct administrative control is commonly used in unitary states than in federations. It has some advantages such as a close relationship between debt policy and other macroeconomic policies; better terms and conditions of international debts; avoiding the risk of contagious effect of one subnational's credit rating to other borrowers; and central government's commitment to bear the responsibility of subnational foreign debt. At the same time, excessive central discretion over local borrowing decisions may result in inefficiencies, particularly if the central government is not able to identify the most valuable local government investments or if the review process is subjected to political pressures.

[3] On-lending is a practice where a central government engages in lending, only to "on-lend" the proceeds of the loan to the local government level.

Although a central-government run local financial intermediary (such as a local government bank or loans board) officially provides direct central government control, the approach could nonetheless accommodate an impartial borrowing framework that gives a high degree of discretion to local authorities. This would be the case if all local governments borrowing is required to go through the loans board, but the board would use a rule-based mechanism to determine local eligibility for access to loan funds. Such a mechanism would provide a high degree of central government administrative control over local borrowing, without the inefficient discretionary intervention of the center in local government budgetary decisions.

Regardless of the borrowing policy chosen, there are important requirements from a financial management point of view. The central government needs to pay attention to the flows of borrowing, the source of credit and forms of borrowing (Potter, 1997). Many countries put close monitoring to the flows of borrowing of individual jurisdictions. It serves the purpose of preventing subnational governments from incurring the level of debt that would threaten their solvency. It also enables the central government to check on the aggregate national borrowing position. But even for the developed countries, this information on debt flows may not be sufficient. First, reported data might not be credible due to "creative accounting" and off-budget financing practices. Second, when subnational entities are the major holders of financial assets, market volatility and unwise investments could result in large arrears, like the case of Orange County in the United States and the Western Isles authority in the United Kingdom.

International practices and experiences. Table 6.1 provides an overview of selected international practices with respect to subnational borrowing and borrowing controls.

Table 6.1 separates international experiences into industrialized countries and developing countries. Industrialized countries tend to rely on a combination of market discipline, cooperative, rule-based and administrative controls (Ter-Minassian and Craig, 1997). Dafflon 2002; OECD (2004). As for the forms of borrowing, there has been a tendency for central governments to increasingly define the acceptable forms of local borrowing mechanisms or instruments, enabling the central government to more closely monitor local government borrowing. This development has been driven by the need to prevent "creative" accounting practices that are outside the normal borrowing controls. Such rules-based frameworks also aim to discourage long term borrowing to meet current short-term expenditure needs. (Swianiewicz, 2004)

Most transition countries in Eastern Europe and the former Soviet Union (not shown in the table) have an outright prohibition of local governments borrowing from the private sector, although in most transition economies' cases short-term budget loans from the Ministry of Finance are allowed. Indeed, many former Soviet republics are still in the habit of providing intergovernmental transfers on a negotiated gap-filling basis (as under the Soviet regime), in which short-term budget credits regularly turn into transfers at the end of each year. (As noted, this is a bad budgetary practice that perpetuates a soft budget constraint and encourages poor local fiscal decisions). Within the former Soviet Union,

the Baltic states do allow local governments to borrow through financial intermediaries (Local Government Banks).

Table 6.1
Subnational Borrowing Controls on Domestic Borrowing in Selected Countries

	Market discipline	Cooperative control	Rule-based control	Direct Administrative control	Borrowing prohibited
Industrial countries					
Australia		•			
Austria				•	
Belgium		•			
Canada	•				
Denmark		•			
Finland	•				
France	•				
Germany			•		
Greece				•	
Ireland				•	
Italy			•		
Japan				•	
Netherlands			•		
Norway				•	
Portugal	•				
Spain				•	
Sweden	•				
Switzerland			•		
United Kingdom				•	
United States	•		•		
Developing Countries					
Argentine		•			
Bolivia		•			
Brazil		•			
Chile		•			
Columbia		•			
Ethiopia				•	
India				•	
Indonesia				•	
Korea, Rep. Of				•	
Mexico				•	
Peru				•	
South Africa		•			
Thailand					•

Source: Ter-Minassian and Craig (1997).

In the absence of well-functioning capital markets, relying on market discipline is simply not an option as a borrowing control for developing economies. Within Latin America, cooperative control mechanisms are widely practiced. However, excessive subnational control over the extent of subnational public borrowing can cause substantial fiscal

instability. This could result if local governments were able to effectively dictate the terms of borrowing, which could cause local governments to borrow excessively.

In the remainder of the developing world, direct administrative control is the most widely practiced approach. This approach gives the central government the greatest degree of control over subnational borrowing (short of an outright prohibition of subnational borrowing). The fact that no developing countries rely on rule-based borrowing is not surprising, given the challenges that this would cause for the central government to monitor and control subnational borrowing and debt. As such, Tanzania's current practice follows the pattern of most developing countries. While this approach provides the center with a high degree of discretion and fiscal control, the flip-side of this coin is that the current approach greatly limits the ability and discretion of local government authorities to access loans, even in cases where this is economically justifiable and efficient.

6.4 Use of transfer system as a potential guaranteeing mechanism

The possibility for local government defaults on their debt obligations creates a problem of a soft budget constraint. This is particularly true when the local borrowing framework is not integrated well into the rest of the local government financing framework. For instance, when grants and borrowing are taken independently (which is almost always the case), they often provide conflicting and poor incentives for local fiscal behavior. First, heavy use of grants and subsidized loans provides local governments with incentives to undervalue capital when making investment decisions. Second, government distortions of the price of capital can generate inefficiencies and inequities across local governments. Third, indiscriminate grant allocation and other subsidies weaken the correspondence between costs and benefits, and this weakens the incentives for cost recovery and cost efficiency. Lastly, poor repayment creates a sustainable revolving fund to finance development in future infrastructure, as the local government is not pressed with loan payment while still enjoying the flow of grant money.

There are two main ways in which closer integration of the borrowing and transfer framework would result in an overall improvement in the system of local government finances. From a local fiscal administrative viewpoint, linking the borrowing framework to the transfer system could improve the overall effectiveness of local finances by creating proper incentives for debt repayment. If the borrowing framework would be linked to the transfer system in such a way that local authorities which default on their loan obligations would automatically be penalized by the transfer system (for instance, by having the loan repayment plus penalties recovered as a first charge from their unconditional grant, and/or by losing access to certain capital grants), this could go a long way in avoiding the moral hazard often encountered in local government borrowing schemes (Smoke, 1999).[4]

[4] Note that it is only possible for the central government to use unconditional grants to guarantee local government loans, since sectoral loans are earmarked for specific purposes.

More closely integrating the transfer system into the capital financing system might allow the development of a hybrid system where well-off governments and revenue-generating projects would rely more heavily on loans, while poorer local governments and projects that cannot recover costs would be subsidized (Smoke, 1999). As such, the integration of intergovernmental transfers and the loan system within a consistent financing framework would be consistent with the pursuit of a more equal allocation of subnational resources while, at the same time, supporting the gradual development of a municipal credit system (Weist, 2004). Such a hybrid system can institutionally evolve by either introducing a grant component into local government borrowing operations, or by including a component of borrowing into a grant program. For instance, the World Bank-supported Municipal Development Fund in the Republic of Georgia provides local governments with capital development funding on the basis of a 20% local matching share, a 40% grant, and a 40% loan component against concessionary conditions (www.mdf.org.ge). Of course, greater equalization could be achieved by varying the matching rate and the size of the grant component based on local fiscal conditions.

6.5 Recommendations for Tanzania

Based on this review on borrowing, the study team believes that there is a need to cast a wider role for LGA borrowing in Tanzania than is currently available. The Local Government Loans Board views its own role in a very narrow manner; the Board is too much a part of the central government; the Board's capitalization is inadequate (both the amount as well as the manner); its current mode of operations gives the Board substantial discretion in selecting local projects to be funded, and is viewed by many to favor poorer, rural districts in its funding decisions. As such, the current lending mechanism is substantially biased against wealthier urban areas, who –despite their greater need for capital development and their greater resource potential for repaying loans- do not have systematic access to loans to finance capital development projects. Box 6.3 provides an illustration of how such an alternative lending mechanism could possibly function.

Box 6.3
An illustrative design of an alternative loan mechanism

We do not believe that the current, single lending window will adequately accommodate the borrowing needs of all local government authorities in Tanzania. As such, we recommend that instead of (or in parallel to) the current loan mechanism operated by the LGLB, a separate on-lending window is established (hereafter referred to as the Alternative or Supplementary Loan mechanism) with the purpose of providing loans to wealthier local governments. In order to prevent administrative duplication, if administratively feasible, it would be desirable to have the LGLB's Secretariat administer this new loan window. However, this would require a further reorientation and strengthening of the LGLB, and closer cooperation with the Ministry of Finance.

If the Supplementary Loan mechanism could be funded from loan proceeds from international financial agencies or donor agencies,[5] the relative size of this borrowing mechanism would not be restricted by the limited capitalization of the Tradition Loan mechanism, but instead be determined by the demand for loans from qualifying councils, which in turn would be guided by their ability to repay these loans. Qualification for Supplementary Loans would be rule-based: one set of rules would determine which councils would have access to loan funds, and a second set of rules would curtail the amount and use of these funds. In the presence of such an appropriately capitalized Supplementary Loans mechanism (at concessionary rates), local governments would have no need to borrow from the private sector.

Although the exact design of a Supplementary Loan mechanism goes beyond the scope of the current study, it might be useful to illustrate what such a lending window could look like. The following only provides an *illustration* for a Supplementary Loan mechanism.

Based on the illustrative access criteria and limitations provided below, a rough estimate of the maximum capitalization requirement of the supplementary loan window would be approximately TSh 7.5 billion. For comparison, a total of TSh 317 million in loans was issued under LGLB's Traditional Loan mechanism in 2003.

Qualification for Access

In order for local government authorities to qualify for access to the Supplementary Loan mechanism, it would have to meet the following criteria:

- The council has to have a minimum level of local revenue collections of at least TSh 2,000 per person.[6]
- The council has to be current on all obligations to LGLB's Traditional Loan mechanism.
- The council meets the same Minimum Access Conditions applicable to the Local Government Capital Development Grant
- The council has a capital development plan in place, and budgets in the context of a unified local budget.

Restriction on the amount and use of loan proceeds

- Loan proceeds may only be used for capital investment purposes, for either infrastructure investments in the social sector (schools, clinics, etc.) or for public investment in economic activities (markets, roads, and so forth).
- Maximum borrowing limit: a council's outstanding debt may not exceed 25% of general-purpose resources (own revenue collections plus general-purpose grants)
- Maximum limit on interest payment: projected interest payments may not exceed 20% of a local authority's discretionary general-purpose resources.
- The central government (PO-RALG and MOF) will guarantee that if the LGA defaults on its loan repayment, the loan repayment will be withheld as a first charge from the unconditional grant and paid directly by the Treasury. This would constitute a violation of the minimum

[5] Since local authorities are liable to repay these resources, it may be possible to attract loan funds through the World Bank, African Development Bank, or other more specialized agencies, such as the German KfW Development Bank or Japanese Development Bank.

[6] This recommended minimum level (TSh 2,000) is approximately twice the average level of local collections, assuring that qualifying councils have a minimum ability to repay loans under the Supplementary Loan mechanism. Based on preliminary revenue data for the first half of 2004, 18 councils would meet this criterion. The level may be adjusted upward over time to provide an incentive for local governments to increase own source revenues in order to maintain access to the Supplementary Loans window.

access conditions.

Loan conditions
Qualifying loans could be issued against a concessionary interest rate of X % per annum, with a maturity of 3-5 years and a one-year grace period for the principal.

A recent study commissioned by LGRP (2005) recommends that the LGLB and its operations be significantly transformed. The LGLB study recommends the following key reforms:

- Transformation of the LGLB into an autonomous Local Government Finance Corporation (Limited)
- Modifying the composition of the Board to reflect ownership of the capital (resulting in greater autonomy and greater ownership outside central government)
- Capitalizing of the loans board through the issuance of shares, supplemented by capital obtained from development partners (including on-lending). The study envisions an initial capitalization of TSh 1.51 billion through the issuance of shares.
- Modifying the lending operations in line with international best practices, including expansion of the staff to encompass 55 professional and support staff.

In principle, the recommended transformation of the LGLB into a Local Government Finance Corporation (LGFC) fits well within the overall local government finance framework, as is developed and recommended by the Strategic Framework for Local Government Finance. However, the study team has a number of concerns and reservations about certain details of the recommendations made in the LGLB study. Our concerns include the following:

- The absence of an inherent hard budget constraint. The LGLB study acknowledges that there is a "culture of non-repayment" by local governments. Despite the fact that the LGLB document provides great detail on the reform of lending operations under the new Corporation, relatively little attention is paid to mechanisms to assure repayment of loans by LGAs and provide a hard budget constraint.

- The need for limitations on borrowing to assure repayment. In fact, the study asserts that the reformed lending mechanism will be able to serve urban, rural, and even village authorities. However, we believe it to be highly unlikely that most district authorities or village authorities (and even some urban authorities) would have the fiscal capacity to viably access and repay local government loans. The imposition of conditions and limits on LGA borrowing will likely reduce the ability of LGAs to absorb loan funding below the amounts envisioned by the LGLB study. This would be especially true for poorer (predominantly rural) LGAs.

- Concern about the issuance of loan guarantees. The issuance of loan guarantees by the Local Government Finance Corporation without a credible and viable way for

the Corporation to assure repayment by LGAs (e.g., through bankruptcy legislation) presents a major risk for moral hazard. We suggest the issuance of loan guarantees is a risk that would unnecessarily complicate and compromise the integrity of the proposed mechanism.

- The absence of linkages with the Capital Development Grant System. The lending mechanism developed by the LGLB study seems to be developed almost independently from other potential sources of capital development funding, especially the Capital Development Grant mechanism. The worst thing that could happen is for these mechanisms be uncoordinated and to "compete" between each other. For instance, we would want to avoid unaccountable local governments that fail to qualify for the LGCDG to be able to access capital resources through the lending mechanism. As such, it will be critical that Minimum Access Conditions are cross-referenced between the LGCDG and the LGA lending mechanism.

- The implications for human resource capacity. The proposed transformation of the LGLB has significant implications for the human resource requirement to manage the operation. Two concerns here are, first, whether the LGLB has the human resource capacity to transform itself into the corporate entity envisioned by the LGLB study, and second, whether the scope of the proposed professional and administrative staff for the Local Government Finance Corporation is justified given the relative minor role played by borrowing in the local government finance framework and the scarcity of available experts in the area of local government finance issues in Tanzania.[7]

- The source of capitalization. It is not clear whether the source of funding for the initial capitalization of the LGFC would interfere with the funding of the LGCDG. This should obviously be avoided. Given the current funding constraints at the local level, it would be illogical to expect (and it is unlikely that LGAs would have the own revenue sources) to substantially buy into the LGFC.

- The speed of the reform. The LGLB study seems to suggest moving forward rapidly with the transformation of LGLB into a Corporation (in fact, the study provides draft languages for implementing legislation). While local government borrowing is an important pillar of fiscal decentralization, the reform of the LGLB may not be sufficiently high of a priority within the realm of local government finance. It also appears that key stakeholders (e.g., within the Ministry of Finance) still need to be sensitized to the appropriateness of this reform.

[7] By comparison, less than a dozen budget officers are available in the Ministry of Finance to administer and oversee the portfolio of TSh 474 billion in local government grants. The central government currently does not provide a single expert on local government revenues to support LGAs in revenue collections, which accounts for TSh 35-50 billion annually. Similarly, the proposed staffing for the LGLB would exceed the staffing for the entire LGRP Finance Component, including all ZRT Finance and Finance Management Experts.

- Ability to proceed with many of the recommendations under the current legal framework. We note that if the political will is present to pursue the recommended reforms, many of the recommendations made by the LGLB study could be implemented by the LGLB in its current incarnation without major legislative and institutional reforms.

In other words, we suggest that the Government of Tanzania in principle should move forward with the reforms that are recommended by the LGLB study, with the specific caveats as noted above. While the overall direction of the proposals for the transformation of the LGLB into a Local Government Finance Corporation is sound, there is no major reason to rush the introduction of these reforms. Instead, a more gradual transformation of the LGLB into an LGFC would be appropriate given the prominence of other ongoing reforms in the field of local government finance.

Section 7

Institutional and administrative dimensions of local government finances

The policy design of a framework for financing local governments cannot be separated from considerations as to how it is to be implemented. This, in turn, makes it necessary to consider the role of administrative practices and institutions in the context of the recommended strategic local government financing framework. This includes, on the one hand, the role of local revenue administration and local expenditure management issues, and on the other, the administrative arrangements at central government level necessary to support the system. Of course, the role of local tax administration is already dealt with in Section 4 of this Final Report.

Indeed, the ultimate benefits from decentralization (both in the quality of local services as well as the nature of the local revenue system) are often determined by the manner in which fiscal decentralization reforms are actually implemented, which may differ significantly from its original conceptualization. It is possible, for example, that an expenditure program designed to be progressive in its incidence becomes highly regressive as a result of failure to implement or administer the program as intended. The administrative dimension is thus crucial to the reform of local government finances.

As indicated, the implementation of local government finance reforms takes place in two distinct realms. The first realm relates to changes in local government finance at the local level, whereas the second relates to changes at the central level necessary to support a devolved system of public finances. The local component has, in turn, two different dimensions. The first dimension relates to the establishment of sound revenue sources – including ensuring that the set of local government taxes is successfully administered as intended.[1] The second dimension relates to the use of financial resources at the local level: local planning, budgeting and financial management processes should be in place to assure that local governments make the appropriate choices around how they allocate their resources, and how this translates into effective service delivery. These dimensions are intrinsically related: there is widespread evidence in Tanzania that the legitimacy of local taxes (and thus the willingness of residents to pay them) is strongly compromised

[1] As noted earlier, the issue of local revenue adminstration is addressed more fully in Section 4 of this report.

by the perceived failure of local authorities to use local revenues appropriately and effectively. While an important part of this failure is systemic,[2] an important part of the solution lies in improved financial administration and management. Too often local financial management is viewed as encompassing mainly good accounting practices. While accounting is a crucial component, the essence of sound financial management (especially at the local level) lies not in "accounting" *per se* but in the wider concept of "accountability". The need to strengthen and transform local budget processes and local government financial management techniques –in order to assure participation, transparency, and accountability at the local level- is further addressed in Section 7.1.

Box 7.1
Feedback from the Second Stakeholder Workshop (May 2005):
The Institutional Framework for Decentralization

The second stakeholder workshop on the development of a strategic framework for local government finances –held in Dar es Salaam in May 2005- was presented with the following statement for discussion and debate: "The institutional framework for fiscal decentralization needs to focus on building a 'center of gravity' within the central government, as well as stimulating bottom-up demand for a sound system of local government finance."

Unanimous agreement and consensus exists with regard to this statement.

Stakeholder feedback concurs that effective coordination on local government finance policy issues is quintessential to the sustainability of decentralization reforms. As such it was suggested that policy coordination should occur as close to the nerve center of policy decision-making as possible. In order to achieve this, a policy coordinating committee on local government finance issues was recommended to include all key stakeholders at the PS level, including PO-RALG, Ministry of Finance, PO-PSM, PO-P&P, and the Prime Minister's Office. ALAT may be called upon as an observer on behalf of local government authorities.

With respect to increasing bottom-up demand for decentralization reform and involvement of local governments themselves, it was noted that more extensive vertical consultation is needed through ALAT. However, it was further noted that ALAT is currently not in a position to adequately represent the diversity of local authorities in the country. For this purpose, it was suggested that ALAT restructure itself to better represent specific subsets of local authorities, including urban authorities as well as rural authorities.

The second "local" element of local government finance reform relates to the need to assure that the central government is appropriately structured to deal with policy issues surrounding local government finance. In order for the central government to be able to coordinate local government finance issues among the various central government stakeholders and in order for the center to effectively support the local government level,

[2] As discussed in Section 2, the absence of an unconditional grant requires local governments to bear an inefficiently large burden of local government administration costs from own sources.

there is a need for a competent and clear "center of gravity" at central government level as the basis for relating to decentralized government. Channels for financial and other relations between the center and local governments need to be as clear as possible; when there is a multitude of different processes and channels through which the central government relates to local governments, these often become contradictory and confusing. An assessment of the institutional framework in support of fiscal decentralization –and suggested improvements in this institutional framework- are made in Section 7.2.

The reader should be reminded that it is the intention of this report to develop the broader framework for local government finances. As such, it is not the purpose of this section to develop detailed and comprehensive recommendations for the technical details on improving local fiscal management. Instead, this section seeks to add a discussion of the administrative and institutional dimensions to the proposals on the overall local government financing framework. The ideas and challenges identified herein should thus be addressed further by the relevant stakeholders as the particular reforms to the system of local government finance are selected and implemented.

7.1 Building legitimacy for decentralized local governance through improved local financial management

The effectiveness of the tax system at the local level depends crucially on the perception taxpayers have about the effectiveness and honesty of local governments. Taxpayers' willingness to comply voluntarily depends critically on whether they perceive they get a fair deal in services from their local governments. Therefore, local governments must build legitimacy among their constituencies. This can be accomplished in a variety of ways.

7.1.1 Financial management and the creation of effective local government authorities

Many problems in the management of local finances are understood as being administrative problems. There is no doubt that if financial administration is poor, good governance is severely undermined. However, while good financial administration is a necessary condition for sound governance, it is not a sufficient condition.

Moreover the problem of establishing sound financial administration is often seen as a problem of procuring suitable technical skills, such as accounting. There is little doubt that accounting skills are important; but, if the success of local finances were only contingent upon the employment of accountants, the solution to poor local financial management would be comparatively simple.

Characteristics of an effective authority. Effective financial management requires an effective local authority overall. An effective local authority will be able to marshal resources, spend them appropriately in ways which elicit real and desired benefits for the

community, and gain popular support in doing so. This in turn will be accompanied by a greater readiness to pay taxes on the part of the community.

Broadly, effective authorities display three key characteristics, namely good leadership, good strategies, and good ability to implement. Implementation capacity is usually dependent, in turn, upon a combination of sufficient skills, well designed systems and structures, and adequate financial resources.

The objective in building effective decentralized systems is to create the conditions for effective authorities to emerge. Creating such conditions does not guarantee effective local authorities. Of the three core characteristics cited, good leadership is often the key. Good leadership will generally be able to develop good strategy, and over time develop the capacity to implement. But systems can only encourage but not assure the emergence of good leadership.

Leadership and the appointment of senior officials. Leadership consists of both political and administrative leadership, embodied and led by the head of the council and the head of the administration. In bigger councils and cities it is critical that these individual leaders are able to gather a senior leadership team of political representatives on the one hand and officials on the other if they are to be successful. The relationship between the political and administrative leadership is crucial to success. The degree of trust between the two will have a significant influence on the effectiveness of the authority. It is possible but very difficult for an effective administrative head to operate in the absence of good political leadership. It is similarly difficult for an effective political head to operate effectively in the absence of good administrative leadership.

Political leadership is elected. Thus there is little that can be done in terms of system design to assure good leaders. It is important that political parties recognize the importance and complexity of running decentralized governments. In doing so the status of the local leadership will be elevated, which in turn, will attract better caliber leadership. At the administrative level the issue of who appoints senior local leadership flows from this debate.

In Tanzania there is currently vacillation between whether appointment of senior administration officials should be by the central government or by the local council. Many in favor of decentralization would urge local appointment. They would argue that only if local councils are able to appoint their senior leadership will they be able to be held responsible for delivery. This in turn is the basis for local democracy. Furthermore, local appointments would create the basis for building trust between political and administrative levels.

The counter to this is that local politicians may not be in a position to truly understand the nature of skills required to effectively run a municipality. It is often argued (particularly by central government officials) that if local politicians are given the power of appointment they will use it inappropriately and nepotistically. The stakes are high, too,

because local government is not just responsible for the delivery of purely local services, but for the national priority services, too.

The optimal position is probably to be found in a compromise where local leadership have the power to appoint but from a set of people who meet certain qualitative criteria, such as skills and experience, which are determined and vetted by central government. This appears to be the direction which Tanzania has adopted but not yet properly implemented. It is crucial that a clear and well considered position is developed on this issue, since it is one of the most important in building a decentralized system. Certainly it is crucial, inter alia, to the nature of financial administration which eventually emerges.

Developing a capacity to implement. The National government has a substantial role to play in creating effective capacity to implement. Firstly, it should create a framework for the emergence of successful systems and structures. Secondly, in the Tanzanian context, as has been stated already in this document, it has a role to play in the provision of sufficient financial resources to enable a sound local administration to be put in place. Thirdly, it can enable and encourage skills development, although it would be desirable that these processes are driven by associations of local authorities. In particular, ALAT should play a key role in this respect.

The broad framework for systems and structures should be established in national legislation. Legislation on structures should govern issues such as how councils are elected and structured; this is largely in place. Legislation on systems should govern issues such as principles of public participation, human resource management, performance management, procurement, delegations of authority and the governance of public-private partnerships. Legislation is also required to establish the principles of financial management.

7.1.2 Financial management and clarity of accountability

At the heart of effective financial management lies clarity of accountability. Since the management of resources often lies at the center of local effectiveness, creating clarity around financial management procedures and patterns of accountability within the financial domain is crucial.

The starting point for sound financial management lies in determining the responsibilities of the political and administrative heads and the procedures and sanctions to be applied in cases of non-performance. All responsibility ought to lie ultimately with the local political authority and the administrative head of council, with clarity about the division of responsibility between these two. In some systems independent power is given to the head of the treasury in an attempt to enforce better financial management. However, such approaches rarely work, since key decisions cannot effectively be made over the heads of the administrative head and the political authority. Once the division of responsibilities between the political authority and administrative head is established accountability can be delegated appropriately, with some guidance in national legislation.

The Local Authority Financial Memorandum (LAFM) published by the Prime Minister's Office in 1997 in terms of the Local Government Finances Act No. 9 of 1982 provides a good basis in this regard, but needs to be updated as the system evolves. It is our understanding that a review and update of the LAFM is currently underway by LGRP. As part of the review of the local budget processes and financial management framework, the regulatory framework should clarify the overall strategic approach that "finance should follow function". In addition to greater clarity surrounding the assignment of expenditure responsibilities, key issues to be addressed in the review of the local budget and financial management processes relate to the budget process, establishment of a common accounting framework for local governments, procedures for reporting, principles of revenue and expenditure management, procurement of goods and services, borrowing and the management of investments.

An issue to be considered is the extent to which the framework should be defined in legislation or in memoranda, as is currently the case. Defining the framework in a memorandum offers greater flexibility, but runs the risk of being contradicted by legislation in other sectors. Whichever approach is taken, the advantages of establishing common, nationally standardized systems are significant, especially in an emerging system of decentralization such as in Tanzania where significant system development is required. Legislating systems in this way, provided that the legislation is well designed, provides for a degree of standardization which in turn greatly facilitates transparency, clarity, and the development of skills. In a system where such a large proportion of the expenditure of local governments is on the concurrent national priorities, and funded from the center through grants, it is imperative that the central government plays an appropriate role in policy and monitoring.

Once the standards are established skills development of individuals and capacity development of local government authorities can proceed in a much clearer and more focused manner.

7.1.3 Transparency and local involvement

The key driver for effective government, particularly at the local level, is the local electorate. Broadly, systems should be established to enable the local electorate to determine what services it wants, to contribute resources to enable the delivery of such services (in conjunction with appropriate resources from the center) and pronounce through the ballot box and other mechanisms on whether it is satisfied with the delivery achieved through either re-electing or replacing political leadership. Systems where the key decisions are taken by central government, as is the determination as to whether councils have succeeded or failed, are ultimately weak and generally ineffective.

The key to local involvement is transparency and access to information. Two spheres of access to information are required. On the one hand, technical information, such as accurate financial accounts, and details about procurement decisions need to be made

public. Even in countries with relatively low levels of technological presence, the scope for using the internet for making such information easily available is significant. While this is premature for most of Tanzania, it may not be long before it becomes more feasible[3]. Such information will generally not be accessed by voters. However, it does provide for easy monitoring by independent and official bodies to a significant effect. Where such systems are accompanied by legislation which requires the publication of certain key information, the transparency engendered is significant.

The second sphere of information access is at the local level to ensure that local citizens have maximum awareness of council issues and decisions. Simple tools such as public notice boards can be useful in enhancing local transparency, although a notice board in itself only provides the hardware.[4] Mechanisms also need to be developed for conveying information and receiving feedback in contexts where literacy levels might be low. This creates a basis for local involvement in determining council actions.

Techniques for doing this effectively need to be developed. Building a culture of local involvement in council affairs can take time. Yet if it can be established the rewards in terms of better governance can be substantial. One such technique successfully used in developing and developed countries is holding a number of council meetings open to the public and providing time and opportunity for citizens' participation.

Realism is required around the type of involvement that is likely from the public. The public tends to respond on an issue-by-issue basis rather than in a more comprehensive and systematic manner. Expecting the public to engage with the budget process in the manner councilors should do so is unrealistic and usually benefits only a very small sector of the public. But facilitating involvement in broader questions around discussion of pressing issues can be highly beneficial to all.

While ensuring technical skills are available to administer council finances is of critical importance, developing these broader mechanisms for accountability lie at the heart of establishing effective financial management over the long term.

7.1.4 A single, credible budget process

A prerequisite for transparency is a single, credible budget process. There will always be differences between the budgeted and actual figures. However, the credibility of the budget process depends to a large extent on budgeted and actual expenditures and revenues being reasonably close. This seems not to be the case in a number of instances in Tanzania. For instance, public expenditure tracking surveys suggest that there is a

[3] It should be feasible already for Dar-es-Salaam councils and a handful of the other bigger councils

[4] The "real" (technical) challenge is to achieve the increased participation, transparency and accountability sought with notice boards by developing the contents that should be posted on a notice board. How should local budget data be presented in order to usefully inform the local community, without overwhelming residents with incomprehensible information and without excessively raising the data-collection burden for local officials? Civil society organizations and NGOs should be able to make significant contrubutions to answering this question.

substantial gap between budgeted OC allocations for priority sectors and the manner in which these resources are actually spent. Similarly, there seems to be quite a difference between personal emoluments that are budgeted for local councils and realized PE spending. Very little effort is exerted in the budget processes (both at the central and local government levels) to verify that the budget is executed as planned. The manner in which the budget is presented should allow stakeholders (local residents and central government officials alike) to verify to what extent the budget is executed as planned. Such monitoring should occur both at the central government level (as grants disbursed from the treasury) as well as at the local level (as part of the local budget reconciliation at the end of the budget year).

In addition to allowing a comparison between budgeted local expenditures and actual local expenditures, presentation of the local budget should also allow some link to be drawn between inputs and what is produced. Such a link is implicitly made in the "MTEF approach" advocated and followed by the Ministry of Finance, which is actually a rudimentary form of a performance-based budget approach. In contrast, the current tendency to present the personnel expenditure as a single item separate from each of the sectoral items is misleading. Personnel is generally the largest part of any budget, so failing to link the personnel costs in each of the sectors to other expenditures by sector makes it extremely difficult to assess resource utilization by sector, let alone by outcome.

Of great importance in order to achieve coherence in the process of making resource allocation decisions is that there should be a single budget process. Where resource allocation happens through a number of different and separate processes the ability to make clear trade-offs is absent. A multi-channel flow of funds, where the actual amount available through each channel becomes known at different times reduces transparency. This can be a problem where there are large aid flows (i.e., TASAF) or earmarked ministerial subventions which are not aligned in a transparent manner as part of the core budget process (e.g., PEDP capitation funding from pooled donor funds embedded in the MOEC budget).

Box 7.2
Local Government Budget and Accounting Procedures in Tanzania

Local governments are gradually adopting locally operated Integrated Financial Management Systems (IFMS) for the overall management and control of local public finances. Already 32 councils have an Epicor-based IFMS system in place; the remaining councils are expected to be brought on the Epicor system with support from the Local Government Reform Programme in 2005 and 2006.

The introduction of an improved framework for local government finance offers an excellent opportunity to review and improve the local government budget and accounting procedures in Tanzania. Some features of Tanzania's local government budget practices are outdated or can be improved to strengthen the system of public finances. For instance, the budget classification and reporting systems could be improved in order to (a) assure a more comprehensive local budget approach, which is (b) consistent with national PRS II approach and (c) standardized to enable the

center to monitor local government compliance with grant conditionalities.

Furthermore, the current financial management procedures support outdated financial management principles, by effectively promoting the creation of a multitude of local government accounts. Rather than serving as a control mechanism on local financial accounts as intended, the presence of multiple accounts in fact gravely complicates local budgeting and financial management, and increases the potential for non-transparency and financial abuse.

The systematic reliance of local governments on multiple accounts stands in contrast to the "best practice" in public sector budgeting which in principle promotes reliance on a single account. Cash management is much simpler when relying on a single bank account; local treasurers do not have to shift resources from one account to the other from time to time to remedy temporary cash-flow shortfalls in specific accounts, which makes the local accounts significantly more transparent and easier to audit.

In some cases, more complex financial management systems may indeed use multiple budget accounts, but in most cases these additional sub-accounts are used for accounting purposes only. In this scenario, for instance, a payment of user fees for refuse collection could flow from the single revenue account through the refuse collection account, but the payment would be cleared through this account on the same day, so that all sub-accounts have a zero balance at the end of each business day. This approach would provide both the cash-flow benefits of a single revenue account, as well as having the advantage of systematically producing bank records for specific spending categories. However, given the advances in the introduction of computerized accounting software, it is questionable whether this level of complexity is even necessary for local authorities in Tanzania.

7.1.5 Recommendations and next steps to improve local budgeting and expenditure management

Improvement of local financial management system has been a critical component of the LGRP/ Finance Component's activities since the inception of LGRP. The improvement of local financial management has largely focused on the introduction of a computerized integrated financial management software (a version of Epicor software modified for local governments) at the local government level. Yet while a credible, comprehensive local budget planning and process is needed for an efficient, transparent and accountable system of decentralized local government finance, current budgetary processes at the local level in Tanzania do not appear to provide a comprehensive system, severally reducing the legitimacy of the local government finance system. Major problems arising from the current local financial management systems include:

- When LGAs are asked to report their outlays, major gaps exist between self-reported local expenditures and (much lower) reported funding inflows. Clearly the financial management and reporting systems are out of synch if LGAs report spending twice more than their resource inflows. Further investigation is needed whether (or to what extent) local governments are over-reporting outlays (for

instance, accidentally or purposely double-reporting expenditures in local accounts) or underreporting resource inflows.[5]

- The use of multiple earmarked accounts at the local level within the regular local budget process (as opposed to single treasury account approach) is not considered best practice. Although multiple accounts can serve the purpose as a cash-flow management control, multiple budgetary accounts can also complicate local financial management and significantly decrease transparency as a result of frequent inter-account transfers (see Box 7.2).
- In addition to the multiple accounts within the regular budget process, there are numerous extra-budgetary funding mechanisms that run parallel to the local budget (e.g., TASAF). In order to assure a comprehensive local budget process, these extra-budgetary funds should be integrated into the local budget to the extent possible; at a minimum, the local budget process should report on the activities funded by parallel mechanisms.
- The Ministry of Finance and PO-RALG do not properly coordinate the guidance given to LGAs on local financial management issues. For instance, there are differences and disagreements on the budget classifications to be used by LGAs, and there is a lack of coordination on the role of MTEF and NSGPR in local budget preparation. The belief that local budgets are not responsive to these national policies detracts from the legitimacy of local government finance.
- Local governments do not have a unified budget which properly integrates recurrent spending and capital development spending. Although the accounting structure provides for a Development Account at the local level, some sectoral programs (e.g., PEDP classroom funding) route capital expenditures through the sectoral OC account.
- Public expenditure tracking surveys (PETS) conducted in Tanzania report significant outflows or diversion of sectoral OC. This is not consistent with the majority of audits of LGA accounts, which do not seem to flag this issue. This inherent contradiction might arise if the audit strictly focus on compliance with accounting standards, and do not look at compliance with other budget practices or conditionalities.
- Many local government budgets report all personal emoluments in a single line item. Breaking down staffing by sector, and possibly even including the exact location (service post) of staff postings by sector in the local budget could be a tremendous boost to community monitoring of local staff and prevent ghost workers. The budget process currently lacks such basic measures to enhance transparency and participation in the local budget process.

While many of these shortcomings of the local budget processes can be "explained", they nonetheless significantly impede the credibility of the system of local government

[5] In a positive light, this imbalance might be the result of spending that is funded through parallel systems (e.g., TASAF) that is entered as an outflow but not as an inflow. A more negative scenario is that this might be the result of spending getting recorded more than once, on different accounts. For instance, due to the multiple parallel funding flows in existence, a classroom could be built and billed to two different accounts (say, TASAF and PEDP) with a relatively low chance of detection.

finance. As consistently argued by Fjeldstad (2004), the lack of trust in the finances of local government authorities is an important contributing factor to local tax compliance. In order to strengthen the broader framework for local government finance, there is an ongoing need to review and revise –as necessary- the local government finance regulations and accounting procedures.

The recommended review of the local financial management would need to take place in several sequential steps:

- First, a serious assessment needs to take place of the regulatory framework for local government budgets and financial management: to what extent is the regulatory and administrative framework consistent with a participatory, transparent, and accountable local budget process.[6] Is the regulatory framework adequate, or is there a need to provide different (or additional, or more consistent) guidance to LGAs? The mantra that local government financial management is more about "accountability" than "accounting" should be an important theme in the review of the local budget process.
- Next, an external assessment should be conducted to determine whether local financial and accounting regulations are being followed? If not, where are the (main) discrepancies between the regulated and actual practices? What are the causes of the deviations? What oversight mechanisms should be strengthened or put in place to correct this failure?
- Finally, an assessment of the auditing process of LGAs would need to take place. Are the breadth and depth of audits for LGA budgets and accounts adequate for the purposes at hand? Particularly given the increased importance to LGAs of a clean (or at least, non-adverse) audit report as a minimum access condition for the LGCDG, it is important that the audit process is objective and accurate. Failure to have a credible audit process reduces the credibility of the entire local government reform process.

As a matter of process, in assessing the current local budgeting and financial management process in Tanzania, it would be very important to involve CBOs, local government officials, NGOs and other organizations within the private sector and civil society. There is a (partially valid) perception in some circles that local government reform in Tanzania has largely been a "top-down" exercise that has largely eschewed bottom-up inputs. Given that the local budgeting and financial management processes are evolving from a predominantly centralized, vertical system of control to a more horizontal system of participation, accounting and control, feedback is needed from a wider variety of actors. The review and reform of local government planning, budget and accounting processes provides an appropriate entry-point for the private sector, civil society organizations, CBOs and NGOs to make specific suggestions and positive contributions to discussions on how to improve the current system of local government budgeting and financial management.

[6] The regulatory framework includes –but is not necessarily limited to- the Local Authorities Accounting Manual, the Local Authorities Financial Memoradum, Local Tendering Regulation, Epicor user documentation, as well as program-specific budgeting and accounting regulations.

7.2 The institutional framework for central-local relations

Effective financial management at the local level also requires coherence at the central government level. The complexities of running local government are often not sufficiently appreciated. The complexity is driven, in particular, by the multitude of role players which local governments must deal with. At the local level there are numerous political representatives on a single council, often with varied and even conflicting agendas; this is unlike national government departments where there is generally only one political head (the Minister) responsible. Local governments are in direct contact with the citizenry who make direct demands in relation to services delivered; they sometimes have to manage large numbers of employees, which can be complex; while, on the other hand, local governments tend to have fewer resources and less access to power.

Beyond this, local governments often have to manage the demands of a multitude of central government departments, agencies and donors, often with divergent or even conflicting requirements. They are unlikely to have a similar degree of access to national level information which the other role players have.

7.2.1 Organizing the center to reduce complexity at local level

If local governments are to be able to operate effectively, it is crucial that, firstly, there is coherence at the central government level between different departments and role players. Secondly, that the relationship between the center and local governments is based on predictability, transparency and simplicity.

A critical area is in the flow of funds to local government. Ideally these should flow through a single channel in a predictable manner. While it may be appropriate to set certain conditions on these funds, these should be clear and easily reported upon. Ideally one set of reporting should be sufficient to address all reporting requirements arising from the central government level. It should be desirable, particularly once the new fiscal framework is clearer and somewhat established, to be able to provide indicative figures for grants from the center three years in advance. These should all be published in a government gazette, and no grants should be allowed to flow to local government from the center unless published. This will provide for much greater clarity, transparency and predictability.

The relationship between the Ministry of Finance and PO-RALG is critical in establishing a coherent “center of gravity” at the center as a basis for relating to the local level. A strong and well founded relationship between these two departments, with support from the highest political levels is generally the key to ensuring coherence at central government as a whole, including the line departments. These two departments

must focus on building this solid relationship and use it as a basis for networking across all departments at central government level.

While the driver for enhanced effectiveness at the local level is the local community, the role of the center in monitoring is crucial. Monitoring should not be aimed at placing the central government in a better position to direct local government where it is regarded as not meeting required standards. Rather the aim of monitoring is to be able to gain a much better strategic understanding of what is happening in local governments across the country, publicize widely accurate and relevant information about local actions, developments, achievements and failures, and to put the central government in a position to both support and put pressure on local authorities to comply with the requirements. This then allows the relevant stakeholders in different situations to act accordingly, putting pressure where it is due. The conditions placed on local grants have been rationalized to focus on financial reporting and compliance with certain engineering and other standards on the delivery side. As indicated in a previous section, these need to be more closely monitored.

It is typical for central governments and others to seek to design transfer systems such that there are sanctions in cases of non-performance. While there is scope for this under certain circumstances, implementing sanctions is often extremely difficult. Where a system has sanctions designed into it, but they are not enforced for a variety of reasons, the outcome is often worse than having no sanctions designed initially.

7.2.2 Overview of institutional progress and challenges at central level

Coordination is needed in the various aspects of intergovernmental relations: coordination between the central government and local governments (so-called vertical coordination) on the execution of local government responsibilities; coordination between the central government tax system and the local tax system (involving the Ministry of Finance, the Tanzania Revenue Authority and PO-RALG); coordination between PO-RALG, Finance, and the various line ministries regarding the structure of the system of intergovernmental transfers; coordination in the development of the framework for local government borrowing. Coordination between central government agencies on intergovernmental fiscal issues can be referred to as “horizontal” coordination.

Recognizing the importance of the institutional context of central-local fiscal relations, during the consultations held during the inception phase of the study, the Ministry of Finance specifically noted the need to address the institutional framework as an integral part of this current study.

In many centralized countries, the Ministry of Local Government (or the President’s Office – Regional Administration and Local Government, as is the case in Tanzania) is tasked with the exclusive responsibility of monitoring and coordinating most aspects of intergovernmental relations. However, as local government reforms in Tanzania are gradually decentralizing the public sector, PO-RALG is neither well-positioned nor

equipped to act as the only link between central government and local governments.[7] As such, alternative or supplementary mechanisms are needed to provide proper intergovernmental coordination in a more decentralized system.

While PO-RALG continues to take a leading role on local government finance issues – particularly through the activities of the Local Government Reform Programme (LGRP)-, much has happened since 2003 that has enhanced the coordination between the institutional actors involved in local government finance:

- The joint government-donor Fiscal Decentralization Task Force has provided an effective forum for identifying opportunities and priorities for reform, and holding the Finance Component of LGRP to task on these issues.
- Coordination between the Ministry of Finance and PO-RALG (including LGRP) was strengthened substantially by the Intergovernmental Grants Study, which was overseen jointly by the two ministries. In the aftermath of the study, the implementation of the formula-based block grant system further fortified this relationship between the Ministry of Finance, PO-RALG, and the involved sector ministries by the establishment of a Coordinating Block Grant Implementation Team (see below for further details).
- Sectoral ministries that have policy responsibilities for services delivered at the local government level have been pulled into the discussion of local government block grants and other relevant intergovernmental finance issues through their inclusion in the Coordinating Block Grant Implementation Team and the establishment of Sectoral Block Grant Implementation Teams (for education, health, agriculture, water and roads, respectively).
- In September 2004, the first Local Government Fiscal Review was published under the auspices of the Coordinating BGIT. Envisioned to be an annual publication, this Review provides broad access to the state of local government finance and provides a platform to inform the policy debate on important policy issues.
- During the budget formulation process of FY 2005/06, much closer coordination was pursued between the development of the Budget Frame by the Ministry of Finance and the Budget Guidelines issued to LGAs by PO-RALG. The improved coordination –which was made possible in part by the harmonization of the local budget cycle with the central government's fiscal year- allows for much greater consistency between the policy decisions in the budget frame and the local budget guidelines.

However, the evolution of the institutional framework –from one that worked in a centralized system of local government, to one that will work well in the context of a

[7] For a more detailed account of this issue, see Jamie Boex and Jorge Martinez-Vazquez. 2003. Developing the institutional framework for intergovernmental fiscal relations in Tanzania. LGRP Technical Report 2003-9.

decentralized public sector- is still in its early stages, and the local government finance system can benefit significantly from further institutional strengthening.

This section discusses the institutional framework in which central-local fiscal relations take place in Tanzania, and identifies options for strengthening this framework. Within the context of the assessment matrix presented in Table 3.1, the institutional framework is covered by a number of cells in the matrix, predominantly in the top row (structure and scope of the public sector) and in the final column (participation by civil society and the private sector). Challenges pointed out in Table 3.1 regarding the institutional subtext for intergovernmental fiscal relations include:

- The evolution of PO-RALG from an institution controlling local governments to a ministry facilitating local governments.
- The need for ongoing improvements in coordination between PO-RALG, the Ministry of Finance, sector ministries and other stakeholders.
- The need for actors outside the central government (including LGAs through ALAT, as well as other NGOs) to have a stronger voice in the development of the local government finance system.
- The relatively weak participation of civil society at the local level in local budgetary decisions, including the setting of local tax rates and local expenditure priorities.

As part of its mandate, this study considers what steps should be taken to improve the institutional framework for central-local fiscal relations. To this end, the remainder of this section reflects on the respective roles of the main central government stakeholders on intergovernmental fiscal issues, including PO-RALG and the Ministry of Finance (subsections 7.2.3 and 7.2.4, respectively). We further discuss the need for institutional coordination on local government finance issues at the technical level (subsection 7.2.5) as well as at the policy level (7.2.6). Line ministries should also consider their organizational structure and how they interact with local authorities (subsection 7.2.7). Finally, we address the need for a stronger role of local governments and civil society in the national policy debate surrounding fiscal decentralization and local government finance issues, as well as a stronger role for civil society on local government finance issues at the local level (subsection 7.2.8).

7.2.3 The role of PO-RALG in intergovernmental fiscal relations

In Tanzania's institutional and legislative framework, the President's Office – Regional Administration and Local Government (PO-RALG) is the ministry responsible for administering local government affairs, including the coordination and oversight of local government finance issues. According to the Local Government Finance Act (1982), Part IV (Finances and Resources), Section 33, the Minister responsible for local government (i.e. PO-RALG) "shall, in relation to a local authority under his charge, subject to the provision of the [Local Government] Act and of this Act, be responsible for:

a. Ensuring the proper management of the finances of the local government authority;
b. Facilitating the securing of funds for the operations of the local government authority;
c. Promoting the timely preparation of the annual budget of the authority and securing that the authority operates within the limits of the budget as prepared.

While the Act provides PO-RALG with a broad mandate to deal with local government finance issues, consistent with a decentralized finance framework, the intention of the Act appears to be for PO-RALG to be in a facilitating and oversight role:[8]

- With regard to the securing of funds (including intergovernmental grants) for the operations of local government authorities, PO-RALG is mandated to play a *facilitating* role in this regard; the Ministry of Finance and the sector ministries play a lead role in the final determination of the amount of resources available for the various local government activities.
- With regard to ensuring proper budget formulation, the oversight role of PO-RALG is executed through the issuance of budget guidelines, procedures, and instructions on the development of the local budget.
- With regard to ensuring proper budget execution, PO-RALG facilitates sound financial management through the provision of technical support and capacity building (including supporting the roll-out of the EPICOR financial management system); and the auditing of local government budgets to assure that local budgets are implemented or executed as planned.

In other words, PO-RALG's legislative mandate gives it a prominent role in developing, monitoring and guiding local government finances. The leading role of PO-RALG on local government finance issues is generally respected by the other stakeholders,[9] and this strong mandate should continue to be recognized and respected in the evolution and strengthening of the institutional framework for intergovernmental relations in Tanzania.

Box 7.3
The successful role of LGRP's Finance Component in the reform of the local government finance system

The Local Government Reform Programme (LGRP) was established in 1999 following acceptance of the Government's Policy Paper on Local Government Reform (MRALG, 1998) to

[8] Contravening this apparent decentralized policy design, the Local Government Acts continue to give PO-RALG substantial control over local government affairs and local finances, including the power to post or transfer local government staff – along with the requirement to fund this post- without explicit council approval.

[9] The main area of local government finance where PO-RALG does not appear to have played a decisive role is the recent reforms of local government revenues in 2003 and 2004, where the Ministry of Finance took a leading role.

be the implementing arm of PO-RALG for local government reform.

LGRP has played a highly effective role in moving forward the reform of the local government finance system, particularly in the development of a formula-based system of intergovernmental transfers. The success of LGRP's Finance Component was highlighted by the Joint Government-Donor Review of 2004 (JGDR, 2004). In addition, in contrast to experiences in some other decentralizing countries, the policy successes of the LGRP Finance Outcome area have been achieved with relatively limited resources: the policy activities of the Finance Component are currently staffed by one Outcome Manager and one Finance Advisor,[10] with less than full-time external technical support on policy matters.

LGRP's success in the area of fiscal decentralization reform can be attributed to the confluence of a number of factors:

- Commitment and leadership at the highest level within PO-RALG.
- Good inter-ministerial coordination at the PS-level (through the Inter-Ministerial Technical Committee) and political support at Cabinet level.
- Good cooperation within the donor community and between government and the donor community, providing positive pressure from the Fiscal Decentralization Task Force and the LGRP Basket Fund Steering Committee.
- The introduction of the formula-based transfer system was successfully used as a technical entry-point for reform, which in turn now drives the reform of other decentralization issues (such as local service reform and improved local financial management).
- The realization that the lack of appropriate institutional mechanisms to coordinate and allocate public resources was a predominant constraint (not the absence of resources *per se*). Thus, the introduction of a formula-based transfer system has focused systematically on laying the groundwork for improved inter-ministerial and intergovernmental coordination and institutional strengthening.
- The ability of LGRP to achieve consensus on the vision of a single government-driven intergovernmental transfer system, instead of fragmentation of resources due to parallel funding mechanisms, such as sectoral parallel basket funds and area-based capital development programs. Development partners such as donors and the World Bank have accepted this vision and are aligning their programs with the Letter of Sector Policy. For instance, instead of developing the World Bank's Local Government Support Project as a stand-alone project, LGSP was designed as an integral part of the Local Government Capital Development Grant System.

Although LGRP's Finance Component has been quite successful in advancing a constructive agenda of local government finance reforms, in many other ways the institutional capacity of PO-RALG to administratively deal with local government finance issues could be deemed rather weak. In fact, in response to these concerns, an organizational review of PO-RALG was conducted last year with the purpose of strengthening the institution's organizational structure.[11] The associated capacity building

[10] The Zonal Reform Teams (ZRTs) are assigned Finance Experts. However, these experts predominantly contribute to strengthening local financial management, and generally do not contribute to policy reforms.
[11] See: PO-RALG. Proposed Functions And Organisation Structure of The President's Office, Regional Administration And Local Government. February 2004.

and institutional strengthening of PO-RALG that is required for it to more effectively fulfill its functions in accordance with the new organizational structure is to be implemented with support from LGRP and LGSP.

While it is beyond the scope of the current study to critique the newly adopted organizational structure, the reorganization does raise a number of opportunities (and in fact, some concerns) about PO-RALG's institutional ability to facilitate local governments as part of a sound system of intergovernmental fiscal relations:

- A positive feature of the new structure is the presence of a data gathering unit which would manage the Plan-Rep system to gather fiscal and non-fiscal local government data. Currently, gathering of local fiscal data is done on an ad hoc basis through the ZRTs.
- Another positive feature of the new organizational structure is the expanded focus on information sharing and communications through the introduction of an Information, Education and Communication Unit.
- At the same time, there is some concern that the new Division of Sector Coordination has the potential for becoming a little "government within the government". Although intended as a link between sector ministries and local authorities, the directorate has the potential to become an unnecessary layer in the central government hierarchy, thereby duplicating efforts within sector ministries.[12] Alternatively, the directorate risks absorbing itself into implementing sector projects in a centralized manner that will actually be a stand-in-the-way for real sector devolution.
- Further fragmentation of the organizational structure may encourage the establishment of "fiefdoms" that may make it increasingly hard to coordinate local government finance issues horizontally within PO-RALG.
- Beyond the re-organization proper, LGRP currently falls outside the organizational structure. Yet many of the core responsibilities of RALG are currently performed by LGRP; for instance, preparation of local budget guidelines. The absence of a formal division of responsibilities between LGRP and PO-RALG creates some confusion and limits the sustainability of the strengthened capacity of LGRP.
- Local government finances fall under the Director of Local Government; there is no separate Director for Local Government Finances. This provides a relatively weak position to the LGA Finance Section, which has far-reaching responsibilities in overseeing the local government finance system. This section will be responsible for producing LGA Budget Guidelines and bear ultimate responsibility for ensuring sound local financial management and for local compliance with these guidelines; supporting LGAs in the implementation of a sound system of local revenues; coordinating with the DPP/PORALG, the Ministry of Finance and other stakeholders on the size of intergovernmental

[12] Actually, sector ministries rarely have a single focal point for local government issues. As such, different divisions within a line ministry may prepare circulars for LGAs without adequate sectoral coordination within the sector ministry itself.

transfers to local government (as part of the development of the annual Budget Frame). It is thus critical that this unit is extremely well-capacitated.

Recommendations. PO-RALG is institutionally well-positioned to continue its leading institutional role in the coordination of intergovernmental fiscal relations, particularly with the expertise embedded in LGRP. The study team supports the recommendation made by the JGDR (2004) to upgrade the status of PO-RALG as a central ministry, which should further strengthen its role in coordinating intergovernmental affairs. It should be hoped that the reorganization of PO-RALG will support the development in the medium term of PO-RALG's LGA Finance Section into an organization that provides both oversight and facilitation to local governments on local government finance issues.

Although the LGRP Finance Outcome component should ultimately be re-integrated into (the LGA Finance Unit of) PO-RALG proper, there is no question that this component within LGRP will continue to function as a driving force in the institutional framework for local government finance reform. In fact, given the very narrow human resource base of the LGRP Finance Component, it would be prudent to expand the component with several professional staff to allow it to more effectively implement reform in the areas of local government finance that need continued attention (including local financial management, local revenues, and the recurrent and capital transfer systems). It would be appropriate to include, at least, two additional full-time experts/manager to manage the transformation of the local revenue system and to guide the other proposed reforms.

Perhaps the biggest institutional challenge faced by PO-RALG is that the change that is needed from PO-RALG is a change in mentality, from PO-RALG serving as a hierarchical boss to local governments to being true facilitators. It is hard to see how the current re-organization positions PO-RALG better as a facilitator, but it does not necessarily stand in the way either (with the possible exception noted above). We note that the recent step to post a website is a small but significant first step in the right direction. The website could become, not only a point for policy documents from LGRP, but ideally evolve into a "one-stop" service center for information and access for LGAs on a wide variety of local government (finance) issues.[13]

7.2.4 The role of the Ministry of Finance over local government finance issues

As part of its mandate under the Public Finances Act (2001), the Ministry of Finance is responsible for the efficient allocation of public resources in the public sector. As such, it has several direct and indirect responsibilities for the system of local government finance

[13] While many LGAs may currently not be in position to extensively use the internet, such a step would reflect a more transparent, open, and less hierarchical mentality of PO-RALG towards LGAs (and donors that are active at the regional level do tend to have such access). One could envision part of the PO-RALG web site dedicated to LGAs to contain relevant information for local government officials, including financial management documents (budget guidelines, EPICOR support); regulatory and procedural guidance (tender regulations; hiring procedures); sectoral regulations and guidelines; local revenue forms, regulations and materials, and information, forms and documents needed for the LG Loans Board.

in Tanzania, including responsibilities for the public sector's tax and revenue systems (including local government revenues); the use of intergovernmental grants to assure appropriate funding of local government expenditure responsibilities and local capital development; and the local government borrowing framework.

Unlike many Finance ministries in decentralized countries, Tanzania's Ministry of Finance does not have a separate Director or Commissioner for Local Government Finance, who would oversee local government finance issues. Instead, the responsibilities for local government finance issues are fragmented between several different departments and sections within the Ministry. Although the Policy Analysis Division (PAD) has clear responsibilities in overseeing a number of local government finance issues as part of the government's fiscal policies, there is currently no Section Head for Local Government Finance; instead the responsibility for local government finance issues are further fragmented between Section Head for Macroeconomic Policy (covering the inclusion of intergovernmental grants into the budget process) and Section Head for Tax Policy (covering local government tax issues). Since not a single Finance official has policy oversight over local government finance issues, local finance issues that should truly be considered in unison are often addressed in isolation of one another.

In fact, the highest-level official within the Ministry of Finance responsible for local finances is found within the Budget Division. As part of the Ministry of Finance's responsibility to assure the efficient allocation of public resources, the Regions and Local Government Section of the Budget Division (BD/RALG, led by the Assistant Budget Commissioner for Regions and Local Governments) has the responsibility to "monitor" (i.e., track, study, and analyze) the finances of the local government sector in order to assure the overall integrity of the system of public finances. The main duties and responsibilities of this Section include:

1. To receive and analyze the Recurrent and Development Budget for Regions and Local Government
2. To monitor and follow-up budget implementation
3. To carry out periodic review and analysis of budget performance
4. Preparation of necessary budget adjustments through reallocation with supplementary estimates.
5. Sectoral Budget analysis and interaction.
6. To finalize Regional and Local Government Estimates for Consolidation with Ministerial Estimates.
7. To appraise demands for reallocations, supplementary funds, Civil Contingency Funds and provide recommendations.

Some observations regarding the role of the Budget Division, Local Government Section (BD/RALG) in central-local fiscal relations include:

- In the past, the lack of linkages between this Section and the other stakeholders in the local government budget process (particularly PO-RALG and the sector ministries that deliver services at the local level) contributed to a structural

disconnect between fiscal policies at the local level and their financial inclusion in the budget.

- In contrast to the decentralized role of local governments, the budget process (through BD/RALG) continues to be oriented in a manner that treats LGAs like central government budgetary units. For instance, key activities of BD/RALG is to capture LGA budgets, and code them into the national budget books at a high level of detail. However, the value of this exercise is highly dubious, as grants are disbursed from the Treasury as block grants, and no reconciliation of local budgets with their budget plans is ever done. In fact, BD/RALG does not even systematically reconcile planned transfers with actual disbursements for PE and OC.
- The role of the Local Government Section has been (and will continue to be) impacted rather substantially by the introduction of formula-based grants, towards a much more pro-active role, which will require critical analysis of local government finance issues. For instance, it should be the unit to compute the size of block grants, monitor compliance with conditionalities, and to monitor disbursements to assure that they match the budgeted transfers.
- There continues to be an overlap (and/or lack of coordination) between BD/RALG and PO-RALG/LGRP as to their interaction with LGAs. For instance, at the current time, BD/RALG rolls out its own financial management training for LGAs (e.g., on the implementation of MTEFs). This role is legally part of PO-RALG's mandate. If nothing else, improved coordination is needed between the training and instructions provided by MOF and by PO-RALG.
- Furthermore, the Ministry of Finance is unable to fulfill its policy analysis role and its monitoring role without a rudimentary reporting system that would provide it with the basic local government finance statistics needed to get such a complete picture. Currently, the data collection and consolidation by PO-RALG for such purposes is not adequate, as it is not sufficiently timely and incomplete.

Recommendations. The study team has three main recommendations for improving the institutional structure of the Ministry of Finance to contribute to sound central-local relations.

First, while the Ministry of Finance increasingly recognizes that local government finance plays an important role within its mandate, the Ministry is also becoming increasingly aware that dealing with LGAs and local government finance requires a structurally different approach than dealing with MDAs and the rest of the budget. Recognition of these facts should be reflected in the Ministry's organizational structure. Given that local government finance represents well over 20% of public sector finances, the Ministry should consider establishing a separate Commissioner for Local Government Finance. While such a move is desirable and worthy of serious discussion by the Ministry's leadership, the study team recognize the low probability that such a substantial change in the Ministry's organizational structure will be acceptable and materialize in the short run.

Second, a structural re-orientation of BD/RALG is needed. This Section should move away from an "accounting section" for local government budgets to a much more pro-active section, that (a) interacts systematically with key stakeholders involved in the local government budget process (including the education and health sectors); (b) produces regular and informative analyses as part of its mandate to assure proper inclusion of local government finances into the budget as well as proper execution of intergovernmental grants, as well as (c) interacts with LGAs as appropriate, in coordination with PO-RALG. Within Finance, it is this Section that is bearing the bulk of the responsibility for assuring that the new formula-based system is correctly included in the national budget. This responsibility will be further expanded when the Local Government Capital Development Grant is fully implemented. Failure to expedite the reorientation and continued capacity building of this section could have serious consequences for the successful implementation of local government finance reform initiatives.

Third, the study team recommends the introduction of a small Local Government Finance Section in CPAD, headed by an Assistant Commissioner for Policy Analysis for Local Government Finance. As for the Ministry's policy responsibility over local government fiscal issues, this technical person would have the ability to consider local government finance issues in a comprehensive manner, across the current divisions of responsibilities.

The study team recognizes that these recommendations will not be adopted overnight, even to the extent that they may be acceptable and desirable by the Ministry of Finance. As such, we recommend one intermediate step to be pursued immediately in order to achieve (or at least, move gradually towards) the other recommendations. The Ministry of Finance is highly recommended to immediately attract a Local Government Finance Expert/Advisor who –for the time being- would formally report directly to the DPS/ Finance. This Expert/Advisor position would bring in international expertise and experience on a temporary basis (for 2-3 years) to help re-direct how Finance thinks about and deals with local government finances. For instance, the Expert/Advisor would support the Assistant Budget Commissioner for RALG in the restructuring of the BD/RALG; support the ACB/RALG with the Secretariat role of the FACG; see below); while also assisting in preparing the introduction of the Local Government Finance Section under CPAD. After this temporary intervention, the BD/RALG should be properly re-oriented and restructured for its new role, and the Policy Analysis Department's new Local Government Finance Section should have adequate capabilities to analyze relevant local government finance issues.

7.2.5 Technical level coordination: Local Government Fiscal Analysis & Coordinating Group

The respective roles of the Ministry of Finance and PO-RALG can best be distinguished by stating that while PO-RALG –as the central government's implementing arm for local government policies- monitors, guides and supports the implementation of local government finances "on the ground" on a day-to-day basis (i.e., monitoring and analysis in support of proper local financial management), while the Ministry of Finance -in its

role as the steward of the nation's public finances- globally monitors and analyzes "the big picture" of local government finances (i.e., monitoring and analysis of so-called "macro policy issues" surrounding local government finance).

This division of responsibilities is mutually complementary, but requires systematic coordination between PO-RALG and Finance, as well as other technical-level stakeholders involved in local government finance issues (including key line ministries as well as other central government agencies, such as PO-PP and PO-PSM). However, as we noted earlier, the Regional and Local Government Budget Section of the Ministry of Finance historically lacked proper institutional connections to other key stakeholders. Due to the key role that the Section plays in preparing local government budget allocations and grants, this could easily lead to miscommunications and could result in a disconnect between policy intentions and budget execution. During the introduction of the formula-based grant system, an institutional link was built between the Ministry of Finance, PO-RALG, and the other stakeholders through the Coordinating Block Grant Implementation Team (Coordinating BGIT). The Coordinating Block Grant Implementation Team –officially led by the DPS/Finance- meets on a regular basis (approximately quarterly) in order to discuss and coordinate the implementation and proper introduction of the formula-based sectoral block grants into the national budget.

Recommendation. The study team recommends capturing the institutional gains made by the Coordinating BGIT by transforming the team into a Local Government Fiscal Analysis and Coordinating Group (LG FACG), a permanent inter-ministerial technical working group. The LG FACG –which would be anchored within the Local Government Budget Section, but with significant membership from other key stakeholders- would fill this gap by providing a direct linkage, at a technical level, between the Ministry of Finance and the other stakeholders involved in local government finance issues. The TORs of the various contributing members of the FACG should be modified to reflect and recognize their contributions to this inter-ministerial working group.

Box 7.4
Proposed composition of the Local Government Fiscal Coordinating Group

- Deputy Permanent Secretary, Ministry of Finance (or possibly in the future, MOF Commissioner for Local Government Finance), Co-Chair
- Deputy Permanent Secretary or Director for Local Government ,PO-RALG, Co-Chair
- Assistant Commissioner for Budget (Regions and Local Government), Secretariat
- Director for Local Government, PO-RALG
- DPP from involved sectoral ministries (MOEC, MOH, MA&FS, MoW&L, Works)
- Representatives from central agencies (PMO, PO-PP, PO-PSM, NBS)

What specific tasks will the Local Government Fiscal Coordinating Group perform? The Regional and Local Government Budget Section within the Ministry of Finance (MOF) would continue to be responsible for its routine budgetary tasks within the budget process. In addition, however, the LGFACG would provide a platform for coordinating local government finance issues at the technical level. Concretely, the activities of the Local Government Fiscal Analysis & Coordinating Group would include:

1. Acting as the focal point for maintaining a comprehensive data set on local government finances (this task would obviously be closely coordinated with PO-RALG);
2. Maintaining the authoritative set of allocation factors to be used for formula-based allocations, and compute formula-based allocations to individual councils based on the directions of the PO-RALG;
3. Synchronized with the national budget cycle, preparing an annual "Local Government Fiscal Review" which would include analyses of:
    a. the overall expenditure patterns of local governments
    b. the overall revenue collection patterns of local governments
    c. the overall functioning of the system of intergovernmental grants
    d. local government borrowing and debt, as appropriate
4. Informing the policy process by producing specific analyses and reports on local government finances and local government fiscal issues, as needed or requested
5. Providing advise on the application of grant formulas, accessibility conditions, grant conditions and grant procedures, as needed or requested;
6. Providing any necessary background information in support of the inter-ministerial coordinating mechanism on local government finance issues at the policy level (see immediately below).

7.2.6 Policy-level coordination on local government finance issues

One of PO-RALG's current responsibilities is to coordinate the interactions of the different central government ministries with the local government level. As local governments become increasingly autonomous in their functioning, PO-RALG, in its current organizational set-up, will not be as well-positioned to play this role in the future. As such, Tanzania's modality for different central government ministries to coordinate their interactions with the local government level ought to evolve over time.

While the recent improvements in technical coordination on intergovernmental fiscal issues provide for a marked improvement in coordination of central-local fiscal issues, it is insufficient to focus on coordination at the technical level alone; a regular and systematic policy-level coordinating mechanism on local government finance issues is critical to assure coordination at the policy-level and to serve as a platform for the recommendations from the technical level. For instance, interest has been shown in the past by some to establish a Local Government Fiscal Commission. Although international practices offer a number of options for intergovernmental coordination (as discussed in the box below), the study team proposes for PO-RALG and MOF to jointly convene an

annual Local Government Fiscal Consultative Forum, at which policy issues can be discussed at policy level and taken forward into the budget process. The study team sees this option as preferable over the alternative coordinating modalities that are possible.

Box 7.5
International practices in coordinating central-local fiscal relations

International practices offer four more or less standard options for intergovernmental coordination.[14] These options include (1) continued exclusive reliance on PO-RALG to coordinate intergovernmental relations; (2) introduce one of several types of Local Government Finance Commissions; (3) rely on parliament to monitor and coordinate intergovernmental affairs; (4) formal reliance on a local government association (ALAT) for intergovernmental coordination. Below, we discuss the extent to which each of these options would be well-suited in Tanzania's case.

Continued exclusive reliance on PO-RALG. It is recognized by all stakeholders in Tanzania – including PO-RALG itself- that local governance is an issue that extends well beyond the mandate of PO-RALG, and that extensive coordination is needed among central government agencies on one hand, and between the center and local governments on the other hand, to assure the successful function of the system of intergovernmental (fiscal) relations. As such, an approach that exclusively relies on PO-RALG and that fails to build linkages to the other central government stakeholders is not a viable solution.

Local Government Finance Commission. During the 1990s, it appears that the "standard" solution to the challenge of intergovernmental coordination in decentralizing LDCs was the introduction of a Local Government Fiscal Commission. However, in fact, the term applies to basically three types of coordinating mechanisms (vertical, horizontal and autonomous), which have distinctly different objectives. Whether or not an LGFC is an appropriate mechanism depends very much on the objective to be achieved.

A vertically-oriented LGFC. Some LGFCs are predominantly comprised of various representatives from the local government level and are mandated to represent the interests of the local government level at the center. Examples of such commissions include the LGFC in Uganda and the Finance Planning Council in Germany. While in decentralized countries it is important for local governments to have a voice in policy decisions concerning local government finance issues, such "vertically oriented" commissions can have a number of draw-backs. Most importantly, in many LDCs the primary problem within the realm of intergovernmental coordination is the lack of coordination between central government agencies. If this is the case, building an additional bureaucracy to consider local government finance issues may not only be a costly affair that fragments institutional responsibilities and disperses (often limited) human resources, but (in the absence of strong leadership at the center) it can actually worsen the coordination problems at the center. Given that in many ways LGRP effectively fulfills the role of a champion and catalyst for decentralization reform, the study team does not believe that such a

[14] A more complete discussion of the types of available intergovernmental coordinating mechanisms is contained in Boex and Martinez-Vazquez. 2004. *Developing the institutional framework for intergovernmental fiscal relations in decentralizing LDTCs.* International Studies Program Working Paper Series.

vertically-oriented LGFC would be able to contribute significantly to the discussion on local government finances at this stage of reform in Tanzania.

A horizontally-oriented LGFC or Local Government Fiscal Forum. A second type of finance commission is predominantly comprised of central government stakeholders, and serves to more effectively coordinate intergovernmental policies "horizontally" at the central government level. For instance, this is the role for Indonesia's Regional Autonomy Advisory Board (DPOD). While such horizontal policy-level coordination is indeed one of the institutional challenges in Tanzania, a "horizontally-oriented" LGFC or Local Government Fiscal Forum might be somewhat duplicative in the institutional context of Tanzania. Tanzania's Inter-Ministerial Technical Committee (IMTC), a regular meeting of all Permanent Secretaries, is currently proving to provide an excellent mechanism for policy coordination between different ministries once a specific policy issue has been identified. Thus, setting up a LGFC that comprises a large number of the same members of the IMTC would likely be considered unnecessary and duplicative. However, while the IMTC provides the right platform for considering local government policy initiatives and moving them to Cabinet once specific policy issues have been identified, one "shortcoming" of the IMTC (as a policy-level coordinating mechanism for intergovernmental fiscal issues, at least) is that its membership is too broad and too senior to function as a sounding board for local government finance issues.

An autonomous LGFC. A third arrangement is the establishment of an independent commission, comprised neither of local government representatives nor central government stakeholders. Such independent finance commissions –which typically comprise leading academics, technocrats, policy experts and sometimes senior statesmen-, are used in some countries to obtain independent recommendations on the state and direction of the system of intergovernmental relations, without either level of government dominating the discussions. As noted earlier, with the limited technical capacity on local government finance issues in a country like Tanzania, such an arrangement would be superfluous and might even distract from the ongoing policy reforms.

Reliance on parliament for coordination on intergovernmental issues. Some countries rely on parliament to play a leading role in monitoring, coordinating and defining the system of intergovernmental relations. This is particularly true in parliamentary political systems in which parliament plays a strong role. For instance, one can consider the role that the Fiscal Analysis Office played in Ukraine's intergovernmental fiscal relations. Although it is important to increasingly involve Tanzania's parliament in discussions surrounding local government finance issues, the relative strength of the executive branch in Tanzania's public sector currently makes this an impractical solution for the purpose at hand.

Reliance on local government associations for coordination on intergovernmental issues. A fourth institutional arrangement used sometimes to coordinate intergovernmental relations is a formal reliance on local government associations (such as ALAT) for monitoring and regulating the system of local government finances or other non-governmental organizations. Although most types of intergovernmental institutional arrangements somehow include local government associations as an institutional partner, in some countries the local government associations have a much more exclusive and formal role as the central government's key partner in making local government finance policy. Although the study team believes that ALAT should play an increasingly important role in policy discussions surrounding the evolution of Tanzania's system of local government finances, ALAT currently has neither the technical nor the organizational capacity to play a leading role in intergovernmental coordination at this stage,

Recommendations. Since the majority of resources provided to the local government level come in the form of sectoral block grants, we deem that the greatest institutional need is to assure ongoing and effective coordination between PO-RALG, the Ministry of Finance, the different sectoral ministries, and the local government level. While institutional coordination is needed between the various central government ministries, we feel that there is no need to establish a (semi-)autonomous body to manage central-local fiscal relations at this time. Yet as the scope of unconditional grants in the system of local government finances grows over time, a (horizontal) Local Government Fiscal Commission might be an appropriate mechanism at some point in the future to assure cross-sectoral oversight over the pool of resources made available to the local government level.

Given that the Inter-Ministerial Technical Committee in many ways allows policy-level coordination among Permanent Secretaries, in the current context an LGFC would be rather duplicative. Instead, PO-RALG could easily pursue the intergovernmental coordination function and the required consultations on local fiscal issues under its current legal mandate by hosting a regular (i.e., annual) Local Government Fiscal Consultative Forum. Terms of reference for such a Forum or Conference could be drafted at once.

Given the mandate of PO-RALG, the Local Government Fiscal Consultative Forum would appropriately be chaired by the Minister responsible for Local Government (PO-RALG) and co-chaired by the Minister of Finance. Other ministries could be invited on a case-by-case basis, depending on the focus of the policy discussions. The technical-level Local Government Fiscal Analysis & Coordination Unit would be well-positioned to function as the Secretariat of this Forum, and could present its annual Local Government Fiscal Review as the basis for identifying the key policy areas that require attention or that need to be taken on board in the next budget cycle. The consultative Forum could meet once or twice per year to monitor the overall functioning of the system of local government finances; to endorse any changes to the proposed (sectoral) allocation formulas; to approve the allocation of grant resources to individual LGAs based on the application of the allocation formulas; and to approve the qualifying or disqualifying of local authorities who have failed to meet access criteria for certain intergovernmental grant schemes. The main annual meeting of the Forum could take place in October of each year, at the outset of the central government's budget cycle.

It is important to note upfront that the main function of the Consultative Forum would be to provide a platform for coordination, dialogue and communication between the different central government stakeholders, and (to a somewhat lesser extent) between central and local government officials. As such, the membership of the forum would mainly include central government stakeholders (including PO-RALG, the Minister of Finance, PO-PSM, and certain sector ministries) as well as a limited number of local government representatives (ALAT). Although greater involvement of local governments and NGOs is needed (see next subsection), the forum is not envisioned to add an additional independent voice in the local government policy debate. As such, the forum

activities would follow more along the lines of a coordinating council such as the German Financial Planning Council or Indonesia's Regional Autonomy Advisory Board (DPOD), rather than as a local government finance commission with independent views on policy issues, such as Australia's Commonwealth Grants Commission or Uganda's LGFC.

7.2.7 Interaction between line ministries and LGAs

It is fair to state that line ministries in Tanzania often still think of local governments as an extension of the central government apparatus, without according LGAs the role of autonomous government authorities in the public sector; many line ministry officials clearly still tend to think in terms of deconcentration and delegation, rather than devolution. This attitude is clearly reflected in the lack of an organized approach with which line ministries coordinate their relations with LGAs. Currently, it is generally the case that different directorates within the various line ministries issue circulars, guidelines and directives to sectoral section heads at the local government level, without much or any systematic coordination within the sector ministry. This lack of coordination at the sectoral level could potentially result in the issuance of contradictory instructions and guidelines to the local government level, as well as unrealistic expectations about local government performance in the delivery of sectoral services.[15]

In order for line ministries to resolve this lack of institutional coordination, each ministry that has policy responsibility for devolved public services should actively consider how to streamline and structure its communication and interaction with local government officials. One possible suggestion is for these sector ministries to introduce a Director of Local Government Coordination, which would coordinate the sector ministry's relationship with LGAs. Not only would such a department be able to coordinate sector policies at the local government level, but this structure would also give local government officials a single contact point within each sector. Such organizational reform would be in line with the recent reorganization of PO-RALG, which introduced a Directorate for Sectoral Coordination. A less far-reaching proposal -which would possibly be more acceptable to the sector ministries- would be to clearly assign responsibility for sectoral coordination with local governments to a dedicated official within the DPP of each sector ministry.

7.2.8 The role of ALAT, NGOs and civil society in advocating a sound system of local government finance

A paradox about decentralization reforms –including the reform in Tanzania- is that it requires a strong central government to introduce a more decentralized government structure. Indeed, Tanzania's decentralization reforms have been very centrally driven by

[15] For instance, the Director for Primary Education may set objectives and norms for the desired level and quality of public education provision. Likewise, other departments provide further instructions that mandate certain expenditures of the local level. However, LGAs may not be able to respond to the various instructions given the limited sectoral funding provided to them through the sectoral block grant.

PO-RALG through the LGRP. Although this has proven to be an effective management structure which resulted in substantial progress over the past few years, the centralized nature of the reforms has limited the inputs of local governments and local government officials (including ALAT), non-governmental organizations and civil society on the reform of local government finance. Although until recently the predominant institutional concern, correctly, has been to enhance the capacity within the central government to develop and manage a sound system of local government finances,[16] an evenhanded decentralization strategy should not lose sight of the fact that a decentralized approach can only succeed through the involvement of local governments, as well as civil society and the private sectors.

While a more limited role for local governments, civil society and the private sector were desirable and perhaps even appropriate during the initial stages of decentralization reform, in order to consolidate the progress made on the local government reform agenda it is increasingly important to be more inclusive and participatory in the system of local government finance. This is true both at the central level –where local government representatives, sectoral representatives and civil society should play an increasing role in the policy-level discussions- as well as at the local level, where the local government finance system should accommodate civil society involvement through transparent and participatory budget processes.

The most obvious non-governmental representative of the interests of local authorities is the Association of Local Authorities of Tanzania (ALAT). However, ALAT is currently too dependent on the central government for its existence, lacks adequate resources, and does not have the policy-level expertise to be in a position to assertively advocate the position of local governments.[17] We believe that as decentralization reform proceeds, the capacity of the local government sector –among others through ALAT- should be strengthened to play a more active role and to contribute its own views and positions to the evolving policy debates surrounding local government finance issues. In addition, it is important for PO-RALG to actually *encourage* a more independent role of ALAT, as a stronger local voice that would benefit the decentralized environment. In addition, the center may wish to encourage the development of other (parallel or sister) organizations for local government officials, such as a Local Finance Officers Association, which might focus specifically on local government finance issues.

ALAT and other civil society organizations have the potential to play important roles in the system of local government finance. Currently, there is no institutional framework (either within or outside central government) that provides capacity building support to local governments on financial and non-financial issues; that provide independent information to LGAs on fiscal issues; or that engages in research and advocacy on local

[16] This capacity development (focused mostly on the Ministry of Finance and PO-RALG) is taking place in the context of the recommended establishment of the Local Government Fiscal Analysis & Coordination Group. There is no doubt that these institutional capacity strengthening activities need to move forward without delay.

[17] For instance, ALAT sits within a complex of government offices. Furthermore, ALAT predominant activity –the annual meeting- is dominated by officials from PO-RALG. As such, ALAT continues to serve more as a top-down dissemination mechanism rather than give a voice to the local government level.

government finance issues. This is not an appropriate role for the public sector to play: if LGAs are only able to access information about their (fiscal) rights and responsibilities from the central government or regional representatives at the center –without independent verification-, then the centralized monopoly on power could be perpetuated even in a decentralized system.

As such, information sharing, analysis, advocacy and capacity building could potentially be an important niche for non-governmental organizations and private sector, especially given the expected demand in the near future for capacity building by local governments under the Capital Development Grant system (which incorporates a Capacity Building Grant for non-qualifying districts). Since ALAT lacks the internal institutional capacity to deliver such services in-house, it might benefit from forming partnerships with other like-minded organizations such as universities, research centers (such as REPOA), or the Institute for Public Administration. In fact, substantial benefit could be gained from the establishment of an Institute for Local Government –closely aligned with ALAT and other existing organizations– as a knowledge center on local government (finance) issues in Tanzania.[18] Although the establishment of such an institute would require a significant commitment by the reform program and its development partners, the potential of such an institute to inform the policy debate on local government reform issues on a sustainable basis is tremendous.

A final proposal with regard to development of the institutional framework for intergovernmental fiscal relations in Tanzania is the need to develop the capacity of local government actors to be involved in local fiscal decisions. An important part of this activity involves publicly providing information about the participatory local government budget process at the local level as well as on the rights and responsibilities of various local stakeholders. In addition, stakeholders, both at the central as well as the local levels, should be broadly sensitized as to how they can participate in identifying local priorities and monitoring their local governments. In addition to country-wide seminars for local government officials and councilors themselves, such sensitization activities could include academics, journalists, parliamentarians, policy experts and analysts, local chambers of commerce, and NGOs. NGOs that are likely to have a particular interest in being involved in the local government fiscal process include advocacy groups with a sectoral focus –such as Haki Elimu- or NGOs that focus on improving public sector accountability and reducing (local) corruption.

Recommendation. The study team notes that previously, donor support for institutional strengthening was concentrated where it was needed most: within the central government's agencies in charge of managing local government affairs. Yet in order for decentralization to be "locally owned" and for local government reforms to be sustainable in the long run, the time is right to broaden the institutional framework by assuring a more independent role for ALAT and for other like-minded civil society organization in the debate surrounding local government fiscal issues. ALAT already has made some

[18] Such an institute would no doubt also work closely with LGRP on the many areas of common interest. However, the envisioned institute would be autonomous from the center and would set its policy agenda based on the interests of the local authorities (through ALAT), which would be its primary clientele.

small steps in this direction with support from international development partners. However, in order for local governments to achieve a true voice in the policy debate surrounding fiscal decentralization, a much more concerted effort will be needed. The establishment of an Institute for Local Government (for instance, following Ghana's model) that is closely aligned with ALAT (and could work together with LGRP), could be a key mechanism for local information sharing, analysis, advocacy and local capacity building.

7.3 Concluding remarks

This section has sought to broaden the discussion from the more narrowly defined local government finance issues such as the design of grants and local taxes to questions of administration and implementation. It has sought to highlight some of the critical issues inherent in actually implementing a sound system of local government finance. Furthermore, this section has sought to elicit a recognition that establishing sound local finances is predicated upon establishing effective local government authorities in general, and that questions, for example, around how senior management is appointed, or how local leadership functions have a profound impact upon the effectiveness of financial management.

This section has addressed institutional challenges at the central level in some detail, including specific recommendations for institutional strengthening and reform. Our recommendation –which were presented at the stakeholder workshop in May 2005- include:

- The Coordinating Block Grant Implementation Team should become a permanent inter-ministerial Fiscal Analysis & Coordinating Group (led by MOF and PO-RALG)
- MOF should refocus itself to pay appropriate attention on local government finance with support from LG Finance Expert/Advisor
- PO-RALG/LGRP needs to build solid capacity in staffing the LGA Finance Section
- A Local Government Consultative Forum is needed rather than a 'Local Fiscal Commission'
- Sectoral line ministries should analyze their organizational structure in order to assure that coordination and communication with LGAs occurs in a streamlined manner.
- In order for decentralization to become sustainable, top-down reform mentality should shift to broader support. As such, PO-RALG should promote an increasing voice to local governments and NGOs in shaping the framework for LG finance policies and practices.

Likewise, general suggestions have been put forth to improve the processes that guide the formulation and execution of local government budgets, in order to assure that the system of local government finance becomes increasingly participatory, transparent, and accountable. To this end, we propose that PO-RALG/LGRP undertake a comprehensive review of the various aspects of the local planning and budgeting process (participatory

planning process, account structures and budget classifications, comprehensiveness of the budget, horizontal and vertical reporting requirements, audit processes, and so on) in order to identify areas for improvement of the local budget process. Progress on this front should be considered an inherent part of sound local government finance system; after all, without participatory and accountable local governance, the potential efficiency and equity benefits from fiscal decentralization will surely fail to materialize.

THE UNITED REPUBLIC OF TANZANIA

President's Office - Regional Administration and Local Government
Ministry of Finance

Draft Policy Paper on Local Government Finance:

The Framework for the Financing of Local Government Authorities in Tanzania

Preamble to Section 8
The Framework for the Financing of Local Government Authorities in Tanzania

The first seven sections of this study contain all the ingredients for a strategic framework for local government finance in Tanzania. The current section of the *Final Report* pulls together the conclusions and recommendations from the previous sections in a clear and concise manner, and integrates them into a proposed strategic framework for local government finances.

The draft strategy document clearly indicate how each level of local government should be funded (i.e., with what mix of own revenue sources and national transfers) and how each source of local revenues could be optimized. Section 8 is drafted in such a fashion that -while also being an integral conclusionary section of the Final Report- the section can also be read as a stand-alone document, and possibly be used as the basis for the Government's Policy Paper on the Financing of LGAs in Tanzania.

As a result of its structure, Section 8 of this report concurrently functions as the Executive Summary of this Report.

The Framework for the Financing of Local Government Authorities in Tanzania

1. Introduction

Fiscal decentralization is not a new theme in the policy agenda of the Government of Tanzania. Since the reintroduction of democratically elected local governments in 1984, the Government has been systematically expanding the roles and financial responsibilities of Local Government Authorities in a well-structured and considered manner.

As noted in the Local Government Fiscal Review (2004), local governments are an important and an integral part of public sector finances of Mainland Tanzania today, as local governments have significant responsibility in the delivery of key government services such as primary education and basic health care. While local government authorities collect roughly 3-5 percent of all public sector revenues, they are responsible for over 20 percent of public sector spending. As such, a sound framework for local government finance is a key factor in assuring that the public sector delivers quality public services; provides an enabling environment for economic growth; and pursues an aggressive agenda of poverty reduction.

The Government's vision of the country's local government system is clearly set forth in its Policy Paper on Local Government Reform (MRALG, 1998), which was developed in a deliberative and consultative process. The vision is based on the principle of "decentralization by devolution" by which autonomous local governments are empowered with political and administrative control and provided with the financial resources to assure the effective delivery of services to the public. While the Policy Paper provides the broad outlines for the system of local government finances, the document falls short from defining a comprehensive strategic framework for local government finances.

In 2004, the Government of Tanzania determined that it would be useful to undertake a comprehensive review of the policy framework underpinning the structure of the financing of local government, in light of a number of ongoing reform initiatives impacting local government finance. Based on a thorough review of the existing approach to local government finance in Tanzania, sound principles of fiscal policy, and international best practices, this documents sets forth the Government's strategic framework that will henceforth guide its policy decisions on the framework for financing local government authorities, including the assignment of expenditure responsibilities, the collection of own local revenues, the role of intergovernmental transfer schemes, as well as local government borrowing. As such, the current policy framework for the financing of local government authorities is a complementary extension of the Policy Paper on Local Government Reform.

2. Taking stock of the state of local government finances and the policy debate on local government finances in Tanzania

Any system of local government finances covers a broad range of fiscal issues. Given the breadth of the topic, it is useful to subdivide the discussion of local government finance in Tanzania into four main dimensions of intergovernmental fiscal relations, namely:

(1) the assignment of expenditure responsibilities: what are the functions and expenditure responsibilities of each level of government?.
(2) the assignment of revenue sources to local governments: which tax or non-tax revenue sources will be made available to subnational governments, and how are these local revenues administered?.
(3) the allocation of intergovernmental fiscal transfers: what type(s) of intergovernmental fiscal transfers will be provided to local governments? This includes decisions on how the size of the grant pool is determined; how the resources are to be distributed among local governments, and what the allowed uses of these funds are at the local level.
(4) the environment for local government borrowing: are local governments allowed to borrow? What mechanisms for borrowing are available, and what are the restrictions on borrowing and debt by local governments?

To a large extent, the current document follows the structure of these four pillars of fiscal decentralization. Two additional broad topics that are addressed (whenever relevant) in this current policy document are the appropriateness of the overall local government structure, and the institutional mechanisms for intergovernmental fiscal relations in Tanzania, including coordination among central government agencies as well as coordination and communication between different government levels.

<u>Fundamental principles of a sound local government finance system</u>
During the preparation of the current policy document, a number of misconceptions were identified that were held by some stakeholders in Tanzania regarding the framework for local government finance in Tanzania. In order to resolve these misconceptions and establish a positive starting point for the development of local government finance framework in Tanzania, four principles were proposed around which this strategic framework for local government finance was developed. During a joint stakeholder workshop –jointly chaired by PO-RALG and the Ministry of Finance- in January 2005, broad-based consensus was reached on these principles. These principles form the foundation for the strategic policy on local government finance:

- Principle 1: Expenditure assignments form the foundation for a framework for local government finance. Finance should follow function. Both intergovernmental transfers and own local revenues play important but distinct roles in the system of local government finance.

- Principle 2: The role of taxation in the public sector is more than maximizing revenue yield. If structured appropriately, local taxation empowers communities, enhances accountability, helps improve vertical imbalance problems, and overall, it improves the efficiency of the public sector.

- Principle 3: Each government level requires control over at least one good revenue source. The deficiencies in local tax administration should not be addressed by eliminating local taxes without consideration of their revenue impact; rather, deficient local taxes should be transformed into sound revenue instruments. There is a need for a limited "closed list" of local taxes that captures the diverse circumstances of local government authorities in Tanzania. Revenue autonomy should be separated from the issue of tax administration; local taxes can be administered by the central tax administration as needed.

- Principle 4: There is an important future role for sectoral block grants, equalization grants and capital development grants in Tanzania's system of local government finance.

An assessment of the current local government finance system

A "big picture" assessment of the current system of local government finance in Tanzania is captured in Table 1. The rows in the table consider broad functional dimension of local government finance, including the local government structure in Tanzania (in row 1) as well as the four main pillars of decentralization reform listed above (in subsequent rows). The columns in the table consider different levels of policy intervention, including policy reforms, legislative reforms, regulatory and institutional reforms, and so on. The cells in the table contain a brief assessment of the intersection between the relevant functional dimension and the type of policy intervention.

Local government structure. The first row of Table 1 provides a brief assessment of Tanzania's current structure of subnational government, considering the number of government levels, the size of subnational jurisdictions, and so on. The subnational government structure was considered a given (exogenous) factor during the formulation of the local government finance framework.

The current local government structure in Tanzania provides an adequate basis for moving forward, as district and urban councils are generally of an adequate size and have sufficient administrative capacity to operate as local government jurisdictions and to assure the delivery of the range of public services assigned to them. The facilitative role of the Regional Administrations (as opposed to their previous more hierarchical role) is appropriate and is seemingly allowing local governments greater control over their own affairs.

Table 1
Assessing The Current Framework Of Local Government Finance In Tanzania

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society (CS) and private sector
(1) Structure and role of public sector	District and urban councils main LG level Role of village should be clearer and increase	Rural and urban Gov Act; provides sound framework, but duplicative	PO-RALG evolving from controller to facilitator Improved coordination between RALG, MOF, sectors	LGAs have adequate control over own affairs / internal organization, except local public servants	LGAs (ALAT), other NGOs, need stronger voice/link into the LG reform process
(2) Functional and expenditure assignments	"Decentralization by Devolution"	Assigned as listed in LGFA; D-by-D should be clarified further Public Svc Act inconsistent	Generally, sectors OK in dealing w/LGAs Excessive central control over LG hiring/firing	Weak local planning and budget process; needs review and strengthening (Epicor; Plan-Rep)	Limited CS participation in local budget processes (formulation / accountability)
(3) Assignment of revenue sources	Some ambiguity about strengths (importance) and weaknesses of local revenues	LGFA does not provide clear "closed list" (contradicts itself)	No single CG institution responsible for local govt revenue policy	Very weak local tax admin capacity; need for unified regulatory frame-work for local govt revenue administration	Limited CS input in local revenue decisions (local tax payer's associations?)
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandates	Clear commitment to formula-based sectoral grants and CDG system	LFGA provides adequate framework; but contains duplicative provisions	Need firmer link to central budget processes (PER/ MTEF/ PRS) Sectoral block grants coordinated though BGIT	Budget guidelines provide clear guidance for transfers	Limited CS transparency/ monitoring of grant-funded programs
(5) LG borrowing and infrastructure development	Willingness to accommodate needs of urban LGAs, but concern about soft budget constraint	Allowed by law with ministerial permission	LGLB currently only mechanism; inadequate source for local borrowing	Need for unified local budget approach (budget recurrent and dev budget spending together)	Currently no private sector borrowing

Like many developing countries, Tanzania is facing tension between providing local government services by jurisdictions that are generally too large on one hand (thereby risking a lack of correspondence and local accountability) and providing local government services by jurisdictions that are generally too small (thereby risking inefficiencies due to scale economies and inadequate administrative capacity) on the other hand. Along this spectrum, Tanzania has made the prudent choice to assign the bulk of local responsibilities to the district level, while the village level only plays a minor role in the delivery of services and local infrastructure, although the future role of the village level is likely to increase.

Expenditure assignments. The current assignments of expenditure responsibilities in Tanzania are generally sound, as reflected by the second row in Table 1. The government's policy position of "decentralization by devolution" is unambiguous; the legal framework for decentralized provision of services is in place and sectoral laws to a large extent respect this decentralized mode of service delivery; and the services assigned to the subnational level generally follow the subsidiarity principle.

The predominant way in which the central government interferes with local governments' ability to provide public services is through its control over (the hiring and transfer of) local government staff. Although outside the direct scope of intergovernmental fiscal relations, serious problems will arise in the local government finance system unless the local service system is properly aligned with the local government finance system by allowing local governments to make their own hiring and firing decisions (and to eliminate central government intervention in local public service decisions).

However, some of the more serious weaknesses of the local expenditures process lie in local budget formulation and execution. Planning and budget processes at the local government level tend to be weak. The local budget process further involves only limited civil society participation and oversight of budget planning, formulation and execution. While the computerization of local financial management processes is currently being rolled out, the local financial management processes should be reviewed and strengthened to assure greater participation, transparency and local oversight.

Revenue assignments. The revenue assignment question -how much of the national revenue pie should be given to the local government level, and how local revenues should be administered- is probably the weakest component in Tanzania's system of local government finance. Recent reforms of the local revenue system that were aimed at a "rationalization and harmonization" of local government revenues instead has resulted in an elimination of a number of significant local revenue sources, including the Development Levy and a number of minor local ("nuisance") taxes. In addition, a number of other local revenue sources were sharply reduced or strictly limited, including the collection of business licenses and agriculture cesses.

While there is widespread agreement that the previous local revenue system as well as the manner in which local taxes were administered were wholly inadequate, there is now an

increasing realization (both at the central government as well as at the local government level) that local revenues are an integral part of a sound system of local government finance. This leaves the Government with the difficult challenge to transform the current, inadequate and imperfect system of local government revenues into a sound and well-administered system of local government revenues.

Intergovernmental fiscal transfers. Once expenditure responsibilities and revenue sources have been assigned to the local government level, intergovernmental fiscal transfers are needed to achieve vertical and horizontal fiscal balance in the system of intergovernmental fiscal relations. The transfer system in Tanzania plays an extremely important role in financing local governments, as most councils rely for 80-90% on intergovernmental transfers to fund their activities. A study on the intergovernmental transfer system in Tanzania (GSU, 2003) identified a number of serious shortcomings with regard to the manner in which intergovernmental transfers (local government allocations) were allocated; the allocation of local government allocations was done in a highly discretionary manner, lacked objective standards for allocating resources, failed to provide local governments with a predictable stream of resources, and was generally counter-equalizing. As such, transformation of the transfer system has taken center-stage in the reform of local government finances in recent years. The positive steps taken by the Government to reform the intergovernmental transfer system has been one of the major successes of local government reform in recent years (JGDR, 2004).

The broader vision for a formula-based system of intergovernmental transfer was developed as part of the Government's Local Government Reform Policy. Detailed proposals for a system of formula-based recurrent sectoral block grants were adopted by Cabinet in February 2004. The system of formula-based sectoral block grants is currently in the process of being implemented: formula-based grants for primary education and local health services were introduced in July 2004; formula-based grants for the remaining priority sectors are being introduced as part of the FY 2005/06 budget.

In addition to conditional sectoral funding, local governments receive a number of additional intergovernmental transfers, including a (discretionary) Local Administration Grant and a Compensation Grant provided in compensation for local revenue sources abolished in 2003 and 2004 (since 2004, the Compensation Grant is known as the General Purpose Grant). The government is on the threshold of introducing a comprehensive, formula-based Local Government Capital Development Grant system, which is funded from government resources, World Bank loan proceeds and various donor agencies.

Local government borrowing. Borrowing plays only an extremely minor role in Tanzania's system of local government finance. While the legislative framework allows LGAs to borrow with ministerial permission, the only conduit currently available (the Local Government Loans Board) is not in a position to properly address the lending needs of local authorities.

However, the fact that local governments have limited access to lending for the purpose of infrastructure is increasingly becoming a constraining factor in the local government finance system. This is especially the case for urban councils that have a sufficient resource base to engage in lending and repay their loans, and which have a strong interest in developing their infrastructure. There appears to be an interest within the Government of Tanzania to expand the possibilities for LGAs to use borrowing as a way to finance local capital infrastructure, as long as the framework ensures prudent borrowing in the context of a "hard budget constraint".

The institutional framework. A sound institutional framework for the system of intergovernmental fiscal relations is critical in assuring a solid system of local government finance. The institutional framework needs to assure coordination between the various central government stakeholders with an interest in local government finance issues, including PO-RALG and the Ministry of Finance, as well as certain line ministries and other central government agencies. The inter-ministerial linkages have historically been weak in Tanzania, but the establishment of a Coordinating Block Grant Implementation Team has significantly improved the effectiveness with which the central government has been able to deal with local government finance issues. While additional institutional strengthening of the various stakeholders is needed in the coming years, the production of the Local Government Fiscal Review (2004) by this inter-ministerial team should be seen as a strong indication of their improving institutional framework.

In addition to the need for horizontal coordination at the central government level, there is also a need to assure that adequate coordination takes place between different government levels, as well as between the public and private sector. A sound fiscal decentralization approach cannot be driven from the center alone; ultimately, a sustainable decentralized system requires civil society (NGOs, local chambers of commerce and other interest groups) to be involved in the local decision-making process, just like a sound decentralized system requires local governments to have a real voice in the national policy debate on local government reform issues. Since the focus in recent years has been on addressing some main fundamental challenges in local government finance, this has been an area that has received less attention. However, now that the overall framework for local government finance is on an increasingly sound footing, these institutional concerns are becoming increasingly important for a sustainable local government system.

Overall assessment. When taken together, it would be fair to state –based on the assessment summarized in Table 1- that although the current system of local government finance has a number of shortcomings, many of the features of the current system of local government finance are quite sound. The overall policy direction of the Government on local government finance has been prudent and is consistent with overall sound principles for decentralization reforms. In general, the legislative framework provides appropriate guidance, although the relevant laws should be revised to eliminate outdated, duplicative or contradictory clauses. Although the local government revenue system has not received adequate attention in recent years, substantial progress has been made on transforming

the previously highly discretionary transfer system into an objective, transparent, stable and pro-poor funding mechanism for local governments.

While in most respects the overall structure is sound, specific features may need sharpening and fine-tuning in order to form an overall financing framework that is well-integrated and internally consistent. At the very least, the current local government finance system provides a solid stepping stone for the incipient strategic framework for local government finance.

3. Overall structure of local government finance and expenditure assignments

Based on the overall assessment of the current system of local government finance in the previous section, this section and subsequent sections in this policy document develop the strategic framework for local government finance in Tanzania which the government intends to pursue in future years. Again, the discussion will broadly follow the four main pillars of fiscal decentralization (expenditure assignments, revenue assignments, intergovernmental transfers, and local government borrowing).

The Government's assignment of expenditure responsibilities between different government levels should be guided by its stated policy strategy of "decentralization by devolution", which is clearly set forth in the Government's Policy Paper on Local Government Reform (1998). Expenditure functions should thus be assigned in accordance with the "subsidiarity principle" which states that government services should be delivered by the lowest government level that can do so efficiently. The existing expenditure assignments (which are set forth in the Local Government Acts) are basically consistent with the concept of subsidiarity.[1]

<u>The multi-dimensional nature of expenditure assignments</u>

The manner in which expenditure assignments are included in the appropriate legislation should specifically take into account that expenditure responsibilities are multi-dimensional. Multi-dimensional expenditure assignments recognize that "being responsible" for delivering a public services can be broken down into the responsibility to (1) set policy, regulations and standards; (2) funding the activity; (3) providing the service (i.e., assuring that the service is provided); and (4) the actual production or delivery of a service (which may be produced by the LGA itself of contracted out).

Although Tanzania is pursuing "decentralization by devolution", it is widely agreed that this concept means different things for different local government activities. However, this implicit understanding has not been documented explicitly in either the government's local government reform strategy or in the respective laws. In principle, the framework

[1] Possible exceptions to a sound expenditure assignment are secondary education (the provision of which could be assigned to the local government level) and urban fire-fighting services (which could be fully devolved to the local government level).

for local government finance in Tanzania should recognize five different types of services or activities that may take place at the local level, which are summarized in Table 2.

Finance should follow function

Under the concept that "finance should follow function", each of the different types of local government activities noted in Table 2 should be funded through different funding modalities.

Table 2
The assignment of expenditure responsibilities in Tanzania

Local government functions	Policy, regulation and standards	Finance	Provision	Production / Delivery
Locally provided "national" public services	CG	CG: sector block grants	LGAs	LGAs
Local government administration	CG	CG: GPG	LGAs	LGAs
Pure local government services	LGAs	CG / LGAs: own sources and GPG	LGAs	LGAs
Capital development activities	CG / LGAs	CG / LGAs: LGCDG, loans, own sources	LGAs	LGAs
Delegated central government functions	CG	CG: ministerial subventions	CG	LGAs

The most prominent category of local government responsibilities are (national) public services for which the provision is devolved to the local government level. These services include the five priorities sectors (primary education; local health services; agriculture extension and livestock; water supply; and local roads). For these activities, the central government continues to bear responsibility for setting policies, regulations and norms, as well as for the financing. As discussed below, the local delivery of priority sector activities should be fully funded by sectoral block grants.

The second type of local government expenditure responsibility is local administration. It is appropriate to fund local administration from central government resources since local governments are an integral part of Tanzania's national system of public administration, and since the predominant responsibility of local government authorities is to provide nationally-mandated public services. As discussed below, local governments should receive resources for local administration through the General Purpose Grant. While the

central government should set regulatory standards for local government administration (such as reporting requirements, and so on), it should refrain from interfering with managerial or administrative decisions of individual LGAs.

The third category of local government activities in Tanzania's framework for local government finance includes "truly" or "purely" local government services, such as refuse collection, street sweeping, and other such services. Since the benefits from these local public services befall only the local community, the entire responsibility for these activities (including policy direction, financing, provision and production) should be assigned to the local government level. These activities should be predominantly funded from own resources. However, to the extent that the local government revenue system provides inadequate resources –and in order to assure horizontal fiscal balance- part of these local government activities should be funded from the unconditional General Purpose Grant.

To the extent possible and appropriate under the subsidiarity principle, purely local services and activities should take place at the village level. The central government should provide regulatory guidance for the distribution mechanism of district resources to the village-level, commensurate with the expenditure responsibilities of the village level.

Fourth, local capital development activities should be funded by a combination of own source revenues, local borrowing, and grants (Capital Development Grant system). To the extent that these capital development activities fall within the priority sectors, the central government may impose policy guidance, regulations and norms. Whenever appropriate, again, local capital development responsibilities should be devolved to the village level.

Finally, there may be a number of central government activities which (statutorily or otherwise) may be delegated to the local government level. These activities should be fully funded by earmarked ministerial subventions to the local level. These ministerial subventions should be clearly identified in the central government budget. The prevention of contagious illnesses may be considered such a delegated responsibility.

Local budget processes and local financial management

In addition to assuring that expenditure responsibilities are assigned consistent with the subsidiarity principle in a manner where "finance follows function", a sound fiscal decentralization approach requires that mechanisms are in place to assure that local governments make expenditure decisions in a responsive and accountable manner.

In order for the expected benefits from decentralization to arise, local governments have to spend their resources in a manner that is responsive to the needs of the local community. This requires that local stakeholders are able to articulate their needs and priorities to their locally elected officials through a participatory local budget process, and it also requires that local government officials take the priorities of their tax-paying constituents seriously. Given that apparently the largest factor in the low levels of local tax compliance is the absence of corresponding benefits, local government officials and

local stakeholders may need to be sensitized about their overall roles in the process of local service delivery and local economic development.

In order for local communities to ultimately benefit from devolved expenditure assignments, they have to be able to monitor their local government's budget in a manner that allows them to hold local officials accountable if they fail to deliver the right services. Such local empowerment requires a clear and transparent system of local government financial management that allows local communities to track local spending and monitor key local performance measures. A serious effort needs to be made to review the entire local financial management process, to ensure that the local budget classifications and budget summaries and reports that are produced are not only relevant for central government budget monitoring purposes, but also that these documents are meaningful inputs into the "horizontal" monitoring of local government activities and finances by the local communities.

Box 1
Legislative reform of expenditure assignments in Tanzania

The assignments of expenditure responsibilities set forth in this policy document are consistent with current practices and the current legal framework. To a large extent, the legal and regulatory modifications that are needed to implement these expenditure assignments reflect a sharpening or clarification of the existing situation, rather than a radical overhaul of existing expenditure assignments.

In fact, the basic legal framework for decentralized provision of services in place in Tanzania is quite sound. Unlike many other decentralizing countries, sectoral laws for the most part respect the decentralized mode of service delivery. Continued vigilance is needed, however, to ensure that sectoral practices continue to be consistent with the government's local government reform agenda. For instance, the central government's control over local water boards is inconsistent with its overall vision of decentralization by devolution (as opposed to deconcentration or delegation).

The Local Government (Urban and District Authorities) Acts and the Local Government Finance Act do need to be reviewed and revised in order to clarify the current expenditure assignments. Instead of the current list (or lists) of local functional responsibilities, the Act should reference the different dimensions of expenditure assignments and clarify the distinction between different types of expenditure responsibilities to the local government level.

Furthermore, a number of revisions in the Local Government Acts could simplify and clarify the Acts by eliminating duplicative and redundant clauses pertaining to the local government structure, including a single assignment of expenditure responsibilities across urban and rural districts (which can be relegated to a Schedule); clarification of the expenditure responsibilities of DSM City Council; and clarification of the expenditure responsibilities of the village level.

4. Local government revenues and local tax administration

The realization that a significant overhaul of the local revenue system needed to take place –and the realization that this reform should take place in the context of the broader local government finance system- was an important impetus for the formulation of a Policy Paper on Local Government Finance. These discussions show that the main shortcomings of the current local revenue system are as following:

1. LGAs are mostly assigned low-yielding taxes. It is a fact that the central government has reserved itself the most important and elastic tax bases in the economy, making it so much harder for local governments to have any substantial revenue source of their own.
2. Fragmentation causes horizontal inequity. The local tax system has seen a proliferation of small taxes, which has led to significant horizontal inequities between local taxpayers.
3. The benefits principle is misunderstood or missing as a conceptual foundation for local government revenues. The benefit principle of taxation (especially as applied to the local level in Tanzania) seems to be poorly understood by some stakeholders and missing as a foundation for the system of local government revenues.
4. Excessive focus on the redistributive impact of local revenues. There appears to be an excessive focus in Tanzania on the redistributive impact of local government revenues.
5. Most taxes currently assigned to the local level are hard to administer and hard to enforce. A sound revenue assignment (and well-designed local taxes) should take into account the relative ability of local governments to administer local taxes. There is clearly a mismatch between the tax structure at the local level (many low yielding taxes which offer relatively limited tax handles) and the generally weak capacity of local tax administration.[2]
6. Compliance costs for local taxes are high. Compliance costs for local government revenue sources are quite high, among others due to the fragmentation and lack of uniformity of the local tax system. Because the high compliance costs for local taxpayers have a potential negative impact on economic growth, the reduction of such compliance costs should weight heavily in the design of future reforms.

[2] Some observers consider weak local tax administration as perhaps the single-most important weakness of the current local tax system. Although weak local tax administration (and the concept of "net tax take") is certainly one of the factors contributing to the low revenue performance at the local level, the cost of local revenue administration is likely not the major cause of inefficiency in the local revenue system. Potentially a more important failure of the local revenue system is the heavy burden borne by local governments for local administration with up to 60% of local revenues spent on administrative overhead (as discussed in Section 3, and in Section 3.2 of the Final Report). This sharply reduces the value-for-money received by local taxpayers and has a major negative effect of local tax compliance.

7. Local governments are assigned the least politically acceptable revenue sources. It must also be recognized that local governments have been handed down the task of implementing and enforcing sources of revenue that tend to be particularly unpopular.
8. Cross-cutting problems with the system of local government finance. The incentives for local revenue collections are impacted by a number of cross-cutting problems with the system of local government finance, including a lack of trust by local residents, inadequate local financial management, the absence of a hard budget constraint, and the heavy burden of local administration.

On the issues of local government revenue structure, the policy stance of the Government of Tanzania has been somewhat vague. While there was a recognition that the local revenue system was substantially flawed, stakeholders within the central government lacked consensus on the way forward. On one hand, there was great concern over the impact of local taxation on economic development, spurring the Government to rationalize the local revenue system through a process of eliminating local revenue sources. On the other hand, government officials recognized the importance of local revenue autonomy, leading to hesitance to forcibly restrict revenue discretion at the local government level.

Given that both concerns are valid in the design of a local revenue system, the government's policy stance should combine the desire for a clearly structured, transparent and efficient local revenue system on one hand with the desire for local revenue autonomy on the other hand in the context of a well designed local government revenue system. Broad agreement was reached that as a guiding principle in the transformation of the system of local government finance, the deficiencies in the local structure and local tax administration should not be addressed by eliminating local taxes without consideration of their revenue impact; rather, deficient local taxes should be transformed into sound revenue instruments.

In the shorter term, the goal should be to at least recover the level of self financing that local governments had before the "rationalization and harmonization" reforms that took place in 2003 and 2004. This would mean restoring local revenue collections to about 5 percent of national revenue collections or about 15-20 percent of total local government resources. In the longer term, revenue autonomy at the local level should be high enough to allow richer (fiscally better-off) local governments to self-finance their own expenditure responsibilities. The increased fiscal disparities that will inevitably accompany higher revenue autonomy, especially between rural and urban areas, should be addressed through a system of formula-driven unconditional equalization grants.

The first step in the reform of the local tax system should be to clean and clarify the terminology and concepts currently being used (see Table 3).[3] The interest of clarifying

[3] We specifically distinguish between four types of local revenue instruments: local taxes, local levies, local fees and charges, and contributions. There may or there may not be agreement with this precise set of

these concepts lies in making the system easier to understand for taxpayers and local government officials alike, thereby contributing to greater legitimacy of the system of local government revenues. Greater clarity and greater legitimacy should also help to improve the administration of local government revenues, improve taxpayer compliance, and also in facilitate the monitoring of the performance of local tax systems.

Table 3
A consistent categorization of local government revenues in Tanzania

Category	Defining Features	Examples of local revenue sources included
I. Local Taxes	▪ Broad-based local revenue source ▪ No *quid pro quo* involved ▪ Primary function is to raise revenues	▪ Local Property Tax ▪ Unified Local Business Tax
II. Local Levies	▪ Local revenue source levied on a specific tax base ▪ Although levies may be used for regulatory purposes, primary function is to raise revenues (i.e., tax revenues should exceed cost recovery) ▪ No *quid pro quo* involved, although proof of payment may be needed to engage in specified activities	▪ Hotel / Guest house levy • Levy on motor vehicles and plying • Levy on fishing vessels • Levy on liquor establishments
III. Local Fees and Charges	▪ There is a specific *quid pro quo* ▪ Fees and charges are collected exclusively for cost recovery of the provided service	▪ User fees ▪ License fees • Market fees
IV. Contributions	▪ Payments that do not flow to the accounts of District-level LGA for the purpose of funding local government activities	▪ Village Contributions ▪ Cash or in-kind contributions to community projects ▪ Primary society contribution

As a second step in transforming the local revenue system, local revenue autonomy should be pursued within the context of a "closed list" of local taxes in order to achieve both objectives (a standardized, more efficient framework for local taxation, as well as local revenue autonomy and flexibility),. The existence of a "closed list" would ensure the overall legitimacy of the local government revenue system and would prevent onerous local taxes from re-emerging. Yet, the closed list approach would nonetheless provides local governments with the discretion to change local tax rates (within centrally established limits); the closed list approach should be defined in such a way that it provide flexibility to LGAs by allowing them to select from various different options of

definitions that are presented in Table 3; what is important is that a clear and consistent set of definitions is adopted and used in formulating the local government revenue system in Tanzania.

how to administer local taxes. As such, the reform of the local government tax system would allow for asymmetries in revenue assignments. For instance, the right to collect certain revenues might be subject to certain centrally-defined minimum conditions.

The reform should focus on the simplification of the current structure by combining several fragmented local taxes and levies into a small number of broad-based local tax instruments with a more significant revenue potential; the prime sources of local revenue would be the Unified Local Business Tax and a Local Property Tax. Compliance costs and horizontal inequities would be further reduced by the introduction of a nationally standardized framework for local revenue administration, which would assure that taxpayers across the country would face the some administrative processes and procedures, including the same local tax forms. Additional local revenues would also be collected from a number of Local Levies (local taxes with a specific tax base) as well as from User Fees. The framework for local government revenues would further be tightened by clearly defining the role of Contributions in the local government finance system, and providing additional context for village-level revenues.

In addition to the transformation of the current local revenue framework, the Government should also consider enhancing the fiscal space of local governments, which have the capability of providing considerable room for enhanced revenues and accountability at the local level. Possible new local revenue sources could include a “piggyback” Local Personal Income Tax Surcharge; the introduction of local excise taxes on utilities; or reassignment of annual Local Motor Vehicle registration fees to the local level.

Based on the objectives and desirable elements of the local revenue system, the local government financing study considered measures that could be taken to optimize the revenues from local sources. The specific recommendations are organized into, first, the reforms of the current system of local taxation (immediately below) and second, possible new revenue options.

Introduce a Unified Local Business (ULB) tax

The Local Government Finance Study (Section 4) recommends introducing a Unified Local Business Tax which would absorb (eliminate) the following current local taxes: the Service Levy, taxes on agricultural production (including the crop cess and the forest produce cess), business income taxes for minor settlements, fees on extractive production, and any other local taxes on productive activities. The ULB will also absorb (eliminate) the current Stamp Duty which is currently assigned to the central level.

The ULB tax is envisioned to be a broad-based presumptive tax on business income based on gross turnover. For smaller businesses or businesses that cannot produce turnover information the local government will assess fixed charges according to a centrally legislated schedule that will allow variations by type, size, and location of the business. These fixed charges by construction will make it a more expensive alternative for taxpayers than the general regime based on turnover. Tunisia’s local gross receipts tax

and Kenya's Single Business Permit provide examples of how the ULB might be formulated.

Given that the introduction of the ULB tax would be a major reform of the local tax system, a first step would be to pull together the various existing business taxes under a single "umbrella" tax instrument and to broaden the tax base to include all businesses and productive enterprises at the local level, including any business currently not taxed locally. Broadening the local tax base by reaching smaller businesses would improve horizontal equity in accordance with the benefit principle and would allow the rate structure to be set low by spreading the costs of local government services to all businesses that benefit from it, rather than by burdening only a narrow base of local businesses.

For enforcement purposes, the local authorities could issue an annual "*business permit*" or a "*certificate of payment*" as proof of payment of the ULB tax which businesses would be required to display on a permanent basis within their premises.

A subsequent step in the introduction of the ULB would be to harmonize the effective tax rates (and the schedular charges) applied to gross turnover across the different business activities and categories. Currently, the main tax rates range from 0.3 percent of turnover for the Service Levy and 2 percent for the Stamp Duty to 5 percent for agricultural products. However, given that the relationship between gross turnover and net income may vary across industries and sectors, it is not necessarily the case that the tax rate imposed on turnover for each type of productive activity under a presumptive local business income tax is necessarily the same. Furthermore, the ULB tax rate schedule should be harmonized with the differential rates imposed by central government taxes. Further study will be needed to determine the appropriate relative tax rates between different types of business activity in order to assure horizontal equity.

Continue strengthening the role of the local property tax

The property tax has been identified by many previous studies as one of the local taxes in Tanzania that has not lived up to its revenue potential. Numerous improvements should be made to the structure and administration of the property tax over time, across all facets of the tax, including improvements to the valuation, assessment, administration, collection, and enforcement of the property tax.

Two additional measures in the realm of property taxation are to be pursued. First, assign the Land Rent exclusively to the local government level or (perhaps more politically viable) shift revenue sharing from the current 80/20 sharing (in favor of the Ministry of Lands) to 20/80 in favor of districts. Ultimately, the Land Rent should be fully integrated into the property tax. Second, the environment should be strengthened for imposition of Betterment Levies by encouraging local councils (subject to rules and conditions set in the reformed Local Government Finance Act) to levy a special property rate to cover the costs of capital infrastructure developments with identified localized benefits for a

limited number of properties in the ratable area, such as street lighting, sidewalks, and so on.

Local levies (licenses) and User Fees and Charges

With respect to local levies (licenses) and local user fees and charges currently on the book (including the business and professional license fees not absorbed into the ULB tax), the assessment recommends generally keeping these revenue sources and realigning them in accordance with the proposed new local revenue classification. Of all the business and professional license fees currently on the books, the Government should reconsider the implications of imposing a license fee on private health facilities. Given the trend in public health provision in Tanzania to move away from user fees and given the desire to assure broad-based access to health care services, it might be appropriate to eliminate the license fee on private health facilities.

With the exception of the billboard fee (which should become a variable business license, not based on the cost recovery principle), the current administrative fees currently provided in Schedule 1 of the LGFA should be kept. The fee schedule imposed by each local government for these user fees should be guided by the principle of cost recovery for the specific activity. While this means that LGAs might set different rates for these local administrative fees and charges based on cost variations, these local fees may not exceed levels necessary for cost-recovery.

Consider the introduction of a formalized Village Contribution

During the 2003 Budget Speech, the Minister indicated that the abolished Development Levy would be replaced with a more appropriate village-level revenue instrument. However, as of yet, no formal village-level revenue sources have been introduced. Instead, village councils rely on all sorts of informal and "voluntary" village contributions (which are permitted –but not well-defined- under the current "closed list").

Box 2
A formalize Village Contributions scheme

A formalized Village Contribution scheme could have the following features:

- The administration of an annual Village Contribution would be guided by an official (yet simple) administrative manual issued by PO-RALG.
- The Village Contribution would have a simple, graduated structure. Village councils would have discretion over the rates, within the limits set by the guidelines. The contribution scheme would be optional; instituted only on the action of the Village Council.

- The collection, administration and use will be fully entrusted to the village level (VEO). As a condition to use this funding source, villages would be required to follow basic participatory procedures in determining the tax rate and keep a book of accounts. The District Treasurer would annually audit the village accounts.
- The Village Contribution could have a simple, three-tiered structure. The Village Council could set the standard charge per adult of working age in a pre-determined range (e.g., from TSh 100 to Tsh 1000 per person). In addition, the contribution would be subject to a maximum of, say, TSh 2000 per household.
- For poor households, a zero-rated tier would be introduced. Qualification for this rate would be based on a "pauper certificate" issued by VEO with public notification and Village Council approval. Those with a "pauper certificate" may be required to provide an in-kind labor contribution (based on predetermined criteria).
- The Village Council will optionally be able to impose a higher rate on wealthy household based on assessment of "conspicuous consumption". Conspicuous consumption would be assessed by the VEO based on a list of specific criteria (ownership/use of automobile or motorcycle; children attending a private school; salaried employees above certain threshold, and so forth). The higher rate for the Village Contribution would be set at twice the standard rate (subject to a per-household maximum twice higher as well).
- Certificates (or tokens that could be affixed to residences) could be provided to households to signify compliance. While village tax collectors would have discretion to administer the tax in a flexible manner, the enforcement of the tax would be community-based.

In addition to the reform or elimination of current local taxes, there are also a number of significant and efficient taxes, fees and charges that could serve as potential sound local revenue sources that are currently not being used at the local government level. Our suggestions include the following possible local revenue sources, which adhere to the principles associated with sound local revenue sources:

- ***Local Personal Income Tax Surcharge.*** A possible appropriate new local revenue source is the introduction of a local surcharge (or piggyback tax) on the central government's personal income tax. Such a surcharge would be collected by TRA and would be credited regularly (e.g., monthly) to the respective local government accounts, desirably on a residence basis (as opposed to the place of work). The local surcharge income tax could be levied on the exact tax base of the central government personal income tax, although local governments would have discretion to set a flat (proportional) rate within nationally defined minimum and maximum rates.

- ***Local excise tax on utilities.*** The Government could consider the introduction of a Local Excise Tax on Electricity Consumption (and/or other utility services). Such an excise tax would conform to both the benefit principle as well as the ability-to-pay principle. The taxes could be collected by the utility companies at rates set by the local governments from a range with maximum and minimum rates determined by central government regulations or legislation.

- ***Motor Vehicle Registration***. We recommend reassigning the Annual Permit

associated with the motor vehicle registration that is currently collected by the TRA district offices to the local government level.

- ***Revenue sharing from extractive industries.*** For consideration in the medium to long run, the Government should explore some degree of revenue sharing of taxes on extractive industries with local governments. Further discussion and analysis would be needed to determine whether this option is administratively feasible and desirable.

As noted above, in order to promote a legitimate local government revenue system, provide a stable local business environment, and minimize the compliance burden faced by taxpayers from local government taxes, the administrative of local revenues should be guided by detailed set of nationally standardized local revenue administration guidelines. For each local tax, these guidelines should provide a clear definition of the taxpayer and the tax base; the valuation of the tax base; the administrative procedures in collecting the revenue (including the tax forms to be used); as well as any enforcement and appeals procedures. Standardization of local tax administration will also enable central government officials to more systematically monitor the collection of local government revenues and to assist in building local government tax administration capacity. Significant capacity will have to be built at the central government level to guide local government taxation, while the rolling out of the new local revenue system should incorporate extensive capacity building support for local revenue administration officials.

Given that one of the most noted reasons for low levels of local revenue compliance is the absence of a link between local revenues and local expenditures, other steps to be taken to encourage greater local revenue performance including, first, an increase in the participatory nature of the local budget process and greater transparency in how local resources are spent, and second, the introduction of a general-purpose grant to cover local administration expenditures (enabling LGAs to provide better value-for-money for local services). Rolling out of the new regulatory framework for local government revenues should be accompanied by an intensive series of seminars and capacity building workshops for local government officials. The transformation process should involve every LGA going through a process of identifying gaps between their current local revenue structure and the new permitted list of local revenues, as well as any gaps between their local revenue administration practices and the regulatory guidance contained in the nationally standardized regulatory framework for local revenues. Local governments should then be provided sufficient time (and possibly limited external support) to develop and implement reforms to come into compliance with the new local government revenue system.

A concerted effort will be needed to ensure the transformation of local government revenues into a sound local revenue system. The FDTF, in close collaboration with the TRTF, should instigate a participatory process that includes central government stakeholders, local government representatives, as well as private sector stakeholders and civil society to determine the final structure of the new local government revenue system. After a consensus reform package is attained, LGRP should draft the necessary revisions

to the LGFA, develop standardized local tax regulations and a local tax administration manual, and roll out the reforms to the local government level. Technical assistance will be needed to not only develop the policy framework (including legislative changes and the drafting and the regulatory and administrative manuals) but also to orchestrate and support the rolling-out of the reforms to the local level.

5. The intergovernmental fiscal transfer system

In addition to own revenue sources, the intergovernmental transfer system plays a central role in the framework for local government finance in Tanzania. The transfer mechanism has provided –and should continue to provide- a large majority of local government resources. The intergovernmental transfer system should be structured to provide four different types of intergovernmental transfers, notably:

1. A set of recurrent sectoral block grants for priotiy sectors, including primary education; local health services; agriculture extension and livestock; water supply; and local roads.
2. A General-Purpose Grant (combining the current administration grant and the existing Compensation Grant/GPG).
3. A Local Government Capital Development Grant system
4. Where appropriate, ministerial subventions should be provided in a transparent manner for delegated functions

The system of intergovernmental fiscal transfers should be consistent with the vision laid out in the Government's Policy Paper on Local Government Reform (MRALG, 1998), as well as with the principles of sound transfer design formulated by GSU (2003) (see Box 3). Most importantly, all transfers provided to the local government level should be allocated in an objective, formula-based, transparent and fair manner.

Box 3
Principles in the Design of a Formula-Based Allocation Mechanism

Universal principles of sound transfer design

- Provide revenue adequacy: A transfer formula should provide a source of adequate resources to local governments to achieve its policy objectives.
- Preserving budget autonomy: A transfer system should balance budget autonomy at the local level with the constraints provided by national priorities
- Enhancing equity and fairness: The transfer mechanism should support a fair allocation of resources.
- Stability: Transfers should be provided in a predictable manner in a dynamic sense.
- Simplicity and transparency: Transfer formulas should be simple and transparent, and should pursue one objective at a time.
- Incentive compatibility: The transfer system should not create negative incentives for local

revenue mobilization, and should not induce inefficient expenditure choices.

- Focus on service delivery: Transfer formulas should focus on the demand (clients or outputs) rather than the supply (inputs and infrastructure) of local government services.
- Avoid equal shares: Reliance on the "equal shares" principle as a major allocation factor should be avoided in the design of an allocation formula.
- Avoid sudden large changes: The transfer system should avoid sudden large changes in funding for local governments during the introduction of the new transfer mechanism.

Desirable characteristics of allocation factors

- Accuracy: The variable should accurately reflect the specific characteristics and should be statistically sound.
- Regularly updated: The variable should be regularly updated in the future.
- Independent source: The variable should come from an independent source respected by all stakeholders
- Free of local manipulation: The variable should be drawn from a source that cannot be manipulated by local governments (unless the central government has an adequate capacity to monitor and verify locally reported statistics).
- Reflect needs or demands: The variable should reflect needs or demands for public goods (for example, the number of clients) rather than outputs such as infrastructure.

Source: Intergovernmental Transfer Study (GSU, 2003).

Formula-based recurrent sectoral block grants.
The most important funding modality in Tanzania's system of local government finance in terms of financing local government activities is the system of recurrent sector block grants. Five sectoral block grants should be present: one for each of the five priority sectors that deliver services at the local government level, notably primary education; local health services; agriculture extension and livestock; water supply; and local roads. The purpose of each sectoral block grant mechanism is to fully finance the provision and maintenance of essential sectoral activities at the local government level. Each sectoral block grant provides funding both for PE and OC.

Size of the transfer pools. Over the past years, the central government has consistently allocated 17-18% of the central government's recurrent budget to local government activities in the priority sectors. As sectoral block grants exclusively fund pro-poor government activities at the local government level (which is both true under the sectoral approach of PRS I, as well as under the cluster approach of PRS II), we would expect for the total pool of sectoral block grants to increase faster than the entire central government budget. Also, as sectoral pooled funds (such as PEDP and the Common Health Basket Fund) are increasingly integrated into the regular sectoral block grant system, we should expect the overall percentage of recurrent transfers in the central government budget to increase to 20-25 percent in the medium term.

As the local government sector is currently expanding, it would be limiting to specify the size of transfer pool based on a fixed rule. Instead, for the time being, the size of each sectoral transfer fund could be determined on an annual basis as part of the budget process in the context of the Government's strategic policy objectives, as reflected in the MTEF, PER and NSGPR (see Box 4).

Box 4
Determining government priorities and establishing the size of transfer pools

The central government's budget process is supposed to drive spending changes from year to year in line with the government's strategic priorities. The budget formulation process is guided by the PRS, PER and MTEF frameworks. For central government agencies, the Budget Frame (which is prepared from October-December for next budget year) determines the relative sectoral policy priorities for the country. This process of prioritization is currently being modified with the introduction of PRS II (or the National Strategy for Growth and Poverty Reduction NSGPR) to more closely align government spending practices with its policy priorities.

Under the new poverty reduction strategy (PRS II or NSGRP), sector ministries are supposed to prepare their budget requests in the context of a poverty-focused, clustered "performance-based" budget analysis, by which the increased budget request is supposed to be tied to expected increases in public service outputs and, ultimately, NSGRP outcomes. Customized software was introduced by the Ministry of Finance as part of the FY 2005/06 Budget Frame to guide sector ministries in prioritizing their spending programs.

Unfortunately, the sectoral block grants were considered in the Budget Frame outside the context of other sectoral allocations, thereby creating a disconnect between sectoral spending and goals at the central government level, and sectoral activities at the subnational level. As such, the budget formulation and its implementation should be fine-tuned, which will enable the size of the sectoral grant pools (i.e., the vertical allocation) to be determined as part of the broader budget frame.

Horizontal allocation of resources. Once the size of the sectoral block grant pools are determined, sectoral allocation formulas are applied to these transfer pools in order to distribute these resources among all local government jurisdictions (see Table 4). In order to assure stability in the system of local government finance, these formulas should be held constant for a period of three years after which their impact should be re-assessed. The Fiscal Analysis & Coordination Group should monitor that these sectoral formulas are accurately applied in distributing sectoral block grant resources to the local government level.

During the first few years of the formula-based grant system in 2004, phasing-in and holding-harmless provisions were put in place to assure no major deviations from historical allocations would take place that would derail the reforms. This means that

during the first few years of the new formula-based grant scheme, local governments may be receiving a block grant allocation that is either more or less than the particular amount determined by the formula.[4] However, these mechanisms were put in place as transitional features only. As a result, the Government should take proactive steps to achieve convergence between the existing allocation levels and formula-based allocations with the goal of eliminating these transitional mechanisms by FY 2007/08; it should be the intention of the government that by this year, all LGAs receive their formula-based amount. Particularly in the agriculture and livestock sector, as well as in water supply and local roads, significant sectoral adjustments will need to occur to achieve convergence of local sectoral resources in accordance with the formula-based sectoral block grant system.

Table 4
Sectoral Allocation Formulas

Sectoral grant	**Grant Pool FY 2004/05**	**Allocation formula**
Primary Education	TSh 245.9 billion	Number of school-aged children: 100% (plus earmarked amount for special schools)
Health Services	TSh 63.6 billion	Population: 70% Number of poor residents: 10% District medical vehicle route: 10% Under-five mortality: 10%
Agriculture Extension	TSh 13.9 billion	Number of villages: 60% Rural population: 20% Rainfall index: 20%
Water	TSh 11.2 billion	Equal shares: 10% Number of unserved rural residents: 90%
Local Roads	TSh 5.0 billion	Road network length: 75% Land area (capped): 15% Number of poor residents: 10%

Use of transfers at the local government level. The local government budget guidelines issued to LGAs provide policy guidance and conditionalities with respect to the manner in which these resources can be used at the local government level. These guidelines are intended to provide policy direction to local governments in making local spending decisions. The guidelines are intended to do so in an objective and verifiable manner, that does not unnecessarily restrict the autonomy of LGAs to respond to local community needs. The local budget guidelines should be prepared annually by PO-RALG in close collaboration with the Ministry of Finance; the guidelines should be reviewed each year by the Fiscal Analysis & Coordination Group.

[4] See LGRP/GSU. 2005. The implementation of the formula-based grant system in Tanzania: Convergence of phasing-in and holding harmless provisions. Technical Note 2005-2.

Box 5
Inclusion of intergovernmental transfers in the central governments budget processes

As the initial introduction of sectoral block grants is taking place, a number of subsidiary challenges is arising with regard to the inclusion of intergovernmental transfers in the central governments budget processes. In order for the system of local government finance to work, the transfer system has to be well-integrated into the central government's budget formulation and execution processes.

- As already noted in Box 4, intergovernmental transfers have to be integrated into the central budget formulation process. For instance, sectoral block grants should be identified as separate items in the MTEF. The Local Government Fiscal Review could be absorbed into the annual PER/PRS processes.
- The current budget structure for intergovernmental transfers (organized around 21 regional votes) was appropriate in a centralized, deconcentrated public sector, but may not be appropriate for a more decentralized, formula-based system of local government finance. Different approaches to inclusion of sectoral block grants in central government budget should be considered.
- The current level of detail with which local government spending from transfers is included in the central governments budget document is excessive and impractical. The manner in which intergovernmental transfers are documented by the central budget process needs to be reconsidered. This may have an impact on the budget classifications and budget approach that local governments are supposed to follow (MTEF, PRS clusters, etc.)
- The current budget process allows for a lapse in budget control at the central government level to the extent that local governments are able to increase their personnel emoluments beyond the resources available to them through the formula.
- Efforts need to be made to monitor that intergovernmental transfers are indeed disbursed as planned. Likewise, a financial reconciliation needs to take place at the end of the year.

These steps will be critical is assuring the efficient and transparent allocation of intergovernmental fiscal transfers, as well as for consolidating the progress made thus far in the reform of the intergovernmental fiscal transfer system.

An unconditional, equalizing General-Purpose Grant

The objective of the General-Purpose Grant (GPG) is to provide unconditional financial resources to local government authorities in order to assure that the local government level is provided with adequate resources (vertical fiscal balance). The General Purpose Grant should be disbursed in an equalizing manner, so that LGAs with higher local expenditure needs (outside the priority sectors) and lower fiscal capacity receive a greater transfer.[5]

Size of the transfer pool. Given the coverage of the other transfer schemes and spending from own source revenues, the General Purpose Grant should be adequate to cover, first,

[5] In this sense, the envisioned GPG is distinctly different from the current GPG/Compensation Grant, which was renamed the GPG in 2004 but which has an incidence which is decidedly not pro-poor.

the cost of local government administration, and second, part of the cost of non-priority local government activities. It was earlier noted that it is appropriate to fund local administration from central government resources since local governments are an integral part of Tanzania's national system of public administration, and since the predominant responsibility of local government authorities is to provide nationally-mandated public services.

Based on current spending patterns for local government administration, the size of the GPG transfer pool should be at least TSh 50 billion, as the overall cost of administering local governments lies approximately around this amount (the figure of TSh 50 billion is based on roughly TSh 20 billion which is currently provided by the Local Administration Grant and approximately TSh 30 billion -about 50% of Tsh 60 billion- of local own source revenues that are currently spent on administration). To the extent that the GPG is also provided as a supplement to own source revenues for funding non-priority local government spending, the GPG should exceed this minimum threshold. In the budget frame for FY 2005/06, a combined TSh 60 billion is set aside for administration and the general purpose grant. A possible vertical sharing rule for the GPG could be determined as 15% of total sectoral block grant allocations.

Horizontal allocation of resources. Given that the purpose of the general-purpose grant mechanism is to provide resources for local administration and general (non-sectoral) local purposes in an equalizing manner, it would be important to include measures of local needs and local fiscal capacity, and to provide greater resources to local governments that have greater expenditure needs and a more limited ability to raise own revenues. However, as suggested by the previous studies, the data to adequately measure local fiscal capacity in Tanzania are currently lacking.[6] As a feasible and more practical alternative, the allocation formula for the General Purpose Grant could be built around a number of fiscal needs measures, such as population, land area, and the poverty incidence, with the knowledge that fiscal capacity in Tanzania is inversely related to land area and poverty.

As such, a good starting point for the discussion of the general-purpose grant formula could be the current formula used for the capital development grant system: population 70%, poverty 20%, and (capped) land area, 10%. Introducing such a formula would mean that although the GPG formula would provide additional resources to all local governments, it would assure that poorer, rural local governments would receive a larger allocation from the grant mechanism. Such a formula based approach would be a significant improvement over the current discretionary (and counter-equalizing) allocation of general-purpose resources.

Use of transfers at the local government level. Although the General-Purpose Grant is intended to be basically an unconditional grant, some restrictions on the use of this

[6] In order to come up with an objective measure of fiscal capacity (which measures the revenue raising potential of a local government rather than the actual revenues raised), we would not only need to be able to measure the actual revenue collections of a jurisdiction, but also the size of the local economy or the size of the local government's tax base.

funding have already emerged. For instance, the administration grant is currently specifically earmarked for administrative purposes while it also includes an earmarked component for funding firefighting equipment. Likewise, when the Compensation Grant was introduced, the guiding circular instructed local governments that these resources should be allocated in the same manner as the eliminated own revenues, but then proceeded to mandate that a certain share of the grant (currently 50%) should be shared with the Village-Level. Any specific conditions on the General-Purpose Grant should be removed, so that the general-purpose grant takes on the nature of a true unconditional grant. Any general conditions on sound local government administration (such as the resource-sharing between district and village level) should be introduced as part of the overall Local Government Financial Management Manual, and should apply broadly across all general-purposes resources at the disposal of local governments (i.e., both unconditional grant as well as own source revenues).

Capital development grants

In principle, the Local Government Capital Development Grant scheme which was developed with support from the World Bank's Local Government Support Project (LGSP) and rolled out in April 2005 provides a sound and well-integrated element of the overall strategic framework for local government finance.

Size of grant pool. Based on thorough analysis of the investment needs and costs, the LGA absorption capacity, experiences from other programs and grant schemes, and the supply side (the availability of the funds), it is planned to have an average annual allocation of capital grants of US$1.50 per capita. The optimal size of the capital development grant was determined using qualitative analysis based on international experiences, balancing the available resources from the donor community and the government with the expected absorptive capacity of local government authorities.

Horizontal allocation. It has been decided that the following formula and weighted elements will be used in distributing the CDG capital grant funds: population (70%); poverty indicator (20%); and land Area (10%).

The allocation formula adopted by the CDG is fully consistent with the sound principle of transfer design as laid out by the intergovernmental transfer study (GSU, 2003). The formula allocates greater resources to poorer local government authorities, as well as to geographically larger local government districts (in other words, rural district authorities). This is consistent with a needs-based equalization approach. As the CDG system evolves over time, the allocation formula should be reviewed from time to time to assure that the formula achieves the policy objectives that it is intended to secure.

Local use of resources. The capital development grant will cater for a broad range of investments in infrastructure and service provision within the mandates of the LGAs. The grant will be a non-sectoral discretionary capital transfer to LGA for capital investments in new infrastructure and rehabilitation of the existing stock. Councils that do not meet the performance conditions for capital development funding but do meet (lower) minimum conditions will receive a capacity building grant. LGAs can use these resources

according to their own priorities for improvement of their performance and enhancement of their capacities.

While the CDG is an important step in the process of arriving at a unified capital development funding mechanism, the current design of the CDG simply lumps together capital development spending for the key priority sectors (e.g., building classrooms, clinics, and so on), and capital projects that are truly local in nature (e.g., minor roads, local markets, other local infrastructure, and so on). The next step for the CDG system should be to widen the CDG system by incorporating potential sectoral "windows" for formula-based sectoral capital development transfers under the same overall mechanism. In that case, all capital development funding schemes -including sectoral capital development grants- could be planned and budgeted as part of the comprehensive local budget process, and could flow through the same budgetary mechanisms and accounts at the local level.

Ministerial subventions and private donations

To the extent that intergovernmental transfers are intended to fund devolved delivery of services (such as the case in primary education, basic health care and so on), intergovernmental fiscal transfers should all be provided through (and not around) the sectoral block grant mechanism. Likewise, the donor community should avoid creating parallel financing structures (either within the context of the central government budget, or completely around the public budget) that by-pass both central government and/or local government budgets.

The funding of functional responsibilities which are delegated by central government ministries to the local government level (as opposed to "devolved" to the local government level) may be appropriately achieved by earmarking transfers within ministerial budgets, as long as these resources are clearly identified, the allocation between jurisdictions is done in an objective, fair and transparent manner, and the Ministry of Finance (BD/RALG Section) and PO-RALG (through the LG FA&CG) are advised of the distribution. The annual budget will have to note the purpose for which these resources are earmarked, and confirm that this activity is indeed not a devolved function.

7. Local government borrowing

There is a need to cast a wider role for local government borrowing in Tanzania than is currently the case. The Local Government Loans Board views its own role in a very narrow manner; its current mode of operations gives the Board substantial discretion in selecting local projects to be funded, and is viewed by many to favor poorer, rural districts in its funding decisions. While the current borrowing mechanism for small-scale local capital investment under the LGLB might continue to form an element of the local

borrowing framework, a single lending window will not adequately accommodate the borrowing needs of all local government authorities in Tanzania.

As such, a separate on-lending window ought to be established with the purpose of providing loans to wealthier local governments. In order to prevent administrative duplication, if administratively feasible, it would be desirable to have the LGLB's Secretariat administer this new loan window. However, this may require a further re-orientation and strengthening of the LGLB, and will need close cooperation and concurrence from the Ministry of Finance. There should be access criteria (based largely on the minimum access conditions for the CDG scheme), and limitations on borrowing levels to ensure that only creditworthy LGAs are able to access the lending mechanism. Great care needs to be taken to assure that the local government borrowing framework operates as an integrated part of the larger local government financing system, rather than "competing" with other financing mechanisms for financial and human resources.

8. Institutional framework for local government finances

Decentralized fiscal systems are unlikely to function efficiently without an appropriate degree of oversight, monitoring and coordination among the different levels of government. Coordination is needed in the various aspects of intergovernmental relations: coordination between the central government and local governments (so-called vertical coordination) on the execution of local government responsibilities; coordination between central government tax system and the local tax system (involving the Ministry of Finance, the Tanzania Revenue Authority and PO-RALG); coordination between PO-RALG, Finance, and the various line ministries regarding the structure of the system of intergovernmental transfers, coordination in the development of the framework for local government borrowing. Coordination between central government agencies on intergovernmental fiscal issues can be referred to as "horizontal" coordination.

Although significant progress has been made in strengthening the institutional framework on local government finances (particularly through the Coordinating Block Grant Implementation Team, CBGIT), the institutional context is becoming increasingly important in order to consolidate the progress in local government finance reform made over the past several years. Specific observations and recommendations include:

- There is a need to continue to strengthen the management of local government finances at the central government level, including strengthening the ability of both the Ministry of Finance and PO-RALG to fulfill their respective responsibilities in the realm of local government finance. For PO-RALG, this will require building stronger capacity in the new LGA Finance Unit (including in the area of local government revenues). The Ministry of Finance could significantly benefit from attracting a Local Government Finance Expert who could assist the Ministry in refocusing its fiscal processes surrounding local governments across the Budget Department and Policy Analysis Department.

- At a technical level, there is a need to continue strengthening inter-ministerial cooperation, in particular through the formalization of the CBGIT into a permanent inter-ministerial Fiscal Analysis and Coordination Group.
- As PO-RALG is moving to introduce a Directorate of Sector Coordination, it is becoming increasingly clear that sector ministries are not well-structured to deal with local governments. Whereas previously in the centralized system local sectoral offices were simply a deconcentrated extension of the line ministries (so that all line ministry directors were free to interact with local sectoral officers), now a sectoral Director or Coordinator for Local Government Services would better facilitate coordination and communication between central and local government levels.
- Whereas the Fiscal Analysis and Coordination Group provides a coordinating mechanism at a technical level, there is a need for a more formal coordinating mechanism at a policy level. Rather than creating additional parallel structures such as a Local Government Finance Commission, it is recommended that PO-RALG convenes an annual Local Government Fiscal Consultative Forum (possibly in October of each year). The annual Local Government Fiscal Review can be presented at this time to help identify the government's priorities pertaining to local government finance issues early on in the budget process.
- In order to make the benefits from decentralization sustainable, there is a need to significantly improve communication with the private sector and civil society, as well as strengthen the role of local governments (individually and through their associations) as well as NGOs and civil society in the debate surrounding local government finance.

9. Areas of reform / Next Steps

It was noted earlier in this document that although the current system of local government finance has a number of shortcomings, the overarching structure of the current system of local government finance is quite sound. The historical policy direction of the Government on local government finance has been prudent and is consistent with overall sound principles for decentralization reforms. In general, the legislative framework provides appropriate guidance, although the relevant laws should be revised to eliminate outdated, duplicative or contradictory clauses. Although the local government revenue system has not received adequate attention in recent years, substantial progress has been made on transforming the previously highly discretionary transfer system into an objective, transparent, stable and pro-poor funding mechanism for local governments.

While in most respects the overall structure is sound, specific steps need to be taken to transform the components of the current local government finance system that need sharpening and fine-tuning in order to arrive at a comprehensive local government financing framework that is well-integrated and internally consistent.

Broadly, three concrete areas of reform can be identified that need to be pursued in order to achieve the desired strategic framework for local government finance. As detailed in

Table 5, these three areas include, first, continued policy support and institutional strengthening at the central government level; second, the transformation of the local government revenue system (including local tax administration); and third, improvements of the financial management processes at the local level and strengthening of the role of LGAs and civil society in the decentralization process.

Table 5
Proposed next steps for the implementation of the strategic framework for local government finance

Reform Component	Activities to be undertaken
I. Continue policy support and institutional strengthening at the central government level	▪ Finalize the introduction of a formula-based transfer system (include equalizing GPG) ▪ Assure the proper integration of transfers in the national budget process ▪ Formalize and strengthen the LG FA&CG, and continue strengthening PO-RALG, MOF, and other stakeholders ▪ Review and revise the legal framework on expenditure assignments, transfers and other fiscal issues ▪ Develop and introduce a Supplementary Loans Mechanism (through LGLB)
II. Transformation of local government revenues and local tax administration	▪ Determine the final composition of the local government revenue structure and an implementation plan ▪ Develop a comprehensive, standardized local revenue administration manual ▪ Implement the new local government revenue structure and build the capacity of local governments to administer the new revenue sources
III. Improvements of financial management at the local level and strengthening of the decentralization process outside the central government	▪ Systemic review and reform of LG budgeting process and financial management procedures, including monitoring and reporting mechanisms ▪ Develop the institutional framework for supporting local government finance outside central government (e.g., support to ALAT, the development of an Institute of Local Government Studies for Local Government Finance Officers Association)

Achieving the strategic framework for local government finance envisioned in this document is an achievable objective. Most importantly, achieving this policy vision will first require consensus among all involved central government agencies –and ultimately Cabinet. Once such consensus has been achieved, coordination within and between the various stakeholders (including PO-RALG, the Ministry of Finance, PO-PSM, as well as other agencies) is needed to assure that the different components of the local government finance system fits together in an integrated manner. Whereas the Fiscal Decentralization Task Force is well-positioned to oversee the overall implementation of the various reform efforts, close coordination is needed with a variety of other reform programs, including the Tax Reform Task Force (with regard to the transformation of the local government revenue system); Public Service Reform (with regard to the coordination between budget planning processes and the planning and implementation of the PE budget); and the Public Finance Management Reform Program (with respect to the integration of local government finances into the national budget formulation, execution and reporting processes).