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Local Government Finance Reform in Developing Countries

The Case of Tanzania

Jameson Boex and Jorge Martinez-Vazquez

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List of Abbreviations

ALAT	Association of Local Authorities Tanzania
CAG	Controller and Auditor General
CBGIT	Coordinating Block Grant Implementation Team
CCM	Chama Cha Mapinduzi
CDG	Capital Development Grant
CRT	Council Reform Team
CSD	Civil Service Department
DAS	District Administrative Secretary
DAU	Dana Alokasi Umum (Indonesian General Allocation Fund)
D-by-D	Decentralization by Devolution
DC	District Commissioner
DED	District Executive Director
DEO	District Education Officer
DMO	District Medical Officer
FDTF	Fiscal Decentralization Task Force
FY	Fiscal Year
GPG	General Purpose Grant
GSU	Georgia State University
HIPC	High Indebted Poor Countries initiative
IMF	International Monetary Fund
JGDR	Joint Government Donor Review
LDC	Lesser Developed Country
LGA	Local Government Authority
LGCDG	Local Government Capital Development Grant
LGFC	Local Government Finance Corporation
LGLB	Local Government Loans Board
LGRP	Local Government Reform Programme
LGSP	Local Government Support Programme
MDA	Ministries, Departments and Agencies
MRALG	Ministry of Regional Administration and Local Government
MTEF	Medium Term Expenditure Framework
NBS	National Bureau of Statistics
NMS	National Minimum Standards
NSGPR	National Strategy for Growth and Poverty Reduction
OC	Other Charges
O&OD	Opportunities and Obstacles to Development
PE	Personal Emoluments
PEDP	Primary Education Development Programme

PER	Public Expenditure Review
PETS	Public Expenditure Tracking Survey
PO–PSM	President's Office—Public Service Management
PO–RALG	President's Office—Regional Administration and Local Government
PMG	Planning and Management Guide
PRS(P)	Poverty Reduction Strategy (Paper)
PWC	PriceWaterhouseCoopers
RAS	Regional Administrative Secretary
RC	Regional Commissioner
REPOA	Research for Poverty Alleviation
RS	Regional Secretariat
TASAF	Tanzania Social Action Fund
TRA	Tanzania Revenue Authority
TSh.	Tanzanian Shillings
UAPP	Urban Authorities Partnership Project
ULB	Unified Local Business tax
UNCDF	United Nations Capital Development Fund
URT	United Republic of Tanzania
VAT	Value Added Tax
ZRT	Zonal Reform Team

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1

An Overview of Local Government Finance Reform in Tanzania

In recent years, developing countries all around the world have been embarking on ambitious decentralization programs. While the impetus for these reforms has come from different sources, in many countries the emphasis has been on greater economic efficiency and growth, and even the need to fight poverty by providing poor rural households with access to basic services. In this light, the Government of Tanzania has been actively pursuing the reform of the role that local governments play in the public sector and the manner in which local government activities are financed. Although local government authorities in Tanzania have played a substantive role in the delivery of key government services since the mid-1980s (including primary education and basic health care), the central government has traditionally maintained tight control over most resources provided to local governments.

At the moment, Tanzania is moving rapidly from being one of the most fiscally centralized countries in Africa (to the extent that until recently local governments virtually had no control over their own budgetary resources) to one of the most soundly decentralized systems on that continent. The backbone of Tanzania's drastic reformulation of its system of local government finances is a formula-based system of intergovernmental grants that was introduced in 2004. Secondary reforms being pursued in Tanzania in the realm of local government finance include the strengthening of local planning and budget processes, the rationalization of the local government revenue system, and the possible transformation of the local government borrowing environment. As Tanzania moves forward in implementing these reforms, the country is poised to become one of Africa's best practice examples and success stories with respect to fiscal decentralization reform.

Successfully reforming one's system of local government finances is no easy task, particularly for developing countries. While over 75 developing and transition countries worldwide have pursued decentralization reforms since around 1980 (Ahmad *et al.*, 2005), only a handful of countries are recognized as having been (partially) successful in achieving their objectives.

The ongoing success of Tanzania's decentralization reforms is especially noteworthy since the country is one of the least developed economies in Africa, and thus provides an opportunity to consider "what went right" in its reform of local government finances. This is the overarching motivation for the current book.

The critical importance of a sound local government finance system is easily overlooked, especially in the context of developing countries which sometimes even lack the financial resources and the administrative capacity at the central government level to provide some of the most basic public services. However, in recent years increasing recognition has been given in the international development community to the shortcomings of centralized, top-down development initiatives, as decentralization offers a clear alternative to the failed interventionist and centralized policies of the post-WWII period. Besides the basic economic efficiency argument, proponents of decentralization reform argue that decentralization can have a dramatic positive impact on the well-being of a nation as it brings public sector decision-making substantially closer to the people. Hence, before proceeding to the specific case of Tanzania's and its system of local government finances, our first goal in this introductory chapter is to identify the importance of local government finance reform in the context of a pro-poor development strategy (Section 1.1).

Next, this introductory chapter provides some of the historical background needed to place Tanzania's current local government finance reforms in the proper context. Section 1.2 provides a brief history of local governments and local government reforms in Tanzania since independence, followed by an overview of the main elements of Tanzania's current system of intergovernmental fiscal relations (Section 1.3). We close this introductory chapter by discussing how the remainder of this book is organized (Section 1.4).

1.1 The role of local governments and local government finances in a pro-poor development strategy

Fiscal decentralization and local government finance reform is an important policy strategy in many, if not most, developing and transition countries. While decentralization reforms are used to pursue different goals in different countries, local government finance reforms are commonly pursued with the goals of assuring improvement in the delivery of key services, such as education and health care; empowering local communities by increasing participation and accountability of the public sector through local governments; and increasing the transparency and equity with which public resources are allocated across the national territory. In the context of the poorest and least developed economies, including Tanzania, improving public service delivery and assuring that services are delivered in an equitable manner—including in the context of a national poverty reduction strategy (PRS)—takes on even greater urgency.

Decentralization has been defined as the transfer of authority and responsibility (including fiscal authority and responsibility) from the central government to subordinate or quasi-independent organizations or the private sector (Litvack and Seddon, 1999). This somewhat mechanical definition understates the important role that local governments may play in the public sector in countries around the world. Some 95 per cent of democracies around the world have elected subnational governments, and countries everywhere—large and small, rich and poor—are devolving political, fiscal, and administrative powers to subnational tiers of government (World Bank, 1999). While some countries rely more on subnational governments in providing public services than do other countries (with subnational governments' share of public spending ranging from virtually nil to over 50 per cent), virtually every country around the world requires a system of intergovernmental fiscal relations to assure the proper funding of subnational government activities. In fact, the period 1990–2005 has seen a series of countries engage in high-profile reform of their intergovernmental fiscal relations in order to accommodate new political and economic realities, including countries such as Indonesia, the Russian Federation, South Africa, Uganda, and Tanzania.

In contrast to the more traditional definition of fiscal decentralization, a more recent attempt to define decentralization provides a clearer explanation as to why decentralization has been a popular reform theme in developing and transition economies. By way of a working definition, Bahl (2005b) defines fiscal decentralization as "the empowerment of people by the [fiscal] empowerment of their local governments". This definition, in line with an emerging policy literature on community-based development, underscores that the underlying objective of decentralization is to empower local communities by giving them greater control and choice over the public services they receive, their public finances, and the elected public officials that manage their affairs. As such, on one hand, successful decentralization can greatly improve the efficiency and responsiveness of the public sector while accommodating variations in demand for public services across the national territory. On the other hand, if decentralization reforms fail to properly empower local communities while weakening central government controls, such unsuccessful decentralization reforms can contribute to economic and political instability and severely disrupts the delivery of public services.

Given the major cross-sectoral implications of any local government finance system, the topic not only requires attention from public finance specialists within the Ministry of Local Government and the Ministry of Finance, but also warrants consideration from policy makers and development experts across a wide variety of government sectors, especially from those sectors that rely on local governments to deliver sectoral services. The impact of local government finance on the implementation of a pro-poor development strategy is based on a number of important political, economic, and social considerations.[1]

Local governments deliver key social and economic services

Traditional public finance theory suggests that under certain conditions local governments are able to provide public services more efficiently and are better able to respond to the needs of local communities than a single central government (Tiebout, 1956; Oates, 1972). In accordance with the subsidiary principle (as discussed in greater detail in Chapter 2), local governments are commonly assigned the responsibility to deliver key public services such as primary education, basic health care services, and other typically local government services such as local markets and infrastructure.

To the extent that a country's development strategy aims to improve the quality of public services that are appropriately delivered at the local level (typically including basic education, basic health care, prevention of HIV/AIDS, and access to clean drinking water), it is quintessential that sectoral development programs incorporate a strong role for local governments along with a sound system for financing these local government services. Indeed, the primary objective behind Tanzania's local government reform strategy is the improvement in the quality of service delivery in the public sector (MRALG, 1998).

Unfortunately, most sectoral development programs and sectoral basket funds supported by international donors and international financial institution (modalities that are common for primary education, health care, and agriculture development) have generally downplayed or ignored the role that local governments play in improving the quality of public service delivery. Development policy has traditionally been approached as a central government challenge that is implemented in a top-down fashion.[2] Even when the recognition is made that community involvement is needed to assure improved accountability for the delivery of public services, many sectoral development initiatives and community-driven development programs continue to purposely circumvent local government authorities, which are seen as inefficient, corrupt, and prone to elite capture. In reality, experience has shown that a well-designed decentralized service delivery strategy can be highly effective in improving the access and quality of public services.

Local governments are partners in delivering pro-poor public services and achieving pro-poor economic growth

Despite the fact that development strategies have traditionally been approached in a centralist, top-down fashion, the notion of pro-poor, community-driven development—which embraces the view that poverty is local and that poverty alleviation requires involvement of the local level—is increasingly gaining traction in the development literature and among policy practitioners.[3] As such, local governments are recognized as critical partners of the central government in implementing a national poverty reduction strategy in at least two respects (Boex *et al.*, 2005).

First, as noted immediately above, local governments are typically assigned the responsibility to deliver key public services that affect the quality of life for all residents and that have an important impact on the incidence of poverty. For instance, many of the social services and economic infrastructure included in the U.N. Millennium Development Goals (including basic education, basic health care, and access to safe drinking water) are typically provided at the local level. These public services not only have an impact on poverty through their redistributive nature, but serve as investments in a well-educated and healthy labor force, which is a fundamental ingredient of any comprehensive, sustainable poverty reduction strategy. Likewise, local governments are generally in a better position to implement poverty reduction programs and to assure food security, since the proximity of local government officials to the target groups reduces the information costs for identifying the poor and providing successful pro-poor interventions at the local level.[4]

Second, subnational government involvement is needed to create a positive, enabling environment to ensure economic growth and job creation, which provides the ultimate engine for sustainable poverty reduction. Economic growth at the local level is impacted in a variety of ways by local authorities, including the presence of road access and other local infrastructure, local educational opportunities for the local workforce, and the attractiveness of a local jurisdiction as a residential base for skilled and unskilled workers. On the other hand, poorly run or poorly financed local governments can be a major obstacle to local economic development, by imposing excessively high and inefficient taxes, by creating bureaucratic obstacles to business, or by failing to provide good local government services.

Assuring an efficient allocation of public resources

In the context of a decentralized government system, an efficient allocation of public financial resources requires, on one hand, that local governments are given discretion over local financial resources, while requiring, on the other hand, that local governments are monitored (both by the central government as well as by local communities) to ensure that their financial resources are used in an efficient manner.

Whereas skeptics of decentralization suggest that decentralization may be less efficient than centralized provision of services, proponents of decentralization believe that public resources are allocated *more* efficiently when local communities are given discretion over the use of local resources.[5] For instance, with respect to the promotion of local economic growth decentralization experts would argue that it is unlikely that central government bureaucrats situated in a distant capital would be able to accurately identify the most productive infrastructure investments in any given local community; therefore, an efficient, pro-poor investment strategy will require extensive local involvement in the context of a decentralized decision-making process. In this regard, Sachs (2005: 278) notes that public investments decisions need to be made in "hundreds of thousands of villages and in thousands of cities. The details [of public investments] will have to be decided at the ground level, in the villages and cities themselves, rather than in the capitals or in Washington. Decentralized management of public investment is therefore a *sine qua non* of scaling up."

A corollary to entrusting local governments to have significant control over financial resources is the requirement for local governments to use these public resources in an efficient and accountable manner. When local governments are assigned the responsibility to deliver key government services, it is not unusual for subnational governments to be provided with a significant share of national public finances, either in the form of intergovernmental fiscal transfers or in the form of the authority to collect significant own source revenues. In their role as stewards of the country's public finances, central government ministries such as the Ministry of Finance or the Ministry of Local Government have important responsibilities in monitoring that local governments use public resources in an efficient manner. Of course, central government monitoring and supervision of local government finances should not be confused with central government control over local spending decisions.

Local governments can improve democratic, participatory, and accountable governance

From a governance perspective, decentralized systems of governance tend to improve good governance and public accountability. While a number of observers of local political relations in developing countries have raised concerns about the possibility of elite capture at the local level, there is no systematic evidence to suggest that the absence of strong local democratic institutions cannot be overcome by the introduction of participatory local planning processes or vigilant guidance and monitoring from the center.[6] Local government is the level of government closest to the people. If local governments are not given real responsibilities and not provided financial resources to fulfill their responsibilities, the democratic content of the country is lowered. Tanzania is gradually moving away from a highly centralized, one-party political system to a decentralized, pluralistic political system with checks and balances. Local government reform has the potential of allowing for more participatory planning and more direct accountability of the government sector to the citizen.

The benefits from increased participation and accountability are twofold. First, good governance and accountability are obviously an important precondition for assuring a pro-poor, pro-growth economic environment in which government services are delivered in an efficient and effective manner. Second, fiscal empowerment of local governments in a way that brings government truly closer to the people may provide an even more direct benefit to the poor, by strengthening their voice, representation, and basic freedoms.

1.2 A short history of local governments and local government finance in Mainland Tanzania

A brief historical overview of the role that local governments have played in the public sector in Tanzania suggests that Tanzanian policy makers have recognized the importance of decentralization as an increasingly integral part of its national development strategy since around 1980. Developments in local government finance in Tanzania from independence until today can broadly be divided into four periods: first, centralization during the post-colonial period (1961–1981), during which elected local governments were actually abolished; second, the initial wave of decentralization reforms (1982–1995) that restored elected local authorities; and third, the subsequent phase of decentralization reforms (1996–2001) that promoted "decentralization by devolution" ("D-by-D") as a means to improve the quality and efficiency of government service delivery at the local level. A fourth phase of local government reform effectively began in 2002, with the explicit recognition that local government finance reform was the most appropriate and effective technical entry point to strengthen the role of local governments in the public sector.

Centralization following statehood (1961–1981)

Tanganyika (now Mainland Tanzania) gained its independence from British colonial rule in 1961. Subsequently, the United Republic of Tanzania was formed in 1964 through the unification of Tanganyika and Zanzibar. Since Zanzibar has its own internal local government structure, this book focuses exclusively on local government relations in Tanzania's mainland.

At independence, Mainland Tanzania inherited a relatively decentralized system of local government (Mawhood, 1983). However, as part of the country's move toward a centralized, planned economy in the post-colonial era under President Julius Nyerere, elected local governments were abolished in 1972 in favor of a more centralized system of government. Instead of the elected local councils which had existed since before independence, deconcentrated units of central government line ministries were put in charge of the administration of basic government services at the local level, including basic education, local health care, and other public services. However, the quality of locally provided services declined during these years of centralized control as the central government's grip over the economy and public service delivery diminished. Although the centralized civil service exploded in size during the 1970s, it lacked proper organization: hierarchical controls were weak, while the erosion of public sector wages led to low productivity, poor work ethics, and corruption.[7]

Although many of the specific post-colonial policies pursued by Nyerere have since been abandoned and reversed, some aspects of the underlying philosophy of Nyerere's African-style socialism continue to have a lasting impact on the policy environment in Tanzania (Legum and Mmari, 1995). The tangible legacy of the centralist post-colonial era includes:

- A tradition of a national civil service and a strong sense of national unity. The development of a large, "Africanized" national civil service in the post-colonial era and the promotion of a unifying national identity in the management of tribal and religious diversity resulted in a stronger national identity with much weaker (ethnically based) local or regional allegiance than is common in many other Sub-Saharan African countries.
- An expectation of a relatively egalitarian society in which residents expect a (almost paternalistic) public sector to provide a wide range of public services without a *quid pro quo*.
- A land ownership philosophy that promotes weak private land ownership in favor of communal (nationalized) ownership of land.
- Nyerere's personal emphasis (as a former school teacher) on the value of education as a tool for self-reliance.

However, it was only with hindsight that President Nyerere recognized the importance of subnational governments in assuring a participatory and accountable public sector. In 1985, President Nyerere expressed regret for the earlier abolition of elected local authorities, stating that "[t]here are certain things that I would not do if I were to start again. One of them is the abolition of Local Government . . . We had . . . useful instruments of participation, and we got rid of them" (Ngware, 1999).

The "first phase" of decentralization reforms (1982–1995): Reintroducing local governments

By the early 1980s, deteriorating economic conditions and major budget deficits forced the central government to pursue a major change in the overall direction of government policy with regard to the organization of the public sector (Boon and de Jong, 1999). Local governments were reintroduced in 1984 following the enactment of the 1982 Local Government Acts. Realizing the need for economic reforms (in particular institutional reforms) to strengthen the economy and to speed up the economic recovery, President Mwinyi negotiated a structural adjustment program in 1986 with the aim of reducing the role of the public sector in the economy. During the early 1990, a Civil Service Reform Program was launched, consisting of six components, one of which was Local Government Reform. This component was aimed at decentralizing government functions, responsibilities and resources to districts and strengthening of local authorities. While initially the Local Government Reform component was small compared to the other components, it gradually expanded into a larger, eventually separate, reform program.

While a system of local governments was reintroduced by law in Mainland Tanzania in 1982, the system was a top-down one and local governments were tightly constrained by the central government bureaucracy (Baker *et al.*, 2002). Although local governments were officially entrusted with the delivery of key local government services, central government line ministries (through their regional administrative offices) continued to hold strong powers to direct the affairs of local governments, to the point that local government budgets were in fact included in the national budget. However, this *de jure* decentralization of government services failed to yield the improvements in the delivery of government services that were hoped for.

The "second phase" of decentralization reforms (1996–2001): Decentralization by devolution

Renewed reform of the system of local government was initiated in 1996 through a national conference seeking to move "Towards a Shared Vision for Local Government in Tanzania". The vision resulting from the conference was summarized in the Local Government Reform Agenda and, in October 1998, was endorsed by the Government in the Policy Paper on Local Government Reform. The reforms contained in the Policy Paper clearly laid out a policy of devolution of functional responsibilities versus the earlier *de facto* deconcentrated approach to governance, which had continued to persist despite the reintroduction of elected local governments. "Decentralization through devolution" was, and continues to be, the motto of the government's decentralization policy. The main features of the government's policy on local government reform included (MRALG, 1998):

1. Promoting popular participation in governance at the local level, including through the election of local councils and increased participation in local planning and budget process;
2. De-linking local administrative officers from their former ministries, creating a new local government administration answerable to the local councils, and bringing local public services truly under the control of these local councils;
3. Improving financial management and accountability at the local level and securing adequate finances for better public services at the local level;
4. Creating a new system of central–local government relations based not on hierarchical orders but on legislation and negotiations. An early significant, albeit not uncontroversial, element of this reform was the Regional

Administration Act of 1997, which greatly weakened the regional level by transforming the regions from a hierarchical, top-down government tier to a facilitator of Local Government Authorities.

In order to implement the government's new decentralization strategy, the Ministry of Regional Administration and Local Government (MRALG) was moved to the President's Office to become the President's Office—Regional Administration and Local Government (PO–RALG). Within PO–RALG, the Local Government Reform Programme (LGRP) was launched in January 1999 to operationalize the government's Local Government Reform Agenda. The LGRP provides advisory services and implementation support to the PO–RALG on policy, planning, capacity-building initiatives, and management capacity for funding, communication and coordination. In addition, the LGRP extends technical support to regional administrations and local governments in implementing local government reforms through Zonal Reform Teams (ZRTs) and Council Reform Teams (CRTs).

The "third phase" of decentralization reforms (2002–present): Local government finance reform as a technical entry point

While a joint government–donor review of the LGRP in 2001 endorsed the overall policy direction of the local government reform process, the Programme's midterm review found that the implementation of the reforms was slow and that the initial implementation schedule was unrealistically ambitious (JGDR, 2001). Obstacles hindering reform were found to include institutional resistance to the reforms, poor communications between the different agencies, lack of implementation capacity, and the persistence of financial mismanagement at the local government level. In response to the review, a new Medium Term Plan for the implementation of local government reform was drafted in 2002 (LGRP, 2002).

An important feature of the "third wave" of decentralization reforms has been a sharp change of focus of LGRP's Finance Component starting in 2002. Whereas during the initial years of the LGRP, the finance component predominantly concerned itself with improving local financial management through the phase-wise introduction of a computerized financial management system at the local government level, its focus shifted to the policy-level development and introduction of a formula-based recurrent grant system. This change of focus was championed, among others, by the Fiscal Decentralization Task Force (FDTF), a joint government–donor task force that was established to serve as reference group for LGRP, which has played an important role in the formulation of LGRP's priorities in the area of local government finance.[8]

Reform of the transfer system was primarily seen as a technical entry-point that would assure a more objective, transparent, efficient, and equitable distribution of resources among local governments, while forcing greater institutional collaboration and government ownership over the decentralization process itself. Subsequent to Cabinet's approval of the new system of formula-based recurrent block grants in February 2004, the scope of local government finance reforms in Tanzania was further expanded to incorporate the introduction of a capital development grant system and the transformation of the local government revenue system. As noted by a second joint government–donor review of LGRP in 2005, the development and implementation of the framework for the financing of local governments is proceeding apace and has served as a motivating force in the broader local government reform process (JGDR, 2004).

1.3 An overview of the current system of local government finance in Tanzania

Before proceeding with a more detailed analysis of Tanzania's local government finance system in the subsequent chapters of this book, it may be useful to provide an introductory overview of the system of intergovernmental fiscal relations in Tanzania. For the purpose of discussion, any system of intergovernmental fiscal relations can be broken down into four separate, but closely interrelated, components: the assignment of expenditure responsibilities, the assignment of revenue sources, intergovernmental fiscal transfers, and local government borrowing.

From a legislative viewpoint, the different aspects of Tanzania's system of local government finances are governed by a set of laws jointly referred to as the Local Government Acts, which include the Urban Authorities Act (Act No. 7 of 1982), the District Authorities Act (Act No. 8 of 1982), the Local Government Finances Act (Act No. 9 of 1982), as well as a number of related acts. The Acts have been revised intermittently to take on board policy changes over time.

Resource profile of local governments

Although no single, comprehensive database of local government fiscal data is currently available, the available data suggest that local governments play an increasingly important role in Tanzania's public finances: local government expenditures increased from TSh. 255 billion to TSh. 341 billion from 2001 to 2003 (Table 1.1).[9] When compared to total public expenditures in Tanzania, local government accounts for approximately one out of every five Shillings (20 per cent) of public spending.

Like in most developing countries, local governments in Tanzania rely heavily on intergovernmental transfers in financing their expenditures. Table 1.1 shows that revenues from transfers account for around 80–90 per cent 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

Table 1.1 Overview of local government financial resources in Tanzania

	2001/02	2002/03	2003/04
		TSh. million	
Local government transfers	201,119.0	247,027.3	290,973.8
Own source revenues	53,904.4	59,924.7	50,408.0
Local government borrowing	50.0	225.0	317.5
Total financial resources	255,023.4	306,952.1	341,381.8
		As a percentage of total	
Local government transfers	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 financial resources	100.0	100.0	100.0

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

grants contributed about 80 per cent of local funding in FY 2001/02, by FY 2003/04 almost 86 per cent of total local government finances was derived from transfers.

Both own source local revenue collections and local government borrowing play a much more limited role in the total financial inflows for local governments. In FY 2001/02 and 2002/03, own revenue sources accounted for approximately 19–20 per cent of local government financial resources. In FY 2003/04, own source revenues experienced a significant decrease in its importance as a share of total local government finances, dropping to only 14.2 per cent of the local financial resources.

Local government expenditure responsibilities

Expenditure responsibilities of local governments are assigned to local governments in the Local Government Acts of 1982 (Acts 7 and 8, for rural and urban local governments, respectively), which assign responsibility to local governments in three broad policy areas, including:

1. maintaining peace, order, and good governance
2. promoting social welfare and economic well-being
3. subject to national policy, promoting economic and social development.

According to the Acts, 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 Acts, listing specific functional responsibilities of local government. Government services provided by local governments include:

- *Basic education.* Local governments are responsible for building and maintaining schools and providing primary education for school-aged children and adults.
- *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 laying 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, slaughterhouses, community centers, public parks, refuse collection, and other local amenities.

In reality, local governments in Tanzania indeed play an important role in the delivery of these 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 generally considered typical "local" services, and the assignment of expenditure responsibilities broadly coincides with sound principles of expenditure assignment. As discussed in greater detail later in this book, the main concern in the assignment of expenditure responsibilities is that the level of discretion that local governments have in implementing their responsibilities is substantially limited due to centralized financing of local government services and the continued imposition of inflexible central government guidelines and conditionalities.

Local government revenue sources

Whereas the responsibilities of rural and urban local governments are defined by the Urban and District Authorities Acts (Acts No. 7 and No. 8 of 1982, respectively), the financial resources available to local governments are specified in the Local Government Finances Act (No.9 of 1982). According to the latter, local governments depend on four key sources for financial resources: own revenues, shared revenues, intergovernmental grants from the central government, and donor assistance.

Until changes were made to the Act in 2003, the Local Government Finances Act generally allowed local governments to raise their own revenues in a permissive ("open list") manner from taxes, licenses, fees, charges, and other revenues. As such, each individual local government was allowed to define the exact nature of the local revenue instruments as well as the actual mix or structure of local taxes and revenue sources. The main categories of local taxes and revenue sources used by many or all local government authorities included:

- a centrally-defined "Development Levy", which was initially intended as a progressive local income tax (not unlike Uganda's Graduated Tax), but which evolved over time into a local head tax;
- property rates, levied locally on structures;
- a Service Levy (earlier "industrial cess"), levied on business turnover for business above a certain size;
- local business license fees;
- crop and livestock cesses (that is, taxes on agricultural production);
- Other fees and user charges (for example, fees for refuse collection, abattoirs, markets, and others).

While local governments collected only a small share of their budgetary resources from own source revenues (local revenue collections comprised about 4 per cent of total revenue collections in Tanzania), a "rationalization" of local government revenues was initiated by the Ministry of Finance in 2003 in order to reduce the potential negative impact of local revenues on business activity and economic growth. The rationalization consisted of the abolition of the Development Levy as well as a number of minor local "nuisance" taxes. In addition, local governments' discretion to introduce new taxes or to determine local tax rates was sharply curtailed. In 2004, local government revenues were further negatively impacted by a reform of business licensing, which served previously as the main revenue instrument to tax small businesses.

Concerned about the impact of the reduction in local revenue autonomy caused by the rationalization measures on the overall local government finance system, 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 Tanzania, resulting in a draft Policy Paper on Local Government Finance. As discussed further in Chapter 4, this review was completed in June 2005 and contains numerous recommendations for the reform of the local revenue system.

Intergovernmental Fiscal Transfers

Prior to the introduction of a formula-based grant system in 2004, Tanzania's system of intergovernmental grants was dominated by a series of earmarked, conditional recurrent grants. These conditional recurrent grants were separately provided for each of the priority sectors, including primary education, basic health services, water, road maintenance, agriculture extension and livestock development, and local administration. Grants for each of these sectors were further divided—both during budget formulation and during budget execution—into personal emoluments (PE) and other charges (OC). The dominant feature of the previous transfer system was the high measure of central government discretion in determining local government allocations. In fact, the degree to which the central government felt ownership over these resources was reflected by the fact that these local resources were budgeted for on a line-item basis as part of the national budget. As such, this method of local government financing was appropriately referred to as local government *allocations* (rather than local government *grants*).

Conditional recurrent grants

Prior to 2004, no formula-based approach was used to divide the available local government resources among the different local government units. Instead, local government units were essentially treated similar to central government agencies in the budget formulation process. At the beginning of the central government's budget formulation cycle, budget guidelines were circulated among local governments by PO–RALG, tasking local governments to prepare budget requests based on a framework of "national minimum standards" (NMS). The NMS framework comprised a set of sectoral standards and norms that were supposed to assure a minimum level of service delivery across Tanzania's national territory. For instance, the NMS for primary education prescribed a pupil/teacher ratio of 1:45. In addition, the standards dictated the minimum level of teacher training that was required in each local government and prescribed funding for teacher resource facilities.

The amount of control exercised by the central government over local government grants was similar to the degree of control exercised by the center over central government line agencies. In the annual central government budget formulation process, local governments were required to submit their budget requests based on a budget circular issued by PO–RALG that directed individual local governments to draft their sectoral budgets based on the sectoral minimum standards for service delivery. The local budget requests were then vetted by the Regional Secretariats (with representatives of PO–RALG and the line ministries), and passed to the Budget Commissioner at the Ministry of Finance. The Budget Commissioner reviewed each local government's budget request as part of the regular annual budget formulation process, which involved negotiations with representatives from each local council in order to assure that the total amount of local government transfers fit within the central government's overall budget constraint. Earmarked allocations to individual local government were then included in the central government budget at the line-item level.

The substantial discretion and control of PO–RALG and the Ministry of Finance in determining individual local government budgets was shared to some extent by the President's Office—Public Service Management (PO–PSM), which was previously known as the Civil Service Department (CSD). As part of the President's Office, this body is responsible for apportioning the number of centrally supported staff positions (such as teachers, health care staff, and administrators above a certain civil service grade) in each local government. In determining the assignment of local government personnel across local governments, PO–PSM was supposed to rely on the same NMSs for service delivery that guided the local budget formulation process, although in reality these standards were only applied loosely at best. Once a staff position was approved by PO–PSM, local governments could automatically count on funding for the approved position (depending on the pay grade of the individual hired). The amount of PE that each local government received was thus determined as the actual payroll of the local government (excluding positions funded from own sources) after taking into account new hires. This is a practice that is still followed today.

Shared revenues

In addition to own local revenue sources and sectoral local government allocations, there are two main types of shared revenues between the central government and local governments.

First, there exists a nominal levy on all petroleum sales in Tanzania (currently at TSh. 90 per liter), which is managed by the Road Levy Fund Board. By statute, the majority of the Fuel Levy (70 per cent) is retained by the central government for expenditure on trunk and regional road maintenance and rehabilitation; the remaining 30 per cent is transferred to local authorities for expenditure on district and local road maintenance and construction. According to the Road Levy Fund Board, these funds are divided horizontally between local authorities largely based on the "equal shares" or the equality principle, as well as on road network length and population. In reality, the disbursement of the Fuel Levy resources to local authorities is managed by PO–RALG under a performance contract.

The second type of shared revenue is the Land Rent, which covers rents paid to the state for leases on commercial, industrial, and residential land in areas occupied under non-traditional forms of tenure. The revenues are collected by local authorities on behalf of the Ministry of Lands, deposited in the bank account of the national treasury and a portion (currently 20 per cent) is supposed to be sent back to councils in which they were collected.

Capital development grants

The resources made available by the central government for local government capital development are substantially smaller than the resources made available for recurrent expenditures, and are largely driven by the availability of donor funding for these purposes. Although the figure understates the amount of resources that find their way indirectly to local government authorities, only 4 per cent of the development budget is directly allocated to the local government level (PWC, 2003). At the discretion of central government line ministries, local government authorities receive capital grants for the development of capital development projects in the local priority sectors (primary education, health, water supply, roads, and agriculture). Capital development allocations to local authorities are determined by the central government on an ad hoc basis as part of the annual development budget. In addition, many local governments receive transfers through parallel funding mechanisms that are (partially or fully) outside the central government budget process, such as area-based local government development programs and direct project support from bilateral donors.

On the development side of the budget, local governments are tasked to engage in a participatory planning process to identify community needs. Then, individual local governments receive their capital budget envelope as part of the budget negotiation process, forcing local governments to realign their capital development plans by striking any lower-priority development projects that do not fit within this envelope. As such, the national development budget includes all local government development projects as line items. Apart from the lack of set criteria at the national level, local governments raise the concern that development grants are rarely received at the budgeted levels and the distinction between recurrent allocations and development funding is much less clear in practice than it is in theory.

Other resource flows

In addition to the (recurrent and capital) sectoral funds described above that flow directly from the Ministry of Finance to the individual local governments, there are other resources that flow to the local government level from sector ministry budgets. This practice varies greatly from sector to sector. For instance, whereas essentially all resources in the provision of primary education are fully devolved to the local government level (including resources for the purchase of textbooks), the Ministry of Health controls a much larger share of local health care resources through its ministerial budget. For instance, resources for drugs for use by local health care facilities are nested within the ministerial budget. In turn, the ministry uses an internal allocation formula to distribute the available resources to internal accounts for individual local governments, from which they can purchase drugs from the Ministry's Medical Stores Department. Similarly, the Ministry of Health determines local transportation needs for the health sector in an internal allocation process.

Finally, in many developing countries, the regular grants for capital development are often supplemented by one or more "slush funds" for local projects at the discretion of the president, senior politicians, and/or members of parliament. Although it is notoriously hard to accurately quantify these funds, resources funneled through such slush funds can be quite considerable, at times even accounting for more resources than the regular local development budget. While Tanzania does have a small discretionary transfer fund that allows senior government officials to provide matching funding to local development initiatives, the size of this fund and its application are said to be judicious.

Local government borrowing and budget arrears

If local governments do not carefully balance their annual expenditures with revenues and transfers, this will result in local deficits and the incurrence of debt. Since this would provide an important negative incentive for local spending discipline (and potentially for national macroeconomic conditions), central governments often require local governments to balance their budgets or tightly regulate their ability to hold debt. In addition, if local governments would default on their debt or would be allowed to accumulate significant budget arrears, this would signal the absence of a hard budget constraint for local governments.

The Local Government Finance Act (1982) allows local authorities to borrow, subject to ministerial approval. Although there is no municipal credit market in Tanzania, a limited amount of municipal borrowing occurs through the Local Government Loans Board (LGLB). The LGLB is a semi-autonomous institution within PO–RALG, with its governing body comprising appointees made by PO–RALG and the Ministry of Finance. It extends loans mainly for capital projects at concessional rates, with loan maturities ranging from one to five years. Although the repayment performance of local governments has been poor with most local government borrowers in default for over three years, repayment has improved in recent years (URT, 2004a).

Local budget arrears have not been a significant source of concern in Tanzania, most likely due to a combination of judicious monitoring, control and intervention by central authorities as well as prudence by firms when dealing with local authorities. Local government staff tends to be paid regularly, in large part due the earmarked nature of PE resources. The most recent significant accumulation of local budget arrears occurred during the late 1990s, when many local authorities failed to make their contributions to the Local Authority Provident Fund. As a result, the central government modified its transfer practices and now credits these payments directly to the Provident Fund.

1.4 Organization of this book

Our goal in this book is to present a broad discussion and analysis of Tanzania's recent efforts to reform its system of local government finances, and to do so in a way that proves generally useful to developments specialists, policy makers, sectoral specialists, and government officials. Our discussions aim to be relevant beyond the confines of the fiscal decentralization literature, as the relevance and impact of local government finance extends well beyond those working directly on fiscal decentralization reforms: the local government finance system not only determines the quality and access of key public services delivered at the local level, but indeed—as discussed earlier in this chapter—has much broader implications for the country's overall strategy for economic growth and poverty reduction.

Accordingly, the remainder of this book is structured to provide as clear and accessible an overview as possible of the different dimensions of local government finance reform in Tanzania. As such, the book's chapters are divided into four main parts: one for each main dimension or pillar of fiscal decentralization reforms.

Since "finance should follow function" (see, for example, Bahl's (1999) implementation rules for decentralization), the appropriate starting point for our discussion is the assignment of expenditure responsibilities (Part I). This part consists of two chapters. Chapter 2 provides a descriptive overview of the scope and structure of the public sector in Tanzania, and describes and assesses the current assignment of expenditure responsibilities to the local government level. Since fiscal decentralization reform cannot succeed by itself without adequate decentralization in the administrative and political realms, Chapter 3 broadly considers the impact of non-fiscal issues on the effectiveness of local government finance and local expenditures, including participatory planning, financial management, as well as administrative capacity and local service delivery.

The second pillar of intergovernmental fiscal relations is the assignment of revenue sources to the local government level (Part II). Chapter 4 provides a synopsis of the current local government revenue structure, along with the weaknesses of the current system. Major weaknesses of the system of local revenues that are given specific attention include problems with local tax administration and poor with local revenues compliance. Chapter 5 presents the current proposals to transform and rationalize the structure of local government revenues in Tanzania in order to address some of the shortcomings of the current local government revenue system.

The backbone of Tanzania's system of local government finance is the intergovernmental fiscal transfer system (Part III). Tanzania began pursuing a formula-based system of intergovernmental transfers in 2002, and has already made substantial progress in the introduction of formula-based recurrent block grants. Drawing on the extensive literature on transfer design, Chapter 6 provides the context and principles for developing a sound system of intergovernmental fiscal grants. Chapter 7 discusses the weaknesses of the previous, centralized approach to local government allocations. Finally, Chapter 8 presents the formula-based transfer system that is currently taking shape in Tanzania.

The final pillar of fiscal decentralization, local government borrowing, only contributes a miniscule amount (0.1 per cent) to the total financing of local government activities in Tanzania, but this figure understates the importance of borrowing for the future development of decentralization in Tanzania. Accordingly, the current status of local government borrowing (along with the current plans to strengthen the role of local government borrowing) is discussed in Chapter 9.

Two concluding chapters seek to draw lessons from Tanzania's experiences. Chapter 10 considers the way forward in Tanzania itself, and focuses on the role that local government finances will play in the implementation of Tanzania's new poverty reduction strategy. Chapter 11 draws lessons from Tanzania's experience for other developing economies. In addition to identifying the strengths of Tanzania's local government finance reforms, this concluding chapter also highlights the obstacles still faced in Tanzania as part of the ongoing local government finance reform process.

Part I

The Assignment of Expenditure Responsibilities

2
The Assignment of Expenditure Responsibilities to the Local Government Level

The assignment of functions and resulting expenditure responsibilities is often considered the first "pillar" or building block of fiscal decentralization reform. The question of expenditure assignment encompasses the policy decision what functions and expenditure responsibilities are to be assigned to each level of government. The design of local government finance mechanisms (that is, the determination of revenue assignments, intergovernmental transfers, and subnational borrowing) in the absence of a clear expenditure assignment would be like putting the cart before the horse.

Whether by sound policy design or by good fortune, Tanzania clearly determined its assignment of expenditure responsibilities at the outset of its decentralization reforms in the 1980s. As a result, Tanzania achieved a significant amount of expenditure decentralization during the initial wave of decentralization reforms during the 1980s and early 1990s. The Local Government Acts of 1982 entrusted local authorities with the delivery of key public services, including primary education, basic health care, and other priority sector services. The responsibilities that are assigned to the local government level are generally considered typical "local" services and, as discussed further below, the assignment of expenditure responsibilities broadly coincides with sound principles of expenditure assignment (Martinez-Vazquez, 1998). While during the first phase of decentralization reforms the degree of effective local control over their expenditure responsibilities was limited, local authorities were nonetheless entrusted with the delivery of these key public services. This stands in contrast to many other developing countries (such as Bangladesh, Malawi, or Thailand) where the local government acts assign broad responsibilities for such priority sectors to the local government level, but where in practice the central government continues not only to control and but also to deliver these services.

Before proceeding with a more detailed discussion of expenditure assignments in Tanzania, we need to consider two issues. First, what government levels do policy makers need to consider when determining the expenditure assignment? In other words, what is the subnational government structure in Tanzania? This issue is addressed in Section 2.1. Second, what constitutes a sound expenditure assignment? The answer to this question is explored in Section 2.2.

An analysis of the size and scope of expenditure responsibilities assigned to the local government level in Tanzania is presented in Section 2.3. Sections 2.4–2.7 provide brief discussions of the sectoral expenditure responsibilities assigned to the local government level in primary education, local health services, other priority sectors, and local government administration, respectively. Concluding this chapter, Section 2.8 provides an assessment of the suitability of the current expenditure assignment in Tanzania.

2.1 The structure of subnational government in Tanzania

Since the reintroduction of local governments in 1982, the structure of local governments has changed little. Basically, the government sector in Mainland Tanzania is structured into two levels of governments: a central government level and a local government level. In turn, the central government level is divided into two tiers: the first tier includes ministries, departments, and agencies (MDAs), while the second tier is formed by regional administration secretariats. Similarly, the local government level can be divided into, first, the district-level urban and rural authorities (councils), and, second, the sub-district government units (Village Councils and urban neighborhood jurisdictions, which are known in Swahili as *Mitaa*).

Central government ministries, departments, and agencies

Whereas the Constitution of the United Republic of Tanzania (adopted in 1977) provides Zanzibar with its own Parliament and separate internal government structure to deal with internal matters, the Government of the United Republic of Tanzania functions as the national government of the United Republic, and serves as the central government authority for Mainland Tanzania as well. Thus, for purposes of central–local relations, Mainland Tanzania functions as a unitary state. Mainland Tanzania's central government apparatus consists of an executive branch (including the President's Office, ministries, departments, and agencies), a legislative branch (a unicameral National Assembly), and the judiciary. Although a single political party (Chama Cha Mapinduzi, or CCM) continues to dominate the political landscape since the reintroduction of a pluralistic democratic system in 1992, Tanzania is a stable democracy, with regular direct elections of the president and parliament.

The central government apparatus is physically divided between two locations: while most central government offices are situated in Dar es Salaam, Parliament as well as some other government offices (including the President's Office—Regional Administration and Local Government) have been moved to Dodoma, the official capital of Tanzania.

Within the central government apparatus, the PO–RALG (formerly the Ministry of Regional Administration and Local Government) acts as a focal point for relations between the central government and local governments.[1] According to the Local Government Finance Act (1982), the minister responsible for local government (that is, 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 finance 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.

However, PO–RALG does not have an exclusive mandate over local government financial matters. Under the Public Finance Act (2001), the Ministry of Finance is broadly assigned the responsibility for "the supervision, control and direction of all matters relating to the financial affairs of the United Republic". With respect to local government finances, the Ministry's responsibilities include the requirement to "advise the Government on the appropriate level of resources to be allocated to individual programmes" (implicitly including local government programs) and explicitly to "co-ordinate … inter-governmental fiscal relations". For most matters related to subnational finance, the Ministry relies on the Regions and Local Government Section, which is located within the Budget Division. For instance, local government allocations (intergovernmental transfers) are included in the central government budget through the Local Government Section.

Other central government stakeholders with a clear interest in the financing of local governments include the President's Office—Public Service Management (responsible for all public servants, including local public servants), President's Office—Planning and Privatization, and the various sectoral line ministries whose services are delivered through local authorities (including education, health, agriculture, water, and roads).

A final stakeholder in the reform of local government finances at the central government level that requires consideration is the Association of Local Authorities in Tanzania (ALAT), which represents the interests of the local authorities at the central government level. While ALAT at times has used its position to support specific reforms, the Association is neither technically nor politically very strong. Indicative of the limited voice or autonomy that ALAT has on policy matters is the fact that its secretariat is housed in central government offices.

The regional administrative tier

Mainland Tanzania comprises 21 regions.[2] Rather than forming a separate subnational government level, these regions are in fact deconcentrated administrative units of the central government under PO–RALG. They lack elected representation and own revenue sources, and their role in subnational government has been particularly limited since reforms of regional administrations were introduced in 1997.

Whereas prior to 1997 the regional government tier played a more substantive role in managing local government affairs in a top-down manner, the Regional Administration Act (No. 19) of 1997 greatly limited the role of the regional level. The Act established Regional Secretariats (RSs) whose sole purpose is to facilitate local government authorities in planning and implementing their local development initiatives and to ensure the efficient delivery of local government services. The RS is intended to be a technical resource for supporting local development opportunities and coordinating ministerial services between central and local government.

The administration mission of an RS includes ensuring peace and tranquility, assisting local governments in discharging their responsibilities, and representing the central government in the region. The RS's development mission focuses on building capacity within local authorities to enable them to discharge their (1) development management services (by providing technical expertise in local government administration and finance, planning and economic analysis, community development, legal affairs and auditing); (2) economic development services (support for production-related activities through experts in agriculture, livestock, commerce, industry, natural resources, wildlife, fisheries, beekeeping); (3) physical planning and engineering services (support to infrastructure and land management); and (4) social development services (support and regulation of activities related to health, education, and public and private social welfare in the region).

Each RS is led by the Regional Commissioner's (RC) office. The President appoints the RC. The RC represents the central government in the region and is responsible for maintaining law and order, overseeing implementation of government policies and, through the RS, providing policy and technical support to local authorities in the region. The Regional Administrative Secretary (RAS) is also appointed by the President, heads the operations of the RS, and is the principal advisor to the RC. The RAS coordinates all development and administrative activities in the region and is responsible for all regional employees. The RAS is the accounting officer for all revenues for the RS.

The staff of the RS perform development support in the four clusters described above (that is, management development, economic development, physical planning and engineering development, and social development). The technical staff are employed by individual line ministries and are attached to the RS to provide advice and capacity building support. The RS monitors sectoral trends, offers policy interpretation, and recommends new development opportunities and strategies for improving productivity.

It has to be noted that despite the significance of the reforms contained in Act No. 19 of 1997, the implementation of the regional government reforms has been slow. This has been attributed to a variety of reasons, including a lack of knowledge about the legislation and the lack of an implementing mechanism. For instance, the Regional Planning and Management Guide (PMG), which specifies the structure of the reformed RS and its relationships with local governments and the central authority at PO–RALG, was not published until the end of 2000.

Local Government Authorities

The local level consists of 114 Local Government Authorities (LGAs), which comprise 22 Urban Councils and 92 rural District Councils.[3] Local governments are independent legal entities governed by elected councils, with their own expenditure budgets and revenue sources, and with the ability to borrow funds. Local governments function as important providers of public services; they deliver key public services including basic education, basic health care, local water, and local roads. Local governments are further subdivided into several types of sub-district governments.

Elected local governments were reestablished in Tanzania under the Local Government Acts of 1982. In these Acts, local governments were given wide-ranging powers and responsibilities. As discussed in greater detail later in this chapter, local government councils are broadly responsible for the economic development, social development, and physical planning of their local government areas. Specifically, local authorities are given direct responsibilities for the provision of primary education and health services, water supply, local roads, and agricultural extension.

Most of the funding for these activities comes from conditional grants from the central government. In addition, local governments receive revenues from a number of shared revenue sources as well as own revenue sources, including property rates, agricultural cesses, a number of local business taxes, and other fees and charges. Local governments may also receive capital grants from the central government, while donor funding (both for recurrent as well as capital development activities) is explicitly recognized as a possible source of local government funding. Local governments are expected to operate in a transparent manner and be accountable to both their constituents as well as higher government authorities.

The Local Government Council elects a Council Chairman (or in the case of Urban Councils, a Mayor) from among their midst to lead the Council. In addition, the Council hires the chief executive officer of the LGA, who is known as the *District Executive Director* (DED) in rural councils, and the *Urban Executive Director* in urban local government areas.[4] The chief executive is the secretary of Council meetings, is the head of all staff in the

LGA, and is in charge of the day-to-day running of the LGA. He or she has ultimate responsibility for Council revenue collection and expenditures, and maintains political and public relations with councilors and other external stakeholders; implements Council business through council and committee meetings; and is responsible for policy formulation, coordination and accountability, and legal matters.

Departments in the LGA's organizational structure usually include education and culture, health, water, communications and works, finance, administration, agriculture, livestock and cooperative development, community development, trade and economy, and natural resource development. The heads of departments are local professional public servants who provide advice to the subcommittees in the Council and are responsible for implementing all decisions taken by the Council on matters of development and the delivery of public services.

In addition to these local government officials, the central government has its own representation at the local government level. The District Commissioner (DC), who is a presidential appointee, represents the central government at the district level and assists in the functions of the RC at the local level, including maintaining law and order, creating an enabling political and administrative environment for local authorities to perform their duties and overseeing development activities in the district. The DC is assisted in these duties by a District Administrative Secretary (DAS) and several Divisional Secretaries, who assists the DC in the latter's administrative duties and in overseeing development activities in the Divisions.

Lower-level local governments

Local government authorities are further divided into sub-district government units.[5] Urban and rural local governments have different sub-district government structures. Both in urban and rural areas, LGAs are divided into wards. In the case of urban local governments, wards are further divided into street neighborhoods (also known in Swahili as *mtaa*, plural *mitaa*). In the case of rural District Councils, wards are further subdivided into villages. There is a clear hierarchical relationship between districts and sub-districts entities, with district authorities clearly being the dominant local government level. Although Village Councils are technically corporate bodies, they do not have exclusive sectoral or capital expenditure responsibilities and have no official structure of budget accounts.[6]

The basic role of sub-district units is to identify community priorities and to help secure resources for these community priorities from the local council. Sub-district governments have little or no real own budgetary powers, although they are allowed to keep some of the revenues that they collect on behalf of the local council, and sometimes receive resources from the local council for the implementation of projects. However, little has been formalized with regard to intra-district resource divisions. Budget guidelines require local governments to share certain own source revenues and resources from the General Purpose Grant (GPG) with the village level, and the nascent Local Government Capital Development Grant (LGCDG) system also specifically earmarks resources for village-level priorities (Kragh *et al.*, 2003).

2.2 Expenditure assignment and the subsidiarity principle

One way to examine the adequacy of expenditure assignments in a country is to analyze how well the actual assignment of responsibilities fits the fundamental rules for the "ideal" assignment of responsibilities in a decentralized system of government.[7] There is no absolutely best way for deciding which level of government should be responsible for particular public services. The adequacy of any assignment has to be judged in terms of how well it achieves the goals or objectives set up by the government in its decentralization strategy. As we noted at the beginning of this chapter, the expenditure assignment needs to be the first and fundamental step in the design of a decentralized system of intergovernmental finances. Clearly, without a specific assignment of expenditure responsibilities, it will not be possible to assess the adequacy of the revenue and tax assignment to different levels of government, or the need and effectiveness of a system of intergovernmental transfers.

Consistent with Musgrave's (1959) three economic roles of government, commonly accepted objectives for fiscal decentralization include: (1) an efficient allocation of resources via a more responsive and accountable government, (2) assuring an equitable provision of services to citizens in different jurisdictions, and (3) preservation of macroeconomic stability and promotion of economic growth.

The critical role of the efficiency criterion

The efficient provision of government services requires that government satisfy the needs and preferences of taxpayers as well as possible. This is best achieved by the "subsidiary principle". This principle states that the responsibility for the provision of goods and services should take place at the lowest level of government that can efficiently deliver the goods or service. In other words, subsidiarity suggests that government goods and services should be provided at the lowest level of government compatible with the "benefit area" of the service.

For instance, the benefit area for sanitation services (household garbage collection) is clearly the local community, so in accordance with the subsidiarity principle, this service should be provided (that is, delivered and paid for) at the local government level. Since the benefit area for air traffic control is the entire national territory, this service should be provided at the central (national) government level.

Leaving the supply of public services with small benefits areas up to higher-level governments may be inefficient:

- The greater the distance between policy makers and the people, the less informed will be the policy makers about the preferences and needs of the people.
- The central government will likely not be able to vary its mix of goods and services to match regional variations in the preferences and needs for public services.
- Compared to local government officials, central government officials will be less accountable to voters for the quality of services they provide.
- Central government provision of essentially local public services will make taxpayers less willing to pay for public services, since the link between costs and benefits is lost. Efficiency in the provision of public services is enhanced if consumption benefits are linked to costs of provision via fees, service charges, or local taxes.

Shifting the supply of public services with wider benefit areas to smaller units of government is likely to result in the under-provision of services, which would also be inefficient. For example, if a municipal hospital (financed by municipal taxes) was expected to provide health care services to the entire surrounding region, this hospital would likely provide a suboptimal level of health care. Municipal residents would be unwilling to finance health care services for residents in the wider region; as a result of the mismatch, local residents would put pressure on their elected officials to reduce spending on health care services at the hospital.

The objectives of redistribution and stability are best pursued by the central government

It is generally thought that expenditure programs undertaken by governments to enhance equity or for income equalization reasons, such as social welfare, low income housing, or poverty reduction programs, should be the domain of the central government. Local or regional governments will not be able to sustain programs of this nature at the subnational level without financial support from the central level because these programs will attract needy residents from other areas while they will disproportionately tax potentially mobile non-poor residents more heavily. This would result in wealthier residents fleeing local governments that engage in redistributive policies.

While funding for social programs should be a central government responsibility, the implementation of social policies can often be left to local governments, which may have informational and other comparative advantages in performing this function. Expenditures undertaken for the stabilization of the economy such as massive investment or unemployment compensation are by their scale also naturally ascribed to the central government.

No single best assignment

The application of these rules largely facilitates the assignment of expenditure responsibilities to different levels of government. However, the rules do not always yield an unequivocal answer. Some public services, such as primary education and primary health services, may be of a local nature by the size of their benefit area, but because of their relevance in welfare and income redistribution they may also be considered a responsibility of the central government. It is not very meaningful, in this sense, to talk about the best assignment of expenditure responsibilities. What is considered the best assignment is further likely to change over time with changes in costs and technological constraints, as well as in preferences. However, there is a need at any given moment in time to have a concrete assignment of expenditure responsibilities among the various assignments that could be considered optimal. Failure to have a concrete assignment may lead to instability in intergovernmental relations and to inefficient provision of public services.

Importance of a clear and stable assignment

The lack of a clear assignment of expenditure responsibilities may be less burdensome in practical terms in centralized systems. As fiscal systems become more decentralized, the failure to establish by law a clear assignment of expenditure responsibilities for each government level can become a source of conflict between the central and subnational governments, and can lead to an inefficient provision of public services. In situations where government budgets are tight, which is almost always, the lack of clear assignments may lead to the under-provision of key public services.

Recognizing the multi-dimensional nature of expenditures

It is important to recognize that the assignment of expenditure responsibilities actually has a multi-dimensional component: expenditure responsibility could be broken down into the responsibilities for (1) actually producing a good or delivering a service, (2) providing or administering the service, (3) financing a service, and (4) setting standards, regulations, or policies guiding the provision of government services.[8] For example, while local governments provide elementary education in many countries, higher-level governments often share the responsibility of financing and regulating local education. At the same time, primary education may be delivered or "produced" either by local public schools or by publicly funded private schools. Thus, additional decisions are needed to clarify the assignment of responsibilities for functions that are shared among different government levels. Clarifying responsibilities in these cases means identifying what government level is responsible to produce, provide, finance, and regulate the concurrent or shared government functions. Clarity in the assignment of these attributes for each function is necessary to ensure that different levels of government effectively work together and that services are ultimately delivered.

2.3 An analysis of expenditure assignments in Tanzania

An analysis of expenditure assignments in Tanzania poses a substantial challenge, as there is, at the time of writing, no systematic reporting mechanism for local government expenditure data. The only actual budget data available from the central government's financial management systems are the budget plan amounts for grants that are disbursed from Treasury to the local councils. To the extent that financial resources reach local governments from within the ministerial budgets, the budget fails to systematically identify these resources separately from resources retained at the central government level. As such, the central government's budget documentation fails to properly capture local government expenditures.

The only other source of local government finance data resulted from a financial data gathering exercise conducted by the LGRP in early 2004; this exercise provided a tabulation of (self-reported) local government revenues and expenditures by local councils. However, the local budget data gathered revealed a number of clear problems. Most significantly, local recurrent financial outflows were reported by councils at TSh. 553 billion, thereby inexplicably exceeding local financial inflows by more than TSh. 210 billion. Instead of relying on this self-reported data, we computed local government expenditures as the aggregation of local sectoral transfers (which should translate proportionally into local government spending) plus spending of own local government resources, which is assumed to be spent on three activities: local administration, "truly local" government services (such as refuse collection and so on), and local co-funding of capital development projects.

Table 2.1 provides an overview of local expenditures in Tanzania for FY 2001/02 through FY 2003/04.[9] Over this three-year period, local government spending increased significantly from TSh. 252 billion (approximately US$252 million) to TSh. 339 billion (about US$339 million). Based on recurrent budget figures, we observe that local government recurrent spending is roughly 20 per cent of recurrent public sector spending. Over the period

Table 2.1 Local government spending in Tanzania, FY 2001/02 to 2003/04

	2001/02	**2002/03**	**2003/04**
TSh. (millions)	252,334	304,779	339,241
% of national recurrent spending	20.17	20.09	18.65
% of GDP	2.95	3.21	3.23

Note: Local expenditures are approximated as the sum of intergovernmental transfers, local own source revenues, and local borrowing. Due to the construction of the data set, local government spending excludes local spending of ministerial subventions and local development grants.
Source: Computed by authors based on Ministry of Finance and LGRP data.

under consideration, local government spending gradually increased from 2.95 to 3.23 per cent of GDP.

Expenditure decentralization of 20 per cent of public sector spending reflects that a considerable amount of expenditure responsibility is placed on local governments to deliver government services. By comparison, the average share of public expenditures that take place at the local level in developing countries is only 13–14 per cent (Bahl, 2005b). Despite the relatively high degree of expenditure decentralization indicated by these figures, we should note that these local government expenditure programs have historically been guided by strict conditions and control imposed by the central government.

We are able to analyze a slightly longer period if we exclude spending from own sources and only consider spending from recurrent grants (Table 2.2). When considering nominal allocations, the figures in Table 2.2 continue to show a substantial increase in total recurrent resources allocated to LGAs over the time period under consideration. This sharp increase persists when we

Table 2.2 Budgeted local government allocations by sector, FY 2000/01 to 2004/05

	2000/01	**2001/02**	**2002/03**	**2003/04**	**2004/05**
			TSh. million		
Primary education	129,804	137,914	170,242	202,240	245,945
Local health services	29,112	35,468	43,685	48,856	63,574
Other priority sectors	6,302	9,891	18,067	24,361	30,146
Local administration	14,336	17,846	15,033	15,517	22,102
Total	179,555	201,119	247,027	290,974	361,768
			Percent of total		
Primary education	72.29	68.57	68.92	69.50	67.98
Local health services	16.21	17.64	17.68	16.79	17.57
Other priority sectors	3.51	4.92	7.31	8.37	8.33
Local administration	7.98	8.87	6.09	5.33	6.11
Total	100.00	100.00	100.00	100.00	100.00
			Percent of GDP		
Primary education	1.71	1.61	1.79	1.93	2.12
Local health services	0.38	0.41	0.46	0.47	0.55
Other priority sectors	0.08	0.12	0.19	0.23	0.26
Local administration	0.19	0.21	0.16	0.15	0.19
Total	2.36	2.35	2.60	2.77	3.12

Note: Local spending excludes spending from own sources, the GPG, sectoral subventions, and local government borrowing.
Source: Computed by authors based on Ministry of Finance and LGRP data.

eliminate the impact of inflation by expressing allocations to local government in real terms (not shown here), and even when expressed as a per cent of GDP. The level of intergovernmental transfers increased significantly from approximately 2.3 per cent of GDP in FY 2000/01 and FY 2001/02, up gradually to 3.1 per cent of GDP in FY 2004/05.

When local expenditures are expressed as a per cent of total public expenditures (as shown in Table 2.1), it is much more difficult to detect an upward trend in local government spending over time. However, this should not be taken as *prima facie* evidence for the absence of increasing expenditure decentralization over time. It is quite possible that decentralized resources are funneled to local authorities through sectoral development programs and subventions from line ministry budgets that fall outside the budget votes used to capture local government allocations. If this is the case, such data limitations not only would distort the degree of expenditure decentralization, but could possibly also distort the decentralization patterns over time.

Perhaps, just as important as the overall degree of expenditure decentralization is the degree of expenditure decentralization by sector. While trends in sectoral spending at the local level by sector are captured in Table 2.2, Table 2.3 further indicates the relative shares of sectoral spending that take place at the central and local government levels for primary education, health care, and other expenditures, respectively. Expenditure assignments for the main local government sectors are discussed in greater detail below (Sections 2.4–2.6).

Table 2.3 Decentralization of public expenditures in Tanzania, FY 2003/04 (budgeted amounts, in TSh. million)

	Central expenditures	**Local expenditures**	**Total expenditures**	**Local as percent of total**
Education	45.7	202.2	248.0	81.6
Health	86.4	48.9	135.3	36.1
Others	1,347.7	39.9	1,387.5	2.9
Locally funded expenditures	0.0	48.3	48.3	100.0
Total expenditures	1,479.8	291.0	1,770.8	16.4
Total expenditures (including locally funded expenditures)	1,479.8	339.2	1,819.0	18.6

Note: Central expenditures reflect budgeted sector ministry spending levels; local expenditures reflect budgeted central government allocations to LGAs. Spending from own sources is set equal to own source revenue collections.
Source: Computed by the authors based on LGRP and Ministry of Finance data.

2.4 The delivery of primary education

Consistent with the Education Act of 1978 (as amended in 1995), the Local Government Acts assigns local governments with the responsibility to provide for the primary education of children within their local jurisdictions and to provide for the compulsory attendance of pupils enrolled there. District Education Officers (DEOs)—local government officials that report to the DED—bear the responsibility for the delivery of primary education in each district. While DEOs are required to follow technical guidance from the Ministry of Education and Culture, there is (in principle) a substantial amount of local control over the actual delivery of primary education, including hiring of teachers, the location of new school buildings, and the procurement of non-labor inputs, such as textbooks and school materials.[10] The technical service delivery targets for primary education aim to achieve a pupil–teacher ratio of 45 to 1; provide one textbook for every three pupils; assure that all pupils undergo examinations in Standards IV and VII; and provide ten days of in-service training per teacher per year.

While until recently parents of children enrolled in public primary schools were required to pay school fees, in 2001 President Mkapa announced the (re)introduction of free, universal primary education in Tanzania. As such, funding for the delivery of primary education is provided almost exclusively through the Primary Education Block Grant, supplemented by capitation grants through the Primary Education Development Programme (PEDP).

The delivery of primary education is by far the most important government service delivered at the local government level: allocations for primary education purposes account for between two-thirds and three-quarters of intergovernmental transfers (see Table 2.2). Local governments are the main level of government responsible for delivering primary educations in Tanzania: as noted in Table 2.3, almost 80 per cent of all educational expenditures are spent at the local government level. By itself, local spending on primary education accounts for about 12.5 per cent of national recurrent budgetary spending. Further analysis (not shown in the table) shows that most educational transfers are predominantly aimed at personnel expenditures for teachers, headmasters, and salaries for other local education officials. In fact, over 85 per cent of education transfers are directed toward personal emoluments, whereas only about 15 per cent of educational transfers are set aside for non-wage expenditures (other charges).

Significant increases in local expenditures on primary education can be observed in nominal terms. Over the period under consideration,educational transfers to local governments have nearly doubled from approximately TSh. 129.8 billion (FY 2000/01) to TSh. 245.9 billion (FY 2004/05). Local education spending increased over this period from 1.71 per cent of GDP to 2.12 per cent.

However, it is interesting to note that in relative terms, primary education spending has not really changed much as a share of the national budget: primary education spending at the local government level has fluctuated tightly around 12.5 per cent of national recurrent spending. The absence of a relative increase vis-à-vis other government spending is somewhat surprising given the attention given to primary education as a national priority policy area. Given the stated policy priorities, we would have expected to see a steady increase in the per cent of national budgetary resources allocated to local primary education through the intergovernmental transfer system.

Several caveats should be kept in mind throughout this discussion. First, we should remind ourselves that the current measures of local spending exclude any local spending on primary education that is funded from own local revenue sources or other parallel funding mechanism. Anecdotal evidence suggests that local contributions to primary education funding from own revenue sources are quite limited. More importantly, the current discussion ignores the important role that parental contributions played in the funding of primary education in Tanzania prior to the reintroduction of universal primary education in 2001. Based on sample districts, Therkildsen (1998) argues that parent contributions accounted for up to one-third of public primary education funding in Tanzania prior to 2001. While school fees were officially abolished with the reintroduction of universal primary education in 2001, it is unclear whether all local governments in fact have discontinued the practice of collecting school fees, or to what extent the growth in public spending on primary education has merely substituted for private contributions.

A similar omission from the current analysis is the absence of PEDP donor contributions for recurrent funding of primary education. The government's development partners are providing additional funding to primary education in Tanzania through a PEDP-pooled donor fund, which provides both recurrent and capital development funding to LGAs. On the recurrent side of the budget, the PEDP fund provides supplementary capitation grants to local governments (which, when combined with government funding, are supposed to assure a capitation grant equal to US$10 per enrolled student) to support the operational costs of primary education, essentially replacing the resources lost by primary schools as a result of the abolition of primary school fees. On the capital development side, PEDP provides School Committees (through their local governments) with grant funding for the maintenance and construction of educational facilities, such as classrooms and school furniture. These resources are supposed to be allocated among LGAs in proportion to the infrastructure needs of local governments.

A final qualification that should be made is that, due to the limitations of the available data, the current discussion and analysis are based on local governmental allocations budgeted by the central government for the purpose of funding local primary educational activities. In addition to the exclusion of PEDP funds and possible own source contributions, these budget figures may not accurately reflect actual educational spending at the local government level. First, there is no firm evidence that local government allocations are in fact distributed to local authorities as budgeted by the Ministry of Finance. Although actual disbursements to local governments commonly, exceed the aggregate budgeted amounts (often in response to staffing decisions made mid-year by the line ministries), the exact impact of budget implementation on primary education spending is unclear. A second potential wedge between the transfer amounts and actual sector spending at the local level is caused by the fact that local governments have been known to divert such resources, particularly education resources for OC, to other (non-education-related) activities. Such outflows are discussed in Chapter 3, including in the context of several public expenditure tracking studies.

2.5 Local health services

The second-most important sectoral responsibility of local governments in Tanzania is the provision of basic health care. Under the guidance of the District Medical Officer (DMO), local authorities are responsible for operating and maintaining district-level hospitals, health centers and clinics, as well as dispensaries and health posts. From a fiscal viewpoint, Table 2.3 notes that only about one-third of all health care expenditures in Tanzania are executed through local governments, whereas the central government directly controls over two-thirds of the national health sector budget. Local government spending on health care accounts for about 3 per cent of total (national) recurrent government expenditures, excluding local government spending from own revenues sources.

The objective of the Government of Tanzania is to provide all Tanzanians with access to basic health care, and to assure universal access to health care by making sure that a local health facility is located within six kilometers of every household. Health care services specifically take into account the special needs of specific demographic groups, including expecting mothers and the under-five population (which have a high disease burden as a result of malaria, fevers, and diarrheal illnesses) and an older demographic cohort which is disproportionately affected by the burden of HIV/AIDS and other HIV-related illnesses (such as tuberculosis).

Compared to the more straightforward provision of primary education, the provision of local health care services requires an intricate organization at the local level, with links to regional and national health facilities. The most basic health care services and access to medicine are provided at Health Posts and Dispensaries. Several Health Post and Dispensaries feed into Health Clinics for more advanced health care services, and more serious illnesses are treated at the District Hospital, which serves as the focal point for health care services at the district level. For even more serious illnesses, District Hospitals serve as referral hospitals for advanced health care services provided at regional and national hospitals, which fall directly under Ministry of Health.

Although health facilities, in principle, are allowed to charge fees for services, they are required to provide health care services free of charge to those who are not in a position to afford these services.

Although health care expenditures are a much smaller fraction of the local budget than educational expenditures, allocations for local health care funding seem to be increasing at a slightly higher pace. In nominal terms, grants for local health expenditures have roughly doubled from TSh. 29.1 billion to TSh. 63.6 billion over the observed period. The growth in resources set aside for local health care is more than proportional when expressed as a share of recurrent expenditures: whereas local health spending (from intergovernmental transfers) accounted for only 2.86 per cent of national recurrent budget resources in FY 2000/01, the level had increased to 3.24 per cent by FY 2004/05.

While allocations for both PE and OC have increased over time, the overall increases in local health sector allocations have increased disproportionately in favor of OC, which accounted for more than half the increase in health transfers. By FY 2001/02, OC in health accounted for one-third of centrally funded health care expenditures at the local level.

Caveats should again be placed with the analysis of local health care funding similar to those that were made in the discussion of local education finance. For instance, local spending on basic health services excludes the cost of medicines, which are supposed to be provided to local governments in kind through the Ministry of Health's Medical Stores Department. Furthermore, the analysis does not take into account local government grants provided by the donor-funded Health Sector Basket fund, which provides US$ 0.50 per capita in local funding to local governments for recurrent health care services. In addition, it appears that there is a gap between budgeted allocations for local health services and actual disbursements in the health sector. This gap appears to be caused by the fact that it is disproportionately hard to fill health care positions at the local level. As a result, even though the budget includes resources for PEs at the local level, under the current budget procedures, these resources simply do not get disbursed when the position does not get filled.

2.6 Agriculture extension, local road maintenance, and water supply

After primary education and local health services, agriculture extension, water supply, and road maintenance jointly place a distant third in the importance of local sectoral spending. Despite a significant boost in nominal funding for these sectors from TSh. 6 billion in FY 2000/01 to TSh. 30 billion in FY 2004/05 from intergovernmental transfers, allocations for these three sectors combined still only account for approximately 8 per cent of local government spending (excluding own source spending).[11]

These three sectors, like education and health, have all been identified as priority areas in the context of the country's first poverty reduction strategy (2000), and are all likely to have a significant impact of the productivity and quality of life of (poor and non-poor) residents. Yet, the extremely low central government funding levels for recurrent operations for agricultural and livestock extension, local road maintenance, and the water sector may imply that the role of the local government level in these sectors is relatively limited and/or that these policy areas are simply considered relatively less important of a priority when compared to basic education and health care. Alternatively, the more limited funding from central government for these sectors could imply that the central government expects local governments or local users to bear a greater share of the financial burden for these services.[12]

Part of the challenge in assuring adequate funding for these local government responsibilities is that local government allocations are more or less overlooked in the budget formulation process (including the Medium Term Expenditure Framework, the Public Expenditure Review, and the NSGPR). Despite the sectoral nature of these spending programs, the central government contributions to spending at the local level are contained in a series of regional votes under PO–RALG, although they are disbursed by the Ministry of Finance to local government under a standing order. As such, there is no consistent, strong central government stewardship over these decentralized resources.

2.7 Local government administration

A primary responsibility for any local government is to assure proper functioning of the local council and to meet the cost of local government administration. While some countries provide local governments with unconditional general purpose grants to cover (part of the) operational costs of local authorities, Tanzania does not provide unconditional grants to the local government level.[13] Instead, the central government provides local authorities with earmarked allocations to cover the salaries of senior local administrative staff and other (centrally approved) local government officials. Expenditures on local government administration (excluding own source spending on local administration) have grown relatively slowly over the period under consideration, slipping from almost 8 per cent of local government spending to around 5–6 per cent of local government spending. There are a number of potential factors that may have contributed to this trend.

Part of the relative decrease in local administration grants over time may be explained by changes in budget classifications. While until FY 2001/02, agricultural extension services were included under the heading of local administration, in later years these resources were moved to a separate sectoral heading.

More substantively, the decrease in local administration funding from central government resources may signal a change in perceived central government priorities. With increased attention paid to improved service delivery within the priority sectors under the first Poverty Reduction Strategy Paper (PRSP), the relative decline in administrative expenditures at the local level may have been due to the relative lack of central government priority attached to sound government administration at the local government level. As such, the relative reduction in expenditures for local administration seems to be inconsistent with the government's decentralization policy, which assigns increased responsibility to the local government level in the management and delivery of decentralized public services, as local governments are supposed to operate in an increasingly participatory fashion and the role of the regional administrative level is diminished.

Regardless of the exact causes of the trend, the relative decline in central funding for local government administration over time—without a corresponding decrease in the level of responsibility for local government administration—seems to have contributed to local governments bearing a greater burden for local administration from own source revenues.

2.8 An assessment of Tanzania's expenditure assignments

The current assignment of expenditure responsibilities in Tanzania has evolved gradually since 1982, consistent with the notion that in a properly sequenced decentralization process, the determination of financing instrument should follow the functional expenditure assignments (that is, "finance should follow function").

The expenditure assignments that have evolved over time in Tanzania are quite clear and have been stable over time, with some caveats discussed further below. The functions actually performed by local authorities generally coincide with their legislated responsibilities in the Local Government Acts, while the relevant sectoral legislation is largely consistent with the country's Local Government Acts and the government's decentralization policy. Furthermore, the overall expenditure responsibilities assigned to the local government level are in line with the subsidiarity principle and international best practice.

Although the overall assignment of functions and expenditure responsibilities to the local government level in Tanzania is quite sound, the current expenditure assignments may require some further fine-tuning.[14]

Need for clarification of concurrent functions

One of the most important shortcomings of the current expenditure assignments in Tanzania is that the assignment of expenditure responsibilities in the Local Government Acts focuses exclusively on the responsibility of the local government level to provide or deliver certain government service, and fails to recognize the multi-dimensional nature of expenditure assignments. Likewise, the government's policy of "decentralization by devolution" does not distinguish at all between different types of local government spending.

By failing to consider the multi-dimensional nature of expenditure assignments, the legislative framework is unable to distinguish between concurrent expenditure assignments (including expenditure functions such as primary education, which are national in nature but for which the provision is devolved to the local government level), exclusive local expenditure functions (activities for which the responsibility is fully devolved to the local government level), and functions which are merely delegated to the local government level (where the local government acts as an agent for the central government). In the absence of this formal distinction, it is unclear as to which level of government is responsible for regulating and/or funding the various responsibilities for which provision is assigned to the local government level.[15]

Considering the nature and funding of local government administration

Another 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 responsibility that is appropriately assigned to the local government level. While there is no comprehensive indication of the total amount of spending on local government administration, the available evidence from various LGAs suggests that (in addition to administrative salaries covered by the local administration grant) local governments in Tanzania spend somewhere between 50 and 60 per cent of their own source revenues on local administration (Kobb, 2001a,b,c).

The fact that these own resources have to be generated locally for administrative expenditures 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, it would be appropriate for the central government to contribute to the general operating cost of local governments through an unconditional transfer scheme. One argument supporting this contention is that local government authorities are an integral part of Tanzania's national system of public administration and that the predominant responsibility of local government authorities is to manage the provision of nationally mandated priority-sector services (such as primary education and health care). Secondly, it is important to recognize that the category of local administration spending currently captures a variety of activities outside the main priority sectors that are nonetheless considered national priorities, such as local environmental programs or community development.

The role of central government ministries over local functions

Although the principle of D-by-D is clearly articulated in the legislative framework, this does not mean that there is universal acceptance of the role of local governments in providing government services assigned to the local government level. In practice, many central government line ministries continue to assert a role for themselves within the responsibilities legally assigned to the local government level, often citing weak local government capacity as a reason for continued central government involvement.

For instance, within the health sector, the Ministry of Health continues to provide in-kind transfers of medicines to LGAs rather than devolving greater flexibility in purchasing medicines 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. 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 the local governments' role in exercising their functional responsibilities.

As such, continued efforts are required to sensitize central government officials as to the vision of a decentralized system of governance, which requires central–local relations that—rather than continuing the centralist, top-down approach from the past—are built on central government ministries that limit themselves to providing policy direction, regulation, as well as facilitation of LGAs in the delivery of local public services.

Ongoing central government interference in local government staff placement

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. As discussed in later chapters, 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 exercise appropriate regulatory control over local budget decisions (in a less discretionary manner) through the local budget guidelines.

Possibly the last bastion of excessive central government control over local administration and the local delivery of public services is through its unwarranted 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. 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 within the context of their formula-based grants. This is a major hindrance in fully implementing the new 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 decisions in compliance with the decentralized approach envisioned in the country's Policy Paper on Local Government Reform (MRALG, 1998).

3 The Management of Local Government Finances: Local Planning, Budgeting, and Service Delivery

The ultimate benefits from decentralization (both in the quality of local government services as well as in the overall improved efficiency of the public sector) are greatly influenced by the manner in which decentralization reforms are actually implemented. In fact, it is not unusual for the implementation of decentralization reforms to differ significantly from its original conception. It is possible, for example, that a local expenditure program designed to be accessible by all households and to be progressive in its incidence becomes highly regressive in practice due to the failure of local governments to implement or administer the program as intended. As such, the political decision-making processes as well as the local administrative dimension (encompassing both local financial management as well as the actual delivery of services) are crucial to the sound functioning of the local government finance system.

Thus, in order for fiscal decentralization reforms to succeed and for sound expenditure assignments to translate into a well-functioning decentralized system, corresponding reforms are needed in the realms of political decentralization and administrative decentralization, respectively. These reforms include: first, a transparent local financial management process that allows communities to judge the performance of their local elected officials and to hold local government officials accountable (Section 3.1); second, a participatory local political process that enables the community to express, pursue, and achieve its priorities through its local leaders (Section 3.2); and third, administrative processes as well as the administrative capacity at the local government level to provide adequate public services (Section 3.3).

3.1 Local financial management[1]

In Chapter 1 of this book, we defined fiscal decentralization as the empowerment of local communities through the fiscal empowerment of their local governments (Bahl, 2005b). This definition presumes that local governments are provided with financial resources, and that local officials have a degree of control over these resources. This definition further assumes that the institutions of transparent planning, budgeting, and financial management are in place to allow local residents to communicate their priorities to locally elected officials and to assure that their local leaders indeed pursue these priorities in the context of their financial decisions. Thus, in order for fiscal decentralization reforms to succeed and for sound expenditure assignments to translate into a well-functioning decentralized system, a transparent local financial management process is needed. Ultimately, this process should allow communities to judge the performance of their local elected officials, and to hold local government officials accountable for their spending decisions.

Indeed, improving the practice and transparency of local financial management has been an important priority in Tanzania's local government finance reforms. In particular, the LGRP has sought to build the capacity of local treasurers and other local finance staff. Since 1999, the government has also been pursuing the roll-out of the Epicor program, a computerized financial management system customized for local authorities in Tanzania. Unfortunately, the roll-out of Epicor has not proceeded at a very steady pace: by 2005, only about one-quarter of local governments had successfully put in place the computerized financial management system. This fact notwithstanding, the proportion of adverse audit reports issued by the Account-General for local governments has steadily declined since 2000 (Table 3.1). Likewise, there appears to be a positive trend in recent years in the number of clean audit reports.

While the introduction of accounting software and better accounting practices may improve the financial processes at the local government level, it does not automatically create accountability. In order for local stakeholders to be able to hold their local officials accountable, the public needs to have access and be able to scrutinize local budget plans and reports; budget data should be presented in a way that it provides relevant, verifiable

Table 3.1 Summary of audit certificates for local governments, 1998–2003

Year	**Adverse**		**Qualified**		**Clean**		**Not submitted/no certificate**		**Total**
1998	40	36%	53	48%	18	16%	0	0%	111
1999	51	46%	51	46%	10	9%	0	0%	112
2000	75	65%	23	20%	16	14%	1	1%	115
2001	43	37%	59	50%	12	10%	3	3%	117
2002	29	25%	69	59%	17	15%	2	2%	117
2003	27	23%	50	43%	39	33%	1	1%	117

Source: CAG reports (1998–2003) as presented by Sundet (2005).

information; and governance processes are needed for residents to question local government officials regarding financial decisions.

Despite clear improvements in local financial management processes in Tanzania over the last five years, concerns still persist about the integrity of local financial management practices (for example, Mushi and Melyoki, 2005; Sundet, 2005; URT, 2005b). Despite the desire of the central government to pursue an approach of "eyes on, hands off" toward local government finances, there is currently no basic monitoring and evaluation system for local government finances that is able to credibly answer even basic questions such as "how much are local governments spending?" To the extent that self-reported local budget data are available, substantial differences between the reported local expenditures and the total local resource inflows (own source revenues plus transfers) raise serious concern about the accuracy of these available budget data (URT, 2005b). Furthermore, several public expenditure tracking surveys show persistent deviations between planned local expenditures and actual local spending (Sundet, 2004).

It might be reasonable to conclude that, thus far, the focus within the realm of local financial management has been placed on local government *accounting*, whereas inadequate attention has been paid to local budgetary processes and *accountability*.

A comprehensive, credible budget process

A prerequisite for transparency is the presence of a single, credible budget process. When local resource allocations occur through a number of different and separate processes where the actual amount available through each channel becomes known at different times, the ability for local government officials to set clear priorities and make clear trade-offs is greatly compromised. Furthermore, a budget process that relies on multiple funding channels greatly reduces transparency and accountability, as it opens the possibility for double-reporting of extra-budgetary activities.[2] This practice is a substantial concern in Tanzania, since there are substantial aid flows to local communities (for instance, through TASAF) or earmarked ministerial subventions which are not incorporated in a transparent manner as part of the regular local budget process.

While there will always be differences between local budget plans and actual expenditures, the credibility of the budget process depends to a large extent on budgeted and actual expenditures and revenues being reasonably close. This does not necessarily seem to be the case in Tanzania, and this has been the cause of some concern. For instance, as already noted, public expenditure tracking surveys suggest that there is a substantial gap between budgeted allocations for priority sectors and the manner in which these resources are actually spent at the local level. A tracking study conducted in 1999 found that local councils diverted a large part of funds disbursed by the center for non-wage education and health expenditures to other uses or used the resources for private gain (PWC, 1999). Leakage was estimated at 57 per cent in education and 41 per cent in health care. Salaries appeared to be less prone to diversion, but payrolls suffered from ghost workers and frontline staff suffered from delays in salary payments. Subsequent tracking surveys noted similar results (Sundet, 2004, 2005).

Similarly, there seems to be quite a difference between PEs that are budgeted for local councils and realized personnel spending. To the extent that data are available, it appears that many of these deviations are actually driven by central government staffing decisions that are made during the budget year or by the inability of local governments to staff available positions. However, very little effort is exerted in the budget processes (either at the central or at the local government levels) to verify that local budgets are executed as planned, or to correct any misallocations. The manner in which the local budget is presented should allow stakeholders (local residents and central government officials alike) to verify to what extent the budget is executed as planned, and should note why deviations from the budget plan have occurred. Such monitoring should occur both at the central government level (as grants are disbursed from the Treasury) as well as at the local level (both during budget execution and part of the local budget reconciliation at the end of the budget year).

Local financial management and clarity of accountability

At the heart of effective financial management lies clarity of accountability. Since the management of resources is critical to assuring effective local service delivery, creating clarity around financial management procedures and patterns of accountability within the financial domain is crucial. The starting point for sound financial management is the determination of the responsibilities of the political and administrative heads and the procedures and sanctions to be applied in cases of non-performance. All responsibilities ought to lie ultimately with the local political authority and the administrative head of council, with a clear division of responsibility between these two.

In Tanzania, the legislative and regulatory context for local financial management practices is provided by the Local Government Finance Act (1982), the Local Authority Financial Memorandum (1997), and the Local Authority Accounting Manual (1992). In addition, various pieces of national legislation apply to local governments' financial transactions, such as the Public Procurement Act (2004) and its regulations. These regulations are further supplemented on an annual basis by Local Government Budgeting Guidelines prepared by PO–RALG, which provides specific instructions for the annual local government budget (and since FY 2005/06, a medium-term plan). While these regulations provide an explicit sense of internal accountability, the regulatory framework does not provide for coherent guidance on the need for local budget processes to be transparent and accountable toward the local electorate. Although various regulations and guidelines require local governments to take certain actions to enhance the transparency of the local budget process, the local financial regulatory framework lacks a unified policy defining explicit transparency standards that local policy makers and managers at the local level must achieve (Mushi and Melyoki, 2005).

In this context, a relevant policy issue that should be considered is the fragmented nature of the regulatory framework for local government financial management. While defining the framework for local financial management in a series of memoranda, guidelines, and instructions offers greater flexibility to central government officials, this approach runs the risk of fragmenting and unnecessarily complicating and even confusing local fiscal processes. Instead, there are significant advantages to establishing a single, comprehensive regulatory framework that covers local financial planning, budgeting, accounting, transparency requirements, and audits. Regulating local fiscal systems in this way provides for a degree of standardization which in turn greatly facilitates transparency, clarity, and the development of local administrative skills. In a system such as Tanzania's, where such a large proportion of local government expenditures is dedicated to concurrent national priorities and funded from the center through grants, it would seem especially important that the central government plays an appropriate role in defining standard requirements and reporting formats for the monitoring of local government finances.

Transparency and local involvement

The key driver for an effective decentralized system of government is the local electorate, and the key to local involvement is transparency and access to information. Two spheres of access to information are required. On one hand, technical information about local government finances, such as accurate financial accounts and details about procurement decisions, needs to be reported to the central government and made publicly available. Although such information will generally not be accessed by local voters, the availability of such data does provide for easy monitoring by community-based organizations, NGOs, the media, and official bodies. Even in countries with relatively low levels of technological development, the scope for using information technology to collect, aggregate, and make such information publicly available is significant. 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. In this sphere, the main technical challenge is to translate the available budget information into contents that could be posted on a notice board in order to usefully inform the local community. This will require balancing the need for specific (rather than aggregate) budget information regarding observable service delivery and infrastructure performance on one hand, and the need to avoid raising the data-collection burden for local officials on the other hand. Civil society and community-based organizations should be able to make significant contributions to answering this question.

Although transparency requirements should be imposed on local governments, realism is required around the type of involvement that is likely from the public. International experience suggests that in monitoring local governments, the local public tends to respond on an issue-by-issue basis rather than in a more comprehensive and systematic manner (for instance, by reviewing the entire local budget). While expecting the public to engage with the budget process in the manner councilors should do 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. Building a culture of local involvement in local government affairs will take both time and effort, but the rewards in terms of better (more participatory, accountable and effective) governance over time can be substantial. From this viewpoint, it would also be important to pursue the introduction of a comprehensive and transparent regulatory framework for local financial management and to ensure that technical skills and tools are available to effectively administer local government finances. The development of these broader mechanisms for accountability lies at the heart of establishing effective financial management over the long term.

Next steps in improving local financial management

Despite the emphasis that local government reforms have placed on strengthening local financial management, substantial improvements to local financial management practices are still required. A number of steps can be taken to this end:

At the central government level, central authorities could improve the transparency and accountability of local government budget processes by rationalizing the way in which local government finances are addressed within the central government budget. For instance, assuring that local government grants are strictly allocated on a formula-basis would prevent the persistent disparities between formula-based grant amounts contained in the Local Government Budget Guidelines, the central government's budget plan, and the actual transfer disbursed by the Treasury. The central government could further encourage improved local government planning in the context of a medium-term expenditure framework by providing local governments with medium-term projections for the intergovernmental transfers that they expect to provide local authorities over the medium-term period. Furthermore, the central government should actively identify and eliminate parallel funding mechanisms (such as ministerial subventions) for functions which are devolved to the local government level. These concerns are discussed in greater detail in Chapter 8.

Likewise, significant improvements can be made at the local government level to improve financial management practices. In addition to continuing to strengthen the capacity of local finance officials, much could be gained from developing, and ensuring adherence to, a standard reporting format for local government finances that goes beyond the consolidated budget summaries that are now commonly published.

For example, developing a reporting format in which local budget execution figures are compared to the budget plan would be a major improvement in reporting practices. In addition, presentation of the local budget should allow local residents to establish some link between local spending and staffing levels on one hand and the local services that are delivered on the other hand. For instance, the current tendency to present the personnel expenditure as a single item by sector is not informative. Since personnel spending generally forms the largest part of any budget, failing to provide any further information on the way in which staff is being utilized makes it virtually impossible for local stakeholders to assess whether personnel resources are used efficiently, effectively, and fairly in order to pursue particular outcomes. In contrast, requiring local governments to break down the number and type of local government employees for each service post in the local budget could greatly increase the transparency of the local budget and financial management process.

3.2 Participation and local government finance

While economists who study fiscal federalism theory at times have the luxury to "assume away" the political and planning mechanisms required for successful decentralized system, assuring local participatory mechanisms is an important element of local government finance in the real-world implementation of decentralization reforms, especially in developing countries. Indeed, as we note below, local participatory planning processes are a necessary but not a sufficient condition for true community empowerment; in order for such participation to be effective, it is quintessential for the system of finance to be decentralized in a way that empowers local communities. Furthermore, political decentralization and local political processes need to be instituted in such a way that they empower both local political leaders and the local electorate, while preventing the capture of the entire process by local elites.

Participatory planning approaches in Tanzania

There appears to be a general political commitment in Tanzania to participatory planning at all levels of government. This is seen as a means to strengthen democratic processes and to engender economic growth and social development. Among others, this commitment is highlighted in the Tanzania Development Vision 2025, which identifies the need for democratic participation to take place at all levels in the development processes (Mushi and Melyoki, 2005). Correspondingly, sectoral development programs such as the PEDP and the District Agriculture Development Programme contain requirements for extensive participatory planning processes at the local government level.

Recognizing the importance of local participation as a key ingredient to successful decentralization, in 1998 PO–RALG started the development of a local planning approach known as "Opportunities and Obstacles to Development" (O&OD) with assistance from several development partners (JGDR, 2001). Subsequent to the completion of an official O&OD manual in 2004, PO–RALG promulgated O&OD as the official planning methodology to be used by local authorities. The O&OD process is a highly participatory bottom-up process which, within the context of local government institutions and structures, seeks to take advantage of the knowledge accumulated at the community level. The O&OD methodology focuses on planning from a positive perspective with emphasis on local strengths and opportunities for local development to come up with manageable development plans in accordance with local priorities.

Although O&OD was adopted as the official local planning methodology by PO–RALG, there are a number of practical challenges in operationalizing the O&OD approach across all local governments. Among others, the planning methodology is costly, requires a level of facilitation skills commonly not present at the local level. In addition, the planning process is time-consuming and it is questionable whether local residents in fact are (and remain) committed and interested to such an intensive planning approach over time (JGDR, 2001). Indeed, an assessment of local planning processes in 2005 found that although some type of participatory planning is being undertaken at the village and ward levels by most of the councils, it is also evident that in many villages and councils the O&OD planning tool is either not well-understood or not implemented altogether (Globe Accountancy Services, 2005). In contrast, because the O&OD approach is the only participatory process that is officially endorsed, there are no alternatives when local governments find this approach too complex or too costly to conduct. As a result, Mushi and Melyoki (2005) find that often only very limited consultation takes place in the development of district-level plans.

Effective participation and the need for fiscal decentralization

In addition to the shortcomings of the O&OD methodology noted above, any participatory planning process will fail to produce budget decisions that are consistent with the community's priorities unless the planning process properly links up to the local government budget process. Thus, while the existence of a consultative and open planning process is a necessary condition for a well-functioning decentralized system, it is equally important to assure that the planning process is properly integrated into the decentralized system of local government finance.

The failure of participatory planning when accompanied by a centralized system of finance is well illustrated by the following unsatisfactory experience with participatory planning relayed by an unidentified local government official in Tanzania. In accordance with central government instructions, the local government engaged in an exhaustive local participatory process within each of the district's villages and wards in which facilitators were used to identify local infrastructure priorities to address development opportunities. However, since the planning exercise took place within the context of a centralized, discretionary system of government finance, the local government was not given a budget ceiling within which to conduct the planning exercise. Accordingly, the local government compiled and prioritized the local needs identified in the participatory process and forwarded its development plan to central authorities for approval and funding. Naturally, the local expenditure needs identified by the communities far exceeded the financial resources available within the central government budget for the district. In order to bring the local development plan in line with the available financial resources, the council's development plan was revised in a process of negotiations between central and local government officials during which central government officials selected a limited number of local projects deemed worthy of central government funding, while the majority of the local projects (some of which were deemed local priorities) were eliminated. In the end, local planning officials were criticized from both sides: central government officials blamed local officials for preparing an unrealistic development plan, while local communities chided local planning officials for failing to secure their highest-priority community projects despite the high expectations generated and the extensive time commitment and inputs provided by the communities.

In contrast to a centralized, discretionary system where financing decisions are ultimately made by central government officials, the introduction of objective and pre-announced criteria for funding local governments (such as in the case of a formula-based grant system) provides an opportunity for true local ownership over the local planning process. The introduction of a decentralized financing mechanism can bring a different perspective altogether to the relations between local-level planning and the central government's top-down planning system. Reflecting on the experiences of the UN Capital Development Fund (UNCDF) in implementing Local Development Funds in several countries, Romeo (1999: 10) notes that under decentralized financing conditions

> local planning is no longer the preparation of a wish list of projects that are meant to be fed bottom-up to regional-national agencies for their

selection, financing and implementation as part of sector programmes they administer. Instead local resource availability and discretion over their use allows a more meaningful local planning process—one in which local choices can and must be made under clear budget constraints.

Political decentralization and local government finance

Although participatory planning processes and decentralized financing modalities are both necessary ingredients in a successful decentralization approach, local government finance reforms cannot take place without considering the political space in which local fiscal decisions are made. Fundamentally, local fiscal empowerment requires political decentralization. Yet, the presence of elected local governments is only the first step in assuring that political decentralization successfully complements fiscal decentralization reforms.

A political system that is decentralized in an effective manner requires that local government leaders are elected and are given a substantive degree of political decision-making authority. Effective political decentralization also requires that local politicians are made to be both responsive and accountable to the local community. Since political institutions naturally vary greatly from country to country, no one single approach to political decentralization should be expected to fit all countries. Nonetheless, the choice of the type of political system can have an important impact on the responsiveness and accountability relationship between elected officials and voters. For instance, one could argue that the accountability relationship at the local level is more direct in single-member constituency systems such as in Tanzania (where each ward elects one local councilor) compared to countries that rely on a party-list proportional representation system. Other aspects of the local political system can have an important impact on the responsiveness of the system as well, including the processes for nominating and selecting local party candidates, and the decision whether to elect or appoint local executives or mayors.

Despite having a locally elected council, local empowerment over local fiscal decisions in some countries may be frustrated when the local executive officer (Mayor or District Executive Director) is appointed by the central government. In contrast, in other countries, the local political structure can actually fail to be effective when power over the appointment and control of the local executive is yielded to local councils, which can result in ongoing political interference by the council in the management of local affairs. Yet, while it could be argued that directly electing local executives might result in a system that is more responsive to all local needs (rather than beholden to the interest of selected constituents), there are many well-functioning politically decentralized democracies where local executives are not directly elected.

Indeed, even the process of nominating and selecting candidates for local office can influence the effectiveness of local political structures. For example, if candidates for local political office are selected or appointed by national political party structures, the primary loyalty of these local politicians will be first to the national party apparatus, rather than to the local community—at least, if he or she wishes to be nominated by the party for another term. Other local electoral rules—such as the ability of the electorate to remove local politicians from office before the end of his or her term through special recall elections—may increase the participatory and accountable nature of local political processes.

While democratic and downwardly accountable local governments are more or less the norm in industrialized economies, similar local institutions and processes are generally not present in developing and transition economies like Tanzania. Particularly in Africa, many countries have chosen local political mechanisms that—while often democratically elected—promote upward (rather than horizontal) accountability of local elected officials (Crook, 2003; Olowu, 2003). In this respect, Tanzania conforms to the model that is prevalent in much of Sub-Saharan Africa: the local political organization is highly centralized, with candidates for local office being nominated by national party leaders. In fact, the central political monopoly may even be more pronounced in Tanzania than elsewhere in the region; although technically a multi-party democracy, the ruling party (CCM) still has a strong political hold in many parts of the country, especially in rural areas.

Despite the upward-looking nature of local political system in Tanzania, political decentralization—and the impact of local political structures and processes on the overall decentralization process—has received relatively little attention in the country's local government reform process. Neither the nomination of local political candidates by national party officials nor the absence of directly elected local executives seem to be considered major impediments or even contributing factors to the perceived lack of responsiveness and downward accountability of local councilors. Nonetheless, the political power of elected local governments was enhanced to some extent by the revision of the Public Service Act (2002, as modified in 2004), which now states that local executive directors serve at the pleasure of the local councils. In practice, however, the Minster responsible for Local Government still acts as the official appointing authority for local executive directors and has substantial weight in the local selection of an executive director.

Local government finance and local elite capture

When considering political decentralization in developing economies like Tanzania, a pervasive concern expressed in the development literature is the notion of local elite capture (for example, Crook, 2003). Given the absence of well-functioning political mechanisms at the local level to ensure participation and accountability, the concern arises that local political elites might be able to "capture" the local decision-making process, including control over local government finances. Anecdotal evidence certainly suggests that local elite capture is a major concern in Tanzania. For instance, in his study of decentralization and democratization in Tanzania, Mukandala (1998: 47) notes that many villagers (and even residents in urban areas)

> claimed that there was always an element of force in the background if one disagreed with the position of the chairman. Asked why the chairman could behave in such an authoritarian manner, when he faced elections every five years, respondents claimed that it was very difficult to unseat incumbents. Some also claimed that elections were always rigged so that a chairman in alliance with powerful elements in the village, especially rich peasants and traders, was always assured of victory. It was also claimed that people were not very willing to stand up to the chairman because as chief of the party in the village, he could hurt you in many ways.

Although there is significant anecdotal evidence that elite capture is a fact of life in Tanzania (as in many developing economies), there is an ongoing debate in the development policy literature whether local political capture can be overcome, or whether local elite capture could prevent successful decentralized development from taking place in a pro-poor manner. Obviously, international experiences in this matter could have an important impact on the sequence of fiscal decentralization reforms and expenditure assignments in Tanzania; if local elite capture has an adverse impact on local speedy decisions, then policy makers may not wish to proceed with further fiscal decentralization (by devolution) until political and administrative decentralization mechanisms are put in place.

Unfortunately, there is extremely limited direct evidence in the empirical literature either in support or in opposition of the elite capture hypothesis. While it is easy to get the impression from advocates of the elite capture model that decentralized local governance will unreservedly fail in the absence of substantive political decentralization (Crook, 2003; Crook and Sverrison, 2001; Platteau, 2004), there is no systematic evidence that the absence of strong local democratic institutions cannot be overcome to assure positive local outcomes. A more balanced assessment of local elite capture weighs the risks of local elite capture with possible political capture at the central government level. In this vein, Bardhan and Mookherjee (2004) find that accountability problems in West Bengal were caused largely by central political discretion, rather than by elite capture at the village level.

Mansuri and Rao (2003) suggest that the literature is inconclusive on this point, not so much about the existence of this phenomenon as to its importance and impact on weakening the attractiveness of decentralized approaches to poverty reduction. In their assessment, Mansuri and Rao conclude that there is evidence that a decentralized approach to providing government services can create effective community infrastructure and improve welfare outcomes, and that the limited quantitative evidence available suggests that local participation in decision-making and project implementation has a beneficial effect on service delivery. Yet, it should be recognized that involving the community in choosing, constructing, and managing a public good is a process that will almost always be dominated by elites because they tend to be better educated, have fewer opportunity costs, and have the greatest net benefit from participation. However, it is not clear that this will necessarily result in pro-wealthy expenditure decisions, as a distinction should be made between benevolent capture and malign capture.[3]

Mansuri and Rao (2003) further conclude that since the success of decentralized approaches to service delivery and poverty reduction are crucially conditioned on local cultures and social systems, support to decentralization processes should be provided within the context of each country's institutions rather than with a wholesale application of international best practices. For instance, Tanzania has a strong political tradition of egalitarianism, which—as expressed through the national poverty reduction strategy and other policy documents—guides the way in which local governments are required to spend their resources. Even Crook and Sverrison (2001) conclude that marginal populations are best served by decentralized authorities when the central government supports poverty alleviation and other programs to serve the interests of the poor. As such, while the discussion of local elite capture points to a need to carefully consider the role of participatory planning and local democratic processes, in the end there appears to be some consensus that local elite capture is an obstacle that can be overcome through a well-designed, pro-poor decentralization framework.

3.3 The quality of local government service delivery

The main policy objective stated by the Government of Tanzania in justifying the policy of D-by-D in Tanzania is to improve the quality of government service delivery (MRALG, 1998). However, detractors of decentralization reform in Tanzania have argued that, in addition to the absence of appropriate democratic and political mechanisms, the limited administrative capacity of local governments will prevent the potential benefits of decentralization from arising. Although there is no data source available that tracks changes over time in the satisfaction with public services in Tanzania, recent survey evidence indicates varying degrees of satisfaction with public services (Table 3.2). It should be noted that the issue of local capacity should only consider the administrative or managerial capacity of local government officials, since, at least at the present time, the professional

Table 3.2 Percent of survey respondents satisfied with local public services

	Ilala MC	**Bagam. DC**	**Kilosa DC**	**Iringa DC**	**Moshi DC**	**Mwanza CC**	**Total**
Primary school	68.6	61.4	83.3	73.3	66.7	67.1	70.1
Secondary school	19.0	21.0	29.0	34.3	16.2	21.4	23.5
Health clinic	25.2	23.8	5.2	15.7	9.5	13.3	15.5
Dispensary	45.7	36.7	34.8	36.7	35.2	38.1	37.9
Agricultural ext.	1.9	8.1	12.4	5.7	10.0	9.0	7.9
Water supply	18.1	10.0	21.0	35.2	18.6	30.0	22.1
Road maintenance	25.7	27.1	13.3	27.6	13.8	24.8	22.1
Market place	19.0	11.9	3.8	4.8	24.8	14.8	13.2
Garbage collection	19.0	5.7	1.0	0.0	7.1	10.0	7.1
Sanitation	23.8	16.7	20.5	26.2	21.0	18.6	21.1
Electricity	23.8	10.0	20.0	15.2	27.6	19.0	19.3
Law and order	21.9	12.4	24.8	27.6	9.5	15.2	18.6
Unweighted average	26.0	20.4	22.4	25.2	21.7	23.4	23.2

Source: Based on Fjeldstad (2004).

capacity of teachers, health workers, and other local government staff does not depend on whether services are centralized or decentralized.

As reflected in Table 3.2, survey evidence (based on a survey conducted in October 2003 in six local government councils with a total of 1260 respondents) suggests that some variation exists in residents' satisfaction or dissatisfaction with the delivery of public services between different local government authorities (Fjeldstad, 2004). This could indeed suggest that local governments have different levels of administrative capacity in delivering services, thereby providing support for the notion that service delivery outcomes are affected by the degree of local capacity.

However, the responses presented in the table suggest that the variations in service satisfaction are in fact much more substantial between different types of government services (both within and between different sectors) than between local governments. For instance, while less than 10 per cent of total respondents indicate satisfaction with agriculture extension services and local garbage collection services, over two-thirds of respondents (70 per cent) indicate that they are satisfied with the delivery of primary education in their jurisdiction. The variations in the satisfaction with public service delivery provide an affirmation of local government capacity to the extent that centrally provided or centrally regulated government services (including secondary education, public order, and electricity) simply do not receive any higher satisfaction ratings than local government services.

The high degree of satisfaction with the local delivery of primary education vis-à-vis other sectors could potentially be explained by the relatively high level of financial resources dedicated to the sector, as well as the attention paid to local sectoral planning through participatory planning and accountability mechanisms under the PEDP. As such, the fact that respondents are generally satisfied with their local government's performance in one sector (primary education) suggests that local governments certainly have adequate capacity to deliver government services in other sectors, at least to the extent that these services are, first, adequately financed, and, second, to the extent that the local capacity to deliver sectoral services is enabled by the central government through a sectoral planning framework. Likewise, the pattern of satisfaction with local government services further seems to support the earlier contention that local elite capture—while certainly a policy challenge to be addressed in Tanzania—is not an unavoidable obstacle to increasing access to public services at the local level.

A final requirement in order to secure improved satisfaction with the delivery of local government services—in addition to sound local planning and adequate funding—is to pay greater attention to local human resource needs and to assure increased local government control over local staffing decisions. In fact, human resource limitations may play a role in explaining a pattern revealed by the survey data suggesting that the public's satisfaction with health services differs greatly across service delivery units: health clinics receive less than half of the satisfaction rating of dispensaries. It is not inconceivable that the inability of local governments to attract qualified staff for health clinics and district hospitals is an important factor that is limiting the quality of health services provided. More broadly, the quality of local government service delivery is determined to a large extent by the degree to which local governments are able to effectively employ their local government staff within the constraints imposed by the central government. Thus, if local authorities are to be effective in improving the quality of local service delivery, the authority to hire and fire personnel that is legally provided to them in the Public Service Act needs to be implemented in a meaningful way.

Although the role of central government line ministries is drastically changed by decentralization reforms, line ministries can nonetheless play an active and important role in improving broad, pro-poor access to local government services. First, line ministries can improve the quality of sectoral services by being advocates for increased funding through sectoral block grants. Second, and perhaps more importantly, line ministries can support improved service delivery at the local government level by backstopping the institutional development of local governments, particularly in the areas of local sectoral planning and local human resource development. In practice, central government line ministries in Tanzania have been slow to adapt to their new roles as facilitators and regulators rather than as providers.

Part II

The Revenue Assignment

4

Local Government Taxes in Tanzania: Weaknesses of the Current System of Local Government Revenues

It is clear that there are problems with the current system of local government revenues in Tanzania. A common critique of local government revenues in Tanzania is that local government revenue sources are low yielding, inequitable, form an obstacle to local economic growth, are inefficiently administered, and impose high compliance costs on taxpayers. Based on such a negative assessment of local revenues, some central government politicians and stakeholders have arrived at the conclusion that own local government revenue sources are not a necessary ingredient for a sound system of local government finance. In fact, a "rationalization" of the local government revenue system announced in June 2003 (which included the elimination of the Development Levy as well as the abolition of a number of other minor local revenues) suggests that it proved politically 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, as opposed to attempting to fix the problems with the current local government revenue system.

However, most fiscal decentralization experts would argue that a well-designed local government revenue system forms an indispensable component of any local government finance system. Although the primary function of local government taxes and local non-tax revenues is obviously to provide financial resources to cover the cost of delivering local government services, there are other important reasons to provide local governments with a certain degree of revenue autonomy. For instance, unlike intergovernmental transfers, local government revenues encourage the efficient use of public resources by establishing a direct link between the benefits of a public service on one hand and the cost of providing that service on the other hand. Furthermore, local government revenues can form an important mechanism for ensuring the accountability of local government officials toward their local constituents. Other advantages of increased local revenue autonomy include the development of creditworthiness and an effective way to address vertical imbalances against local governments in the intergovernmental finance system.

This chapter considers the shortcomings of the current system of local government revenues in Tanzania. For this purpose, the chapter is divided into five sections. First, Section 4.1 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. Sections 4.2 and 4.3 respectively provide an overview and an assessment of the current local government revenue system in Tanzania. Section 4.4 considers the relationship between local tax administration and the efficiency of the local government revenue system. Section 4.5 highlights the need to transform the system of local taxation and provides some concluding remarks. Subsequently, Chapter 5 presents the main outlines of a proposed transformation of the local government revenue system in Tanzania.

4.1 Principles of a sound 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 question is: 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).

Objectives of revenue decentralization and 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 makes market forces superior to a government-planned allocation of economic resources, there are a number of areas where the market fails, 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 (for example, street lighting); and the presence of spillover effects or externalities (for example, vaccination).

According to the subsidiary principle, policy functions related to economic stabilization and income distribution are best assigned to the central government; 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. In contrast, government actions taken to assure allocative efficiency (how to best use the resources available to provide goods and services) may be assigned to local governments when they are able to do so efficiently.

Because taxation only provides the means for government expenditure 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 government within the national system of public revenues.

Characteristics of a good revenue source

Characteristics of a good tax instrument or government revenue source are very intuitive and have been known for many centuries. In fact, substantive guidance on what constitutes sound taxation is provided in Adam Smith's seminal *The Wealth of Nations* (1776). Establishing a general civic obligation to contribute to government revenues, Adam Smith suggests that "[t]he 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." Building on the principles set forth by Adam Smith, the modern public finance literature generally recognizes the following principles as commonly acknowledged characteristics of a good revenue source.

Adequate revenue yield and buoyancy

The revenue yielded by taxes and non-tax revenue sources should be adequate. While the determination of what constitutes an "adequate" level of government revenues is subjective and subject to the notion that all resources are scarce, the economics literature does provide some guidance in assessing the adequacy of revenue yield. Among others, revenue adequacy should be considered relative to the funding needs of the government and relative to the size of the taxable economic base.

In addition to providing an adequate revenue yield at any point in time, a sound tax system should assure that over time government revenues should change roughly in proportion to the economic base. This concept of revenue buoyancy does not mean that government revenues should necessarily follow short-term economic fluctuations. Rather, as the long-term economic development leads taxpayers to demand a wider range and better quality of services from the public sector, a sound tax system would automatically match this increased demand for government services by proportionally generating greater revenue collections without having to adjust tax rates or other aspects of the tax structure.

Horizontal and vertical equity

Good revenue sources ought to be "fair" or equitable. Economists consider two dimensions to fairness in a fiscal system, namely horizontal equity and vertical equity.

The notion of horizontal equity suggests that taxpayers in similar circumstances should be treated similarly by the tax system. Taxes that are arbitrary, either in their design or in implementation, would violate this notion of horizontal equity. For instance, a tax system that imposes a tax on income from one type of business activity but not from another would generally be considered unfair. Likewise, fairness issues would be raised if tax administrators would impose different tax burdens on two taxpayers that have essentially the same tax base (for instance, identical property values). A perception of the tax system as being "fair" is believed to contribute to the probability of taxpayers voluntarily complying with their tax obligations.

In addition to horizontal equity, a sound tax or revenue instrument 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. The principle that taxpayers with a greater ability to pay should contribute more in public revenues is known as the "ability to pay" principle.

A different notion of vertical equity often considered at the local level is the benefit principle. This principle suggests that taxpayers should pay taxes in (approximate) proportion to the benefits received from public services. Adam Smith (1776) already noted that "[t]he subjects of every state ought to contribute toward the support of the government, as nearly as possible . . . in proportion to the [benefits] which they respectively enjoy under the protection of the state". As such, a benefit tax is a tax that generates revenues roughly in proportion to the benefits received. For instance, gasoline taxes are a good example of benefit taxes as the payment of gasoline taxes increases in proportion to the benefits received from use of the public roads network. Unless the intent of the revenue source is explicitly redistributive, the failure of a tax instrument to broadly adhere to the benefit principle could again result in reduced tax compliance.

Economic and administrative efficiency

An additional feature of a sound revenue source is that it should be efficient. An efficient revenue instrument minimizes two things. First, an efficient revenue source minimizes administration and compliance cost, and in particular generates an amount of revenues well above these costs. While it is unavoidable that there is a cost associated with the administration and enforcement of all taxes, these costs should be minimized since they represent a net loss to society. As such, tax instruments that are inherently costly to administer (or costly to comply with) should be avoided whenever possible.

Second, an efficient tax minimizes the incentives given to taxpayers to change their behaviors and discourage productive activities in the economy. For instance, excessively high marginal tax rates on personal or corporate income could provide a negative incentive on economic production. Efficient government revenue instruments rely on broad tax bases, which allow lower tax rates and make them difficult to evade or avoid.

Politically acceptable

Finally, while no revenue instrument will ever be popular among taxpayers, a good revenue source should at a minimum be politically acceptable and sensitive to the historical and institutional circumstances of a country.

Principles of a good revenue assignment to the local level

Besides satisfying the above-outlined criteria of being sound revenue instrument, a revenue source needs to meet some additional conditions to be a good *local* revenue source.

For instance, 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 health care 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. Besides neutrality with respect to income distribution and economic fluctuations and adherence to the benefit principle, fiscal federalism theory and best policy practices suggest a number of desirable characteristics for local government taxes. Some of these characteristics are actually 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 and the local government services funded with these resources. 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). For instance, local property taxes are typically used to fund local government services such as local road infrastructure, public order, fire protection, and other local amenities that provide a corresponding benefit to owners of local property.

The need for correspondence guides various aspects of the design of a sound local government revenue system. In order for the correspondence principle to be effective, 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 to whom it is 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.

Furthermore, in order to adhere to the correspondence principle, taxes assigned to local governments should not interfere with internal commerce nor distort the location of economic activity. 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. In order to maintain the correspondence between costs and benefits, local governments should not be allowed to "export" the burden of their local taxes to taxpayers outside their jurisdiction, for instance, by levying production-related sales taxes or source-related income taxes. Although clearly tempting and attractive to individual local governments, the assignment to local governments of taxes that can be exported leads to inefficient and irresponsible behavior of local governments at a national scale.

Revenue autonomy

Local governments that lack some control over the rates of one or more significant sources of revenue can never truly enjoy fiscal autonomy.[1] In the absence of a minimal amount of revenue autonomy, local governments cannot be responsive to the demands of their constituency as they cannot expand services when there is higher demand and cutback otherwise. Neither would local governments have flexibility for fiscal adjustment in response to rising costs in the absence of minimal discretion over local tax rates.

Other approaches to providing local governments with increased revenue autonomy—including empowering local governments to introduce or eliminate their own taxes or allowing them to define the tax base of local government revenues—are generally less desirable since they can easily lead to increases in compliance and administration costs.

Local tax administration

Certain revenues are inherently better administered at the local level (for example property taxes), while local governments have a relative disadvantage in collecting others taxes (for example, corporate profits tax). Local governments should be assigned taxes for which there are information and enforcement advantages at the local level. It is commonly argued that in the case of property taxes, a more decentralized local tax administration may have superior knowledge of local property ownership and circumstances. The capacity to administer taxes is an important factor in the assignment of taxing powers to lower levels of government and should explicitly 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. Vertical fiscal imbalance is created when a central government assigns itself all high-yielding revenue sources and low-yielding tax sources or no sources at all to local governments. Vertical fiscal balance can be at least partially restored through the local government revenue system by allowing local governments sufficient revenue autonomy, so that they have the fiscal flexibility to offset increases in their expenditure needs with increases in own source revenues whenever they deem this appropriate.

Horizontal fiscal balance

Unless tax bases are distributed completely uniformly across the national territory, allowing local governments to collect their own revenues will result in regional disparities in local resources. However, the general desire to assure equitable access to local public services means that excessive disparities in local fiscal conditions should be avoided. In this context, 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 design of revenue assignments should be made cognizant of the fiscal disparities that it can cause.

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 the 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. Limited subnational taxing authority and dependence on the revenue decisions of the upper-level government undermine 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.

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 recent studies, 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 (for example, Bahiigwa *et al.*, 2004). Although a recent World Bank 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 (World Bank, 2005a). But, before one rushes to eliminate all local taxes because of their alleged income regressivity, we need to consider that the impact of taxes on poverty should not be viewed in isolation from the entire tax system of the country, the impact of the services provided with these funds, and other benefits of local taxation such as greater accountability at the local level. In fact, fifty years of public finance literature suggests that local governments have a very limited role indeed in income redistribution, as this is a functional responsibility that should generally be assigned to the national level.[2] 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 noted above, the benefit principle should provide important 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 taxpayer should be roughly 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 revenue incidence of local taxes (in other words, their progressivity or regressivity) should be the benefit incidence of the services provided by local governments.[3]

4.2 Overview of the current local government revenue system in Tanzania

Local government revenue sources are specified in the Local Government Finances Act (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 2003, Tanzania's Local Government Finances Act followed a "permissive" approach to local government taxation, essentially allowing local governments to define their own local tax structure and freely raise own revenues from local taxes, licenses, fees, charges, and other revenues with few limitations. This approach is commonly referred to as an "open list" approach to revenue assignments. As a result of this permissive approach, the type and number of local taxes, levies and fees differ from one local authority to another. Prior to the local revenue rationalization in 2003, revenue sources typically collected by local governments in Tanzania included the following:

- *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 Levy had the nature of a local income tax. Due to its many perceived shortcomings and its political unpopularity, the Development Levy was abolished in June 2003.

- *Property tax*: Property tax is charged on the owners of real property (excluding land), 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 for most residential properties.
- *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 per cent of business turnover (excluding VAT—value added tax).
- *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 central government regulations mandate that the rate is not to exceed 5 per cent of the farm-gate price. (Livestock cesses were abolished in 2003.)
- *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. While at face value providing a high degree of revenue autonomy to the local government level, the central government had assigned itself all major government revenues sources (including the VAT, incomes taxes, business taxes, and even vehicle registration fees), thereby effectively preventing local governments from competing in any meaningful fiscal space. On the other hand, the open-list or permissive approach to local revenues contributed to the evolution of a highly fragmented local tax system based on a large number of minor, low-yielding taxes, which in turn imposed an excessively high burden on local taxpayers (through potentially high cumulative rates but especially through high administrative and compliance costs) and caused an environment not conducive to local 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.

A quantitative analysis of local government revenues

The most detailed data source available for local government revenues in Tanzania is the self-reported local government fiscal data gathered by the Local Government Reform Programme (LGRP, 2004). This source provides local revenue data from 2001 through to June 2004 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 (that is, the Industrial Cess/Service Levy), land rent, licenses and fees, charges, and other taxes and levies (Table 4.1).

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 revenue yield for local governments. For 2001, these categories contributed 21.5, 18.2 and 16.7 per cent to total local own source revenue collections, respectively. Together, these three local revenue categories accounted for almost 60 per cent of local government revenues. All local revenue sources together generated a revenue yield of TSh. 51 billion in 2001 (about US$51 million) and almost TSh. 58 billion in 2002 (approximately US$58 million).

Table 4.2 presents own source local revenue collections in per capita terms, ranging in total from TSh. 1725 in 2002 to a new low point of TSh. 1028 in 2004. These numbers provide some insight into the relative tax burden imposed by local government revenues as on average, local taxpayers pay less than 1 per cent of their income in local government taxes. The limited nature of local revenue autonomy is further accentuated by the realization that per capita local revenue collections reflect how much money is available at the local level to finance the provision of "truly local" public services. Even

Table 4.1 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
Agricultural 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

Note: * Annualized estimate, based on collections for January–June 2004.
Source: Computed by authors based on LGRP (2004).

Table 4.2 Consolidated local government revenue collections by source, 2001–2004 (actual collections, in 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

Note: * Annualized estimate, based on collections for January–June 2004.
Source: Computed by authors based on LGRP (2004).

before the rationalization of 2003, one could wonder whether the revenue sources assigned to the local government level were adequate when local governments only had TSh. 1700 per person at their discretion to deliver local government services.

The nature of own source revenue collections in Tanzania is further explored in Table 4.3 which presents descriptive statistics for per capita local government revenues for 2002 (the year prior to the local revenue reforms). The statistics in this table suggest that there is substantial variation in revenue collections across LGAs. In fact, in per capita terms, the wealthiest local government generates 40 times more own source revenue than the most poorly-endowed local government. Furthermore, the table breaks local authorities into urban and rural councils, highlighting the fact that urban local governments on average generate almost three times more local revenue than rural local government. The statistics displayed in Table 4.3 fail to illustrate further substantial differences in urban and rural revenue patterns. While in 2002 the main revenue sources for urban

Table 4.3 Descriptive statistics for local government revenue collections in 2002 (actual per capita collections, TSh. per person)

	Urban councils	Rural councils	All councils
Average	3,363.86	1,156.97	1,598.35
Standard deviation	2,465.43	584.72	1,494.00
Coefficient of variation	0.73	0.51	0.93
Minimum	862.99	266.57	266.57
Maximum	11,186.85	4,241.11	11,186.85

Source: Computed by authors based on LGRP (2004).

local governments were licenses and fees (including business licenses), the Service Levy and property taxes which together accounted for roughly two-thirds of total revenues for an average urban government, in contrast the Development Levy and agricultural taxes provided more than half of local revenues in rural local governments.

"Rationalization" of local government revenue during 2003 and 2004

Although the weaknesses of the local government revenue system were well known prior to 2003, PO–RALG pursued piecemeal improvement of the local government revenue structure through voluntary rationalization of local government revenues at the local government level (PO–RALG, 2002). By pursuing reforms at the local government level within the context of the permissive, open list approach to local taxation, PO–RALG sought to preserve the revenue autonomy of the local government level. However, this approach failed to recognize some of the more systemic problems with the local government revenue structure and was unable to achieve significant improvement in either the local government revenue structure or in local tax administration.

In light of the ongoing shortcomings of the local government revenue system, the system of local taxation in Tanzania was significantly reformed in June 2003 (and further modified in 2004) in a top-down manner by proclamation of the Minister of Finance during the Budget Speech. The reform effort—unfortunately known as the "rationalization and harmonization" of local revenue sources—eliminated the Development Levy, abolished eight fees (for bicycles, culture, health facility registration, health inspection, business premises inspection, water connection, land, hides and skin), 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. The reform also introduced detailed restrictions on the maximum tax rates chargeable by local authorities. Subsequently, in 2004, local business license fees were virtually eliminated in an effort to reduce the regulatory obstacles that were thought to be prejudicial to economic growth.

The local revenue reforms introduced in 2003 and 2004 required several modifications to the Local Government Finances Act. Most significantly, the Act now provides LGAs with a restrictive list of taxes, levies and fees that local governments are allowed to collect (Table 4.4). In contrast to the permissive approach to local taxation that prevailed before 2003, this new approach is known as a so-called "closed list" approach to local taxation: 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 structure their local revenue policies within the context of the list of permitted local government taxes, as well as within the tax rate limits determined by the central government.

Given the sudden transition from the permissive approach to the restrictive approach, local authorities were ill-prepared to implement the

Table 4.4 List of permitted local government taxes and revenue sources for 2004

Taxes on property • Property rates *Turnover taxes* • Service levy *Taxes on goods and services* • Crop cess • 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[a] • 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

Note: In addition to the taxes, levies and licenses listed above, the Ministry of Finance also provides a list of permitted local non-tax revenues, including specific Administrative Fees and Charges; Entrepreneurial Property Income; and Fines, Penalties and Forfeitures.

[a] In 2003 the fee for the "application for the license" was abolished, but not the fee for holding the license itself.

new policy requirements. As such, it is somewhat unclear to what degree local governments strictly adhere to the new "closed list" and the maximum rates imposed by the central government. 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.

4.3 An assessment of the current local government revenue system in Tanzania

The first section of this chapter provided an overview of what features combine to form a good local revenue instrument. These factors include adequate revenue yield and buoyancy, horizontal equity, adherence to the benefit principle and correspondence, adherence to the ability-to-pay principle whenever feasible, easy administration and compliance, economic efficiency, and political acceptability. Guided by these principles, the current section assesses the strengths and weaknesses of the current local government revenue system in Tanzania.

It is fair to say that there are three basic shortcomings associated with the current revenue assignment and local taxation in Tanzania. First, there are a number of significant shortcomings in the overall structure of the local government revenue system. Second, there are a host of problems specific to virtually each of the revenue instruments assigned to the local government level. Third, there are a number of problems with the manner in which local taxes are administered in Tanzania (Section 4.4).

Systemic shortcomings of the local government revenues system

The ineffective nature of the 2003 "rationalization" of local government revenues is highlighted by the fact that—despite the abolition of the Development Levy and several other nuisance taxes, resulting in a 40 per cent decline in local revenues—the system of local government revenues continues to be perceived as highly inefficient.

As such, the unresolved shortcomings of the system continue to necessitate a significant transformation of the local revenue system, a reform that should take place in the context of the broader local government finance system. This realization was an important impetus in 2004 for the Ministry of Finance and PO–RALG to engage in a comprehensive review of the policy framework underpinning the structure of the financing of local government in Tanzania, including the local revenue structure (LGRP/GSU, 2005). This comprehensive review identified a number of systemic shortcomings in the current assignment of revenue sources to the local level in Tanzania.

LGAs are mostly assigned low-yielding taxes

Tanzania's central government has reserved itself the most important and elastic tax bases in the economy, making it much harder for local governments to generate any substantial revenues from their own revenue sources. While Tanzania is not an exception in the international experience in this sense, critics of the poor revenue performance of local authorities in Tanzania should duly take into account the inherent low-yielding nature of revenue instruments available to the local government level.

Fragmentation causes horizontal inequity

Because no single tax assigned to the local government level consistently yields any significant revenues, the local tax system in Tanzania has seen a proliferation of numerous local 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 their tax bases and tax 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 been used strategically as an argument for the further elimination of local government taxes.

The benefit principle is misunderstood or missing as a conceptual foundation for local government revenues

As noted in Section 4.1, economists believe that the benefit principle should be an important guiding concept in determining a country's revenue structure, especially at the local government level. However, some stakeholders in Tanzania have interpreted the benefit principle in its narrowest sense, arguing that they should not have to pay local taxes unless they receive specific local government services. Of course, this statement presents a chicken-and-egg problem: after all, unless taxpayers pay their local taxes, local governments will lack the financial resources necessary to provide their residents with local government services.

Although a narrow interpretation of the benefit principle can be 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. Instead, many local services need to be financed by local tax instruments that reflect a broader interpretation of the benefit principle, particularly when it is impossible to exclude non-paying residents from receiving benefits. For instance, providing street lighting or making road improvements in front of one residence would benefit all adjoining properties. Yet, it would be impossible to finance such local services from user fees, as it would be impossible to withhold the benefits of the improved infrastructure from those taxpayers that refuse to pay. Instead, it would be appropriate to pay for such local expenditures through a mandatory local property tax.

As such, there is a need in Tanzania to reinforce the benefit principle in local government finances. Reinforcement of the benefit principle will require a clearer correspondence between the taxes local residents pay and the benefits they receive, greater transparency in the local government's budget process, and improved communications between local officials and community residents.[4]

Excessive focus on redistributive impact of local revenues

It has been argued that one of the purported shortcomings of the system of local taxation in Tanzania is the system is anti-poor and regressive. Although policy makers must not lose sight of vertical equity issues, there are several conceptual (and possibly factual) errors in the policy discourse of this issue in Tanzania.

First, the most-recent estimates of local tax incidence in Tanzania (World Bank, 2005a) show that as a whole, local taxes strongly conform to the ability-to-pay principle: before the revenue rationalization of 2003, high income local taxpayers paid six times more in local taxes and fees than low income taxpayers. Although adequate data are not available to make a conclusive determination, it is quite possible that local government revenues in Tanzania are in fact slightly progressive.

Second, as noted earlier in Section 4.1, there is a wide consensus among public finance experts that for practical and conceptual reasons, the goal of income redistribution, including through the revenue system, should not be left to local governments. Instead, the function of funding redistributive activities should be assigned to the central authorities. As such, the incidence of local taxes should be considered jointly with the rest of the tax system and with the benefits arising from the locally provided public services.

Most taxes currently assigned to the local level are hard to administer and enforce

It is disingenuous to argue, as is often done in different circles, that local governments in Tanzania 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 the fact that many of the taxes currently assigned to local governments (such as the property tax) are notoriously hard to administer (especially in the context of property rights in Tanzania), 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 Section 4.4.

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 between different local governments. Because the high compliance costs for local taxpayers have a potential negative impact on both local tax compliance as well as local economic growth, the reduction of such compliance costs should weigh heavily in the design of future reforms.

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.

Cross-cutting problems with the system of local government finance

It is sometimes overlooked that the poor local revenue performance in Tanzania is caused not only by a poor revenue structure, but also by failures in other dimensions of the local government finance system. For instance, 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. Likewise, the fact that locally raised revenues are mostly used to finance local government administration is an obstacle that prevents local government from using locally generated revenues for services that provide direct and tangible benefits to local residents. Similarly, the absence of hard budget constraints (for instance, to the extent that LGAs are able to divert sectorally earmarked transfer resources for other local purposes) further reduces the incentive for local governments to collect own source revenues.

Much of the blame for the inefficiency and ineffectiveness of the local government revenue system has traditionally been assigned to unwilling local politicians or the limited capacity of local revenue collectors. In contrast, this assessment suggests that many of the problems with local government revenues may be caused by systemic failures of the local government finance system. While capacity strengthening and sensitization at the local level are essential ingredients in the transformation of the local government revenue system, the systemic nature of many of the challenges suggests that transformation of the system will need a lot more than local-level reforms alone.

Shortcomings of specific revenue instrument assigned to the local government level

In addition to the broader, system-wide problems with Tanzania's local revenue system, many problems exist with the specific revenue instruments commonly used at the local government level. The discussion of the shortcomings of specific revenue instrument available to the local government level is organized around the eight broad categories of local government taxes and revenue instruments noted in Table 4.1.

Development Levy

With the abolition of the Development Levy in 2003, local governments essentially lost their only effective direct tax on residents. While broad-based progressive personal income taxes are typically assigned to the central government level, the part of the "fiscal space" that covers the taxation of incomes of households and smaller firms also allows the opportunity for local government taxation.

Local taxes on the income of households are sound local revenue instruments for a number of reasons. 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 strong incentives for local participation and local accountability mechanisms. Second, local income taxes have the potential for being somewhat adjusted in accordance with the ability-to-pay principle, either as a proportional income tax or through a graduated presumptive tax structure. Third, local income taxes (both on households and firms) generally serve as benefit taxes in the sense that wealthier local taxpayers typically benefit more from the public services provided by the local government level. Fourth, to the extent that taxpayers are registered with the Tanzania Revenue Authority (TRA), local income taxes should be relatively easy to administer (possibly even as a piggy-back tax by the central tax administration authorities).

Local property taxes

In most countries, property taxes are a good and commonly used local government source. First of all, taxes on real property (that is, land and buildings) 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 benefit principle. Further, property taxes follow the ability-to-pay principle, as wealthier taxpayers tend to have more taxable property. In principle, the property tax should be easy to administer since property is very visible and immobile across local jurisdictions, which should give local officials a strong "tax handle". However, in order to tax property in an equitable way generally requires costly revaluation of property on a regular basis.

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 per cent of local revenues, the property tax in Tanzania only yields 13 per cent 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 per cent (Kelly and Musunu, 2000). Rural property is essentially untaxed.

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 (as discussed further below) is assigned almost completely to the central government. 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 throughout Tanzania in the medium to long run. This is especially true for urban local governments (where most structures are located), 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. Outsourcing the administration of the property tax may limit the ability of local politicians to undermine its effectiveness by doling out politically motivated exemptions.

Taxes on agricultural production

The crop (or produce) cess, a tax on the sales of agricultural crops, is the highest yielding source of local revenues for most rural local governments in Tanzania, despite its maximum rate of 5 per cent. However, Tanzania's approach to taxation of agricultural production has long been criticized as inefficient and impractical (Bird, 1974).

A peculiarity of the crop cess is that rather than imposing the tax directly on local agricultural producers, the cess is collected indirectly from the purchaser or wholesaler. Although the indirect collection of the crop cess as an indirect tax is arguably intended to facilitate administration and enforcement, the indirect nature of the tax has also improved the political acceptability of the tax. At the same time, the indirect collection approach hides the fact that local crop producers likely bear the lion's share of the economic burden of the tax.

In reality, however, it is not altogether clear whether the archaic licensing, registration and transaction procedures currently used actually improve local revenue performance. It might in fact be much simpler (although probably much less popular with the local electorate) to clearly shift the legal burden of the tax back onto the farmer rather than on the buyer/wholesaler. Shifting the legal incidence back to the farmer would re-establish the link toward the produce cess as a local benefit tax.

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 taxation, which is levied at the point-of-sale of agricultural products. 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 toward a more integrated local government tax system and toward improving the perception of fairness across different groups of taxpayers.

Service Levy

The Service Levy is an important revenue source for local governments in Tanzania, particularly for urban local governments. The Service Levy is collected from large businesses (producers with turnover in excess of TSh. 20 million); the levy is collected as a rate equal to 0.3 per cent of turnover, as determined by central government directive.

On one hand, the Service Levy provides an attractive revenue source for local governments with a potentially high yield. As a tax on business production, the Service Levy can be considered a benefit tax—paid in some proportion to the firm's use of public infrastructure and services in the local government. A very attractive feature of the Service Levy is that its collection can be coordinated with VAT collections by the TRA. This means that local governments can readily identify the taxpayers as well as quantify the amount of turnover subject to the local 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, 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, 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 a 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. 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, it is still only applied to larger firms, thereby requiring a separate taxing mechanism for smaller productive enterprises. As argued in the next chapter, it would make a lot of sense to address taxes on business production and turnover in a more comprehensive fashion.

Land rent

While (as noted above) the local property tax in Tanzania is applied to structures only, the taxation of land is done through the payment of Land Rent. Although the 1995 Land Policy reintroduced the notion of private property and legalized market alienation of land, notions regarding land ownership and land taxation are greatly influenced by Tanzania's post-independence history of common (that is, nationalized) land ownership.

Based on two separate Land Acts, there are essentially two systems of land tenure in Tanzania (Shivji, 1994). 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.[5] 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. The level of the rent is set by the central government but collected by local authorities, who are subsequently credited 20 per cent of collections on a derivation basis as compensation for collecting the land rent. As such, 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 per cent 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.

Licenses, fees, and charges

Since 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 force local governments to provide poor services (due to the lack of cost recovery). Setting fees above the costs for services provided would be suboptimal as well, because it would induce lower consumption below optimal levels, and would raise fairness issues to the extent that the public sector has a monopoly over certain services (for example, 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.

It is important to recognize that unlike the permitted user fees that are intended to be used on a cost-recovery basis, licenses or fees can be used as a mechanism to collect general purpose revenues, in which case the issuance of licenses or permits in fact predominantly functions as an administrative tool in the collection of local general purpose 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.

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 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.

4.4 Local tax administration and efficiency of the local government revenue system

Two of the main arguments that led to the rationalization and elimination of local government revenues in 2003 were, first, that the inefficiencies inherent in the local government taxes system form an obstacle to local economic growth, and second, that local government revenue administrations are so inefficient that the local tax system results in a suboptimal allocation of public resources at the local level. Indeed, there is a broadly shared assumption that the quality and effectiveness of local tax administration is consistently poor.

On this point, critics of fiscal decentralization base their arguments on conceptual conjecture and anecdotal evidence. Unfortunately, little hard (empirical) evidence is available about the efficiency or inefficiency of the local tax system as a whole, and the efficiency or inefficiency of local tax administration in particular. Although there is ample qualitative evidence to suggest that the local tax system is quite likely the weakest dimension in the intergovernmental fiscal system in Tanzania, it would not be prudent to attribute the inefficiency of the system to poor local tax administration at face value.

Although limited direct evidence is available on the effectiveness of local tax administration, the available research allows us to consider three aspects of local tax administration. First, we can consider the impact of local tax administration on gross local revenue collections. Second, we can break down the factors that influence tax administration performance. Third, we should consider the efficiency of the tax administration apparatus and the cost of local tax administration.

Local tax administration and gross local revenue collections

The bottom line in assessing the administration of any tax system is whether it is able to collect the expected level of revenues. Indeed, referring back to Tables 4.1 and 4.2, a common complaint regarding local tax administration is that local governments simply do not collect enough money. Mathematically, the amount of tax revenue collections could be represented by the following equation:

$$\text{(Gross) tax revenue} = \text{tax rate} \times \text{tax base} \times \text{tax administration performance}$$

where the tax rate is the statutory local tax rate set by the local government (within the limits defined by the central government); the tax base is the total amount of the economic activity subject to taxation (such as the value of personal income or property); and the tax administration performance ratio is a measure of the effectiveness of the tax administration. Tax administration performance ranges from 0 per cent, at which point gross revenue collections would equal zero, to 100 per cent, at which point the tax administration would collect 100 per cent of the local revenue potential at the given tax rate.

Low local revenue collections in themselves are not evidence of poor local tax administration. As noted in the previous section, the tax bases available to local governments are notoriously narrow (particularly in rural areas) and fragmented. Likewise, local tax rates are often bounded by central government at low rates: the crop cess (often the main revenue source for rural local governments) is subject to a 5 per cent maximum, while the rate of the Service Levy (the main revenue source for urban local governments) is subject to a 0.3 per cent limit. Thus, we should not expect substantial revenue collections to take place at the local level given the current local revenue structure even if local tax administrations were to achieve 100 per cent performance.

The Ministry of Finance's Budget Guidelines for 2004/05 to 2006/07 estimate that less than 40 per cent of potential revenues from local governments' own revenue sources are actually collected (Steffensen *et al.*, 2004). While the overall state of local revenue administration may be highly unsatisfactory, local tax performance varies significantly from district to district and between different tax instruments. For instance, revenue administration performance for the property tax is quite low, with performance in the Dar es Salaam municipalities ranging from 30 to 50 per cent (Kelly and Musunu, 2000). In contrast, tax administration performance of the produce cess in the cashew nut sector is substantially higher; based on figures reported by Fynn (2004), tax administration performance of the produce cess in the cashew nut sector exceeds 90 per cent.[6]

Determinants of tax administration performance

What determines the overall tax administration performance at the local level in Tanzania? Prevailing perceptions in policy circles in Tanzania is that limited administrative capacity is the main culprit. However, tax administration performance is in fact a function of a number of factors, which can be expressed by the mathematical equation:

$$\text{Tax administration performance} = \text{tax base coverage} \times \text{collection ratio} \\ \times \text{revenue corruption}$$

where the tax base coverage ratio can be defined as the share of the actual tax base that is subjected to taxation; the collection ratio is computed as the amount of taxes collected expressed as a share of the tax base subjected to taxation; and the revenue corruption ratio is the share of total revenue collections that is actually deposited into local accounts by local tax collectors, rather than siphoned off by corrupt tax collectors.

Tax base coverage

The first reason why local tax administrators may collect less than 100 per cent of their revenue potential is that the local tax administration is unable to reach 100 per cent of the total local tax base. Examples of tax bases would be the value of taxable local property (for the property tax), the value of farm produce (for the produce cess), or the number of residents subject to the Development Levy (now abolished). There are two basic causes for the tax base covered by the local tax administration to be less than 100 per cent.

First, the tax administration may simply not have a full list of taxpayers from which it should be collecting local revenues, or might otherwise have difficulties fully assessing the value of the tax base. This is especially a challenge in the case of property taxes, where establishing a complete cadastre of properties and valuation of all properties can be an administratively arduous task. In other instances, the technical process of obtaining information about all taxpayers and their taxable bases is much easier to come by for local government officials; for instance, local authorities should be able to extract all necessary information for the Service Levy from VAT records filed with the district office of the TRA.

A second reason why local tax administrators may not pursue revenue collection for 100 per cent of local tax payers (or 100 per cent of tax base) is that they may be instructed not to do so by the local political leadership. Local political pressure to selectively collect local taxes may be the result of political favoritism or corruption, but could also be an expression of the lack of political will to collect revenues. While the absence of political will to collect revenues is often perceived as a shortcoming, there might be a number of good reasons why local officials, and the constituents they represent, may prefer not to maximize local revenue collections. This is especially true considering the onerous nature of many of the tax sources assigned to the local level and the limited tangible benefits (value for money) that local residents perceive to get from local taxes. As such, low revenue yield or poor revenue performance should not a priori be assumed to be caused by incapable local tax administration.

Collection ratio

The collection ratio is computed as the amount of taxes collected expressed as a share of the tax base which is actively subjected to taxation. In other words, what is the success rate in local revenue collections from those taxpayers that are in the local government's tax net? Ultimately, the collection ratio depends on a combination of the voluntary compliance rate and the success of involuntary compliance enforcement.

The importance of voluntary compliance and proper enforcement is confirmed by a recent survey of local tax compliance in Tanzania (Fjeldstad, 2004); four out of ten residents in Tanzania (41.3 per cent) report that they do not pay any local taxes or fees to their local government. Almost six out of ten respondents (58.4 per cent) stated that a major problem in revenue collections was the fact that tax revenues were not being spent on local services, while almost three out of four respondents (72.7 per cent) indicated that they would be willing to pay more tax if public services improved.[7] It is hard to judge the veracity of this statement, and we already noted that the current level of tax evasion presents a chicken-and-egg problem for local governments in improving local services. Furthermore, the concept of "free riding" in public finance theory suggests that if taxpayers were strictly rational, in fact no taxpayer would ever voluntarily pay any taxes. Although local taxpayers might feel better about paying local taxes if they believe their contributions translate into improved local services, taxpayer compliance can only truly be achieved by imposing stringent administration and enforcement mechanisms, so that taxpayers know that payment is unavoidable and evasion carries a severe penalty. In fact, survey respondents suggested that the primary reason for paying local taxes was to "avoid disturbances" (45.6 per cent).

The low collection ratio suggests that one of the weaknesses of local tax administration in Tanzania is the ineffectiveness of local tax enforcement: clearly there is no credible enforcement if 40 per cent of taxpayers are getting away with fully evading taxes. How can local tax administration officials address this problem? Consistent and aggressive enforcement of local tax evasion could result in a substantial increase in local tax revenues, but the popular perception is that local tax collection already relies excessively on antagonistic enforcement, and instances of physical force used in the collection of local revenues have contributed significantly to the unpopularity of local taxes (Mukandala, 1998). Therefore, this option may not be politically acceptable, neither at the local government level nor at the central government level. In fact, an important reason for the abolition of the Development Levy was the perceived harassment of taxpayers by local tax officials in collecting the levy.

Ensuring a credible enforcement mechanism may be more of a matter of sound tax design than a matter of sound tax administration, since credible enforcement requires that a tax has a good "tax handle". For instance, high voluntary compliance rates can be achieved, even in the absence of proactive collection practices, if there is a credible threat of forfeiture of the property in the case of non-payment. However, such reliance on enforcement requires a clear assignment of ownership of land and property rights, and further requires a credible mechanism and the political will for enforcing penalties in case of tax evasion. Typically, these preconditions are not met in developing countries such as Tanzania. In the absence of strong reliance on enforcement techniques, local governments have to rely more on administrative tax handles to assure compliance, such as withholding revenues at source or linking tax payments to the issuance of permits. In contrast, central government regulations in recent years have eroded local tax handles, for instance, by not allowing local governments to collect any revenues other than the crop cess at the market, and by essentially eliminating the ability of local governments to use business licenses as a tax enforcement mechanism.

Revenue corruption ratio

Finally, tax administration performance would be reduced if, after collecting tax payments, the revenue collectors would fail to deposit the full tax payment into the local government's bank account. Such diversion of public resources for private uses could be the result of unilateral action, or could be the result of collusion with the taxpayer (that is, a bribe). Although it is extremely hard to assess the exact extent of such revenue corruption, taxpayer surveys generally support the contention that corruption is a serious problem. For instance, 45.7 per cent of survey participants agreed that dishonest collectors represent a major problem in tax collection, whereas harassment by tax collectors was considered a major problem by 38.2 per cent.

Caution is needed in interpreting these survey results. Perception surveys on corruption are notoriously sensitive to the exact formulation of questions, and it can be difficult to determine whether the survey actually measure the true problem, or whether it captures a biased perception of the corruption problem. For example, 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?" As such, opinions regarding local tax administration may be negatively biased by a strong preference not to pay local taxes, rather than by factual corruption in local revenue collections.

The cost of local tax collection

A point of concern raised by many stakeholders in Tanzania is the low "net tax take" at the local government level, which can be defined as the share of revenue collections that remains available for spending on public services after subtracting the cost of tax administration. Tax administration costs are an inherent inefficiency of the public sector; outlays on public services will always be less than 100 per cent of revenue collections due to the cost of collecting revenues. As a measure of this phenomenon, we could define the net revenue ratio as:

$$\text{Net revenue ratio} = \text{net tax revenue}/\text{gross tax revenue}$$

where net tax revenue can be defined as the amount of (gross) revenue collections minus the costs of tax administration. Not only does this cost include the wages of local tax collectors, but this could also include payments to private firms that are contracted to perform local collections. In an efficient local tax system, collection costs may represent around 1–2 per cent of total collections, meaning that 98–99 per cent of public resources are available for the delivery of local services. Of course, collection costs can vary widely depending on the nature of the tax, the tax administration procedures, as well as the geographical, economic, and fiscal nature of the local environment.

Unfortunately, there are no empirical data readily available to quantify the net tax take of local governments in Tanzania. While it is likely that the net revenue ratio is substantially higher at the central government level than at the local level due to scale economies and more efficient operations, a valid question that yet remains to be answered is whether the cost of local tax collection is indeed so much higher that it would cause serious suboptimal public finances.

While it is likely that some efficiency gains could be made by streamlining and reducing the cost of local tax administration, a much more significant problem is the fact that a huge proportion of local revenue collections are actually used to cover local administrative costs rather than the delivery of local services. Sample evidence suggest that anywhere from 40 per cent to upwards of 60 per cent of local revenue collections are spent on local administration costs, with only a small portion of this being attributable to local tax administration (Kobb, 2001a,b,c; REPOA, 2004). As such, out of every TSh. 100 paid by local taxpayers, 40–60 shillings are diverted to general local administrative overhead and therefore simply not available for funding of local government services that benefit local residents. In Section 2.8, we noted that this is a fundamental shortcoming in the assignment of expenditure responsibilities in Tanzania, which could be remedied by covering the basic administration cost of local governments through the transfer system.

A final potential source for inefficiency arising from local tax administration lies 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. Compliance costs are exacerbated by the fragmented nature of the local government revenue system. 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. The main policy tool to reduce compliance costs is in the hands of the central government, through the introduction of standardized set of local taxes, each of which has a streamlined and nationally standardized set of administration procedures.

4.5 Concluding remarks: Toward a transformation of local government revenues

The local government revenue system perhaps poses the most significant challenge in the reform of a sound system of local government finance. Unresolved shortcomings of the local government revenue system include major systemic challenges, such as the excessive fragmentation of the tax system at the local level. In addition to these systemic problems, other shortcomings include the poor design of individual local tax instruments, problems with weak local tax administration, and inadequate central government guidance and monitoring of local taxation. Despite having the right intentions, the rationalization and harmonization that took place in 2003–2004 failed to resolve any of these problems.

The transformation of local government revenues was not given center-stage during these years as part of the local government finance reforms, perhaps because local revenues contributed only a small part of local government finances. Yet, since significant progress was being made on the reform of the intergovernmental transfer system in 2003–2004 the transformation of the local revenue system became an increasingly higher priority for reform for Tanzanian authorities. This coincided with a realization that in order for the different pieces of the local government finance system to be effective, the reform of the intergovernmental transfer system and the reform of the local revenue system should take place in the context of the broader local government finance system. As noted earlier, this realization was an important impetus in 2004 for the Government of Tanzania to engage in a comprehensive review of its entire framework for financing of local government, resulting in a draft strategic framework on local government finance. This policy review was completed in June 2005 (LGRP/GSU, 2005). At the time of writing, the resulting draft Policy Paper on Local Government Finance, which contains a road map for the transformation of the local government revenue system, is under consideration by the Cabinet, and will likely be taken forward after the presidential elections in December 2005.

5
The Proposed Transformation of the Local Government Revenue System in Tanzania

Chapter 4 assesses the current local government revenue system in Tanzania and identifies a number of far-reaching shortcomings in the revenue sources assigned to the local government level as well as the broader framework for local government revenue collections. This assessment led to the conclusion that the traditionally "permissive" (open-list) approach to local taxation in Tanzania resulted in a system that virtually lacks any sense of uniformity. Furthermore, (1) local governments are mostly assigned low-yielding taxes; (2) fragmentation of the local tax system causes horizontal inequities and inefficiency; (3) the benefit principle is largely missing as a conceptual foundation for local government revenues; (4) there is an excessive focus on the redistributive impact of local revenues; (5) local revenues are hard to administer and hard to enforce; (6) compliance costs for local taxes are high, and (7) local governments are assigned the least popular and politically acceptable revenue sources. Addressing these problems goes well beyond assisting individual local governments in improving their tax structures and strengthening local tax administrations in a bottom-up fashion. Instead, resolving these shortcomings will demand a comprehensive transformation of the local revenue system.

Based on the recommendations contained in the study of Tanzania's local government financing framework commissioned by the Government of Tanzania in 2004, this chapter outlines the main elements of the proposed transformation of the local government revenue system (LGRP/GSU, 2005). For this purpose, this chapter is divided into six sections. Section 5.1 considers the need to reduce the fragmentation of local taxes and impose a degree of uniformity on the local government revenue system. With a more standardized local revenue framework, well-designed, broad-based local government taxes will have a chance to succeed. As such, local revenue reforms also means transforming the main local taxes into sound revenue instruments. Sections 5.2 and 5.3 consider the reform of local business taxes and local property taxes respectively, which are likely to form the main engines for Tanzania's local revenue system. Section 5.4 considers the role on non-tax revenues as well as the issue of "voluntary contributions" collected by local authorities. Potential new local revenue instruments are discussed in Section 5.5, before the way forward is considered in Section 5.6.

5.1 Consolidating and standardizing the current system of local taxation

The excessive fragmentation and the lack of uniformity of the local revenue system in Tanzania should be considered among the main culprits contributing to the system's inefficiency and inequities. Therefore, the main thrust of the transformation of Tanzania's local government revenue system should be to impose a standardized revenue structure at the local government level and to standardize and strengthen local tax administration processes.

Need for a "closed list" approach to local taxation

Thus, as a first step, the local revenue system should be transformed to formally pursue local revenue autonomy within the context of a more restrictive "closed list" approach to local taxes, allowing the local tax system to achieve local revenue autonomy in an efficient and effective manner. On the one hand, the imposition of a restrictive "closed list" would provide a needed degree of uniformity to the local government revenue system and ensure the overall legitimacy of the system, while preventing onerous local taxes from re-emerging. On the other hand, the closed list approach would nonetheless provide local governments with adequate revenue autonomy through their discretion to determined local tax rates (within centrally established limits).

The reform should further focus on the simplification of the current local revenue structure by combining several fragmented local taxes and levies into a small number of broad-based local tax instruments with more significant revenue potential. 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 the benefit principle without, in any serious way, contradicting the ability-to-pay principle. As described below (in Section 5.2), the ULB Tax is envisioned as an amalgamation of the various local business taxes, fees and charges currently imposed on local business activity. Furthermore, efforts to strengthen, improve and consolidate the Local Property Tax should continue to move forward (Section 5.3).

Need for a clear categorization of local revenues

Another element in the reform of the local tax system should be to impose a degree of uniformity on the terminology and concepts used in the realm of local taxation. Definitions for basic terms such as "levy", "cess", and "fee" are lacking or not adhered to. 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 should also facilitate the monitoring of the performance of local tax systems.

Table 5.1 presents a possible categorization of local tax instruments—based on common internationally used definitions—that could help to clarify the different types of revenue instruments available at the local level in Tanzania. This categorization distinguishes between four types of local revenue instruments: local taxes, local levies, local fees and charges, and

Table 5.1 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 (that is, 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

contributions. Table 5.1 specifies defining characteristics for each of these terms and further provides examples for each of these revenue types. There may or may not be consensus in policy circles with the categorization or the precise set of definitions that are presented in Table 5.1. What is important, however, is that a clear and consistent set of definitions is adopted and used in formulating the local government revenue system.

In addition to the broad-based local taxes that will likely form the mainstay of the local revenue system, there is a continued role in the local revenue system for a variety of local levies that are selectively imposed on more narrow bases. Many of the local revenue instruments that would fall in the category of "local levies" are currently referred to as licenses (for example, motor vehicle license or liquor license). However, this current practice is not consistent with the concept of licensing adhered to by the Ministry of Finance, which considers licenses strictly as a regulatory instrument.

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 are collected exclusively for cost recovery of the provided service. As discussed further in Section 5.4, many of the fees and charges which local governments are currently permitted to collect are appropriate sources of local government revenue. A final revenue category constitutes "contributions" which could be defined as payments to community-based projects and other local activities that do not flow to local government accounts. To the extent that such contributions are collected by the local government on behalf of local organizations (for instance, contributions to primary societies of local farmers), these funds should flow into earmarked trust accounts.

Nationally standardized tax administration regulations

The introduction of a detailed set of nationally standardized local revenue administration regulations and guidelines could have numerous benefits to the local revenue system: it would strengthen local revenue collection, promote the legitimacy of the local government revenue system, provide a stable local business environment, and minimize the compliance burden faced by taxpayers from local government taxes. Such an approach would mean that every local authority would use the same revenue administration manual, use the same local tax forms, and follow the same tax administration processes and procedures. Standardization of local tax administration processes can also prevent harmful idiosyncrasies of the current local tax system. For instance, in the absence of standardized regulatory framework that defines in which jurisdiction local businesses should pay their taxes, two different local governments might actually impose the same local tax on a firm that operates in both jurisdictions.

For each local tax permitted by law, these proposed regulations and guidelines would 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. However, a standardized regulatory framework would have to be flexible to accommodate major differences between local government jurisdictions; for instance, an approach to property valuation that might be appropriate in larger urban areas would not be appropriate at all in small, rural districts. As such, the regulatory framework would have to accommodate such variations rather than enforcing a "one-size-fits-all" approach.

Bringing uniformity to local tax administrative practices sharply contrasts with the current situation, where the central government provides no systematic backstopping or monitoring of local government revenues, and local government revenue administration practices vary widely from district to district. Standardization of local tax administration will also enable central government officials to monitor more systematically 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 a new local revenue system should also incorporate extensive capacity-building support for local revenue administration officials.

5.2 Consolidating the various local business taxes

As repeatedly noted above, one of the major shortcomings of the current local government structure is the fragmentation of local taxes on business activity. This problem could be resolved to a large extent through the introduction of a Unified Local Business Tax which would absorb (that is, consolidate, rather than eliminate) all existing taxes on local productive activity, including the Service Levy, taxes on agricultural production (including the crop cess and the forest produce cess), business income taxes for minor settlements, local fees on extractive production, and any other local taxes on productive activities.

The ULB tax is envisioned to be a broad-based presumptive tax on business income or business value. In many cases, business value could be approximated by gross turnover, as is currently the case for the Service Levy and produce cesses. For smaller businesses or businesses that cannot produce turnover information, the local government could 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 tax 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 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. The concept of the ULB tax as an "umbrella tax instrument" is similar to the Income Tax, which is also an umbrella tax instrument for a number of different types of income: 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 (for example, presumptive rates versus the graduated rate schedule).

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 remain low by spreading the burden of local government taxes to all businesses that benefit from local government infrastructure, rather than by burdening only a narrow base of local businesses. Even at a relatively low 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 local governments 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, the specific procedures for estimating the tax base and collecting the ULB tax should not be fully standardized. 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 and sectors in order to maximize the different respective tax handles. This would allow the introduction of a standardized business tax across all local governments, while maintaining sufficient flexibility for individual local authorities to collect local taxes in a manner that assures compliance and revenue yield.

A subsequent step in the introduction of the ULB tax—which should probably take place some time after the initial 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 local tax rates range from 0.3 per cent of turnover for the Service Levy to 5 per cent for agricultural products. However, given that the relationship between gross turnover and net business value or business income varies 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 has to be 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 government 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.

A final consideration with respect to the proposed introduction of a unified local business tax is that this would be a major departure from current practices. As such, it would 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 or a "certificate of local tax compliance" as proof of payment of the ULB tax which businesses would be required to display on a permanent basis within their premises in order to be allowed to operate their business. Such an enforcement mechanism would have to creatively work around the central government's policy that licenses should exclusively be used for regulatory purposes.

5.3 Strengthening and reforming of the local property tax

In principle, a local property tax should be easy to administer since property is very visible and immobile across local jurisdictions, which should give local officials a strong "tax handle" if they can use the legal seizure of property as an enforcement mechanism for noncompliance. But for the use of the property tax to be maximized, improvements in local property taxation are needed across all facets of the tax, including assuring a complete cadastre, valuation and assessment, administration and collection, as well as enforcement.

Property valuation

The property tax applies only to buildings in Tanzania, with distinctions made between urban and rural LGAs. Although legally the base of a modern 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 applied 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. However, valuations of individual properties 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 in ownership 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.

The national regulatory framework should continue to offer flexibility in the way in which local property is valued. It would be appropriate to allow local governments to select an approach for the valuation of properties from a menu of options that it deems most appropriate for the conditions at hand. Depending on the nature of the local government area and type of structure under consideration, appropriate forms of valuation could include the use of flat rates for all residential and business properties within a jurisdiction, using a graduated property tax structure based on the approximate size and characteristics of properties, area-based methodologies for assessing values based on the neighborhood in which the property is located (and possibly the square meters of built space), and assessment based on market value.

A nationally defined property tax schedule for area-based assessment could differentiate between rural and urban areas and, within urban areas, could distinguish between three or 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 to be applied to the area-based assessed values. While the range of permissible tax rates would also be legislated at the national level, local governments would have significant overall discretion in determining the structure of local property taxation by being allowed to select the tax rate and the valuation approach from the legislated options. Local governments would also continue to have control over the administration of the tax, although they could choose to outsource the development of the fiscal cadastre, the valuation of properties, and/or the billing and collection of the tax.

Local administration and collection of the property tax

Another part of the challenge may simply be administrative: many local governments in Tanzania may currently lack the administrative capacity to produce an accurate cadastre of taxable structures and to appropriately value these properties. The challenges with the administration and collection 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. 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, sound implementation of a property tax also recognizes that 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. If necessary, the central government can also develop and maintain the fiscal cadastre for local governments that lack an adequate level of administrative capacity.

Enforcement and political viability

Yet another structural challenge with the property tax in Tanzania is the enforcement of the tax and the political viability of enforcement. If property taxes are enforced stringently, noncompliant taxpayers should be subject to forfeiture of their property for failure to pay their local property taxes. Fear of losing their property is the reason why taxpayers in many developed economies "voluntarily" pay their property taxes. However, this enforcement mechanism may not be a viable option for local authorities in Tanzania, for social, legal, political, or practical reasons. Yet, if property tax collections are not enforced (or indeed, are not enforceable) then the property tax is essentially reduced to a truly voluntary contribution mechanism that should not be expected to yield any revenue at all. As such, considerable thought needs to be given to appropriate enforcement mechanisms for property taxes in the context of Tanzania.

Assignment of the 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, which is officially assigned to the central government level, although local authorities actually collect the Land Rent on behalf of the Ministry of Lands. 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, and eventually to consolidate the Land Rent with the local property tax.

There are essentially two systems of land tenure in Tanzania, which both continue to be influenced by the socialist ideals of the postcolonial era (Shivji, 1994; Legum and Mmari, 1995). For officially registered lands, land charges are collected through a system of annual Land Rents administered by the Ministry of Lands. The level of the rent is set by the central government but collected by local authorities, who are subsequently credited 20 per cent of collections on a derivation basis as compensation for collecting the land rent. 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.

There are several good reasons for reassigning the Land Rent to the local government level and integrating it with a property tax. First, under the logic that nationally 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 (that is, 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 per cent 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 or all of the collections. Furthermore, the separate collection of the property tax and Land Rent is duplicative and is likely reducing local tax compliance compared to a combined local property tax on land and structures.

5.4 The role of local non-tax revenues

Consistent with the classification scheme presented in Table 5.1, there would be two different types of non-tax revenue sources in Tanzania's future local government revenue system: Local Levies, and Local Charges and Fees. The distinguishing feature between the two types of local revenue would be whether the instrument would be intended for the purpose of generating general revenues (levies), or whether they would be imposed in order to assure cost recovery for the specific service for which they are charged (charges and fees). In addition, as we have seen, local governments may become involved in the collection of local contributions.

Local government levies

Most of the business and professional license fees currently on the books are appropriate revenue instruments that are commonly assigned to the local government level. These local non-tax revenue sources include a commercial fishing license fee, intoxicating liquor license fee, taxi license fee, plying (transportation) permit fees, forest products license fees, and other such levies and business license fees (see Table 4.4). Typically, these levies are imposed on activities for which additional taxes are justifiable (in addition to general business taxes) based either on the correspondence principle (for example, motor vehicle license/levy, or for regulatory reasons based on negative externalities (for example, local liquor license/levy).

We should note that the purpose of these revenue instruments goes beyond direct cost recovery for the issuance of licenses. For instance, a local authority may wish to impose a levy on taxis in accordance with the correspondence principle in order to offset the additional demands on local infrastructure and services that taxis may impose, including the construction of taxi stands, the more intensive use of local roads, and the potential need for increased street cleaning around taxi stands. As a result, these revenue instruments should be considered local levies under the classification presented in Table 5.1. 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—according to the terminology used by the Ministry of Finance—these terms imply a regulatory tool and/or a charge that is only 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 5.1.

The only current business fee (or levy) that might require reconsideration is the license fee on private health facilities. Given the desire to assure broad-based access to health care services, it might be appropriate to eliminate the local license fee on private health facilities. Of course, this presumes that the (central or local) government has appropriate regulatory mechanisms in place to regulate private health clinics, and that private health providers are appropriately taxed through other mechanisms (for instance, under the ULB tax and/or the central government's Income Tax).

Local (administrative) fees and charges

The administrative fees that local governments are currently authorized to collect in Tanzania are all revenue instruments that are commonly and appropriately assigned to the local government level. While local authorities might set different rates for these local administrative fees and charges based on local cost variations, these local fees should generally not exceed levels necessary for cost recovery.

With the exception of the billboard fee, it is appropriate for the fee schedules that are imposed by each local government for these revenue sources to be guided by the principle of cost recovery for the specific activity. The fee for billboards and posters (which is currently treated by the Ministry of Finance as an administrative 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. Instead, billboards impose a negative externality that can provide the community with a source of general revenue. As such, the regulations for the Billboard Levy should allow for graduation by type of billboard and size.

Given that the closed list approach to local revenues (including administrative fees and charges) is not intended to limit the range of local services funded by user fees, the central government should duly consider any requests from local governments to expand the list of permissible local administrative fees and charges for the funding of additional appropriate local government services.

Local contributions

In order to assure a comprehensive treatment of all local revenue sources, the legislative and regulatory framework for local government revenues should carefully define the concept of "contributions" or "voluntary contributions". According to the classification system proposed in Table 5.1, the central feature of a "contribution" is 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.

The reason why it is important to clearly define this term is to prevent abuse of the current perceived loophole in the local revenue structure; according to the schedule in the Local Government Finance Act, local governments are permitted to collect "voluntary contributions". While in some cases, contributions have been collected by local governments for the purpose of participatory community projects at the village level, anecdotal evidence suggests that this clause has been exploited by numerous districts to collect less-than-voluntary contributions to benefit the district's own budgetary resources.

Such abuse of the "voluntary contribution" clause could be prevented by clearly defining what constitutes a "Local Contribution"; the classification presented in Table 5.1 provides such a definition (although this is not necessarily the only solution). In accordance with this definition, although Contributions may be collected by the district-level LGA on behalf of village authorities or Primary Societies, they should not be considered as local government revenues and must flow directly into a Trust Account specifically set up for this purpose.

Considering formalized village contributions

When the Minister of Finance announced the abolition of the Development Levy during the 2003 Budget Speech, he suggested that the 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—as noted immediately above—are permitted, but not well-defined, under the current "closed list" approach.

While district authorities are currently required to share their General Purpose Grant, Local Capital Development Grant, and own revenue sources with village-level councils, the introduction of a more formalized Village Development Contribution scheme could fill the current void of the local government revenue structure at the village level. The administration of a more formal Village Contribution scheme could be guided by an official (yet simple) administrative manual issued by PO–RALG.

A more formal village-level contribution scheme could bring increased autonomy, transparency, and fairness to the present system of "voluntary" contributions, while requirements for reliance on participatory procedures in allocating the resources from the contributions could enhance accountability at the village level. However, introduction of a Village Contribution scheme should be done in a way that is not too formalistic, so as not to bureaucratize true grass-roots local participation and stifle village traditions.

5.5 Potential new local revenue options

Although unintentional, the so-called rationalization and harmonization of local government revenues in 2003 and 2004 greatly reduced local governments' own source revenue collections and consequently greatly reduced their effective degree of revenue autonomy. Whereas the restructuring of local government taxes and improvements in local tax administration over time may result in some improvement in revenue yield, it is unlikely that administrative reforms alone will be sufficient to cause a significant reversal in local revenue trends. The only other way to achieve greater local revenue yield and autonomy without raising tax rates is to expand the revenue instruments that are made available to local governments.

Until recently, the central government largely disregarded the need to create minimally viable fiscal space for local governments. As noted in the previous chapter, all major (high-yielding) tax instruments are assigned to the central government level, leaving mostly minor, unpopular, and low-yielding revenue instruments for the local level. The current transformation of the local government revenue system offers the opportunity to carefully examine the fiscal space occupied by the central government in Tanzania and consider how this fiscal space may be shared more appropriately between the central and local government levels. The strategic review of the local government finance framework commissioned by PO–RALG and the Ministry of Finance in 2004 identified four potential revenue sources that could appropriately be (re)assigned to the local government level in accordance with the sound principles of taxation and revenue assignment (LGRP/GSU, 2005). These four options are discussed in greater detail in the current section.

At the time of writing, no policy-level decision has yet been made on whether any of the recommended potential new revenue sources will indeed be introduced and/or reassigned to the local government level. In considering whether the introduction of new local revenue sources is desirable at some point in the future, the government will have to carefully balance the benefits of additional local revenue yield and increased local revenue autonomy, on the one hand, with the political and administrative costs that the introduction of new local revenue instruments would bring about on the other hand.

Reassigning the annual permit fee for motor vehicles to the local government level

A first option available to expand the local government revenue yield and autonomy in Tanzania would be to reassign the annual permit associated with motor vehicle registration to the local government level.[1] Although the Local Government Finance Act actually assigns vehicle license fees to the local government level, in reality this fee (currently set at TSh. 20,000 per vehicle per year) is currently collected by the district office of the TRA and retained by the central government. As such, the annual vehicle permit renewal fee could easily be reassigned to the local government level. This would give local government a potentially high-yield local revenue source and significant revenue discretion, while the collection of the annual vehicle permits in fact could continue to be done by the TRA's district offices (perhaps for a collection fee of 1–2 per cent). The TRA would then simply transfer the collected revenues to the local authority rather than transferring the resources to the central government treasury.

Registration fees and licensing fees for motor vehicles are generally considered to be an excellent candidate for revenue decentralization (for example, Bird, 2000; McLure, 2000). Bird (2000) notes that, in principle, an appropriate set of annual automobile license fees can serve the function of a local benefit tax quite well, as different cars impose different externalities in different locations. Assigning the permit fee to the local government level would allow local governments to vary the local permit fee based on local conditions, within centrally determined limits. The benefit principle would be reinforced as cars in some locations (especially urban locations) add more to pollution and congestion. Likewise, local permit fees could be varied based on such features as the age, engine size, and weight of the vehicle, as older and larger cars generally contribute more to pollution, while heavier vehicles do exponentially more damage to roads and require roads that are more costly to build. Another attractive feature of decentralizing automotive permit fees is that this revenue source is likely to display a more-than-proportional income-elasticity, so that the growth in local revenues from this source over time would likely exceed the overall economic growth rate.

There are two potential concerns associated with the possible reassignment of the annual vehicle permit fee to the local government level. The first potential concern is that the revenue effect of this reform would be concentrated in Dar es Salaam and a select number of other urban areas, where the majority of vehicles is likely to be concentrated. The potential increase in revenue inequality is an unavoidable result of decentralizing benefit taxes and to the extent that this is a real concern, this could be mitigated by the introduction of an equalization grant. A second concern is that there is a likely obstacle to achieving decentralized annual vehicle permit fees in Tanzania: it is quite possible that the central government would oppose such a move, as it may not be inclined to give up such an attractive revenue source.

Local personal income tax surcharge

Another possible appropriate new local revenue source for Tanzanian local authorities would be the introduction of a local surcharge (or piggyback tax) on the central government's personal income tax. Such a surcharge could again be collected by TRA and would be credited regularly (for example, monthly) to the respective local government accounts, preferably on a residence basis (as opposed to the place of work of the worker). 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. 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.

The primary advantage of a piggyback local income tax would include the sizable and elastic revenues that such a tax could yield. A secondary advantage of the tax would be the low administrative cost, as its collection would be piggybacked on to 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 and 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 a likely 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 (or levy) on utilities

Another possible new local revenue source that could be considered in order to expand the revenue yield and autonomy of local governments in Tanzania would be the introduction of a local excise tax on public utilities (for instance, on electricity consumption and/or telephone services). Like the other alternatives suggested, the introduction of such a local excise tax would conform to both the benefit principle and the ability-to-pay principle and would be relatively easy to administer.

Although the tax would be imposed on the individual consumers of electricity or phone services, the local excise tax 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. This mechanism would provide a good tax handle and potentially a high yielding and elastic source of revenues, which is successfully used at the local level in other countries (particularly South Africa). However, given that electric tariffs are already considered too high in Tanzania, there are likely to be certain limits to the usage of this tax both in terms of political feasibility and efficiency concerns.

Revenue sharing from extractive industries

If the government wishes to explore new potential local revenue sources, a final option would be to consider some degree of revenue sharing of taxes on extractive industries between the central government and the local governments. Revenue sharing from natural resource revenues would compensate local governments for the negative externalities commonly associated with extractive industries. Whereas revenue sharing from mining and other extractive industries is not likely to be possible in the near future, largely for administrative reasons, its adherence to the benefit principle and correspondence as well as its potentially high revenue yield makes it an option that cannot be ignored in the medium term. Further policy discussions 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 might result in extremely high and undesirable levels of horizontal fiscal imbalance.

5.6 Transforming the local government revenue system: The way forward

Although the Government of Tanzania has generally pursued a consistent and coherent policy reform strategy on local government finance issues, the Government's policy stance on the transformation of local government revenue systems in the past 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 the one hand, the Ministry of Finance, greatly troubled by the impact of local taxation on economic development, 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 the one hand with the desire for local revenue autonomy on the other hand in the context of a well designed local government revenue system. Although the Cabinet is yet to decide on the final details of the government's strategic framework on local government finance, its deliberations are guided by a draft Policy Paper on Local Government Finance that expresses a vision for a less fragmented, more uniform approach to local government revenues.

Reform of certain key aspects of the current approach to local revenues is required in order to assure a successful transformation of the local government revenue system in Tanzania. Regardless of the final composition of local revenue sources in the new system, the transformation will have to focus on the simplification of the current structure in the context of a "closed list". As suggested in this chapter, the easiest way to do so would be by combining several fragmented local taxes and levies on business and property into a limited number of broad-based local tax instruments with a more significant revenue potential. Additional uniformity to the local revenue system would be contributed 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, thereby further reducing the system's compliance costs and horizontal inequities.

In addition to the transformation of the current local revenue framework, the Government should also consider several options for enhancing the fiscal space of local governments, each of which will be able to provide considerable room for enhanced revenue yield, fiscal discretion, and accountability at the local level. Possible new local revenue sources under consideration include a "piggyback" local personal income tax surcharge, the introduction of local excise taxes on utilities, or reassignment of annual motor vehicle registration fees to the local level. While the introduction of a new local revenue source or the reassignment of a revenue source to the local government level would provide an injection of financial resources at the local government level, such a step would be much more politically contentious. The likelihood is high that such a decision would be left for a later date.

Agreement on the final composition of Tanzania's local government revenue system is only the first step in the transformation process. Once consensus is achieved on the policy direction for the local government revenue system, a concerted effort will be needed to ensure the transformation of local government revenues into a sound local revenue system. This effort will involve a number of key stakeholders, including PO–RALG, the Ministry of Finance, local government representatives, as well as private sector stakeholders and civil society. Implementation will involve drafting the necessary revisions to the Local Government Finance Act as well as the development of a standardized regulatory framework for local revenues. Subsequently, all 114 local government authorities in Tanzania will have to review their local tax systems for consistency with the new local revenue system and align their local practices with the new structure.

Time will have to tell whether—and at what pace—the transformation of the local revenue structure in Tanzania will proceed. Even with a clear policy vision, the transformation process will face a number of challenges, including political challenges (no tax reform is ever popular), technical challenges (no tax reform is ever easy), and institutional challenges (changing the status quo is never easy). The speed and success of the upcoming local government revenue reforms will be a determining factor of whether the proposed local revenue structure indeed reflects a balance between the desire for local revenue autonomy, on the one hand, and the assurance of an efficient tax system, on the other, that is acceptable to all.

Part III

Intergovernmental Fiscal Transfers

6
Principles for Developing a Sound Intergovernmental Fiscal Transfer System

The reform of intergovernmental fiscal transfer systems is arguably one of the most common, but often also one of the most challenging, components of fiscal decentralization reform. The policy challenge faced by the Government of Tanzania (and other countries pursuing reform of their intergovernmental transfer systems) is complicated by the fact that intergovernmental transfer schemes have a variety of different dimensions, thus offering many potential ways to structure the transfer system as a whole.

Unfortunately, there is no single best approach to designing a transfer system; the appropriate design of intergovernmental grant system is determined by a variety of country-specific factors, including the institutional framework, history, politics, the administrative capacity of the central government, the capacity and accountability of the local governments, and so on. This raises two important questions: what are the policy options available to the Government of Tanzania in designing a system of intergovernmental grants in order to fund local government activities, and what are the principles that the Government of Tanzania should follow in reforming its transfer system?

In addition to the synopsis of Tanzania's transfer system contained in Section 1.3, three chapters in this book deal with the design and reform of Tanzania's system of intergovernmental fiscal transfers. The current chapter discusses the dimensions of transfer schemes and the principles involved in designing a sound transfer system. Chapter 7 assesses Tanzania's system of intergovernmental transfers that was in place until 2004, which provided significant control over local government finances to the central government. Chapter 8 presents the design of the system of formula-based grants that was introduced in 2004, and highlights the ongoing implementation of the formula-based transfer system.

The term "intergovernmental fiscal transfers" captures a wide variety of intergovernmental funding instruments, by which one government bestows or grants another government (often at a lower level of government) with financial resources. Examples of intergovernmental fiscal transfers range from disbursements from the simplest grant mechanisms to highly complex grant systems, including such diverse transfer instruments as the Federal Allocations to state and local governments in Nigeria, unconditional grants from the General Allocation Fund (DAU) in Indonesia, village development block grants in Nepal, and fraternal revenue sharing among Germany's Länder. To confuse matters further, different countries use different terms, from intergovernmental transfers and grants-in-aid to subventions, intergovernmental settlements and local government subsidies.

Not only do transfer systems look very different in different countries, countries may have different reasons for introducing a transfer scheme. Thus, the first consideration in this chapter is what sound justifications exist for the introduction of a transfer scheme (Section 6.1). Once we have considered the policy justification for the introduction of a transfer mechanism, there are a number of dimensions along which different intergovernmental transfer schemes can be differentiated and classified. Once the government has determined the policy objective of a transfer scheme, an intergovernmental transfer scheme could be differentiated and assessed based on three broad dimensions:

1. *How is the total amount of the grant pool determined ?*
   There are different approaches that can be followed in determining the total grant amount; these approaches are discussed in greater detail in Section 6.2. In some cases, the total grant fund (also referred to as the "grant pool") is determined from year to year on an ad hoc basis as part of the annual budget process. Alternatively, the vertical allocation of resources could be determined based on some type of vertical sharing rule; for instance, the size of a grant pool could be determined as a fixed percentage of the national budget. Finally, the size of the grant pool could be determined as (a specified share of) a reimbursable cost.
2. *How is the divisible pool distributed among eligible units ?*
   Several mechanisms can be used to divide up the grant pool among the eligible subnational government units (Section 6.3). It is not uncommon, particularly in developing or transitional countries, to determine the horizontal allocation of grant resources on an ad hoc basis or as a result of (informal) negotiations as part of the annual budget process. In other instances, some type of formula-based approach is used to determine the horizontal allocation of resources. In the case of intergovernmental revenue sharing, revenues could be distributed in proportion to where the tax is collected. Finally, funds could be distributed across local government jurisdictions in proportion to costs which are being reimbursed (either fully or partially).
3. *What can the transfer funds be used for at the local level ?*
   A third dimension of any grant scheme is the degree and type of discretion that local government officials have over the resources (Section 6.4).

Are the resources provided on an unconditional basis as general purpose funding or are the resources conditionally provided and earmarked for a specific purpose. In fact, the conditionality of intergovernmental transfers can fall at any point along a spectrum from completely earmarked (conditional), to funding for sector-specific purposes, to completely unconditional grants.

After we discuss the sound justifications and three main dimensions of designing a transfer system in greater detail, the remainder of this chapter explores the guidance that public finance theory and international experiences provide in designing intergovernmental grant systems. The chapter considers three tools and issues in laying out guiding principles for developing a sound intergovernmental fiscal transfer system. Section 6.5 discusses the Bahl-Linn typology of transfers, which allows us to classify individual intergovernmental transfer schemes in Tanzania in accordance with a system of discrete transfer types. Section 6.6 discusses an alternative taxonomy of intergovernmental transfer systems that allows policy makers to place the grant system in the context of the country's decentralization strategy. Section 6.7 finally considers a number of generally accepted principles for intergovernmental grant systems to assure that they are technically sound.

6.1 Sound justifications for transfer mechanisms

Governments introduce intergovernmental transfers for a number of good reasons, while sometimes relying on them for a number of not-so-good reasons.[1] In this section we review the reasons for transfers, and we stress the point that the design of the system should be driven by the objectives to be accomplished. Generally accepted reasons for introducing intergovernmental fiscal transfers include:

- improving the vertical fiscal balance of the system of intergovernmental relations;
- improving the horizontal fiscal balance of the system of intergovernmental relations (in other words, equalization);
- compensating for the presence of spillovers or "externalities" between jurisdictions in the provision of regional or local public services;
- funding national priorities or "merit goods";
- administrative justifications for intergovernmental transfers.

While these principles provide good guidance in most cases, there are variations related to the specifics of public finances in developing and transition countries.

Vertical fiscal balance

There is virtually always an imbalance between the expenditure responsibilities of subnational governments and their revenue raising powers. At the early stages of development, the priority public sector responsibilities are infrastructure development, the provision of basic living necessities, and the protection of economic stability. These functions may be best achieved through the centralization of fiscal resources. But with economic growth and urbanization, public expenditure needs shift more toward services provided by local governments, such as social services, water supply, and so on. This shift is often accompanied by the inability of local governments to finance an adequate levels of public service. The gap must be filled in one of two ways: by giving local governments more revenue-raising powers or by revenue transfers from the central government to the subnational governments.

In developing and transition countries, there are limited choices for the delegation of taxing autonomy to local governments; in addition, central governments are often hesitant to give local governments significant revenue-raising powers. The alternative is to leave the bulk of revenue-raising power at the central level, and to provide a grant to local governments to accommodate the mismatch (in other words to fill the gap between local fiscal needs and their available own revenue sources). The result is that in practice transfers comprise a major component of subnational government financial resources. As local governments grow in their ability to use modern local tax instruments, the importance of transfers should diminish. For example, in the United States transfers finance less than one-fourth of all state and local government expenditures and subnational governments have access to a wide variety of consumption and income taxes. However, the story is different in developing and transition countries, where relatively fewer major taxes are suitable as subnational government revenue sources.

A major issue faced by those who design transfer systems and are driven by the vertical balance objective is how to measure vertical fiscal balance. In order to determine the required size of the transfer pool, one must estimate the difference between the revenues available to subnational governments as a whole and the expenditure needs of each level of government. This can be a subjective matter, because, without being accompanied by a precise definition, expenditure needs are almost limitless. Some countries that use the vertical balance approach determine a "minimum service level", and fill the gap with transfers. In other cases, the amount of transfers is determined by a central budget constraint rather than by a "minimum requirements" approach. Alternatively, historical spending levels are used to determine subnational government "needs".

Equalization

Equalization—achieving some degree of horizontal fiscal balance between different government units at the same level of government—is another justification for intergovernmental transfers. Developing and transition countries are characterized by wide fiscal disparities among regions and localities. It is not unusual for the average income in the richest places to be 20 times greater than that in the poorest places. To the extent that subnational governments are given more revenue-raising powers, these disparities will widen because the more urbanized local governments have the greatest tax capacities and the strongest administrative infrastructures.

If countries are to equalize inter-regional differences in financial capacities, it must be done with intergovernmental transfers. As will be underlined below, the potential to equalize does not necessarily mean that equalization will occur, nor does it mean that equalization is necessarily a good policy for a country. In order to assess the overall equalizing impact of intergovernmental transfers, we must consider three questions: How large is the transfer pool and how are intergovernmental transfers financed (that is, what is the distributional impact of the central government taxes that support the transfers), what distribution formulas are used to allocate resources among the local governments, and what is the distributional impact of services that subnational governments deliver?

Externalities

A third justification for the use of intergovernmental transfers is to offset externalities. That is, when local governments are left to make their own decisions, they may underspend on certain services where there are substantial external benefits to third parties, such as surrounding local governments. For example, subnational governments would probably underspend on vaccinations and immunizations compared to the level that is desired by the nation as a whole, given the fact that the benefits from the inoculations (a reduced change of an outbreak of a contagious disease) are felt by residents both within and outside the local government area. In this case, economic theory tells us that a grant conditional on spending for the service in question could stimulate spending on it.

Externalities or positive spillover effects do not necessarily benefit adjacent local jurisdictions only; benefits from locally provided services may accrue to the nation as a whole. For instance, individual local governments, especially in rural areas, typically only receive a small share of the benefits from providing basic education; in fact, if the student moves away after receiving his or her education (for instance, in search of economic opportunities in an urban area), the local authority may receive no direct benefit at all. In contrast, the nation as a whole benefits in a variety of ways from a better educated and more productive populace, including through increases in central government tax collections and reductions in the demand for poverty-related expenditure programs.

National priorities or merit goods

A fourth justification for intergovernmental transfers is the concept of national policy priorities or "merit goods". A merit good is defined as a useful good or service, such as education, that will be underprovided if the consumption decision is left up to consumers (or lower-level governments) because the consumer does not recognize the true value or benefit of the good. The concept of a merit good thus presumes that the central government is in a better position to determine the socially optimal level for this good than either individual citizens or local governments. Again, economic theory suggests that conditional grants could stimulate spending on such goods or services.

Administrative justifications

A final justification for the existence of intergovernmental transfers is administrative. On the expenditure side, local governments may have an advantage in implementing certain programs that are national in scope, such as the identification and delivery of cash transfers or food stamps to the poor. These programs can be financed and regulated by the central government but are better implemented by local governments with funding from conditional grants or reimbursement programs.

On the revenue side, the argument can be made that the central government has an administrative capacity to assess and collect taxes that is much greater than that of subnational governments. It is less costly and more efficient, therefore, for the central government to collect the taxes and then to allocate the revenues to local government in the form of transfers. There are two concerns about administrative justifications on the revenue side. One is that it may not be true that all taxes are more efficiently administered at the central level. In fact, some taxes are known to be more cheaply administered, and with higher collection rates, at the local level. The property tax, user charges, and local licenses are generally better administered at the local level; likewise, certain types of taxes related to the ownership and use of automobiles can often be more efficiently administered at the local level as well. The second issue is that the allegation of inefficient local government tax administration can become a self-fulfilling prophesy.

Bad justifications for intergovernmental transfers

The above are the proper justifications for intergovernmental transfers. But governments in transition and developing countries often do not use these justifications. Rather, they adopt intergovernmental transfers for other, less justifiable reasons. These "bad" reasons fall into three categories.

A first bad justification for introducing transfers is to discourage local government autonomy. That is, a central government could be resistant to giving up control over the resources and the decision-making power that would come with giving revenue-raising powers to local governments. As an alternative, intergovernmental transfers are given as a local government revenue source. Thus, central governments may prefer to give intergovernmental transfers to local governments to discourage local fiscal autonomy or in an attempt to maintain or enforce a high degree of uniformity in subnational expenditures across the national territory. In this case, the unfortunate goal of the central government would be to resist diversity on the part of local governments, either in terms of local expenditures or in the local revenue structure.

A second inappropriate reason for intergovernmental transfers would be a belief that local governments are more corrupt than the center, and that therefore a shift of revenue-raising powers to subnational governments would lead to an increase in the waste of public revenues. While there may be some truth to the argument that local government officials are more susceptible to corrupt influences from local citizens, there is no evidence to suggest that a decentralized local governance system is more corrupt than a more centralized public sector (Martinez-Vazquez *et al.*, 2004). In contrast, centralized government structures often face a major problem in effectively detecting and addressing corruption, because the central government is unable to hierarchically oversee and hold accountable deconcentrated civil servants at the local level.

Thirdly, a transfer system may be put in place as part of a strategy to offload the central government's budget deficit on to local governments. For example, a grant system may be put in place to fund devolved government activities, but the transfer mechanism may purposely underfund these activities in order to reduce the central government's own budget deficit. Such offloading was a major factor in Russia's decentralization reforms during the early transition years, and resulted in the imposition of unfunded mandates on the regional and local government levels.

6.2 Designing a sound transfer mechanism: Determining the size of the transfer pool

As noted at the beginning of this chapter, the first major step in the design of a system of intergovernmental grants is to determine the vertical allocation of resources: what approach should be used to determine the size of the transfer pool(s)? As already noted, there are basically three different approaches that can be followed in determining the total grant amount. In some cases, the vertical allocation of resources is determined based on some type of vertical sharing rule; for instance, the size of a grant pool could be determined as a fixed percentage of central government revenues. Alternatively, the size of the grant pool could be driven by (a share of) the amount of costs to be reimbursed, or might be determined in an *ex post* fashion (for instance, in the case of budget loans that are forgiven at the end of the fiscal year). Finally, the total grant pool could be determined from year to year on an ad hoc basis as part of the annual budget process.

Sharing national budget resources, sharing tax revenues, or similar funding rules

Arguably the most decentralizing form of vertical revenue sharing is the automatic sharing of some type of central tax receipts. In this case, the central government allocates a share of national collections of one or more taxes to regional or local governments. Typically, these revenues are then distributed among local government units either on a derivation basis (where the revenues are collected) or on a formula basis. Two design questions arise here: which tax(es) should be shared, and what percentage of collections should be shared?

Tax sharing is widely practiced among larger developing and transition countries that rely on an unconditional-type transfer scheme to fund their subnational governments. There seems to be neither rhyme nor reason to the choices made as to which tax base to share, and countries vary widely in their choices as to the percentage of the tax shared. For instance, in Nigeria, virtually all federal revenues are paid into the Federation Account, which is divided between different levels of government and different government units using allocation formulas. Since 1995, state governments have jointly received 24 per cent of the Federation Account. In the Russian Federation, subnational governments receive a pre-determined percentage from several federal taxes, including 100 per cent of the federal personal income tax on a derivation basis. In addition, Russian subnational governments receive grants from an equalization fund that for many years was determined as a certain percentage (lately 14 per cent) of all federal tax collections, excluding import duties.[2] Other countries rely on different types of vertical allocation rules, for instance, by specifying the required annual change in the funding pool in relation to the inflation rate.

Each country's revenue-sharing approach has unique features, and each country's revenue-sharing arrangement should be considered in light of the intricacies of the country's tax system and the horizontal allocation mechanism used to distribute the resources. Within this context, the relevant policy questions are, first, which taxes should (or more importantly, should not) be shared between different levels of government, and second, how the vertical sharing rate should be determined. This brings us back to the question of objectives of the transfer system and how it fits into the general decentralization program of the country.

Defining the size of a transfer pool based on a share of national budgetary resources is most common when a country predominantly relies on a single unconditional transfer scheme to fund subnational governments, such as the case in Nigeria (the Federation Account), Indonesia (the DAU), or South Africa (Equitable Shares). This approach to determining vertical allocations is much less common for more fragmented transfer systems, for instance, in countries that heavily rely on earmarked or sectoral intergovernmental grants. Fixing a vertical-sharing rule for intergovernmental transfers would also be much less suited when local governments are expected to play an increasingly important role in the public sector over time, as the fixed sharing rule would limit resource increases for the local government level.

Nonetheless, there is some limited experience with vertical rule-based resource sharing in Tanzania as well as in other LDCs. For instance, 30 per cent of the fuel levy in Tanzania is statutorily set aside by the Roads Fund Board for distribution to local authorities.

Vertical allocation and cost reimbursement

A second approach to determining the size of the revenue pool that will go to each level of government is the cost reimbursement approach. The scheme works as follows:

- The central government defines a service for which it will cover the cost incurred by local governments in delivering this service.
- Cost reimbursement may be provided either fully or partially. For example, a central government may decide to fully reimburse local governments for the cost of teachers' salaries. Similarly, the central government could offer local governments to partially reimburse the cost of constructing a road or highway; such a partial cost-reimbursement grant would take on the nature of a "matching grant".
- The transfer to cover these costs may be open-ended; in other words, the central government stands ready to cover the cost of all expenditure incurred by the local government. More often, the transfer is closed-ended, so that the central government will incur the costs up to some maximum.
- Cost reimbursement grants often carry conditions. For example, a grant for teacher salaries can be narrowly defined as covering the costs for a specified number of teachers approved by the Ministry of Education or PO–PSM with specified qualifications and salary levels. Alternatively, a matching grant might be provided more broadly as funding local roads or other infrastructure as long as the local government provides the requisite amount of matching funds.

Cost reimbursement grants have some significant advantages. First, they can be used for directing investment in high priority national needs. Local governments, left to their own devises, would underspend on merit goods or on services with regional and national benefits. Conditional grants that reimburse local governments fully or even partially based on actual costs incurred for specified purposes will redirect funds toward the priority areas. Cost reimbursement transfers may also be used to ensure uniformity of standards across the country. For example, highway construction or maintenance grants are often only awarded if construction or maintenance are up to specified standards, and uniform standards for public employees can be mandated.

The disadvantage of cost reimbursement grants is that they compromise local choice and can retard true fiscal decentralization. Proponents of decentralization almost always argue that too most standards should not be imposed uniformly because demands for services and local conditions vary across regions within the country. The requirement of uniformity also discourages innovation by local governments when standards are set too rigidly by the central government. Finally, cost reimbursement grants impose an administrative cost on the central government (which must monitor the program) and a compliance cost on the local governments (who must do significant reporting on their use of funds and their adherence to standards).

Cost reimbursement grants are widely used as a method of determining the total flow of funds to subnational governments, and in many ways the wage component of recurrent local government allocations in Tanzania is nothing more than a cost reimbursement grant for centrally approved staff positions (as the total number of staff positions are determined by PO–PSM in a discretionary manner from year to year). As a result, this construct gives the central government control over the total amount of funds allocated to the local government sector for personal emoluments, and it gives the center a lot of control over how transfer funds will be spent at the local government level.

Ad hoc decisions on the size of the transfer pool

A final approach for the central government to decide on the size of the transfer pool is to do so on a discretionary basis. That is, each year the parliament or the president decides the size of the allocation for the subnational government sector.[3] Obviously, there are great drawbacks to this approach:

- The approach is not transparent and subject to political manipulation.
- It leads to great uncertainties on the part of the local government sector, as they do not know how much they will receive each year. Fiscal planning and effective budgeting at the subnational level are discouraged.
- This approach denies the link between expenditure responsibilities and revenue resources. While the central government cuts or increases the local revenue share each year, they are less likely to change the

expenditure functions assigned to local governments and a revenue shortfall can produce harmful effects on the level of public services provided.

- Ad hoc decision-making encourages the central government to think of the subnational government sector as a lower priority item, and provides an inducement to think of reduction in transfers as a way to offload budget deficits.
- Subnational governments are likely to be discouraged from increasing efficiency and from becoming self-reliant if all grants are made on an ad hoc basis. Local officials will feel less in control of their budgets, and less accountable to their voters for the level of services provided. It will be very convenient to blame any service delivery shortfalls on the inadequate funds provided by the center.

On the other hand, the ad hoc approach also has some advantages. From the point of view of the central government, it provides maximum flexibility. The government can implement a fiscal stabilization program with a minimum regard for a fixed committed share to the local government sector. If an expenditure austerity program calls for cuts in government spending, the central government can accomplish this by simply reducing the transfer rather than mandating local government spending reductions. Another advantage is that this approach enables the central government to change spending priorities without changing expenditure assignments. For example, subnational governments might be more likely to spend for recurrent than for infrastructure purposes; an ad hoc, conditional grant scheme would allow the center to reduce the flow of revenues to the local sector and use the funds for infrastructure purposes.

The total size of the various recurrent local government allocations in Tanzania is determined from year to year in a discretionary fashion as part of the annual budget process; this is particularly true for the transfer system's non-wage components. The ad hoc approach to determining the size of the distributable transfer pools is arguably the most centralizing approach to designing an intergovernmental transfer system. However, while ad hoc decision-making can result in wide fluctuations in the availability of budget resources form year to year, in the hands of responsible policy makers, it can also result in incremental annual growth of the transfer pool. Furthermore, the vertical fiscal instability associated with a discretionary approach could be reduced by strengthening the central government's budget formulation process with a medium-term expenditure framework or a performance-based budget approach.

Vertical fiscal imbalances in practice: The issue of adequacy

One common problem when a decentralization policy is implemented is determining the level of resources that is "adequate" for the delivery of subnational government services. Determining this level of adequate funding is often a cause for substantial disagreement between the central and subnational levels of government. It is important to consider this question in the context of developing economies.

A defining characteristic of developing economies (and in truth, the crux of economics) is that economic resources are limited; the limited availability of resources naturally constrains the resources that might be made available to the public sector. A nation's fiscal decentralization policy will not instantaneously cause economic resources to become abundant, and public sector resources at all levels of government will continue to be constrained well within socially and politically desirable levels. However, a decentralization program does give local governments increased control over certain revenue sources and also gives governments the right to decide how local resources are allocated.

In this light, the term "adequate" should logically be interpreted within the context of the overall constraint on public sector resources that is relevant to developing economies. As a prudent step in the implementation of a decentralization policy, a more complete definition of what constitutes "adequate resources" should be established before any major expenditure responsibilities are devolved. Reaching this understanding in advance would be beneficial to all stakeholders. Consensus on the meaning of the term "adequate resources" would protect local governments from a tendency of central governments to use the decentralization process in order to resolve their own fiscal problems by "dumping" expenditure responsibilities onto subnational governments. At the same time, the central government would be wise to inoculate itself from future claims by local governments that the transferred resources were inadequate.

Failure to establish a definition of adequacy would give local governments political cover to engage in fiscally irresponsible behavior (that is, overcommit resources with the hope of receiving additional transfers) as soon as the decentralization process starts in earnest. In practice, adequacy can be defined in terms of national expenditures per inhabitant or other client-based norms (Alm and Martinez-Vazquez, 2002). A helpful default measure of relative adequacy is the historical level of expenditures allocated by the central government for a particular service (expressed in per capita terms or as a per cent of the public sector), in the year before it was decentralized.

6.3 Designing a sound transfer mechanism: Determining the distribution of the transfer pool among local governments

No matter how the total grant pool is determined, the distribution of this pool among eligible local governments is a separate (although, of course, a closely related) question. In this section, we discuss four main options for distributing resources among eligible local governments. In the case of intergovernmental revenue sharing, revenues could be distributed in proportion to where the tax is collected. Next, in many countries, some type of formula-based approach is used to determine the horizontal allocation of resources. As noted earlier, it is also not uncommon to determine the horizontal allocation of grant resources on an ad hoc basis or as a result of (informal) negotiations as part of the annual budget process. Finally, funds could be distributed across local government jurisdictions in proportion to costs which are being reimbursed (either fully or partially).

Horizontal allocation: The derivation approach

When subnational governments are assigned to receive all or part of the collections of a tax or revenue source collected by a higher-level government based on the level of collections within their jurisdiction, this is known as the *derivation approach* to horizontal allocations. For example, 25 per cent of personal income tax collections in a country might be allocated to the local government level, and the allocations could be made according to amounts collected inside the boundaries of each local government. It is important to note that public economists would consider this a transfer and not a local tax, because the local government has no control over the tax rate or the tax base.[4] Furthermore the amount received by the subnational government is determined fully by central legislation. In contrast, tax base sharing (where the local government places a sur-tax or "piggyback tax" on to a central tax base) is in fact a local tax and not a transfer. But among the developing and transition countries, such piggybacking is not yet common.

There is great diversity in the taxes shared and the sharing rates across countries. In some countries, derivation-based sharing has been a way for local governments to gain access to the more productive tax bases. Nonetheless, some taxes are more suitable for derivation-based sharing than others. In Tanzania, revenue sharing on a derivation basis is only used on a very limited scale. For instance, land rent is in effect a shared revenue source, collected by the Ministry of Lands and shared based on a derivation basis.

Horizontal allocation formulas

A second common approach to the allocation of intergovernmental transfers among local governments is the formula grant. A formula grant uses some objective, quantitative criteria to allocate the pool of revenues among the eligible local government units. The use of a formula creates a sense of fairness in that all stakeholders know the exact criteria by which distributions are made, and there is flexibility in that distributions may change as the needs for public expenditures change.

Formulas may be used in a variety of transfer schemes. For instance, a simple formula might be used to allocate resources for general purpose funding or for the purpose of equalization, or even for revenue sharing. For example, Germany uses population-based formulas for the sharing of VAT revenues among the Länder, while Canada and Spain use estimates of aggregate consumption for the sharing of VAT proceeds with their subnational governments. Likewise, a formula might be used to allocate resources for conditional or sectoral transfer programs, such as a grant to fund local primary education. Formula-based transfer mechanisms have many of the desirable features that we would like a transfer approach to display. However, not all formulas are created equal, and the development of a transfer formula and the allocation factors to be used is as much a science as it is an art. A horizontal allocation formula has to be carefully designed in order for it to achieve its desired policy objectives; this is discussed in greater detail in Section 6.7.

Until the introduction of a formula-based grant system in 2004, formulas were not used at all by the Government of Tanzania to distribute resources among local government authorities, with the possible exception (on paper, at least) of the distribution of the local share of the Roads Fund to local authorities. Other formula-based mechanisms, which were introduced relatively recently in Tanzania, include the Health Basket Fund formula (initially an equal allocation of US$0.50 per capita for each district) and the PEDP formula, which provides a capitation grant of US$10 per enrolled pupil.

The horizontal distribution of cost reimbursement grants

Another grant type is the conditional grant that is based on reimbursement of costs of specified services. Under such schemes, the center agrees to reimburse the locality for all or a portion of the cost of an activity (if it is a portion, a matching share from the locality is required). Grants to reimburse costs are typically tied to a particular government expenditure item. The two main problems in designing cost reimbursement grants are how to choose the matching ratio for a grant scheme, and how to determine which expenditures are eligible for cost reimbursement.

Consider the case of full reimbursement, in which no matching contribution by the local government is required. The idea is to stimulate the provision of certain services by lowering their marginal cost for local governments to zero and by mandating a certain level of service. For instance, full reimbursement of teacher salaries is a common form of local grant. However, the approach gives central government substantial control over the horizontal allocation of resources, as the local governments only get reimbursed for centrally approved positions.

Although full cost reimbursement, if done right, may promote the equalization of services in different parts of the country and stimulate certain types of activities, it does not encourage local governments to mobilize additional resources or lead to more efficient operations. In addition, a key problem with full cost reimbursement grants is that because the local governments fully pass on the costs of the funded activities to the higher-level government, local authorities have no incentive to be concerned with the productivity or cost-effectiveness of delivering these activities.

Central governments have attempted to overcome the problem of incentives by subsidizing less than 100 per cent of costs, that is, by requiring a matching contribution from the recipient governments. Such grants to reimburse costs partially can stimulate the tax effort of local government on behalf of the aided function. The amount of stimulation depends on the percentage of reimbursement, which lowers the tax price of the service in question; on the price-elasticity of demand for the service, which determines how the local government will expand provision of the service in the face of the lower tax price; and on the fungibility of local expenditures, that is, whether a dollar of matching funds can simply taken from a non-aided service. Despite its merits, this type of grant imposes important costs on the residents of recipient communities and perhaps on society. The stimulation of expenditures induced by the grant will distort the local budget in favor of the aided service and against other services that local residents would have chosen. Another potential cost is that such grants may be counterproductive to the goal of regional equity. Many of the takers will be its wealthy communities, those most able to match the grants. One possibility to address this last shortcoming is to introduce differentiated matching rates that reflect the different fiscal capacity of local governments.

Discretionary (ad hoc) distributions

The discretionary (ad hoc) horizontal distribution of transfer funds among eligible subnational jurisdictions is common among developing and transition countries. There are considerably fewer design issues to consider in developing an ad hoc transfer program since the whole idea of an ad hoc system is to provide flexibility for the central government to change the allocations from year to year as it sees fit.

In this sense, an ad hoc approach to determining the transfer amount for each individual local government authority would essentially treat local governments in much the same way as the central government treats central government ministries and agencies during the budget formulation process. In doing so, the ad hoc allocation of intergovernmental transfers fails to recognize that local governments are fundamentally different in nature from central government agencies. While the Ministry of Finance, through a process of budget guidelines and budget negotiations, is able to prioritize national budget resources among a few dozen central government ministries and agencies, it is questionable (and in fact, quite unlikely) that the central government (either the Ministry of Finance or the Ministry of Local Government) is realistically in a position to prioritize and reconcile budget requests from hundreds or even thousands of local governments.

Under an ad hoc approach, each year the president, or the parliament, could determine the grant amount to be received by each local government. No specific criterion for making this determination is given. There is little transparency in such a system, and usually it is a matter of negotiation between the central and the local government. There are some advantages and disadvantages of a horizontal determination by an ad hoc method:

- The parliament or president retains flexibility to distribute among local governments as they see needs emerge. This is an advantage in countries that are changing rapidly, and it lets the government direct the location of public investments and play some role in guiding regional growth.
- If data are unavailable, an ad hoc method can be based on judgments of those who allocate the resources. In the past, both India and Brazil have used a judgmental approach in allocating some resources to the poorest regions.
- If regions face special needs, an ad hoc system is sometimes used to allocate the funds, and this is generally accepted as "fair". Such emergences include natural disasters, major economic upheavals, civil unrest and support for large projects in the national interest.

There are a number of obvious dangers of an ad hoc system. First, there is a threat that politics will unduly influence the allocation of resources. Second, central government agencies may become paternalistic with an ad hoc system, and take it on itself to determine what the local government is really able to absorb. Third, local government efficiency is thwarted, as the locals see that their resources are not distributed on the basis of how good a job they do with service delivery. Fourth, efficient local budgeting is almost impossible because the year-to-year resource flow cannot be easily predicted. Fifth, the central governments that use ad hoc grants will be resistant to monitoring, therefore even further reducing the transparency of the system. Finally, an almost inevitable result of using ad hoc grants will be to add a program of deficit grants to meet the year-end revenue shortfalls of local governments.

6.4 Designing a sound transfer mechanism: The use of transfer resources at the local level

The final stage in the process of allocating intergovernmental fiscal transfers is the use of the transfer resources at the local level. The actual use of the transfer resources at the local level, and whether the transfer scheme is ultimately able to achieve its intended objective, is dictated by two factors. First, what (if any) are the conditions or restrictions that are placed on the use of the transfer resources? Second, what planning and budgetary decision-making processes are used to actually spend the transfer resources?

Conditions on the use of transfer resources

A critical distinguishing feature of any transfer scheme is whether (and if so, what kind of) conditions are imposed by the central government on the use of the transfer resources.[5] Although conditions and restrictions on the use of transfers are typically driven by the intended purpose of the grant scheme, the imposition of conditions and limitations on the local use of transfer resources can radically change the nature of the transfer scheme. For instance, consider the impact on the local government finance system of the following two revenue-sharing schemes: one transfer scheme provides unconditional sharing of fiscal resources to local governments based on a vertical-sharing rule and a horizontal allocation formula (for instance, the Federation Account in Nigeria), while the other scheme—also based on a vertical-sharing rule and a horizontal allocation formula—provides earmarked transfers for local road maintenance (for example, a typical Road Fund). Obviously the presence of conditions or guidelines on the use of transfer resources (if complied with and/or enforced) has a significant impact on the spending patterns of local authorities, and ultimately, on the success or failure of the local government finance system in achieving its objectives.

Conditions on local government spending can be imposed in a number of ways. On the fiscal side, restrictions could be imposed through the budget process to assure that local governments spend transfer resources in a certain manner. Transfer regulations or budget guidelines for local governments could earmark transfer resources to various degrees, indicating whether transfer resources are completely unconditional, earmarked for spending in a certain sector, or tightly earmarked for a specific program or project. Such guidelines could provide further guidance or instructions on how these resources are to be spent, including the breakdown of spending between different categories (for example, wages versus non-wage expenditures) or limitations on certain types of spending (for example, limitations on allowances, spending on vehicles, or administrative overhead). Alternatively, administrative mechanisms could be used to control local government spending of transfer resources. Sectoral regulations or centrally imposed minimum standards for local service delivery could dictate certain levels and patterns of local government spending, even though the transfer system might in principle be unconditional (for instance, consider the DAU in Indonesia). Another common and far-reaching administrative restriction imposed on local government spending of transfer resources in many developing and transition economies is the requirement for the entire local government budget to be vetted and approved by central authorities.

Local planning, budgeting and financial management processes

Regardless of the budgetary or administrative conditions imposed on the use of transfer resources, the ultimate use of financial resources at the local level is a function of the planning, budgeting, and financial management processes in place at the local level, and the ability of the central government to monitor and enforce any conditions imposed on local government spending.

As already discussed in Chapter 3 of this book, participatory planning processes, transparency in local government finances, and local accountability mechanisms are critical elements in assuring the sound functioning of local governments' (financial) administration and in improving the quality of locally-delivered government services. This statement is especially true in the case of subnational finance systems that predominantly rely on unconditional grants, as these give local governments greater responsibility and control over the ultimate service delivery outcomes at the local government level.

Even in the context of more conditional transfer systems, local planning and budget processes can have a substantial impact on the actual use of resources, and the resulting quality of service delivery. For instance, while a local government may use earmarked transfers as intended to hire a pre-specified number of teachers, the manner in which it manages and administers these resources (whether the individuals are qualified for their positions; where within the local government jurisdiction the teachers are posted; as well as how they are monitored and held accountable for their performance) will be critical in determining whether or not the transfer scheme will achieve its intended policy objective.

Alternatively, especially when central government monitoring is weak, local governments may attempt to divert conditional resources outside their intended purpose. This should not come as a surprise as, depending on the nature of the transfer conditions, local governments actually have an economic incentive to violate transfer conditions if they are able to improve their community's well-being by doing so. Public expenditure tracking survey (PETS) in Tanzania, Uganda, and elsewhere suggests that major deviations are common between how transfer resources are supposed to be spent and how these resources are actually spent. Whether the diversion of conditional transfer resources is done in the context of local elite capture of transfer resources or whether diverted resources are used for community priorities depends to a large extent on the formal and informal financial management processes at the local government level.

6.5 Bahl and Linn's typology of intergovernmental transfer schemes

Although the design of intergovernmental transfers can broadly be broken up into three different elements, there are large numbers of distinct combinations and permutations that can be assumed by individual grant schemes. However, it can be useful for policy discussions and evaluations to classify transfers into a discrete number of grant types. A typology of intergovernmental transfers developed by Bahl and Linn (1992) is helpful in describing and classifying a number of different types of transfers commonly found in countries around the world (Table 6.1). This typology classifies

Table 6.1 The Bahl-Linn typology of intergovernmental transfer schemes

Method of allocating the divisible pool among eligible units	**Method of determining the total divisible pool**		
	Share of national tax revenues/funding rule	**Ad hoc decision**	**Reimbursement of expenditures**
Origin of collection of the tax	A	–	–
Formula	B	F	–
Total/partial cost reimbursement	C	G	K
Ad hoc decision	D	H	–

Source: Bahl (1999) based on Bahl and Linn (1992).

transfers along two dimensions. First, what method is used to vertically divide the resources between different levels of government (that is, how is the transfer pool determined)? Second, what method is used for distributing grant resources among eligible local government jurisdictions?

Bahl and Linn's two-way classification approach results in a typology of twelve (3×4) potential intergovernmental transfer types, eight of which are deemed to be more or less common in developing and transition countries, including:

- A *Type A* grant is a shared tax on a derivation basis, so that each subnational government is allowed to keep a specified share of the revenues that are collected within its boundaries. This is the approach to tax revenue sharing used in most transition countries and in many developing countries.
- A *Type B* grant is based on a share of a national tax, but the distribution among local governments is made by formula. For example, in the Philippines, 40 per cent of national internal revenue collections are distributed among local governments on the basis of population, land area, and equal shares. *Type F* grants are also distributed based on a formula, but the size of the transfer pool is determined in an ad hoc manner.
- The allocation of *Type H* grant is completely determined in an ad hoc fashion: both the total grant pool and the distribution of grant resources among local government units are determined each year in budget negotiations as part of the annual budget process. In some cases, grants are distributed in a discretionary manner, while in fact the size of the transfer pool is determined by a funding rule (*Type D*).
- *Type C, G, and K* grants reflect cost reimbursement grants, for which line ministries typically decide on both the amount of funds necessary

to carry out the work, and which local projects live up to central standards in order to get funded. Examples of this type of grant include local infrastructure grants, teacher salaries grants (where salary amounts are pre-determined), and subsidies to individuals which are fixed in terms of eligibility and payment amount by higher-level governments.

Application of the Bahl-Linn typology to Tanzania's intergovernmental fiscal transfers reveals an evolving range of transfer practices. Prior to 2004, all recurrent sectoral grant schemes were Type H grants (ad hoc determination of divisible pool/ad hoc horizontal distribution), although the PE component of recurrent grants (including the local administration grant) could also be considered Type G grants (ad hoc/cost reimbursement). In contrast, the formula-based sectoral block grants introduced in 2004 are Type F (ad hoc/formula-based) transfers. The newly introduced Local Government Capital Development Grant scheme (discussed in Section 8.3) is essentially a Type B transfer scheme as a funding rule determines the size of the grant pool, while its is distributed among LGAs on a formula basis.

The General Purpose (Compensation) Grant introduced in 2003 in lieu of the abolished revenues (as discussed in Section 8.4) is not classified in the Bahl-Linn scheme: its design is comprised of an ad hoc grant pool that is distributed in proportion to the historical derivation of the Development Levy and other abolished local taxes. Revenue sharing of the Fuel Levy revenues would in theory be a Type B transfer, but is actually a Type D transfer. If Land Rent would be considered an intergovernmental transfer (despite the fact that it is collected by the LGA), then it would be considered a Type A grant. The PEDP capitation grant and the Common Health Basket Fund are best classified as Type B grants: the size of the transfer pool is defined by a funding rule, while the distribution among districts is determined by a formula.

6.6 An alternative taxonomy of intergovernmental transfer systems

While the Bahl-Linn typology provides a rigorous and systematic classification of grant schemes, the typology lacks objective grounds to assess the desirability of different classes of grant types. In other words, the typology provides little guidance whether an individual grant scheme, or the system overall, is technically sound, or whether it meets the government's policy objectives. Arguably, an additional weakness of the Bahl-Linn typology is that it does not address a third important dimension in the design of intergovernmental grants: what conditions, if any, are imposed on local government regarding the use of grant resources.

Since Tanzania, like many other developing countries, is ultimately pursuing the reform of intergovernmental grants in order to empower its population and communities by empowering the country's local governments, it is crucial to assess whether, in addition to being construed in a technically sound manner, the existing transfer system is appropriate for the decentralization strategy that the country is pursuing. To what extent does the transfer system empowers decentralized local governments by allowing local governments sufficient control over their resources?

In order to illustrate the correspondence between a country's fiscal decentralization strategy and its system of intergovernmental transfers, we propose an alternative taxonomy for classifying intergovernmental transfer systems. The taxonomy takes into account the three important dimensions of any transfer system as discussed in the three preceding sections, notably the vertical allocation of resources, the horizontal allocation of resources, and the degree of conditionality or discretion that local governments have over the use of their transfer resources.

Consistent with Bahl and Linn's existing typology, the proposed taxonomy considers the vertical and horizontal allocation of grants resources, but then explicitly adds grant conditionalities as a third dimension to be considered in the classification of intergovernmental transfer systems. The resulting taxonomy of intergovernmental transfers yields three key policy dimensions along which policy makers have the opportunity to make alternative policy choices. The proposed taxonomy of intergovernmental grants is depicted in Figures 6.1 through 6.3 and attempts to capture the three-dimensional nature of the policy choices facing countries in developing or reforming their system of intergovernmental fiscal transfers in accordance with their fiscal decentralization strategy. The resulting taxonomy provides policy makers with a visual map to classify a system of intergovernmental transfers; enables them to identify where they would like the system of intergovernmental grants to be as part of their fiscal decentralization strategy; and allows them to subsequently "map out" how to reform their system of intergovernmental grants over time to achieve their policy objectives.

Vertical allocation of intergovernmental transfers

As portrayed in Figure 6.1, the first dimension of transfer systems considered by the taxonomy is the degree of control that central government officials have over the vertical allocation of grant resources. Although the vertical axis of the diagram distinguishes between *ad hoc* and *rule-based* vertical allocation approaches, we recognize that in reality this truly reflects a full spectrum of policy choices. At one extreme, the vertical allocation of grant resources (that is, the size of the transfer pool) is determined on a yearly basis by central authorities in a discretionary or ad hoc manner. This allows central government officials essentially complete control over the resource envelope at the subnational level, and severely limits the ability of the subnational government level to influence or predict the resources

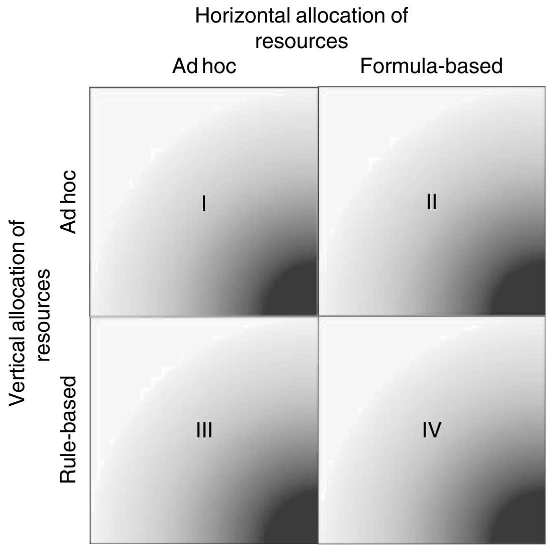

Figure 6.1 Developing an alternative taxonomy of intergovernmental transfer systems

available to it. The more predictable the vertical allocation of resources becomes through the introduction of funding rules, the greater the protection of the subnational government level against the imposition of vertical fiscal imbalances, and the greater the ability of local governments to plan for their own priorities.[6]

Of course, the nature of funding rules can vary from case to case, as can the legal authority of the rule (customary rules, regulatory rules, legislated rules, or even constitutional) and the stringency of its enforcement. A funding rule might specify the size of a transfer fund as a percentage of the national budget, as in the case of Russia's equalization fund, Nigeria's Federation Account, or Indonesia's DAU. Other funding rules might determine the minimum increase of transfer levels from year to year (as in the case of Uganda), or might dictate minimum funding levels tied to the adequate provision of a particular local government service.

Horizontal allocation of intergovernmental transfers

Next, the horizontal axis of the policy matrix in Figure 6.1 represents the policy choice to use an ad hoc approach versus a formula-based approach in the horizontal allocation of resources. Again, we recognize that in reality this distinction truly reflects a full spectrum of policy choices. On one extreme, the horizontal allocation of transfer resources (that is, the allocation of the transfer pool among eligible subnational jurisdictions) can be strictly ad hoc and at the discretion of central government officials. On the other extreme, the horizontal allocation of resources is strictly guided by some type of formula-based approach. The key policy implication of this distinction is that under a formula-based approach local governments are assured a certain level of objectivity, consistency, and autonomy. If the horizontal allocation of transfers is determined in a discretionary or negotiated manner, local governments are in fact fully at the mercy of central government officials, severely limiting their ability to properly plan for the delivery of local government services.

Conditionality of intergovernmental transfers

The combination of the horizontal and vertical allocation of grants gives rise to a matrix with four quadrants, numbered for reference as quadrants I, II, III, and IV, respectively. The third dimension of the taxonomy, illustrated in Figure 6.2, diagonally divides each quadrant into two sections, indicating whether the transfer scheme is unconditional (denoted here by subscript U) or conditional (subscript C).[7] This yields a total of eight policy options. In addition to explicitly introducing grant conditionalities as a crucial third dimension into the policy debate, the new taxonomy allows grant schemes (either generalized grant types or actual real-world grant schemes) as well as entire systems of intergovernmental transfers to be mapped according to these three dimensions.

Perhaps even of greater use is the fact that the taxonomy clearly visualizes which grant schemes are less decentralizing (by allowing central government

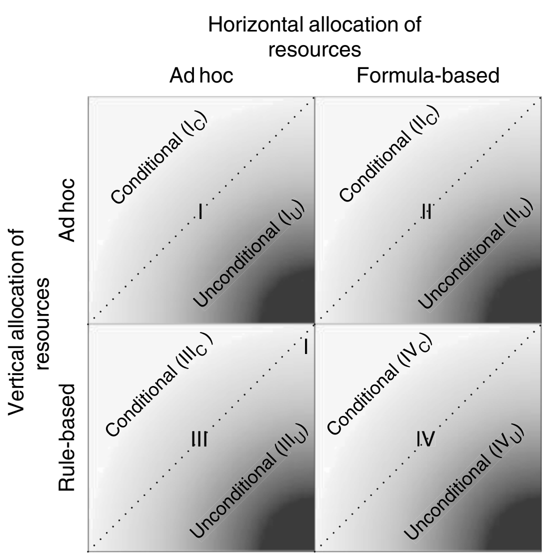

Figure 6.2 An alternative taxonomy of intergovernmental transfer systems

greater control and limiting local government discretion) versus those grant schemes that are more decentralizing (allowing for greater local government control and limiting central government discretion). By design, any grant scheme closer to the top left hand corner of the policy matrix is more centralizing, whereas grants schemes closer to the bottom right hand corner of the taxonomy are more decentralizing (Figure 6.3).

If an intergovernmental grant system is characterized by *Quadrant I* in the proposed taxonomy, both the size of the transfer pool and the horizontal allocation of resources occur on an ad hoc basis, thereby resulting in a transfer system that provides a large degree of discretion to the central government, but that at the same time lacks transparency, stability, consistency, and potentially lacks equity and a hard budget constraint for local governments. If, additionally, strict grant conditions are imposed (Policy Options I_C), then this would leave local governments completely under central government control. As such, the top left hand segment of the matrix is the most centralized policy option. Bahl and Linn's Type G, H, and K grant schemes would typically fall into this classification.

In *Quadrant II*, the size of the available transfer funds is decided ad hoc on a year-to-year basis, while the resources are distributed among eligible local governments using one or more allocation formulas. As a result, these grant schemes are similar to Type F grants in the Bahl-Linn typology. In the absence of a vertical funding rule, the overall transfer pool can fluctuate

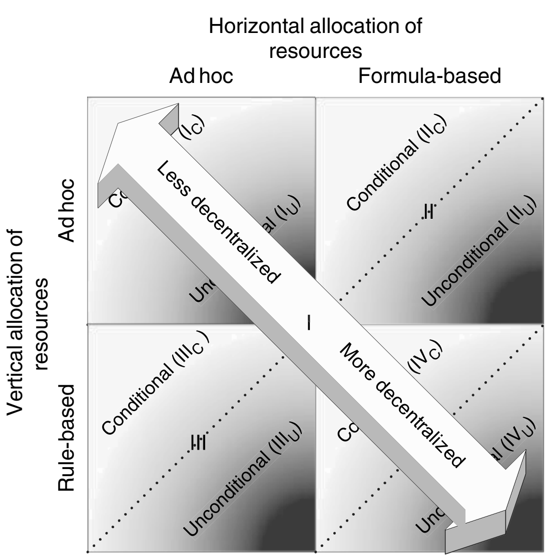

Figure 6.3 A taxonomy of intergovernmental transfer systems: centralized versus decentralized transfer systems

substantially from year to year based on the whim of the central government and vertical fiscal imbalances are likely to prevail, thus failing to assure revenue adequacy and stable funding for local government services.

Under transfer mechanisms or systems falling within *Quadrant III*, resources are assigned to the local government level based on funding rules while the resources are distributed among eligible local governments through a discretionary mechanism during the budget negotiation process (akin to Bahl-Linn's Type D grant). In the absence of a horizontal allocation formula, individual local governments lack an objective, stable, transparent, and equitable funding mechanism that provides them with a firm budget constraint to plan within, thereby compromising the quality of subnational planning.

In the most extreme case represented by *Quadrant* IV_U of the proposed taxonomy of intergovernmental grants, local government resources are assigned as a single unconditional general purpose fund using a vertical funding rule and a horizontal allocation formula (incorporating both Bahl-Linn's Type A and unconditional Type B grants). As such, the bottom right hand segment of the matrix represents the most decentralized approach to intergovernmental grants. Although these highly decentralized intergovernmental grants provide local governments with objective, stable, and transparent funding, this policy approach could lead to concerns regarding the efficient allocation of resources at the local level in many developing countries. If there exists a lack of transparency of local government finances at the local level, and/or a lack of accountability (either upward, but more importantly to the local constituents), this option would possibly risk the inefficient allocation or misallocation of public resources by local governments.

6.7 Universal principles in the design of transfer systems

Not only do individual intergovernmental transfer schemes have numerous different dimensions which need to be carefully considered, in most countries the system of intergovernmental transfer often consists of multiple transfer schemes. Thus, the development of a sound system of intergovernmental transfers should assure the sound design of not only individual grant schemes but also the system as a whole. The overall system should be sound and should achieve the policy objectives that the government is pursuing. In this context, there is a clear consensus among policy experts that the design of a sound intergovernmental grant scheme involves adherence to a number of "universal" principles of transfer design (Shah and Qureshi, 1994; Ahmad, 1997; Ma, 1997; Martinez-Vazquez and Boex, 2001a). These universal principles provide a useful checklist or scorecard to assess whether the individual transfer mechanisms that comprise the transfer system are soundly designed.

Although there are slight variations between the principles set forth by various authors, the principles typically include some combination of the following: a sound transfer scheme should (1) provide revenue adequacy, (2) preserve budget autonomy, (3) enhance equity and fairness, (4) assure stability, (5) assure simplicity and transparency, (6) be incentive compatible, (7) focus on service delivery, (8) avoid excessive reliance on equal shares, and (9) avoid sudden large changes in allocations.[8]

1. *Providing revenue adequacy*
   A transfer formula should provide a source of adequate resources to local governments to achieve its policy objective. As noted above, resource adequacy is subject to national policy priorities and should be considered relative to the overall scarcity of resources within the public sector. Furthermore, it is extremely hard to objectively measure vertical fiscal balance.

2. *Preserving budget autonomy*
   As much as possible, a transfer system should preserve budget autonomy at the subnational level. While sound policy arguments can be made for the introduction of certain types of conditional (targeted) transfer schemes, the grant conditions and budgetary guidelines imposed should be proportionate to the policy objectives pursued by the center. Likewise, general purpose transfers and equalization funding should be lump sum in nature and unconditional. After all, the benefits from decentralization arise from the increased flexibility and spending discretion at the subnational level.

3. *Enhancing equity and fairness*
   The transfer mechanism should support a fair allocation of resources. For instance, an equalization transfer should provide more resources to districts with lower tax capacity and greater fiscal needs. While fairness is a subjective social concept, transfer systems that provide disproportionately more resources to wealthier local governments are often considered "unfair".

   As will be discussed in greater detail in Chapter 7, one of the biggest flaws in the previous system of local government allocations in Tanzania was its erratic and counter-equalizing incidence pattern of local government transfers. In line with Tanzania's postcolonial egalitarian traditions, the new formula-based block grant system was developed around the desire to provide equitable access to local public service in all local government jurisdictions based on local government needs.

4. *Assuring stability*
   Transfers should be stable and provided in a predictable manner in a dynamic sense. The formula should be stable over a period of years to promote revenue predictability and overall budget certainty. Although

the aggregate size of the transfer pools in Tanzania has grown more or less incrementally over time (as guided by the medium-term expenditure framework), the discretionary nature of the horizontal distribution has failed to provide individual local authorities with resource stability from one year to the next for planning purposes.

5. *Assuring simplicity and transparency*
   Transfer formulas should be, to the extent possible, simple and transparent. An important way to keep transfer programs simple is to limit their objectives and to only pursue one policy objective with each transfer program. The formula should also be understandable to all stakeholders, in particular local officials and legislators, and not be subject to political manipulation or negotiation in any of its aspects.

6. *Incentive compatibility*
   The transfer system should not create negative incentives for revenue mobilization by subnational governments, nor should they induce inefficient expenditure choices. For example, negative incentives to revenue mobilization would be created if the amount of equalization transfers were reduced every time a subnational government made a greater effort to increase their own revenues. In order to avoid these negative incentives, it is critically important that equalization formulas should not try to fill the gap between actual revenues and expenditures, but instead focus on fiscal capacity and expenditure needs. A similar negative incentive arises when central authorities provide "deficit grants" to cover local government deficits at the end of the fiscal year. This gives local governments an incentive to incur budget deficits.

7. *Focusing on demand (clients or outputs) rather than supply (inputs and infrastructure)*
   The best measure of a local government's needs is to focus on the number of potential clients for a local public service. For instance, arguably the most basic measure of a local government's expenditure needs for education is the number of school-aged children in a district. Unfortunately, a relatively common but undesirable practice in the choice of allocation factors is a focus on productive inputs (such as the number of teachers in a district) or the available physical infrastructure (such as the number of hospital beds or school buildings) as a measure of the fiscal "need" for a local government. For instance, many developing countries allocate a portion, if not all, of their education transfers based on the number of school buildings and/or the number of teachers in each local government district. This was one of the failures of the previous "national minimum standard" transfer approach in Tanzania.

   The number of school building or teachers in a local government area is typically a very poor measure of the educational needs of a local government. Wealthier local governments, with greater resources available for education, would likely have more school buildings and would thus receive more generous compensation under such as scheme, while poorer local governments (that could not afford to erect school buildings or where the central government historically did less so) would receive fewer resources. Similarly, teachers and other professionals have a tendency to live and work in urban areas. Thus, reliance in a transfer formula on the number of inputs such teachers, doctors, or infrastructure, as opposed to focusing on the number of clients or outputs, would cause historical disparities to be perpetuated in time.

In addition, the use of "inputs" such as school buildings and hospital beds as allocation factors could cause inefficiency by providing an incentive that could distort the optimal allocation of resources. For instance, the inclusion of school buildings as an allocation factor would give the local Finance Director a reason to press the District Education Officer to build a larger number of school buildings in order to increase allocations from the grant system. This would be especially harmful if resources could be better spent hiring additional (or better-trained) teachers, or purchasing more text books. Similar negative inducements to expenditure choices are present, for example, if the amount to be received from the intergovernmental transfers is increased when local governments hire more employees or hoard excess physical capacity in the form of half-empty hospitals or idle school rooms. Therefore, as a rule, transfer formulas should avoid using measures of physical capacity or inputs (such as the number of teachers, the number of hospital beds, the number of schools, and so on) as allocation factors and should focus instead on measures of the number of "clients" or citizens with a certain need.

8. *Avoiding "equal shares" as a major allocation factor*

An important concern in the design of transfer schemes is the excessive use of the "equality principle" or "equal shares" as an allocation factor. While a common factor in the allocation of subnational resources (particularly in developing countries), excessive reliance on the equality principle as an allocation factor (so that each local government gets the same amount, regardless of its population) raises concerns about incentives, efficiency, and basic fairness.

First, the use of equality as a factor in the allocation formula raises a question of basic fairness. If the equality principle would be used as an allocation factor, regions with fewer residents would receive much larger transfers when expressed in per capita terms. This violates a basic concept of fairness in a democratic system of governance. Second, distributing funds based on equality gives politicians a significant fiscal incentive to create new, small local governments that in turn receive a significant fiscal benefit. This incentive may prove politically hard to resist, and often results in excessive fragmentation of local governments. Third, the reliance on the equality principle in the distribution formula would cause substantial efficiency losses by isolating small local governments from the effects of scale economies. Resources would be spent more efficiently if smaller districts would be forced to consolidate into new jurisdictions above the minimum efficient scale.

9. *Avoiding sudden large changes in allocation patterns*
During the introduction of the new transfer mechanism, the transfer system should avoid sudden large changes in funding for local governments. Changes in the existing formula should strive to hold local government "harmless" during the transition to a new allocation mechanism.

For instance, during the design of the reforms in Tanzania, it became very clear that sudden large changes to individual local authorities, particularly resource losses, would not be acceptable. This was even more true since the "winners" of the previous regime (in comparison to demand-driven formulas) were the urban areas, which were generally wealthier and politically better connected. Therefore, an important component of the reforms had to be the appropriate phasing-in of the new formula-based allocations, while assuring that local governments would be held harmless against potentially resource losses under the new formula-based system.

7

Intergovernmental Fiscal Transfers in Tanzania: An Assessment of the Previous System of Local Government Allocations

In most developing, transitional, and industrialized countries, local government transfers form the main source of funding for local government services and infrastructure. Tanzania is no exception to this rule: with more than 80 per cent of recurrent local expenditures funded by intergovernmental grants (Table 1.1), the transfer system forms the backbone of Tanzania's system of local government finance.

In fact, the current stage of decentralization reforms in Tanzania was set in motion with the recognition that the broader local government reform agenda would be ineffective without a sound local government finance system (JGDR, 2001). As a first step in this process, the achievement of a sound local government finance system required a careful assessment and reform of Tanzania's intergovernmental transfer system. Following a detailed assessment of the strengths and weaknesses of the intergovernmental transfer system (LGRP/GSU, 2003), the Government of Tanzania announced the introduction of a formula-based system of intergovernmental fiscal transfers in February 2004, and is further discussed in Chapter 8.

The purpose of the current chapter is to assess the discretionary transfer system that was in place in Tanzania prior to the introduction of the formula-based transfer system in 2004. As was discussed previously in Chapter 6, any intergovernmental transfer scheme can be broken down into, and assessed based on, three broad dimensions: first, how is the total amount of the grant determined? second, how is the divisible pool distributed among eligible units? and third, how are these transfer funds to be spent at the local level? Consistent with this sequence, the current chapter assesses the vertical and horizontal dimensions of Tanzania's previous transfer system in Sections 7.2 and 7.3, respectively.[1] This assessment is preceded by a description of how intergovernmental fiscal transfers are included in the national budget process (Section 7.1).

7.1 Intergovernmental fiscal transfers and the national budget process

Tanzania's system of local government allocations, both before and after the introduction of formula-based grants, has a straightforward structure: there are six sectoral recurrent local government allocation schemes in the central budget, one each for the five national policy priority areas (education, health, water, roads, and agriculture), and an allocation scheme for local administration. For administrative purposes each sectoral allocation scheme is further divided into personal emoluments (PE) and other charges (OC). Within the national budget structure, these local government allocations are contained in 21 budget votes organized by region, reflecting the historical status of local government authorities as hierarchical budget units of the central government. In 2003, a General Purpose Grant was introduced (initially known as the Compensation Grant) in compensation for the Development Levy and other local revenue sources that were abolished in July 2003.

Outside the regular recurrent local government allocations (contained in budget votes 70–89 and vote 95), a number of additional funding mechanisms provided (and continue to provide) resources to the local government level. These parallel mechanisms include the sharing of the fuel levy through the Roads Fund Board; revenue sharing of the Land Rent, as well as various discretionary subventions and in-kind contributions from sector ministries to local government authorities. The latter include donor-funded contribution to sectoral programs, in particular, the donor-funded portion of capitation grants under the PEDP as well as transfers from the Common Health Basket Fund. Prior to 2005, capital development resources were funneled to local governments through the development budget on an ad hoc basis; these allocations were quite small and highly irregular in nature (PWC, 2003). It is difficult to quantify the overall importance of these alternative funding schemes since they are not always clearly identifiable in the central government budget; different funding mechanisms have widely varying levels of local government control and there is no systematic mechanism in place to verify that these transfers to the local government level actually take place.

Vertical fiscal balance and the "national minimum standards" approach

Many fiscally decentralized countries use some type of funding rule to determine the level of funding that is set aside for local governments. However, in Tanzania, the amounts set aside in the central government budget for the various local government activities are determined on a year-to-year basis in a discretionary (ad hoc) manner as part of the annual budget process.

The Local Government Finance Act provides some guidance on the level of funding that the central government should make available to local governments, although substantial discretion is given to the minister responsible for

RALG. With respect to the national priority sectors, Section 10 of the Local Government Finance Act provides for local governments to receive the cost incurred by local governments in the provision and maintenance of primary education, primary health care, water, roads, and agriculture extension.

Prior to the introduction of a formula-based transfer approach in 2004, the overall resource envelope for local government sectoral activities was supposed to be determined by "affordable national minimum standards". The "national minimum standards" (NMS) framework comprised a set of sectoral service delivery standards and norms, developed by the respective sectoral ministries themselves, which were supposed to assure a minimum level of public service delivery across Tanzania's national territory. Under the NMS approach, local governments were supposed to cost out their expenditure needs in accordance with the sectoral standards as the basis for the size of their intergovernmental transfers (PWC, 2000). Unfortunately, the regulatory framework failed to clearly distinguish between NMS for local service delivery and the "affordable national minimum standards". As a result, the NMS generally reflected levels of service delivery that were *desired*, rather than service levels that were *fiscally affordable*.[2]

Since there was no mechanism to reconcile the resources needed to achieve the desired NMS with the available budgetary resources, in practice the determination of vertical fiscal balance was left to the central government's budget process. Similar to central government ministries and agencies, at the conclusion of the budget formulation process, the Budget Commissioner at the Ministry of Finance was responsible for reconciling local government requests with available government resources in a process of negotiations with each LGA.

While done in a discretionary manner, the determination of the vertical allocation of resources was not done in a random manner. In principle, the amounts budgeted for intergovernmental transfers were guided by the government's PRSP (URT, 2000) as well as the Cross-Sector Medium-Term Expenditure Framework (Ministry of Finance, 2002). In practice, however, it appears that a more or less incremental approach was followed in determining the overall budget envelopes for local government allocations.

Shortcomings of the national minimum standards approach

While the use of budget norms or minimum standards as part of a local government finance system is not uncommon, an ill-conceived or poorly designed NMS approach can be seriously detrimental to the decentralization process. On one hand, if the minimum standards set by the central government are set too low, NMS would fail to improve the quality of local service delivery and would be irrelevant to the entire decentralization process. On the other hand, if the minimum standards are in fact set too high and become unaffordable to local governments, this would set local governments up for failure. Indeed, Tanzania's attempt at determining local government allocations based on NMS had a number of important shortcomings, which negatively affected both the vertical as well as horizontal allocation of resources to the local level.

Non-affordability of NMS standards

The NMS approach pursued in Tanzania prior to 2004 focused strictly on local government needs and failed to take into account resource availability. For instance, based on a full costing of educational needs in Tanzania, national government resources were able only to cover 67 per cent of local educational budget requirements (Ministry of Finance, 2002). To the extent that the resource gap between needs and available resources was not covered by foreign donor support, the gap was left unfilled. As such, budgeting from a perspective of needs as defined by expenditure norms without accounting for resource availability was an important cause for the development of unrealistic local budgets (Alm and Martinez-Vazquez, 2002). By setting non-affordable standards of service delivery, the central government created false expectations among local residents about the level of service delivery.

Lack of transparency and downward accountability

Although the expenditure norms set forth in the NMS framework clearly exceeded available public resources, the approach lacked an objective mechanism to reconcile the sectoral "minimum" standards with the availability of resources. As a result, non-transparent and subjective budget negotiations were used to reconcile the local budget requests with available resources. The lack of transparency and the high degree of discretion by central government officials in the mechanism contributed to a lack of local ownership over the delivery of local services. Highly centralized control over local services further prevented local communities from holding their local officials accountable, since local government officials were able to pass any blame for inadequate local government services to the central government.

Failure by the central government to follow the NMS approach

Although the regulations accompanying the Local Government Finance Act required the central government to ensure that local government resources were distributed "in line with determined affordable national minimum standards of services", for all practical purposes the government failed to follow the NMS norms. For instance, despite the "minimum" standard student–teacher ratio of 45:1, the average number of students per teacher varied greatly from 26.2 in Lindi Region to 57.3 in Shinyanga Region (LGRP/GSU, 2003).

NMS were supply-focused, rather than demand-driven

Despite the original intent on the NMS approach, the local government budget allocation process focused more on the current supply of local government services rather than on the actual need or demand for local government services. The local government budget guidelines specified that the allocation of educational resources should be based on actual enrollment levels (that is, the level of schooling that was being supplied by a local government) rather than on the number of school-aged children in each local government jurisdiction (representing the potential demand for schooling). Since poverty has a negative impact on school enrollment, the reliance on actual enrollment levels structurally biased the funding mechanism against local governments with low attendance rates, which resulted in a tendency to under-fund the least developed and most impoverished local governments.

Furthermore, resource allocations to individual local governments were largely determined by the degree to which central government agencies (Ministry of Finance, PO–RALG, PO–PSM, and sector ministries) believed that local government units were able to spend public funds efficiently. As a result, the budget formulation process focused even further on the supply side of local government services, by basing local government funding guidelines on the number of teachers present and existing infrastructure. Thus, while funding for PEs was determined as a function of the number of approved local government staff in each local government, local governments were not assigned additional teachers if there was a shortage of classrooms in the local government area.

Inequitable allocation of resources

As a result of the supply (or input) focus of the previous system, the NMS process favored relatively well-developed and well-managed districts that could afford to fund additional capital infrastructure development and were seen to "efficiently" use transfer resources. Underdeveloped (predominantly non-urban) districts ended up in a vicious circle where they received relatively fewer resources, in turn were unable to expand their human resource base or construct additional physical infrastructure, which in turn resulted in relatively smaller resource allocations from the central government.

No incentives for efficiency in local service delivery

As a result of the supply-driven approach, local governments faced no incentives to improve the quality or efficiency of local service delivery. First, the NMS approach focused on the quantity of inputs used in the delivery of services, disregarding the quality of either the inputs or the services provided. For instance, in accordance with the NMS approach, local governments received local allocations for basic health services in proportion to the number of hospital beds in their jurisdiction. This provided local governments with a financial incentive to buy more hospital beds, whether they were needed or not, but did not provide local governments with an incentive to provide good quality health care. Secondly, the previous approach to local government funding did not stimulate local governments to use their resources efficiently. In fact, local governments were given a disincentive to eliminate overcapacity in infrastructure or to terminate poorly qualified staff, as central government funding was directly tied to their presence.

7.2 The vertical allocation of intergovernmental fiscal transfers

Table 7.1 reflects the amounts of intergovernmental transfers provided to the local government level from FY 2000/01 through to 2004/05. At first glance, the budget data presented in the table indicate that local governments received a substantial amount of resources through the recurrent transfer mechanism and that the resources provided to local governments increased substantially over time.

In nominal terms, the amount of local government allocations doubled over the time period under consideration from TSh. 180 billion to TSh. 362 billion. In per capita terms, an average local government received approximately TSh. 10,000 per resident in intergovernmental transfers in FY 2004/05. When considered as a per cent of the total national (recurrent) budget, the resources provided to the local government level reflect a considerable degree of vertical fiscal balance; local governments in Tanzania annually received roughly between 17 and 18 per cent of recurrent budget resources. This vertical share is well above the average for a "typical" developing country, where total local governments spending (including from own source revenues) typically

Table 7.1 Budgeted local government allocations by sector, FY 2000/01 to 2004/05

	2000/01	**2001/02**	**2002/03**	**2003/04**	**2004/05**
			TSh. million		
Primary education	129,804	137,914	170,242	202,240	245,945
Local health services	29,112	35,468	43,685	48,856	63,574
Other priority sectors	6,302	9,891	18,067	24,361	30,146
Local administration	14,336	17,846	15,033	15,517	22,102
Total	179,555	201,119	247,027	290,974	361,768
			% of recurrent spending budget		
Primary education	12.74	12.30	11.44	12.55	12.64
Local health services	2.86	3.16	2.93	3.03	3.27
Other priority sectors	0.62	0.88	1.21	1.51	1.55
Local administration	1.41	1.59	1.01	0.96	1.14
Total	17.62	17.93	16.59	18.06	18.60

Note: Local government allocations exclude sector ministry subventions and the GPG.
Source: Computed by authors based on Ministry of Finance and LGRP data.

only comprises 13–14 per cent of total public spending (Bahl, 2005b; World Bank, 1999).

However, two concerns should be flagged with respect to the vertical allocation of transfer resources in Tanzania. First, while it is true that local governments in Tanzania received a greater share of the nation's public finances in the form of intergovernmental transfers than in many other developing economies, local authorities in Tanzania were also assigned much greater responsibility for the delivery of public services (including primary education and basic health care services) than in many developing countries. Thus, if we were to judge the vertical allocation of resources in Tanzania based on the mantra that "finance should follow function", we should take into account that local governments' functional responsibilities in Tanzania were much more like the expenditure responsibilities typically assigned to local governments in transitional or developing countries. Corresponding to their greater expenditure responsibilities, during the 1990s subnational governments in transitional and developed countries on average accounted for 26 and 32 per cent of total public spending, respectively (Bahl, 2005a). In the absence of significant revenue decentralization in Tanzania, this brings into doubt whether a transfer pool equal to 17–18 per cent of public resources would be adequate to fund the delivery of the important government services assigned to the local government level.

A second concern flagged by the statistics in Table 7.1 regards the lack of change in the vertical fiscal balance over time. Although we observe that vertical allocations increased steadily in nominal terms from year to year, when considered as share of budgetary resources, it is hard to detect a clear upward trend in the vertical allocation of resources over time. Given that the government services delivered at the local government level all exclusively fell within the priority sectors identified by the PRSP, one would have expected to see a relative increase over time in the share of budget resources set aside for funding these priority sectors at the local government level. In contrast, the observed stability in the vertical allocation of public resources is consistent with an incremental budget process, where increases in resource availability are spread out equally among all spending categories, rather than allowing public expenditures on priority sectors to grow at a faster pace compared to non-priority expenditures.[3]

7.3 The horizontal allocation of transfers: The inequitable distribution of resources across local governments

If the total pool of recurrent local government resources available in Tanzania for FY 2002/03 would have been distributed proportionally among all local governments in the country based on the number of people that resided in each local government area, then each local government would have received TSh. 7269 per person. Yet in reality, as noted in the previous section, the distribution of resources among local governments followed a more complex process in which some local governments ended up receiving more resources than other districts. As noted earlier, despite the intention of the NMS approach to create a more equitable allocation of resources among local government jurisdictions, in practice the failures in the design of the NMS approach may have perpetuated or exacerbated existing fiscal inequalities between different local governments. As a result of the *de facto* discretionary manner in which local government resources were distributed, it is *a priori* unclear if local government transfers were allocated in a fair and pro-poor manner, or if government officials inadvertently (or perhaps knowingly) allocated resources in a manner that benefited wealthier, typically politically more powerful local governments (Boex, 2003).

Regional variations in intergovernmental transfers

An analysis of regional variations in local government allocations suggests that local governments in certain regions consistently received more resources than local authorities in other regions. For instance, local governments in Pwani (Coast) Region on average received the largest per capita transfer in FY 2002/03 (TSh. 11,234 per person), whereas local governments in Shinyanga Region on average received the smallest per capita transfer (TSh. 5259 per person). While these data reflect substantial regional differences in the allocation of local government sources, the figures in themselves do not suggest why these variations occurred or whether these variations occurred in response to sound and plausible policy reasons.

Urban–rural differences in transfer allocations

Further analysis of the data suggests that there was a substantial difference in the way in which local government allocations were distributed between urban local governments and rural local governments, with the former on average receiving TSh. 1500 more per person than rural districts. This finding is troublesome given the fact that urbanized areas generally had lower poverty rates, lower illness rates, higher literacy rates, and higher levels of household income (NBS, 2002), as well as the fact that urban local government generally collected larger amounts of own source revenues. In this respect, the horizontal resource allocation pattern appears to have gone against the government's policy objective of allocating more resources to local governments with a weaker resource base. This should not come as a surprise since the intergovernmental transfer system did not incorporate any transfer scheme that was aimed at achieving fiscal equalization.

Descriptive statistics for variations in intergovernmental transfers

The descriptive statistics for transfers to individual local government authorities in Table 7.2 reflect persistent variations in per capita local

Table 7.2 Variations in budgeted local government allocations between districts, FY 2000/01 to 2002/03 (in TSh. per capita)

	2000/01	2001/02	2002/03
Average	6,563	7,215	8,482
Standard deviation	2,504	2,877	3,225
Coefficient of variation	0.382	0.399	0.380
Minimum	2,251	2,604	3,526
Maximum	14,650	21,054	21,573
Ratio of max to min	6.51	8.09	6.12
Ratio of min to average	0.34	0.36	0.42
Ratio of max to average	2.23	2.92	2.54

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

resource allocations. In FY 2000/01, budgeted per capita transfers varied from a minimum of TSh. 2251 to a maximum of TSh. 14,650. This range reflects considerable horizontal disparity, with the least well-off local government receiving only one-sixth of the highest per capita allocation. Not only were the inter-jurisdictional variations in local transfers quite considerable, they also persisted over time under the NMS approach. Over the period reflected in the table, the inequity in transfer allocations peaked in FY 2001/02 as measured by the coefficient of variation as well as the ratio between the minimum and the maximum allocation.[4] In this year, the best-off local government jurisdiction received eight times more in transfers than the least-endowed district.

Regression-based incidence of local government allocations in Tanzania

Although the descriptive statistics in Table 7.2 are suggestive of a potentially counter-equalizing pattern of local government allocations, descriptive statistics alone were unable to determine whether, prior to the introduction of formula-based grants, the horizontal variations in Tanzania's transfer allocations were pro-poor or pro-wealthy. As such, a more formal empirical model was needed to explain the variations in per capita allocations between local governments.[5] A simple empirical model was estimated to uncover the relationship between per capita local government transfers (Transfer) and a number of explanatory variables that reflect variations between local governments in local fiscal capacity and local expenditure needs, so that:

$$Transfer_{\mathrm{i}} = \mathrm{f}(Local\ Needs_{\mathrm{i}},\ Local\ Capacity_{\mathrm{i}}) + error \qquad (7.1)$$

Several measures of local expenditure need were included in the incidence model, including the regional poverty rate (Poverty: defined as the share of the population that fell below the "basic needs" poverty threshold) and the population density of each local government (Density). Since primary education was the most important local government expenditure responsibility in Tanzania, the number of school-aged children (expressed as a percentage of the population) was further included in the model as an additional expenditure need measure (School Age). These variables are all common measures of local expenditure needs. Thus, if the system of local government allocations was meant to equalize the expenditure needs of local government authorities, then we would expect needier districts (for example, with a lower population density) to have received greater allocations.

The population size of a local government (Population, measured in thousands of residents) was also included in the incidence model. Inclusion of this variable in the model allows us to determine whether scale economies were considered as a factor in allocating central–local resources among local governments. If this indeed was the case, we would expect local governments with larger populations to have received lower per capita allocations.

Next, local governments' levels of fiscal capacity were proxied in the incidence model by regional, median household consumption expenditure levels (Consumption). After all, as household incomes and consumption expenditures rise, local governments should be better able to tax their residents and raise own source revenues. Thus, if local government allocations were equalizing (more specifically, if they sought to equalize fiscal capacity), then we should expect to find an inverse (negative) relationship between per capita allocations and household consumption.

One major problem in studying the incidence of local government allocations in Tanzania is the limited availability of sound local government data. While data on local government allocations were available from the Ministry of Finance, most other data sources (including most social-economic variables) were either incomplete or only available at the regional level. As a result, local poverty and median consumption were approximated by their regional levels, which were drawn from the national household budget survey (NBS, 2002). Given the fact that national politicians and policymakers were not able to observe the exact intra-regional variations in poverty and household income either, this should not be considered a major limitation of the model.[6]

A dummy variable (Urban) was included in the empirical model to account for the different nature of urban areas within each region. The inclusion of such a dummy variable is especially relevant given the fact that the empirical model is unable to observe intra-regional variations for poverty and household income. Urban areas in Tanzania were documented to be considerably wealthier than rural areas, and were generally much more developed than the latter (NBS, 2002). If local government finances were predominantly intended to equalize access to local public services, then an inverse, or negative, relationship should be found between urban status and local government allocations. At the same time, it could be argued that urban local governments had a legitimately higher need for local government services since urban areas served a broader function as regional hubs. For instance, residents from surrounding rural areas benefit from urban amenities such as municipal markets. Similarly, urban local government officials claim that a significant number of out-of-district students attend urban public schools. In that case, a positive relationship could be expected to exist between urban areas and local government allocations.

Six variants of the empirical model were estimated as presented in Table 7.3. In addition to estimating the incidence model with total per capita local government transfers as the dependent variable (Regression model 1, or R1), the table separately presents the results for per capita educational local government allocations (R3), and per capita non-education allocations (R5). Finally, in order to specifically account for the supply-side focus of the NMS

Table 7.3 Regression results: Per capita local government allocations, FY 2002/03

	Total allocations		**Education allocations**		**Non-education allocations**	
	R1	**R2**	**R3**	**R4**	**R5**	**R6**
Constant	3837.85	−1916.13	4077.81	642.55	−239.96	−2558.68
	(1.53)	(−0.84)	(2.70)	(0.46)	(−0.17)	(−1.85)
Poverty	51.88	49.14	0.2	−1.43	51.68	50.58
	(1.72)	(1.93)	(0.01)	(−0.09)	(3.11)	(3.30)
Density	0.39	−0.01	−0.21	−0.45	0.6	0.44
	(0.39)	(−0.01)	(−0.35)	(−0.89)	(1.10)	(0.87)
School age	61.46	82.67	47.84	60.5	13.62	22.17
	(1.55)	(2.46)	(2.01)	(2.98)	(0.62)	(1.09)
Population	−8.76	−7.71	−4.1	−3.48	−4.66	−4.23
	(−6.06)	(−6.26)	(−4.72)	(−4.68)	(−5.84)	(−5.71)
Consumption	0.49	0.37	0.21	0.14	0.27	0.22
	(2.77)	(2.43)	(2.02)	(1.55)	(2.82)	(2.48)
Urban	619.88	34.07	664.77	315.02	−44.88	−280.95
	(0.96)	(0.06)	(1.72)	(0.95)	(−0.13)	(−0.85)
Utilization	–	78.61	–	46.93	–	31.68
		(6.62)		(6.55)		(4.43)
Observations	113	113	113	113	113	113
R^2	0.43	0.60	0.36	0.55	0.40	0.49

Note: *t*-statistics are reported in parentheses.
Source: Updated from Boex (2003).

approach, each of the three equations was also estimated with one additional variable, notably a proxy for the utilization rate for local public services (R2, R4, and R6 respectively). This utilization rate for local public services was approximated in the empirical model by the school attendance ratio, which is defined as the percentage of the school-aged population enrolled in public primary schools (Utilization). Given the fact that the NMS relies on the actual level of services supplied rather than the potential demand for local government services, we would expect local governments with higher utilization rates (as reflected by higher attendance levels) to have received greater local government allocations.

The regression results presented in Table 7.3 suggest that the selected explanatory variables explain between one-third and half of the variation in per capita transfers in Tanzania. The empirical results lead to several interesting conclusions.

First, the results suggest (perhaps surprisingly) that the way in which per capita allocations were distributed across local governments did not systematically equalize the presumably higher expenditure needs of rural areas, as less-densely populated districts did not receive greater allocations. Similarly, local government allocations in Tanzania were not pro-poor across the board; the regression results suggests that only non-education allocations were allocated in a pro-poor fashion, whereas the parameter estimates on Poverty were not statistically significant for education allocations.

Second, as suspected, the empirical results suggest that perceived fixed costs (that is, scale economies) were an important determinant in the allocation of local government resources in Tanzania. Districts with larger populations indeed receive smaller allocations when measured in per capita terms; for every increase in population of a thousand residents, a local government received about TSh. 8 less per person. This result is consistently statistically significant across all models.

Third, the empirical results suggest that the previous, discretionary mechanism for allocating local government resources was counter-equalizing in terms of fiscal capacity: wealthier local governments (based on Consumption) generally received greater allocations.

Fourth, the allocation of local government resources in Tanzania may have been pro-urban, particularly in the case of educational resources: urban areas received significantly more educational resources than non-urban areas, although this effect was eliminated after factoring in the increased utilization levels in urban areas.

Finally, the empirical results demonstrate that, consistent with the NMS approach, local governments that supplied higher levels of local public services (as reflected by higher attendance rates) receive significantly greater local government allocations. It should be noted that school attendance rates are found to impact not only education allocations but non-education allocations as well. This result could be interpreted in three different ways.

First, if attendance rates functioned as a proxy for accessibility and higher income within urban areas, then this result provides further support for the existence of a pro-wealthy urban bias in allocation patterns. Alternatively, we could take this result to mean that a higher primary school attendance rate functioned as a proxy for the spillover usage of other (non-education) local public services by residents from other local government areas. In this case, local governments with higher attendance rates would "deservedly" have received greater allocations from the center as they bore a greater burden from regional spillovers. Third, this result could be interpreted in a more cynical way, since enrollment rates were basically self-reported while the central government had only an extremely limited ability to monitor and verify locally reported data. This more skeptical interpretation suggests that those local governments that artificially inflated their reported attendance rates, and were sufficiently powerful to convince the central government of their inflated figures, simply ended up receiving larger allocations.

In summary, the incidence analysis of local government allocations in Tanzania yields a troublesome picture; despite the official pro-poor, pro-rural policy objectives pursued by the national government, there were important dis-equalizing tendencies in the way in which local government resources were allocated under the previous, discretionary approach to allocating intergovernmental transfers in Tanzania. Whereas wealthier and urban local governments (with higher utilization rates) received relatively greater transfers, poorer and rural local authorities who were unable to serve the needs of their communities did not receive greater allocations under the previous system. As was feared from the outset, this pattern suggests that the previous transfer system caused a vicious circle of inadequate local government services and inadequate local government financing for poor and rural local governments.

8

The New System of Formula-based Grants in Tanzania

As discussed in the previous chapter, the discretionary system of intergovernmental transfers that was in place in Tanzania prior to 2004 had numerous serious shortcomings. Given the prominent impact of these shortcomings on the overall local government finance system, the Government of Tanzania sought to replace its largely discretionary system of local government finances with a sound transfer system that would not only take on board the principles of sound transfer design (Chapter 7) but also achieve the degree of decentralization that it wished to pursue with its transfer system.

Starting in 2002, the government led by the Fiscal Decentralization Task Force and the Local Government Reform Programme set out to address this challenge by formulating a new system of formula-based intergovernmental fiscal transfers. The government's initial reform proposals were developed in a consultative process by a team of decentralization experts during the second half of 2002 (LGRP/GSU, 2003). These recommendations were presented and adopted in a policy-level workshop co-chaired by the Permanent Secretaries of Finance and PO–RALG in January 2003. With continued involvement from the various stakeholders (through so-called Block Grant Implementation Teams), a detailed formal proposal for the new system of formula-based grants was presented in front of a forum of seven involved Permanent Secretaries in September 2003. Tanzania's Cabinet approved the proposed introduction of a formula-based block grant system in February 2004. Implementation of the first formula-based sectoral block grants (for primary education and local health services) began on 1 July 2004. Formulas for the remaining sectors were introduced on 1 July 2005. The formula-based Local Government Capital Development Grant system also became fully operational with the beginning of FY 2005/06. Meanwhile, a General Purpose (Compensation) Grant was introduced in July 2003.

This chapter describes the new system of formula-based grants adopted by the Government of Tanzania in February 2004, which is currently in the process of implementation. Section 8.1 describes the overall decentralization reform strategy that underlies the new transfer system. Section 8.2 considers the introduction of formula-based recurrent sectoral block grants, including vertical allocation issues, the horizontal allocation formulas, and restrictions on the local use of the funds. We also discuss the measures taken to phase-in the new formula-based approach and the "holding harmless" of individual local governments as part of the reform process. Section 8.3 provides an overview of the introduction of formula-based capital development grant system. Section 8.4 presents the rationale behind the introduction of an unconditional general purpose grant, while Section 8.5 considers remaining implementation challenges in the system of intergovernmental fiscal transfers.

8.1 Tanzania's intergovernmental transfer reform strategy

Each country is unique in the considerations that contribute to the particular design of its system of intergovernmental fiscal relations. Although there are universally applicable principles that guide the development of transfer systems, policy makers can never take a "cookie cutter" approach to reforming a transfer system, and blindly impose one country's experience on another country without taking into consideration the differences in institutional environment, fiscal conditions, and geographic and demographic patterns.

Several key themes in the policy context in Tanzania were extremely relevant in shaping the reform strategy that the government ended up taking, including:

- There was a broad consensus among stakeholders that the "National Minimum Standards" approach to local government service delivery that previously drove the vertical and horizontal allocation of public resources in Tanzania was conceptually flawed. The way in which the mechanism of minimum service standards was implemented had clearly failed to bring about an efficient, equitable and transparent allocation of resources.
- Despite the official government policy of "D-by-D", there continued to be a substantial degree of ambiguity over the role that local governments should play in a decentralized system of government finance, as central government agencies continued to exercise substantial control over local government activities through the budget process.
- As part of the consultative reform process, consensus had formed among key stakeholders that in order to achieve more effective and efficient service delivery by local governments, it would be essential that the resource allocations of local governments no longer be negotiated as part of the budget process. Instead, a formula-based mechanism was to divide available resources among the different local government units.

- Despite the desire to move to a formula-based approach, there was skepticism at the central government level with respect to the degree of budgetary discretion that local governments could be afforded, even though the mantra "eyes on, hands off" could be heard often in the Ministry of Finance with regard to local government finance. Little or no support existed for any reform that significantly moved away from the sectoral structure of the previous system of local government allocations, for example, toward a single, unconditional grant.

Sequencing of the reform of the intergovernmental transfer system

Informed by these observations, the taxonomy of transfer systems presented in Section 6.6 (which takes into account vertical allocation, horizontal allocation, and transfer conditionalities) serves as a useful tool in mapping the strategy that Tanzania's government chose for its decentralization reforms. The pre-reform approach to allocating local government resources in Tanzania could be classified as the most centralizing transfer system available: a highly conditional transfer system in which both the size of the overall transfer pool and the distribution of resources among local governments are determined in an ad hoc fashion (Type I_C). In contrast, the long-term policy objective stated in the Policy Paper on Local Government Reform (1998) is the complete opposite: a largely unconditional transfer mechanism in which both the size of the overall transfer pool and the distribution of resources among local governments are determined by formulas (that is, a Type IV_U transfer scheme). In Figure 8.1, this means that the transfer mechanism should be moving over time from the most centralized system of grants (the top left hand corner of the policy matrix) to the most decentralized transfer mechanism possible (the bottom right hand corner of the policy matrix).

While the policy objective stated in the local government reform policy was reflective of the government's desire to yield substantial fiscal discretion to the local government level, there were (and continue to be) sound reasons why the central government might wish to retain some control over local government activities through its financing instruments, even in the long run. For instance, the central government has a legitimate interest in assuring that local governments provide a certain minimum level of education and health care, which it may not be able to assure in the absence of some conditionalities on the transfer system. In fact, it is highly unusual for local governments (especially in unitary countries) to exclusively be given unconditional grant resources. As discussed below, a more appropriate long-term objective for the system of intergovernmental grants in Tanzania might combine an unconditional local general purpose fund and local sectoral funds for key sectors such as primary education and health.

Rather than moving overnight from one extreme to the other, it was felt prudent to follow a more gradual process in moving from the previous,

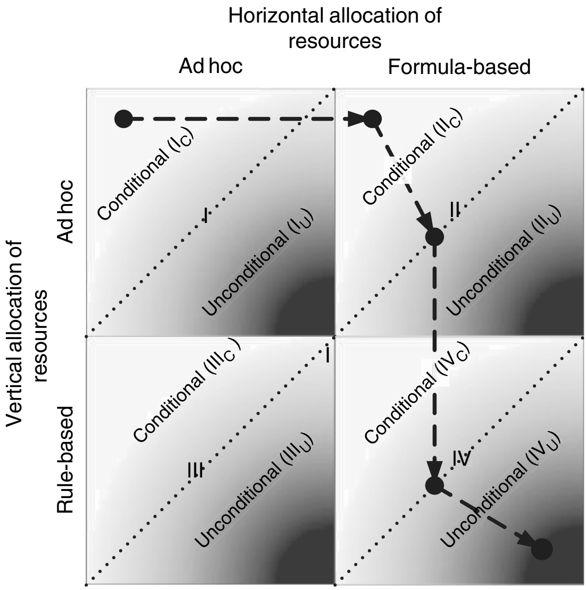

Figure 8.1 A mapping of Tanzania's strategy for reforming the intergovernmental fiscal transfer system

discretionary transfer approach toward the ultimate policy objective of a formula-driven and more unconditional system of local government finance. Given the highly conditional nature of the previous system of local government finance and the absence of strong central administrative controls over service delivery at the local government level, it was felt to be appropriate to move toward a transfer system in which the sectoral resource envelopes for local government grants (at least for the time being) would be determined on a year-to-year basis, but where horizontal allocation formulas would be used to disburse sectorally conditional transfers to local governments (Type II_C).

Once the system of intergovernmental fiscal transfers in Tanzania becomes more stable and transparent as a result of the introduction of horizontal allocation formulas, and as their capacity to manage their own resources in an accountable manner increases, local governments could gradually be given increased space to make fiscal choices. As such, in the medium term Tanzania's transfer system could move toward a Type $II_{U/C}$ transfer system by gradually increasing local fiscal autonomy and by introducing an unconditional grant component in the system and eventually become a Type $IV_{U/C}$ system in which the overall local government resource envelope is determined by a funding rule, and where horizontal allocation formulas are used to disburse both sectoral (conditional) and unconditional funds to local governments (Figure 8.1). However, given that the vertical allocation of transfer resources was not a major problem in the previous transfer approach, the immediate focus has been on introducing a system of objective, transparent, efficient, and equitable transfer formulas that, at least within the context of each sector, would allow local governments greater budgetary discretion over their transfer resources.

A single transfer mechanism, or different transfers for different purposes?

Unlike Tanzania's sectorally based transfer system, some countries provide subnational governments predominantly or exclusively with general purpose resources through a single transfer mechanism that flow into the general account of each local government to supplement the local government's own revenue sources (for example, either through revenue sharing or an equalization transfer mechanism). Local governments are then required to fund their services from these unconditional resources. For instance, this is the general approach in countries such as Germany, Indonesia, Nigeria, South Africa, and many transition countries in Eastern Europe, and the former Soviet Union (including the Russian Federation). This approach does not necessarily mean that local governments are 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. Instead, administrative mechanisms (such as regulations that impose NMS for local service delivery) may be used by the central government to effectively determine or control how local governments spend their resources. As such, it is important to note that the choice for a single grant mechanism (versus an approach that relies on a number of transfer schemes) does not necessarily result in a more centralized or decentralized system.

The single-transfer approach has advantages as well as disadvantages. On the plus side, a process that provides only a single grant to each local government may be more transparent and easier to manage, both for the central government and for local authorities. 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 set their own priorities and 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 numerous services that local governments are supposed to provide, as the single grant scheme is trying to fulfill a number of different objectives at the same time. 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 would give rise to unfunded mandates. Also, a single-transfer approach (or excessive reliance on unconditional resources, in the absence of administrative controls) reduces the ability of the central government to assure that local governments use resources for concurrent functions that are a national priority, such as primary education or basic health care.

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. Most countries that rely on multiple transfer programs have separate funds for different sectoral programs (local education, local health, social programs, and so on), although one of the transfer schemes may actually be an unconditional grant scheme. International practices vary widely between countries with respect to the number and relative importance of different transfer schemes. The stringency of the conditionalities imposed by central governments also varies greatly between countries and in fact can even vary greatly between grant schemes in the same country, from very broad and general conditionalities to highly detailed and extremely rigid earmarking. Almost all grant systems separate recurrent grants from capital development grants.

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 central government funding provided for those activities; this reduces the risk of unfunded mandates. A potential negative could be the added complexity and reduction in transparency of local governments managing multiple budget accounts.[1] Furthermore, if the fragmentation of the transfer system results in the imposition of excessive conditionalities, this would reduce local government autonomy. Depending on one's viewpoint, the inability to move resources between different funding mechanisms (if local governments play by the rules) could be either positive or negative; local governments may see this as limiting their ability to move resources toward their (local) priorities, while the central government may consider this as providing an assurance that each local government will at least spend a certain amount on specific government services that are deemed national priorities.

Overall structure of the new transfer system

Reflecting the cautious and consensus-based policy environment in Tanzania, the policy recommendations for a formula-based grant system, which were proposed in December 2002 and adopted by Cabinet in February 2004, maintained many elements of the previous overall structure of local government grants (LGRP/GSU, 2003). Given the financial management challenges at the local level in Tanzania, the different concurrent expenditure assignments carried out at the local level, and the limited capacity of the center to monitor local spending, it was felt appropriate to maintain much of the previous structure of the recurrent transfer system.

As a result, the current system of recurrent intergovernmental grants continues to be separated into five sectoral funding mechanisms, with additional funding mechanisms for the Local Administration Grant and the General Purpose Grant.[2] Although for administrative and disbursement purposes each sectoral grant scheme continues to be divided into separate streams for personal emoluments (PE) and other, non-wage charges (OC), a horizontal allocation formula is applied to each sectoral grant pool, which combines resources for both PE and OC. As such, the funding which each local government receives for each of the five sectors should be strictly determined by formula. Although central government officials continue to have a role in guiding the local budget formulation process by specifying objective transfer conditionalities that need to be observed by local governments, they no longer (should) have discretionary control over the transfer amounts received by each local government authority.

Although recurrent sectoral block grants for the five priority sectors form the largest share of the transfer system, the local government finance framework recognized that a well-designed intergovernmental fiscal system in Tanzania requires a number of other transfer modalities in addition to the sectoral block grants. As noted in Chapter 6, the conceptual basis for determining the "right" system of intergovernmental fiscal transfers is the assignment of expenditure responsibilities, as there is a need for local government financing to follow the functional responsibilities assigned to the local level. In the context of the current expenditure assignments discussed in Chapter 2, a combination of transfer schemes is thus deemed the most appropriate in order to assure that "finance follows function". As such, the emerging strategy for the transfer system in Tanzania includes the following four components, each of which is discussed in greater detail below:

1. *Formula-based recurrent sectoral block grants*. Formula-based sectoral block grant schemes should form the primary (and exclusive) mode for funding the local provision of concurrent (national–local) 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 provide funding for responsibilities that are exclusively within the purview of local governments. Purely (or exclusive) local responsibilities include the operation and administration of the local government authority as well as other local government services and activities outside the priority sectors. Since local governments do not have adequate own source revenue instruments to fund these expenditures themselves, it would be appropriate to fund these objectives through the implementation of an unconditional and equalizing General Purpose Grant mechanism.
3. *Capital development grants*. Given the fact that local authorities in Tanzania lack access to capital markets, 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 local governments outside the budget votes set aside for local government allocations, 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 in fact 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 budgets should be integrated into the government's formula-based system of intergovernmental grants. The only earmarked ministerial subventions to the local government level should be transfers that are provided for delegated (rather than devolved) functions.

8.2 Formula-based recurrent sectoral block grants

According to Section 10 of the Local Government Finance Act, the overall size and distribution of recurrent sectoral grants should be determined by the Minister of State responsible for local governments as "the cost incurred by [local government authorities] in the provision and maintenance of public health services, education services, . . . " as well as the cost of local programs in the central government's other priority sectors, including water and sewerage, roads maintenance, and agricultural extension. This has provided the legal basis for the highly discretionary transfer system that was in place until 2004. At the same time, clauses were included in the Local Government Finance Act in 1999 (subsequent to the adoption of the Local Government Reform Policy), which define block grants as formula-based transfers which are provided for the same purposes as regular, earmarked grants.[3]

However, despite the revision of the Local Government Finance Act in 1999 to allow formula-based grants, in reality there was no practical distinction between the two types of grants (that is, regular earmarked grants and block grants) prior to 2004, as all sectoral transfers to local government authorities,— although notionally based on minimum service standards, continued to be allocated in a highly discretionary fashion. As such, the reforms that were implemented in 2004 actually provided an opportunity to move away from the supply-based earmarked grants derived from the NMS approach.

While the new recurrent sectoral block grant system (which was introduced for primary education and local health services on 1 July 2004) continues to rely on five sectoral funding mechanisms (one for each sector), the distribution of each sectoral grant pool under the new transfer system, is now determined by an allocation formula based on the demand for local services. Although each sectoral formula is applied to the entire sectoral funding pool (that is, for PE and OC combined), each sectoral account continues to be divided into PE and OC for administrative purposes.[4]

Assuring that funding is driven directly by the level of demand for government services rather than indirectly through the cost of inputs (as under the NMS approach) may seem to be a trivial difference, but it reflects a major shift in the philosophy of local government service delivery. The previous grant 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 that local governments achieved to the national norms. As such, the previous approach was dogmatic and inflexible. In contrast, the formula-based, demand-driven block grant system provides an incentive for local governments to respond to local communities' needs within the context of a hard budget constraint. Indeed, providing local governments with a stable and transparent source of sectoral funding as well as flexibility in delivering local government services in order to meet the needs of local communities lies at the core of achieving the benefits of decentralized provision of public services.

Vertical allocation of sectoral transfers

Currently the recurrent resources set aside for local government grants are determined on a year-to-year basis in the context of the annual budget process. The grant pool amounts determined each year are supposed to be guided by the country's poverty reduction strategy (PRS), as well as the government's cross-sector Medium Term Expenditure Framework (MTEF) and the annual sectoral Public Expenditure Review (PER) process. While the sectoral block grant pools have been increasing steadily over time in nominal terms (as noted in the previous chapter; Table 7.1), intergovernmental transfers as a percentage of the national budget have remained nearly constant since 2000.

One potential problem with the manner in which the size of transfer funds are determined on an annual basis is that the various budget processes guiding budget formulation at the central government level (including the PRS, MTEF, and PER processes) do not seem to be working in an integrated manner in support of the local government finance system. For instance, while the sectoral PERs consider the funding needs for central government ministries in pursuit of strategic policy objectives, these annual sectoral reviews do not provide similar consideration of the sectoral funding needs of local authorities. Introduction of a formal PER document focusing on local government expenditures could contribute to filling this apparent gap in the policy framework.

Alternatively, rather than determining the size of the sectoral block grants from year to year as part of the annual budget process, vertical funding rules could be specified in a number of ways that protect local governments against 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. Another option would be to specify the funding rule in order to guarantee a minimum increase in funding from year to year, such as the rate of inflation.

While there are 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 if sectoral transfer pools are envisioned to increase over time. In line with this concern, the new formula-based block grant system, at least, for the time being, continues the practice of adjusting the size of transfer pools annually as part of the annual budget process, in line with the budget priorities of the public sector. As such, it would be desirable for the central authorities to closely monitor the level of sectoral resources provided to the local government level to prevent central government policy makers from "clawing back" sectoral resources currently provided to the local level in order to increase the central government's own budgetary resources. But, of course, this is again a matter of perspective. For example, from a central government viewpoint such cuts might be justified in order to achieve competing national policy priorities, such as macroeconomic stability or improvements in centrally provided government services.

Horizontal allocation formulas

As pointed out above, on 1 July 2004, formula-based allocations were introduced for the local provision of primary education and health care service. Formula-based allocations for all remaining priority sectors were introduced with the beginning of FY 2005/06 (Table 8.1). Each of the sectoral formulas was developed by a sectoral team that was led by the respective sector ministry, in close coordination with PO–RALG and the Ministry of Finance. While leadership of the line ministries in each of the sectoral teams assured sectoral ownership over the sector allocation formulas, guidance and involvement by PO–RALG and the Ministry of Finance assured that the formulas were developed consistent with the principles of sound transfer design (Chapter 6). With the introduction of the formula-based approach, any direction and conditions imposed by central government ministries over the local use of sectoral block grants are now transmitted to the local government level through the local government budget guidelines.

The sectoral block grant formulas were developed with the intent to capture variations in local expenditure needs by reflecting differences in the demand (and variations in local costs) for local government services which could be measured with objective data sources.[5] For instance, reliance in the primary education block grant formula on the number of school-aged children (as measured by the census) rather than the number of enrolled pupils (as reported by the District Education Officers) reflects the considerations, first, that the number of pupils currently enrolled in schools is determined more by the current supply of schooling than the actual demand for schooling, and, second, that the self-reported enrollment

Table 8.1 Sectoral block grant allocation formulas, FY 2005/06

Sectoral grant	Allocation formula
Primary education	Number of school-aged children: 100% (plus earmarked amount for special schools)
Health services	Population: 70% Number of poor residents: 10% District medical vehicle route: 10% Under-five mortality: 10%
Agriculture and livestock	Number of villages: 60% Rural population: 20% Rainfall index: 20%
Water	Equal shares: 10% Number of unserved rural residents: 90%
Local roads	Road network length: 75% Land area (capped): 15% Number of poor residents: 10%

data are prone to manipulation by local officials that seek to increase the funding from the block grant mechanism.

Holding harmless and phasing-in provisions

Introduction of the new formula-based approach from one year to the next would have resulted in a sudden and fairly dramatic shift in resource allocation patterns, which could have significantly disrupted local government service delivery. Consequently, it was decided to introduce the new formula-based system in a gradual manner over a multi-year period through specific phasing-in and hold-harmless provisions.[6]

First, a gradual phasing-in of the new approach prevented sudden large increases in resource allocations to under-resourced districts, which could have resulted in absorption problems. Sudden large increases in resource allocations would likely have resulted in inefficient or wasteful allocations or even misappropriation of public resources by local governments, which in turn could have triggered a backlash against the entire decentralization process. As such, the formula-based block grant allocations were introduced subject to a maximum increase in allocations of 25 per cent from year to year.

Second, the government decided to hold local governments "harmless" against decreases in their resource allocations. This meant that no local government received fewer resources (in nominal terms) than in the previous year.[7] Assuring that the reform process had no "losers" made the reform more politically acceptable, as the "hold harmless" clause prevented significant negative social consequences: no local government had to reduce any of its services and no local government staff had to be moved involuntarily. Not holding harmless would have been of questionable economic and social merit in the context of a developing country such as Tanzania, as it would have potentially resulted in social infrastructure being idled unnecessarily and other disruptions. Yet, it does need to be noted that holding harmless was not free of costs, as additional budgetary resources had to be made available to the sectoral funding pools for the specific purpose of holding harmless.

The impact of formula-based sectoral block grants

While it is too soon to assess the full impact of the introduction of formula-based block grants in Tanzania, descriptive statistics for budgeted local government allocations patterns since 2003 reflect a decisive improvement in the variations in per capita grants across local government jurisdictions (Table 8.2). Although the formula-based system was not introduced until 2004, increased awareness regarding the inequality of the discretionary allocation system (which was identified by the joint government–donor review of LGRP in 2001) may have contributed to the observed reduction in variation in local government allocations from its peak in 2001 (JGDR, 2001). The reduced variation in block grant allocations since 2002 stands in stark contrast to the high levels of variation and inequality in local government allocations that characterized the period prior to 2002 (Table 7.2).

All statistical measures of variation included in Tables 7.2 and 8.2 show that sectoral resources have been allocated more evenly among local government jurisdictions in the period after FY 2001/02. For instance, the Coefficient of variation was reduced from its maximum of 0.399 in 2001 to 0.249 in the formula-based allocations contained in the local government budget guidelines for 2005/06. Likewise, the ratio comparing the most advantaged council (in terms of per capita transfer resources) versus the least

Table 8.2 Variations in budgeted local government allocations between districts, FY 2002/03 to 2005/06 (in TSh. per capita)

	2002/03	**2003/04**	**2004/06**	**Budget Guidelines 2005/05**	**Budget 2005/06**
Average	8,482	9,718	11,770	14,209	14,666
Standard deviation	3,225	3,498	4,066	3,537	4,429
Coefficient of variation	0.380	0.360	0.345	0.249	0.302
Minimum	3,526	4,330	5,805	8,662	7,167
Maximum	21,573	23,024	26,545	28,849	36,150
Ratio max to min	6.12	5.32	4.57	3.33	5.04
Ratio min to average	0.42	0.45	0.49	0.61	0.49
Ratio max to average	2.54	2.37	2.26	2.03	2.46

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

advantaged council shows a dramatic decline over time; whereas in 2001, the best-off council received eightfold the amount received by the worst-off council, as part of the local government budget guidelines for 2005 this ratio has been reduced to slightly over threefold. Finally, whereas prior to 2002 the council receiving the smallest per capita grants generally received no more than one-third of the average transfer amount, after 2004 this ratio had improved to between one-half and two-thirds.

The trends displayed in Table 8.2 reflect 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 2002, the allocation of recurrent grants since 2002 appears to have occurred in a 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.

While significant improvements have been made in the equitable or fair allocation of resources among local authorities as a result of the introduction of formula-based sectoral block grants, adherence to the formula-based allocations will be critical in order to ensure further progress in the objective, equitable, and transparent allocation of sectoral block grants. As highlighted by Table 8.2, the sectoral block grant amounts that were actually included in the government budget for FY 2005/06 deviate substantially from the formula-based ceilings that were included in the budget guidelines issued earlier in the budget formulation process. These deviations were driven to a large extent by staffing decisions which were apparently made by line ministries and approved by PO–PSM outside the context of the formula-based transfer system. As was the case with the previous allocation system, these discretionary decisions seem to have disproportionately benefited the wealthier councils; thus, deviations in the implementation of the formula-based approach have contributed to a relative reduction in the pro-poor nature of intergovernmental fiscal transfers in Tanzania. As such, enforcing the strict adherence to the formula-based approach (particularly with respect to PE) is one of the remaining challenges of the implementation of the new system of intergovernmental fiscal transfers.

8.3 Local capital development grants

At the central government level, Tanzania maintains a dual budget process whereby the recurrent budget and the development budget are formulated largely alongside each other, rather than planning and budgeting for public expenditures in the context of a single, unified budget process. Although some capital development funding is funneled to local governments through the development budget, until very recently these allocations were relative small, haphazard, and highly irregular (PWC, 2003). Additional concerns with regard to capital development at the local level have been the lack of connection between capital development and recurrent for operation and maintenance, as well as the perception that local capital development patterns are largely driven by sectoral donor programs and geographically targeted area-based local development projects, which cause an unequal allocation of development resources across the national territory. Recognition of these concerns has been a motivating factor in the recent introduction of a national Local Government Capital Development Grant (LGCDG, or simply CDG) system.

Although the national system of formula-based capital development grants was not fully operationalized until 2005, the LGCDG was in fact developed virtually in parallel to the formula-based recurrent grant system. An important driving force behind the development and introduction of the capital development system was the World Bank-funded Local Government Support Program (LGSP), which was intended to provide a subset of local governments in Tanzania with capital development funding as well as capacity building grants. Although the initial conception of the LGSP itself only included a pre-selected sub-set of local governments during it first few years of operation, the LGSP modality was seized upon by the government as a way to prepare the stage for a nation-wide local capital development system. As such, LGSP supported the development of the processes and procedures for the establishment of nation-wide system of formula-based capital development grants that provides fiscal incentives for good local (financial) governance.

While the World Bank loan facility of the LGSP forms one of the funding sources for the new LGCDG system, this funding is complemented by own government financing as well as funding from a number of bilateral donor organizations. Correspondingly, a Letter of Sector Policy on local government reform recognizes the use of area-based local capital development programs and sectoral basket funds as temporary funding arrangements, and notes that these programs should ultimately be folded into the LGCDG system.

While the LGCDG system was introduced in January 2005 for a select number of local government authorities, the World Bank's LGSP funding modality did not become available until April 2005. As a whole, the LGCDG system became fully operational with the beginning of the 2005/06 fiscal year. Consistent with the principles upon which the recurrent transfer system is built, as well as the best practices distilled from Tanzania's various area-based local capital development programs, the CDG system has the following features (PO–RALG, 2004):

Capital development grants and performance conditions for access

The Capital Development Grant component of the LGCDG system is available to finance a broad range of local capital investments in public infrastructure (including economic infrastructure such as roads and markets as well as social infrastructure such as schools and clinics) within the expenditure responsibilities assigned to the local government level. As such, the grant is a discretionary (non-sectoral) capital grant that may be used either for new infrastructure or rehabilitation of the existing capital stock.

Before local governments can access capital development funds under the LGCDG, local authorities have to meet a set of performance requirements within six broad functional areas (financial management, fiscal capacity, planning and budgeting, procurement, functional processes, and project implementation capacity). In fact, local governments must meet minimum access requirements in each of these functional areas before being able to access CDG funding. These access conditions are intended to ensure that funds transferred to the local level are properly used in compliance with statutory and administrative requirements.

Capacity building grant component

Councils that do not meet the performance conditions required to access capital development funding but do meet a more limited set of minimum conditions will receive a Capacity Building Grant. Although access to the capacity building grant is contingent upon the elaboration of a local capacity building plan, local governments can use these capacity building resources according to their own priorities for improvement of their performance on the LGCDG assessment criteria. Access to the capacity building grant is thus intended to provide underperforming local governments an opportunity to mitigate their performance weaknesses and to gain access to the CDG in future years.

Size of the capital development grant pool

The total grant pool for the capital development grant component is determined to provide an average annual allocation of US$1.50 per capita. Once the program is rolled out nationwide, the capital development grant pool (provided all local authorities qualify) would equal approximately TSh. 50 billion per year. This figure was arrived at by balancing the investment needs of local governments and international experiences from similar local capital development programs with the absorptive capacity of local authorities (both at the district level and at lower-level local governments) as well as the availability of the funds from government and donor sources.

Although the transfer pool may be judged to be limited when compared to the size of recurrent transfers amount (TSh. 361 billion in FY 2004/05), hitherto local governments basically did not receive any systematic capital development funding. In addition, there is a concern among policy makers and donor agencies alike that in order for the local government finance system to be sustainable, local governments should have adequate resources (from own resources or recurrent transfers) to maintain and operate the capital development infrastructure that is being put in place. As such, in comparison to the current recurrent transfer pools and local governments' own source revenue base of TSh. 36 billion, the current size of the LGCDG does not appear to be inappropriate for the initial years of the system.

Horizontal allocation formula

The horizontal allocation formula adopted by the LGCDG system for the allocation of capital development grant is based on three factors: population (70 per cent), a poverty indicator (20 per cent), and land area (10 per cent). In its development and execution, the formula is fully consistent with the sound principle of transfer design as laid out in Chapter 6. The allocation formula provides greater fiscal 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 the concept of needs-based equalization. Although the CDG formula is pro-poor in its design, a potential criticism of the formula is that it fails to recognize the presence of a greater capital stock in some districts when compared to other districts. However, given the current state of available data, it would be almost impossible to subjectively quantify the value of existing capital stock in different local government areas. Yet, as the CDG system evolves over time, the allocation formula could be reviewed from time to time to assure that the formula incorporates the best available data and to verify that it achieves the policy objectives that the capital development grant system intends to achieve.

Distribution of resources between district-level and lower-level local governments

According to the guidelines for the LGCDG system, 50 per cent of the capital development grant has to be set aside for and prioritized at the village or mtaa level (so-called "lower-level" local governments). However, given the current lack of financial management capabilities of the lower-level local governments, at this stage no funds are transferred directly to the governments below the district level. However, to facilitate local planning, stimulate public participation and realistic planning within a known resource envelope, notional indicative planning figures should be provided within which the village and mtaa councils can plan.

While this resource sharing between districts and villages as incorporated into the LGCDG follows current mandates regarding the sharing of local own source revenues and the General Purpose Grant, the assignment of expenditure responsibilities only provides weak support for this practice since the village level has no exclusive expenditure responsibilities. Furthermore, in parallel to the LGCDG, the World Bank-supported Tanzania Social Action Fund (TASAF II) will be providing in excess of US$100 million in capital development grants to villages and mtaa through the TASAF National Village Fund. Such a substantive influx of capital development resources at the lower local government level could substantially compromise the ability of districts to manage and oversee capital development at the lower-level local governments, as well as to provide funding for operation and maintenance of local government infrastructure.

Finally, the LGCDG is an important step in the process of arriving at a unified capital development funding mechanism in Tanzania, as the discretionary nature of the system provides local governments substantial budget autonomy. At the same time, however, the LGCDG system in its current form does not allow line ministries to use the CDG system to steer resources to national priorities as may be perceived at the central government level, such as classroom construction, clinic rehabilitation, local roads construction, and so on. Future expansion of the LGCDG system could widen the role of the system by incorporating different "windows" for separate formula-based sectoral capital development transfers under the same overall mechanism. In that case, all local capital development funding, including sectoral capital development grants, could be planned and budgeted as part of the comprehensive local budget process, while flowing to the local level through a unified system of budgetary accounts.

8.4 Introduction of an unconditional, equalizing General Purpose Grant

Whereas formula-based sectoral block grants and the formula-based capital development grant scheme are both in the process of being implemented at the time of writing, the introduction of a formula-based, unconditional equalization grant is still in its design stages. Yet, in order to achieve both vertical and horizontal fiscal balance in Tanzania's system of local government finance, the introduction of an unconditional and equalizing transfer scheme should be seen as an indispensable part of Tanzania's transfer system. Since the majority of local government finances is provided to the local level in the form of sectorally earmarked grants, an unconditional transfer scheme would help enhance the degree of fiscal discretion and autonomy at the local government level.

The role of equalizing, unconditional grants in Tanzania's local government finance system

Until 2003, Tanzania's system of intergovernmental transfers consisted exclusively of earmarked local government allocations and lacked any unconditional transfer mechanism. In fact, the Ministry of Finance was actively opposed to the introduction of unconditional transfers, motivated by the concern that local governments would not use such resources in an efficient manner. Yet, with the abolition of the Development Levy and some nuisance taxes in June 2003, the Ministry of Finance instituted an unconditional Compensation Grant in order to compensate local governments for the revenues lost as part of the local revenue reforms. As such, the introduction of unconditional grants in Tanzania was due more to a confluence of circumstance than due to a specific policy vision. While this Compensation Grant was renamed as the General Purpose Grant (GPG) in 2004, its allocation among councils continues to be determined largely by the distribution of abolished local revenue sources prior to 2003. However, the policy vision for the new formula-based system of intergovernmental fiscal transfers seeks to transform the current GPG/Compensation Grant into a formula-based, equalizing, and unconditional General Purpose Grant.

More specifically, the transformed GPG is envisioned to provide funding for two purposes. First, the GPG would provide an unconditional funding modality which local governments might use to cover the general administrative cost of operating the local government council. Second, in line with the provision of an equalization grant included in the Local Government Finance Act, the GPG would provide equalizing funding to the local government level. However, since sectoral block grants already provide funding for local government services within the priority sectors based on local expenditure needs, the GPG would be intended to (co-)fund local activities that are exclusively assigned (that is, fully devolved) to the local government level, but for which the own local revenue instruments currently assigned to the local government level provide inadequate resources.

This argument that the general operating expenses of local government authorities should be covered in whole or in large part from unconditional grants was already made in Chapter 2 of this book. The case was made in the discussion of expenditure assignments that local authorities are an integral part of Tanzania's national system of public administration since the predominant responsibility of local government authorities is to manage the provision of nationally mandated priority-sector services (such as primary education and health care). Furthermore, the category of "local administration" captures a variety of activities outside the main priority sectors that are nonetheless considered national priorities. The substantial funding of local administration from own local revenues (as is currently the case) thus goes against the concept that "finance should follow function". In fact, as noted in Chapter 4, the practice forms an important contributing factor in residents perceiving that they receive little value for money in return for their local taxes. Since the funding of local administration through centrally earmarked would potentially threaten the autonomy of local governments, it would be more appropriate for the central government to contribute to the general operating cost of local governments through the unconditional GPG.

Size of the grant pool for the General Purpose Grant

One of the challenges in the transformation of the current Local Administration Grant together with the compensation-based GPG into an equalizing, formula-based General Purpose Grant will be the determination of the right size of the unconditional grant pool.

Since the optimal size of funding to be made available to the GPG is driven by the policy importance attached to the functions to be financed by the mechanism relative to the government's resource constraints, unbiased guidance on the appropriate size of the transfer pool could be extracted by analyzing recent and current resource patterns. Such analysis should include consideration of the current size of the Local Administration Grant and the current GPG/Compensation Grant, as well as trends in local expenditures on administration and other non-sectoral local activities from own local revenues sources. For instance, in 2002/03 (the year before the introduction of revenue reforms), local authorities received TSh. 15 billion in Administration Grant and collected almost TSh. 58 billion in own source revenues. From this total of TSh. 73 billion in general purpose resources, a majority of funds were spent on local administration. By 2004/05, the composition of general purpose resources had changed: in that year, local governments received TSh. 20 billion and TSh. 25 billion in Local Administration Grant and General Purpose Grant, respectively, and were estimated to collect approximately TSh. 36 billion in own sources, for a total of approximately TSh. 81 billion in general purpose funding.[8]

In addition to resources that are currently made available to local governments on a discretionary basis in the form of the Local Administration Grant and GPG/Compensation Grant, some additional "general purpose" local resources are made available elsewhere in the budget. For instance, budgetary resources are 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.

A final consideration in determining the most appropriate size of an unconditional equalization grant is the degree of horizontal disparity which is caused by local government revenue system. Obviously, the size of the equalization grant pool needs to stand in some proportion to the fiscal disparities created by own revenues. In this regard, we need to recognize that the size of the current general purpose grant (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.

Once the initial funding pool for the formula-based, equalizing GPG is determined, how should the size of the grant pool change over time? Unlike the case of sectoral block grants, where both line ministries and PO–RALG have an institutional interest in supporting additional funding for local governments (in order for LGAs to achieve shared policy objectives), there is not necessarily the same broad-based coalition of local governments and central government champions to advocate for the size of the General Purpose Grant pool. As such, a vertical funding rule may need to be defined in order to safeguard the relative size of the transfer pool for the GPG over time. For instance, in order to prevent erosion of the GPG, it might be appropriate to specify that the annual increase of the General Purpose Grant should be at least proportional to the increase in the national budget. Alternatively, the size of the GPG could be specified as a percentage of the national budget or as a percentage of total sectoral block grant pool; for instance, the size of the GPG each year could be determined as equal to some percentage of the sum of all sectoral block grants. Whatever vertical allocation rule is ultimately chosen, it would be wise to enshrine this principle in the Local Government Finance Act; doing so would greatly enhance the stability and predictability of the local government finance framework, and would reduce the potential for shirking or "clawing back" by the central government.

The horizontal allocation of the GPG

Although the Local Administration Grant and the General Purpose (Compensation) Grant provide a logical resource basis for an unconditional, equalizing General Purpose Grant, the current incidence of these two grant schemes is clearly inconsistent with the government's poverty reduction strategy and the stated intent of the law about providing equal access to local government services. Historically, the local administration grant has been distributed in a highly discretionary and unequal manner. In fact, the allocation of the administration grant was determined to a large extent by 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 administration grant 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.

Given that the purpose of the general purpose grant mechanism is twofold, 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 policy objective. Consistent with its functions, the first transfer window of the GPG could provide each local government with a base amount of unconditional financial resources that would be adequate for (all or a major share of) the general administration and operation expenses of the local authority. As such, the first window could allocate part of the transfer pool in accordance with measures of local expenditure need associated with local administration, such as population, land area, and potentially a fixed lump sum. In turn, the second transfer window could provide funding for general (non-sectoral) local purposes in an equalizing manner. In order to be equalizing, this second window would include measures of local needs and local fiscal capacity; based on the selected allocation factors, the mechanism would then provide greater resources to local governments that have greater expenditure needs and/or a more limited ability to raise own revenues.

The unconditional use of GPG resources

Although the transformation of the General Purpose Grant is intended to result in an unconditional equalizing grant, some restrictions on the use of this funding source have already emerged. For instance, when the Compensation Grant was introduced, the guiding circular instructed local governments that these resources should be used in the same manner as the eliminated own revenue sources, but then proceeded to mandate that 50 per cent of the resources should be shared with lower-level local governments.[9] While the intention of the mandate is clearly to enhance local participation and accountability, the mandate has the unintended effect of sharply reducing the fiscal autonomy provided by the GPG.

It would be preferable for all conditions tied specifically to the General Purpose Grant to be removed, so that the GPG is allowed to take on the nature of a true unconditional grant. Any resource-sharing arrangements between the district and the village level should not be limited to the GPG, but should more widely consider all general purpose (untied) resources, including own source revenues. Likewise, any general conditions on sound local government administration, such as requirements for local governments to provide funding for ward- and village-level officials, should not be imposed as conditionalities on the GPG. Rather such requirements are more appropriately imposed as part of the overall Local Authorities Financial Regulations.

8.5 Completing the implementation of the formula-based transfer system

Compared to the other components of the local government finance system, the reform of the intergovernmental transfer system began with a head start; the intergovernmental fiscal transfer study that provided the framework for the formula-based transfer system was completed in January 2003 (LGRP/GSU, 2003), whereas the vision for the remainder of the intergovernmental fiscal system was not fully defined until the draft policy paper on local government reform completed in June 2005. Since the full implementation of a comprehensive and sound system of formula-based transfers will form the backbone of Tanzania's future local government finance system, a number of steps are still needed to complete the implementation of the envisioned formula-based transfer system.

Complete the introduction of formula-based recurrent grants

As noted in Section 8.2, the introduction of formula-based sectoral block grants contributed substantially to improving the objectivity of local government allocations and the pro-poor nature of local government finances. However, sectoral block grants are currently not yet fully distributed among local governments based on the respective allocation formulas. First, phasing-in and holding-harmless clauses provide some local authorities with more or less resources than strictly determined by the formula. Likewise, as noted earlier in the discussion of Table 8.2, some challenges are still being encountered in assuring that both the PE and OC components of the recurrent sectoral allocations are distributed fully consistent with the formula-based approach.

Fine-tune the formula-based capital development grant system

At the time of writing, the Local Government Capital Development Grant is only in the early stages of its implementation, and is yet to go through its first complete annual budget cycle. Revisions and fine-tuning of the administrative processes should be expected subsequent to this first budget cycle. In addition, certain more structural questions need to be considered, including the sharing of capital development resources between the district-level and lower-level local governments as well as the possibility of introducing parallel windows into the LGCDG system for sectorally earmarked capital development grants.

Introduction of an equalizing, formula-based General Purpose Grant

The remaining component of the formula-based transfer system that is yet to be fully defined and put in place is the introduction of a formula-based, unconditional and equalizing General Purpose Grant mechanism.

Prevent earmarked transfers and the fragmentation of the transfer system

With the introduction of a set of formula-based sectoral grants, it is likely that some sector ministries will seek to introduce parallel sectoral transfer schemes in order to regain their ability to earmark funding to specific local government activities across local jurisdictions. In general, such fragmentation would unnecessarily complicate the transfer system and has the potential to rapidly dilute the objectivity and transparency that was brought about by the introduction of the formula-based system.

To the extent that the activities that are funded by earmarked transfers are legally and factually devolved to the local government level, such practices would go directly against the concept of D-by-D. To the extent that a central government ministry relies on local governments to implement a specific central government function at the local government level (that is, delegating the implementation of a service), the central government ministry should be allowed to provide ministerial subventions (earmarked, cost-reimbursement transfers) for these purposes in their own budgets. In this case, the ministerial budget should clearly identify the amount of resources flowing to the local government level, as well as upon which criteria these resources are to be distributed among local government units.

Improve the reporting and monitoring of intergovernmental transfers

As the introduction of the formula-based system of intergovernmental fiscal transfers is fine-tuned and completed, the details of the day-to-day administration of the transfer system become increasingly important. In this light, the processes for reporting and monitoring of the transfer system require increased attention. However, in this case, reporting and monitoring should be considered a bi-directional activity. While the central government should require LGAs to report regularly on various aspects of their finances, including the spending of sectoral block grants, central government ministries also have a substantial burden to report on central government financial transactions that impact local government finances.

For instance, sound budget formulation procedures require the central government to provide local authorities with not only detailed information regarding the size of the respective sectoral block grants that they should expected to receive, but also with details on how ministerial subventions and any other parallel funding mechanisms will be distributed among local government councils. The implementation of a monitoring and reporting system that makes such information available during budget formulation and then tracks this information during budget execution is critical for local governments to: (a) develop comprehensive local budget plans, (b) monitor that these resource indeed correctly flow to the local government level and do not get diverted at the central government level, and (c) monitor that these resources are appropriately spent by local government authorities on their intended purpose.

Part IV

Local Government Borrowing

9

The Role of Local Government Borrowing in Tanzania's System of Local Government Finance

In most developed economies, local government borrowing forms an integral part of the system of local government finances. Although public sector borrowing for recurrent spending is generally considered a bad practice, public finance experts generally agree that it is appropriate for responsible and accountable local government authorities to borrow for the purpose of financing capital investments. Borrowing enables local government authorities to fund capital developments (such as roads or school buildings) that produce benefits over a longer period of time and spread out the financial burden for this investment over a number of years, thus providing a stronger link between the costs and benefits of the capital investment over time.

Despite this ideal situation, local government borrowing is much less common in developing economies, including Tanzania, for a variety of reasons. Consistent with experiences in other lesser developed economies, local government authorities in Tanzania have only very limited access to capital development funding from borrowing. While the Local Government Finance Act (1982) in principle allows local government authorities to borrow with ministerial permission, PO–RALG and the Ministry of Finance currently oppose local government borrowing from the private sector. As such, the only borrowing mechanism currently available to local authorities in Tanzania is the Local Government Loans Board (LGLB). Yet, by all accounts the Board is undercapitalized and organizationally ill-equipped to meet all the (legitimate) borrowing needs of local governments in Tanzania. As a result, local government borrowing plays an extremely minor role in local government finance in Tanzania; it represents less than 0.1 per cent of the resource inflows to local government authorities per year (see Chapter 1: Table 1.1).

This chapter explores the role of local government borrowing in Tanzania's system of local government finance. In doing so, we first discuss the potential benefits and risks of local government borrowing in the context of a developing economy such as Tanzania (Section 9.1). In Section 9.2, we provide an overview of different international practices with respect to local government borrowing by discussing what approaches other countries have followed in pursuing the benefits of local government borrowing while minimizing the associated risks. Section 9.3 describes the current status of local government borrowing in Tanzania, including current proposals for the LGLB to evolve into a Local Government Finance Corporation. In Section 9.4, we discuss the linkages between the local government borrowing system and other dimensions of local government finance in Tanzania. Finally, we make some concluding remarks in Section 9.5.

9.1 The benefits and risks of subnational government borrowing

The most obvious benefit of local government borrowing is that it provides a source of financing for local capital development. A secondary benefit is that it can serve as a fiscal mechanism to keep local governments honest and accountable. At the same time, allowing local governments to borrow also brings with it a number of possible risks.

Local government borrowing as a source of local capital funding

Modern public finance theory suggests that 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. After all, when local governments prioritize their recurrent expenditure needs and their budget decisions, this is accomplished by comparing the projected costs of a project with the expected benefits of the project to the community. For instance, a local government may judge that the benefit of hiring an additional teacher for the local school exceeds the (recurrent) cost of doing so, whereas the expected benefits of hiring an additional fire fighter might not be justified by the additional cost.

However, the very nature of capital goods is different from regular recurrent budget items, which complicates the budgetary choices that need to be made. 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.
2. Furthermore, 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 for both social types of infrastructure (school buildings, clinics, and others) as well as productive types of infrastructure (markets, roads, and so on).

3. Once we recognize the intertemporal nature of capital development projects, we should also recognize that it is more equitable to have those residents that will receive the benefits of the capital project over time also to 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. The absence of certain types of infrastructure may be limiting economic growth: while building a market or laying a rural road may generate economic activity, the fiscal resources to build the market or lay the 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 is 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.

While borrowing can serve as an appropriate and desirable mechanism for funding local capital development, it would generally be inappropriate to use borrowing to fund current expenditures or recurrent budget deficits. 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—for instance, to cover deficits arising from uneven cash flows within a budgetary year (Dafflon, 2002; Swianiewicz, 2004).

Local government borrowing as an accountability mechanism

Since acceptance of a local government loan implies a long-term repayment commitment on behalf of a local authority, the ability of the local government to borrow (in the context of a well-functioning borrowing mechanism) can serve as a bellwether of sorts for the local government's creditworthiness. After all, the extension of credit to local governments (whether by private financial institutions or by a public intermediary) should be based on an assessment of the locality's fiscal capacity to repay the loan in future years as well as the local government's political commitment to repaying the loan. To the extent that local governments would like to borrow for capital purposes, the local borrowing framework can serve as an important incentive for local governments to maintain proper books of account; to meet all their financial obligations in a timely manner; and to exert reasonable effort in local government revenues in order to demonstrate creditworthiness.

The risks of local government borrowing

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 in the answer to this question. First, in order to borrow money, local governments need to have adequate revenues to repay their debt. Since many local governments in developing countries lack sufficient own resources (either in the form of own revenue collections or unconditional transfers), it would be impossible for them to credibly borrow funds. Second, even if local governments have adequate resources, local government borrowing raises a number of potential risks.

The first risk of any local government borrowing mechanism is that the local governments succumb to the temptation of "free money" and violate the golden rule by diverting borrowed funds for recurrent expenditures. While this practice in itself may not be catastrophic as long as local governments repay the debt that they incur, it is not sustainable in the long run, certainly not generationally equitable, and would likely reduce the economic efficiency of local spending. Of course, the political risk of having current decision-makers shift recurrent obligations to future generations (and generally to act fiscally responsible) is ever present without a legal constraint informed by the golden rule.

A more significant risk with local government borrowing is the moral hazard problem in subnational borrowing: although a loan between a responsible local government and a (public or private) financial institution could bring benefits to both, the incentive for the local government to repay the debt may change once the loan agreement is executed. In highly developed market economies with an established tradition of local autonomy, the reason that a local government will generally repay its debt is twofold. 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.

However, conditions in most developing 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.[1] The expectation of a bailout, that is, that loans will be repaid by the central government if the local authority defaults, 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 bailouts of regional and local governments in developed and developing countries alike (Rodden, 1999).

Even in the limited cases where short-term borrowing is allowed for cash flow purposes, local borrowing might provide local governments with an opportunity to exploit the soft budget constraint. The experience of many countries is that local governments 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 the year's end, this gives them a perverse incentive to engage in excessive spending and to reduce their revenue effort.

In addition to the risks caused by moral hazard, the incurrence of substantial debts by subnational governments (just like central government debt) could have the potential of driving up interest rates and crowding out private sector investments if left unregulated. Since excessive subnational borrowing or the risk of major defaults would have important ramifications for macroeconomic conditions and for the ability of the central government to rely on fiscal policy as a tool to manage macroeconomic conditions, central governments often require subnational governments to balance their budgets or tightly regulate their ability to hold debt. 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.

9.2 International approaches to local government borrowing

Different countries have followed different approaches in order to exploit the benefits of local government borrowing while minimizing the potential risks.

International practices with respect to local government borrowing can be categorized into five basic approaches, although combinations of different approaches are possible (Ter-Minassian and Craig, 1997). At one extreme, a country could leave local government borrowing completely unregulated and base the ability of local governments to borrow in a responsible manner exclusively on market discipline; at the other extreme, the central government could impose a complete prohibition against subnational government debt. Other international approaches lie between these two extremes, including cooperation by different levels of government in the design and implementation of debt controls, rule-based controls for subnational borrowing, and discretionary central administrative controls on subnational debt.

Reliance on market discipline

In the United States and a select number of developed economies, market forces provide the main mechanism for imposing fiscal discipline on local governments. Under this laissez-faire approach, responsible local governments with excellent repayment records and strong credit ratings are able to secure funding for local capital development projects either through private financial institutions or on a municipal bond market. In contrast, local governments that have limited fiscal capacity or that have shown a lack of fiscal discipline or accountability in the past are punished by the markets and are often only able to access borrowed funds at high interest rates, if at all.

Despite the attractive features of a market-based approach, reliance on market discipline is not a feasible option for many developing countries since there are a number of strict conditions that need to be satisfied for financial markets to create discipline on subnational government borrowing behavior (Lane, 1993). These conditions include:

- Financial markets should be free and open from regulations that place government in a privileged borrowing position.
- Accurate and timely information on borrower's outstanding debt status and repayment capacity needs to be available.
- There should be no perceived chance of bailout of the lenders by central authorities 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 only met in a few countries and are unlikely to be realized in most developing countries. Even many industrial countries engage in various forms of interventions in financial markets to put government securities at privileged positions.

Because of the stringent conditions for market discipline, exclusive reliance on market discipline 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, the central government involves subnational governments in 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 where either national fiscal responsibility laws or supra-national rules (such as in the case of the European Union's Maastricht Treaty) impose caps on the overall size of public debt. 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 to local government borrowing, which puts limitations to local borrowing in the constitution or in the relevant legislation. 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; some other rules may determine a maximum allowed debt service relative to total expenditures in order to limit the new borrowing; while other rules 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 to local government borrowing requires a strong capacity to monitor on the part of the central government, lacks flexibility, and may end up encouraging practices aimed at circumventing the rules. To ensure its effectiveness, the rule-based approach 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 control by central government over subnational borrowing. This control may mean that either every local borrowing transaction from a private lender needs to be reviewed and authorized by the center or the central government restricts local government borrowing to a single financial intermediary (such as of local government bank, loans board, or a local government finance corporation) which is fully under its own control.

In reality, direct administrative control comprises a range of centralized approaches, from complete ad hoc 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 which is only under notional control by central authorities. Direct administrative control is more commonly used in unitary states than in federations. A more restrictive local government borrowing framework has some advantages, including closer management of the relationship between debt policy and other macroeconomic policies; better terms and conditions of international debts; avoiding the risk of a contagious effect of one subnational jurisdiction'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 a variety of 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. It may be particularly difficult for a financial intermediary endorsed by the central government to aggressively pursue defaulters and maintain the position that it will not bail out local governments. This position may handicap the ability of the local financial intermediary to exert fiscal discipline on local authorities and to prevent moral hazard.

Although a central-government run local financial intermediary 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 government 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 closely monitor the borrowing flows of individual jurisdictions, which serves the purpose of preventing subnational governments from incurring the level of debt that would threaten with 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 for two reasons. First, reported data might not be credible due to "creative accounting", off-budget financing practices, and contingent liabilities related to local government enterprises and other forms of local government guarantees. 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.

9.3 Local government borrowing in Tanzania and the role of the Local Government Loans Board

In the absence of a well-developed capital market in Tanzania where local government authorities can freely 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, a government-supported financial intermediary for local government authorities.[2]

The Local Government Loans Board

The Local Government Loans Board, established in 1986, derives its legitimacy from the Local Government Finances Act of 1982. The Board is intended to serve as a source of capital financing for local authorities by way of loans for capital investment. The aim of the capital funding mechanism is to stimulate economic development by supporting the implementation of economic projects. The Board is comprised of seven Board Members appointed by the Minister responsible for Local Government. They include representatives from the central government, local government, and a private sector financial institution.

The Local Government Finances Act (Section 57) stipulates that one of the functions which the Board is mandated to perform is to lend funds to LGAs for development projects and other economic activities geared toward improving and/or increasing local government revenue capacity. It also approves loan applications submitted by LGAs after scrutiny and recommendation by the technical staff of the Board. The Board further performs the role of policy advisor to the Minister responsible for Local Government, advising on policy issues regarding local government borrowing.

The terms for loans from the LGLB are between a minimum of one year and a maximum of five years. The cumulative recovery rate for LGLB loans has increased significantly in recent years. Of the cumulative total amount of repayments due (TSh. 876.3 million), a total of TSh. 628.4 million had been repaid as of 30 June 2004; this is equivalent to a 71.71 per cent recovery rate.

As noted at the outset of this chapter, local government borrowing through the LGLB only accounts for 0.1 per cent of local government funding. While (as noted below) the limited scope of local government borrowing can be attributed in part to the institutional shortcomings of the LGLB, the most significant constraint to local government borrowing most likely is the tenuous fiscal condition of most local authorities in the country. In other words, one on the most significant constraints on the environment for local government lending is the limited tax potential of local governments, which constrains the potential ability of LGAs to repay loans regardless of the borrowing mechanism that is relied on.

Weaknesses of the LGLB

Tanzania's choice to rely on a financial intermediary for local government borrowing is not surprising given the absence of developed capital markets and the weak capacity of the central government to monitor and enforce a rule-based borrowing framework. However, the LGLB suffers from a number of shortcomings that are not uncommon for centrally run local government financial intermediaries. As a central government institution, the Board is beholden to the bureaucratic traditions of the center while the Board's capitalization is inadequate (inadequate both in terms of the amount as well as in its method of capitalization). The Board's current mode of operations gives it 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 arguably 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.

Proposed reform of the LGLB

A recent study commissioned by LGRP on behalf of the Loans Board has recognized many of the shortcomings just discussed and recommended that the LGLB and its operations be significantly transformed. The recommendations include the transformation of the LGLB into an autonomous Local Government Finance Corporation (LGFC). The Corporation would be capitalized through the issuance of shares; its capital base could further be supplemented by the capital obtained from development partners (including on-lending). The composition of the LGFC's Board would be more reflective of the ownership of the capital, arguably resulting in greater autonomy and greater ownership outside central government. The LGFC's lending operations would be transformed to be in line with international best practices in private sector lending, resulting in the expansion of the LGLB's staff to encompass greater in professional capabilities.

In principle, the recommended transformation of the LGLB into LGFC fits well within an overall local government finance framework that recognizes the importance of local government borrowing, not only as the financing mechanism but also as a tool for fiscal discipline and local accountability. However, the proposed transformation of the LGLB fails to resolve a number of core challenges associated with establishing a sound local government borrowing framework in Tanzania (LGRP/GSU, 2005). For instance, reform of the LGLB in itself will do nothing to improve the creditworthiness of local governments and thus will likely only have a limited impact on repayment rates.

9.4 Linkages between local government borrowing and other dimensions of local government finance

One of the main weaknesses of proposed transformation of the LGLB is the lack of consideration given to the linkages between the local government borrowing framework on one hand and the rest of the local government finance system on the other hand. Indeed, the proposed borrowing framework seems to be developed almost independently from other potential sources of capital development funding, especially the Local Government Capital Development Grant mechanism discussed in Chapter 10. One of the worst things that could happen to Tanzania's evolving system of local government finance is for these mechanisms to be uncoordinated and to "compete" with each other. For instance, a situation should be avoided in which unaccountable local governments that fail to qualify for the LGCDG are able to access capital resources through the lending mechanism. As such, it will be critical that LGCDG's Minimum Access Conditions are cross-referenced between the LGCDG and the local government borrowing mechanism.

Furthermore, the possibility for local government to default on their debt obligations creates a problem of a soft budget constraint that is yet to be resolved. This is particularly true when the local borrowing framework is not integrated well into the rest of the local government financing framework. When intergovernmental grants and borrowing are considered 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, which in turn weakens the incentives for cost recovery and cost efficiency. Lastly, poor repayment fails to create 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 could result in an overall improvement in the system of local government finances. From a intergovernmental 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.

Furthermore, 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). The integration of intergovernmental transfers and the loan system within a comprehensive financing framework would be consistent with the pursuit of an equitable allocation of subnational resources while, at the same time, supporting the gradual development of a municipal credit system (Weist, 2004). Such a hybrid system could institutionally evolve either by introducing a grant component into local government borrowing operations or by including a component of borrowing into a grant program.

9.5 Concluding remarks

A fair assessment of the role of local government borrowing in Tanzania's system of local government finance would conclude that while quite insubstantial in scope at the current time, local government borrowing should not be overlooked in the overall design of the larger framework for local government finance. At best, failure to consider the role of local government borrowing would constitute a missed opportunity to improve the funding of local capital development, particularly in the urban local authorities that form the engines of economic growth in the country. At worst, failure to properly consider the role of borrowing in the local government finance framework could result in soft budget constraints that propagate perverse incentives and wreak havoc throughout the local government finance system.

The cautious approach to local government borrowing taken by the Government of Tanzania seems prudent. By restricting local government borrowing from the private sector, the country has avoided problems with loan arrears and defaults that have plagued some of its neighbors (for example, Malawi). At the same time, the central government is laying the foundation to put in place an appropriate borrowing framework to stimulate local capital development in a way that promotes fiscal discipline and assures a hard budget constraint without harming the other dimensions of the local government finance system. However, in the long run the scope for local government borrowing will be determined to a large extent by the ability of local authorities to increase their revenue potential, which is a critical precondition for attaining creditworthiness regardless of the specific institutional approach to local government borrowing.

Part V
Moving Forward and Lessons

10

Moving Forward: Local Government Finance and Tanzania's Poverty Reduction Strategy

At the very outset of this book, we stressed the important role of local governments and local government finances in putting in place a pro-poor development strategy. In Chapter 1, we noted that decentralization reforms are used to pursue different goals in different countries, including improving the delivery of pro-poor public services, such as education and health care; empowering local communities by increasing participation and accountability of the public sector through local governments; and increasing the transparency and equity with which public resources are allocated across the national territory. In the context of Tanzania, the Policy Paper on Local Government Reform (MRALG, 1998) identifies the improvement of the quality of public service delivery in the context of poverty alleviation as the primary motivation behind decentralization by devolution.

In fact, public expenditures can contribute to poverty reduction in a number of ways. A review of the available research on poverty reduction suggests that most poverty reduction is pursued either through investments in human capital (through education and health); by promoting production and creating access to markets through capital infrastructure development (roads and transportation, market infrastructure, and so on); or through reforming economic institutions (to generate more competition, provide access to capital markets, and so on).[1] This means that many "regular" government services such as basic education and basic health care—services that traditionally may not have been considered as "poverty reduction"—should in fact be considered key factors in the implementation of a national poverty reduction strategy.

The fact that the subsidiarity principle assigns the delivery of many of pro-poor social services to the local government level means that local governments in developing countries have an important role to play, side by side with central government agencies, in achieving effective poverty reduction. This is certainly the case in Tanzania, where local authorities are assigned the responsibility to deliver primary education, basic health services, agriculture extension services, water supply, and local road maintenance. However, these expenditure functions are not assigned exclusively to the local government level. In the law and in practice, these functions are seen as concurrent responsibilities of the central and local government levels: while the responsibility for delivery and production of the public services is assigned to local government authorities, the responsibility for setting standards, regulating, and financing these public services remains with the central government. This is consistent with the need to have redistribution (and therefore, pro-poor activities) financed by the center.

The remainder of this chapter assesses the current local government finance system in Tanzania (including proposals for its ongoing reform) in the context of Tanzania's broader development vision and its poverty reduction strategy. In doing so, we come to two conclusions: first, local governments play an indispensable role in implementing Tanzania's poverty reduction strategy; second, with some minor exceptions, perhaps, the local government finance system overall is fully in line with the country's development vision that supports poverty reduction.

10.1 Poverty reduction and its impact on local government finances

The long-term development vision of Tanzania is contained in the country's *Development Vision 2025* (URT, 1999). This policy document establishes a broad vision which seeks to achieve five main objectives by the year 2025: (1) a high quality livelihood, (2) peace, stability and unity, (3) good governance, (4) a well-educated and learning society, and (5) a strong and competitive economy. Interestingly enough, poverty reduction itself is not noted as a primary, direct objective in achieving Tanzania's development vision. However, the reduction of poverty, either directly or indirectly, impacts each of the development objectives contained in the policy vision, as further set forth in the country's poverty reduction strategies.

Tanzania's first Poverty Reduction Strategy (2000/01 to 2002/03)

Supplementing the *Development Vision 2025*, Tanzania developed a National Poverty Eradication Strategy in 1998 (URT, 1998) and adopted its first Poverty Reduction Strategy (PRS) Paper in 2000 (URT, 2000). The government's original PRSP (covering the period 2000/01 to 2002/03) was linked to debt relief under the enhanced High Indebted Poor Countries (HIPC) initiative.

In most aspects, Tanzania's first PRSP was a traditional poverty reduction strategy document; debt relief and other resources were mainly channeled into the "priority sectors" of education, health (including HIV/AIDS), water, agriculture, rural roads, and governance (including the judiciary and land). The basic rationale for this approach was that spending in these areas was considered to have a greater impact on poverty reduction. Correspondingly, progress on the poverty reduction agenda was pursued to a large degree by increasing expenditures in these priority areas.

The final progress report for the PRS notes that as a result of the implementation of the first PRSP, progress was made in macroeconomic performance and various other reforms, including in the financial sector, public service, and local government (URT, 2004b). Yet, despite the distinct efforts that were made to improve the delivery of social services in the priority sectors, the assessment of the first PRS concluded that more effort was still needed in virtually all areas. Looking forward to future poverty reduction efforts, it was noted that beyond merely increasing spending in priority sectors, greater attention was to be paid to quality and equity issues in the delivery of social services.

National Strategy for Growth and Poverty Reduction (2005/06 to 2009/10)

The National Strategy for Growth and Poverty Reduction (NSGPR, commonly known by its Swahili acronym, MKUKUTA) is Tanzania's second national organizing framework for putting the focus on poverty reduction high on the country's development agenda (URT, 2005a). More clearly than the first PRS, the NSGPR keeps in focus the aspirations of Tanzania's development vision as expressed in *Vision 2025*. The NSGPR also commits Tanzania to the United Nations Millennium Development Goals as internationally agreed targets for reducing poverty, hunger, diseases, illiteracy, environmental degradation, and discrimination against women by 2015. The strategy strives to widen the space for country ownership and effective participation of civil society, private sector development, and fruitful local and external partnerships in development. It further commits to regional and other international initiatives for social and economic development.

While the NSGPR builds on the experiences of Tanzania's first PRS, it is fundamentally different in a number of ways. In contrast to the sectoral approach of the first PRS, the NSGPR cuts across all sectors, recognizing that spending outside the so-called 'priority sectors' could very well be pro-poor as well, while not all spending in these priority sectors necessarily supports poverty reduction. Furthermore, while we should note that not all economic growth is necessarily poverty reducing, the new strategy explicitly recognizes that economic growth forms the only foundation for sustainable and permanent poverty reduction.

Thus, instead of limiting the focus of the poverty strategy on a number of priority sectors, the NSGPR focuses on three "clusters" of activities that promote economic growth or poverty reduction. The focus of resource allocation in the context of the NSGPR is no longer on expenditures or inputs, but on outcomes and performance results. Thus, for every cluster, the national strategy determines outcomes/targets to be achieved. Under the NSGPR, the government classifies and prioritizes government programs across all sectors into: (1) promotion of economic growth and reduction of income poverty;

(2) improvement of quality of life and social welfare, including quality service delivery; and (3) good governance and accountability (Table 10.1). Recognizing that poverty is multi-dimensional in nature through the cluster approach, the new PRS gets much closer to the *Development Vision 2025* than the first PRS.

Poverty reduction and local government finances

Since the local government finance system provides funding for key pro-poor public services which are assigned at the local government level, getting intergovernmental finances "right" (aligned with the government's policy objectives) should be a key concern in implementing the poverty reduction strategy. As such, the local government finance system may need to respond to changes in the policy environment. Under the first PRS, the government's policy focus was on increasing expenditures and improving service

Table 10.1 Poverty reduction clusters and goals contained in the National Strategy for Growth and Poverty Reduction

Cluster I: Growth and reduction of income poverty
Goal 1: Ensuring sound economic management
Goal 2: Promoting sustainable and broad-based growth
Goal 3: Improved food availability and accessibility at household level in urban and rural areas
Goal 4: Reducing income poverty of both men and women in rural areas
Goal 5: Reducing income poverty of both men and women in urban areas
Goal 6: Provision of reliable and affordable energy to consumers
Cluster 2: Improvement of quality of life and social well-being
Goal 1: Ensuring equitable access to quality primary and secondary education…
Goal 2: Improved survival, health, and well-being…
Goal 3: Increased access to clean, affordable, and safe water, sanitation, decent shelter…
Goal 4: Adequate social protection and rights of the vulnerable and needy groups
Goal 5: Universal access to quality public services that are affordable and available
Cluster 3: Governance and accountability
Goal 1: Governance that is democratic, participatory, representative, accountable, and inclusive
Goal 2: Equitable allocation of public resources with corruption effectively addressed
Goal 3: Effective public service framework to improve service delivery and poverty reduction
Goal 4: Rights of the poor and vulnerable groups are protected and promoted in the justice system
Goal 5: Reduction of political and social exclusion and intolerance
Goal 6: Improved personal and material security, reduced crime and domestic violence
Goal 7: National cultural identities enhanced and promoted

Source: URT (2005a).

delivery in a number of priority sectors, including primary education and basic health care. Since the expenditure responsibilities assigned to the local government level coincided to a large degree with these priority sectors, there was a clear link between the PRS and the local government finance system: poverty reduction could be implemented directly as part of the national budget process by increasing the relative level of funding made available to the local government level in the form of local budget allocations to these priority sectors.

While the new poverty strategy is organized in terms of outcome clusters and explicitly recognizes that expenditure programs outside the previous "priority sectors" could also contribute to poverty reduction, this does not mean that the sectoral nature of poverty reduction activities, or the importance of local governments in fighting poverty, has fundamentally changed. Although the introduction of the cluster-based approach can help sharpen the focus on pro-poor expenditures both within sectoral programs and between sectors, in practical terms local government programs in basic education, basic health care, access to safe drinking water, agricultural extension, and local roads will continue to be activities of prime importance in pursuing poverty reduction in Tanzania. In fact, the NSGPR continues to recognize the importance of sectoral considerations by categorizing many of the specific goals and targets pursued within each cluster in a sectoral fashion.[2] As such a direct link can be established between the poverty outcomes pursued under the NSGPR, the role of local governments, and the sectoral focus of the local government finance system.

Given the importance of intergovernmental transfers in the finance and delivery of local public services, the transfer system is the main fiscal policy tool available to pursue the broader policy objective of poverty reduction at the local government level. In addition to its impact on the transfer system, the poverty reduction strategy should also be taken into account in the design and implementation of other components of pillars of decentralization and local government finance. These linkages are explored further in Sections 10.2 and 10.3 respectively.

10.2 The pro-poor nature of Tanzania's transfer system

A formula-based grant system generally provides the most effective, transparent, and incentive-compatible mechanism for guiding the allocation of budget resources to the local government level in a "pro-poor" manner (that is, in a manner that is consistent with a national poverty reduction strategy). However, it is not only the design of the formula that matters in assuring that a transfer system is pro-poor. Consistent with the discussion in Chapters 6 and 7, we should recognize that each of the three stages involved in transferring resources from central to local governments (determining the size of the transfer pool, the horizontal allocation mechanism, and the use of resources at the local level) can either promote or form an impediment to the pro-poor use of public resources. In order to clarify how a formula-based approach to funding local government services corresponds with the overall objective of poverty reduction (in the context of the NSGPR), Figure 10.1 consists of three panels that represent the three stages of allocating intergovernmental grants to the local government level.

Determining the vertical allocation of fiscal resources in a pro-poor manner

The vertical allocation of resources between different government levels, including the size of the transfer pool(s), dictates, among other things, the ability of local governments to engage in pro-poor spending. If local governments are assigned expenditure responsibilities that are expected to have a poverty-reducing impact (such as primary education, basic health care, agricultural extension, access to potable water, and local road infrastructure), limiting the size of the transfer pool (or other causes of vertical fiscal imbalance at the expense of local governments) will decrease the ability

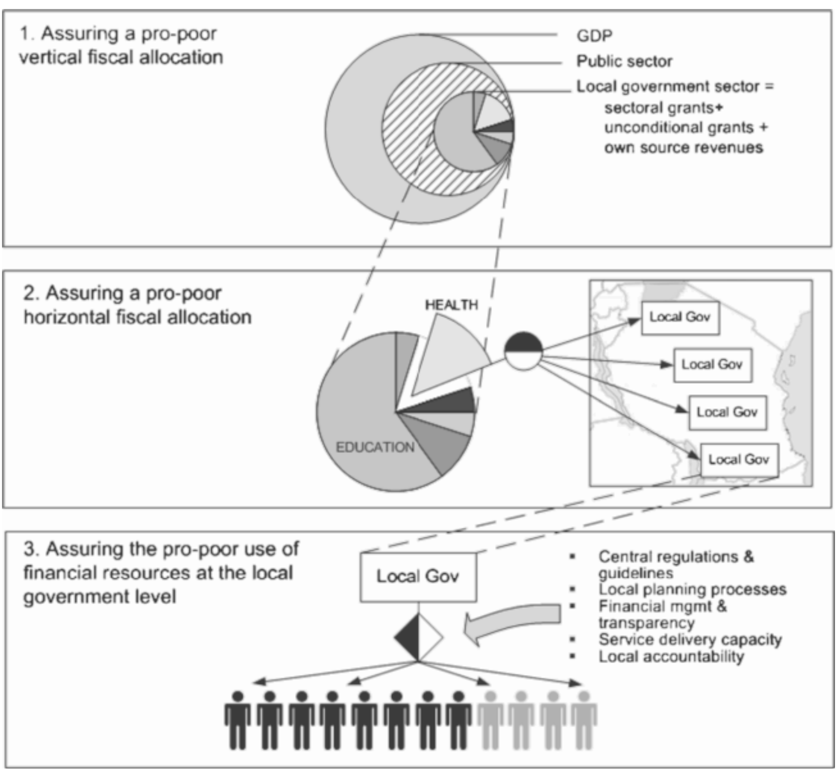

Figure 10.1 Three stages of a pro-poor intergovernmental fiscal transfer mechanism

of local governments to engage in pro-poor spending. Therefore, the first step in assuring that an intergovernmental transfer scheme is supportive of a pro-poor allocation of public resources is to assure that these functions that are delivered by subnational governments are adequately funded.

In practice, the first step in Tanzania's budget formulation process (like in most countries) is to determine the relative policy priorities for the country, which include not only the central government's own expenditure and revenue decisions but also policy priorities which may have to be executed at the local government level. With the President and the Cabinet of Ministers as the final executive decision-maker, the prioritization occurs as part of the formulation of the annual Budget Frame, in a process that is guided by the NSGPR, the public expenditure review process, and the medium-term expenditure framework (Figure 10.1, Panel 1). To the extent that local governments are responsible for delivering concurrent expenditure responsibilities (public services for which responsibilities are shared between central and local governments, including the main social sectors), the central government has a legitimate policy role in determining specific sectoral budgetary priorities to be pursued by the local government level. In contrast, to the extent that expenditure responsibilities are fully devolved, the central government should be willing to allow local governments to determine their own priorities and needs. As such, the central government should cede local governments corresponding fiscal autonomy through the provision of unconditional grants as well as through the provision of a certain degree of local revenue autonomy, which allows local governments the ability to increase their own resource envelope at the margin in response to local priorities and needs.

While a complete discussion of Tanzania's central government budget formulation process falls beyond the scope of the current chapter, it is relevant to note that the technical processes that guide the budget formulation process are currently being modified to more closely align government spending practices with the policy priorities expressed in the NSGPR.[3] In doing so, not only should the budget framework (leading up to the budget guidelines) seek to identify the overall expenditure priorities and budget ceilings for central government ministries in the context of the NSGPR, but the national policy formulation process should also determine the relative importance of the five main sectoral local government functions, and the associated level of funding made available to each of these function through their respective sectoral block grant schemes. By determining the budget envelopes for each of the sectoral block grant pools up-front in the central government's budget process, the center's budget assures that local governments have adequate resources to fund the delivery of (pro-poor) programs within the concurrent functional areas, and that local officials are able to develop realistic local budget plans that fall within the resources available to the public government sector.

As noted in Chapter 7, the resources provided to the local government level in Tanzania reflect a respectable degree of vertical fiscal balance; local governments annually receive between 17 and 18 per cent of recurrent budget resources. Yet, given that the government services delivered at the local government level all fall within the priority sectors identified by the first PRSP as well as the goals specified in the new NSGPR, one might reasonably expect to see a relative increase over time in the share of budget resources set aside for these priority activities at the local government level. On the one hand, the fiscal data presented in Table 7.1 reveals no upward trend in local government spending on "pro-poor" activities. Yet, on the other hand, if we were to include General Purpose Grant allocations into our analysis as well as ministerial allocations made to the local government level within the social sectors, then the proportion of recurrent resources allocated to the local government level would show a gradual yet distinct increase over time (URT, 2005b).

Assuring a pro-poor horizontal allocation

Vertical fiscal balance—provision of adequate funding for (pro-poor) public services at the local government level—is a necessary first step in assuring that local governments are financed in a manner that allows them to contribute effectively to the national poverty reduction agenda. A second precondition to assure that the intergovernmental fiscal transfer system effectively addresses poverty concerns is that transfers are distributed among eligible local government jurisdictions in an equitable and pro-poor manner. As noted in Chapter 6, the distribution of transfer resources among subnational jurisdictions is commonly referred to as the "horizontal" allocation of intergovernmental transfers.

As such, the second stage of allocating transfer resources consists of dividing the resources that are available for each sectoral block grant to individual local governments using a pro-poor, formula-based approach (Panel 2 in Table 10.1). In order to assure that the available resources for each sector are allocated fairly and efficiently among all local governments, the horizontal allocation formulas which have been developed in Tanzania are based on a limited number of allocation factors that measure the variations in the demand for local government services, as well as possible variations in the cost of delivering local government services.

The horizontal allocation mechanism is crucial in reducing resource inequalities between subnational governments in Tanzania. Despite Tanzania's poverty alleviation strategy, we showed in Chapter 7 that the redistributional impact of Tanzania's previous transfer system was actually counter-equalizing. This observation was an important element in the decision in Tanzania to implement a formula-based transfer system. Although the center's adherence to the new formula-based recurrent grant system has not been fully satisfactory, the horizontal allocation of resources has become substantially more pro-poor in its incidence. As noted in the discussion of Table 8.2, the introduction of a formula-based grant system has assured a substantial increase in the amount of resources that have been made available to the poorest local governments.

While the central government is able to directly control the horizontal allocation (across local governments) of intergovernmental transfers, the horizontal allocation of derivation-based revenue sharing and own source local revenues fall beyond the direct control of the central government and tend to favor wealthier local governments. Yet, the central government is able to regulate the degree of horizontal fiscal disparity brought on by shared and own source revenues by taking into account the relative inter-jurisdictional disparities caused by the revenue sources that it assigns to the local government level. Additionally, the central government is in a position to mitigate undesirable horizontal fiscal imbalances by introducing an equalization grant mechanism to offset any counter-equalizing tendencies of own revenue sources.

Furthermore, while it is true that wealthier local governments typically collect or receive more shared and own source revenues, this does not necessarily mean that these mechanisms should be classified as "not pro-poor". Their ultimate poverty incidence depends on how these resources are used at the local government level.

Assuring the pro-poor use of transfers at the local government level

As noted in Chapter 2 of this book, the subsidiarity principle suggests that local governments should not engage nor should be assigned direct income redistribution functions. There are two fundamental reasons for this. First, jurisdictions that are in most need of income assistance are less likely to be able to afford it because of income levels and the incidence of poverty across local jurisdictions. Second, the mobility of factors of production and households would make local attempts to redistribute resources largely self-defeating by attracting more of the poor and expelling the well-to-do and mobile factors of production. Thus, the view held by the modern public finance literature unequivocally suggests that the role of income redistribution should be assigned to the central government level.

Yet, the third dimension of designing a transfer scheme deals with how local governments spend their financial resources, including the transfer resources received from the central government. Once intergovernmental grants arrive at the local level, are these resources actually spent in a pro-poor fashion? Even if a transfer scheme's vertical and horizontal allocation mechanisms are pro-poor, the intended pro-poor outcomes will not be achieved unless the financial resources are used in a pro-poor manner at the local level. Although the local use of transfer resources may to varying extents be regulated by the central government through conditionalities, the manner in which local resources are spent is primarily under the control of local authorities themselves. Thus, in addition to considering "top-down" mechanisms for pro-poor spending at the local level, we should also consider the planning and budget processes at the local level.

As such, the third and final element in financing local government services through a formula-based block grant system is the actual delivery of local government services (Figure 10.1, Panel 3). Under the formula-based block grant approach, local governments use the resources available to them from block grants and other resources in order to deliver the basket of local government service demanded by the local community. Although the central government should not micro-manage local government finances through highly earmarked allocations, it is not inappropriate for local governments to be provided with guidelines and conditionalities for concurrent functions in order to ensure that they spend the block grant funding in an equitable manner, by providing equal access to local public services in pursuit of poverty reduction objectives.

The management and use of financial resources at the local government level was discussed in some detail in Chapter 3. Although we noted that local planning, budgeting and financial management all require further strengthening in Tanzania, we also found that local governments in Tanzania generally have the capacity to deliver public services as long as they are properly financed and supported. To the extent that local authorities have a natural inclination not to engage in redistribution toward the poor, we acknowledged that local elite capture is indeed a problem in Tanzania, but one that can be overcome by a combination of bottom-up participatory processes and top-down requirements for pro-poor use of public resources at the local level. In this context, a central system for monitoring and evaluating local government spending is required to allow the central government to monitor local government compliance with the budget guidelines and to keep local governments accountable for the use of central government resources in accordance with poverty reduction objectives.

Why not a "bottom-up" poverty reduction approach for local governments?

There are some government officials within the Ministry of Finance who are unsure whether the new formula-based grant system fits within the PRS budget processes which were developed for central government ministries, departments and agencies. If local governments would follow the same approach as central government ministries, each local government would prepare its budget request in line with a set of poverty reduction benchmarks or spending norms defined by the central government. Central resources (transfers) would then be distributed in accordance with these local poverty reduction plans. While this approach appears participatory and "bottom up" in nature and has some seemingly attractive features, there are some inherent structural flaws with this approach that contradict universally accepted principles of transfer design (see Chapter 6).

In practice, in order to maintain a minimum degree of objectivity in allocating resources, such a "bottom-up" approach to determining pro-poor transfers would typically boil down to local governments preparing their budget requests based on the physical inputs needed to achieve their poverty reduction objectives and targets. For instance, within the education sector, local governments would prepare their budget requirements based on centrally defined norms such as the required student–teacher ratio and other input-based norms. In effect, this approach would be the same as the NMS approach previously relied on by the government. However, as already discussed in Chapter 7, the NMS approach has an inherent fatal flaw in that it fails to provide for an objective mechanism to assure that the aggregation of local needs based on poverty reduction priorities fits within the government's resource constraints. As a result, in the end, it is the central government that is required to determine spending priorities not only between but also within local authorities.

While it is feasible for the Ministry of Finance and Cabinet to be the arbiter of different sectoral priorities at the central level, the central government does not have the necessary information and insights to prioritize the relative needs of 114 local councils and authorities. In fact, recognizing this information asymmetry is crucial: if the center had perfect information about local needs and priorities, a major reason for having a decentralized government structure in the first place would have been eliminated. Yet, since the central government is unable to observe and identify all local priorities across the national territory and local government officials are aware of this information asymmetry, local governments have an incentive to overstate their relative needs in their budget requests from the center. As such, the asymmetric information about relative local needs and priorities forces the central government to engage in strategic negotiations with local governments. This introduces a substantial discretionary component into the determination of local government grants, which ultimately completely undermines the objective of a stable, transparent, equitable, and objective method of allocating resources to local authorities.

10.3 Poverty reduction and other aspects of decentralization

Although the intergovernmental transfer system funds a large majority of local government expenditures, it is not the only dimension of intergovernmental fiscal relations that plays a role in assuring a pro-poor decentralized system.

Centralization versus decentralization in planning for poverty reduction

Although the intention of any poverty reduction strategy is to empower the poor, an overly centralized implementation of such a strategy may achieve the opposite effect. Strictly pursuing the national poverty targets contained in the NSGPR uniformly across all local governments would impose the priorities of the central government across the national territory while ignoring the true needs and priorities expressed at the local government level. Thus, while continuing efforts should be made to assure that local political processes become more participatory, it is important to give local governments a greater voice in the decision-making process surrounding poverty reduction.

If we believe that the poor at the grass-roots level are in the best position to judge their own needs, then the first thing that is required in order to assure real empowerment of the poor is political restraint on part of the central government. For instance, within the areas of expenditure responsibility assigned to the local government level, the center should allow local governments to set their own operational targets in pursuit of the goals specified in the NSGPR within the context of the resources available to each of them. For instance, while the national strategy sets a specific national target of 15,000 km for the repair of rural roads, central government official should avoid the centralist tendency to subdivide this national target into separate local targets for individual local governments. Providing local governments with operational discretion would enable local officials to identify local infrastructure priorities that achieve the greatest benefits for the local community (including the poor), rather than strictly pursuing centrally imposed quantitative targets. While achieving such pro-poor local outcomes would require certain preconditions to be met (including an effective participatory local planning approach to prevent local elite capture), it is hard to fathom that central government officials would be in a position to identify and plan for the specific needs of poor households across the country without in any way relying on local governments.

Furthermore, it should be recognized that the pursuit of poverty reduction objectives in the context of the current system of local government finances puts clear limitations on local governments. While the introduction of a formula-based grant system in principle has increased the degree of local autonomy with which local governments are able to respond to local priorities within specific sectors, the financing framework does not allow local governments to reallocate sectoral block grant resources from one sector to another to potentially address more urgent local priorities. In other words, to the extent that local government officials are in a better position to identify real local priorities, the largely sectoral nature of financing system may actually *prevent* a more efficient, pro-poor allocation of public resources. Yet, to be fair, there are clear limitations to bottom-up planning and prioritization.

The fact that many locally provided services such as primary education and health care are considered concurrent central-local functions suggests that local government officials are in fact not in the best position to identify local priorities. Therefore, along with increasing the political discretion of local governments to identify local poverty priorities, another longer run challenge is to provide local governments with the appropriate degree of fiscal autonomy in identifying policy priorities between sectors. This will mean striking a balance in the local government financing system between sectorally earmarked resources (that is, sectoral block grants) and general purpose local resources, including own source revenues and unconditional grants.

Local government revenues and poverty reduction

An important policy issue related to poverty reduction and local government finances is the impact of local taxation on economic growth and income inequality. On the surface, it is not obvious that raising revenue by local governments is connected to poverty reduction. In fact, this issue has not received much attention in the literature other than studies that have attempted to determine the share of the local tax burdens borne by the poor in the context of tax incidence analyses. Indeed, 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.[4] Although a recent study in Tanzania found that wealthier taxpayers pay substantially more in local revenues, it is unclear from the preliminary results whether local revenues in Tanzania are actually progressive, proportional, or regressive (World Bank, 2005a). However, the impact of local taxes on poverty should not be viewed in isolation from the national tax system, the impact of services provided with these funds, and other benefits of local taxation.

In fact, fifty years of economics literature 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, the public finance literature generally argues that the benefit principle should be the main guidance for revenue sources assigned to the local government level. According to this criterion, the amount of money paid in local taxes by a local resident should be roughly proportional to the benefits received by this taxpayer from local government services. In order to achieve such a proportional "net" fiscal incidence, we would expect wealthier local taxpayers to benefit disproportionately more from local government services funded from own source revenues given that wealthier households in Tanzania bear a much larger share of the local tax burden.[5] In contrast, unless local elite capture interferes, we would expect to find that local public services that are funded by central government transfers benefit all local residents irrespective of their income or poverty status.

While only limited evidence is available on the incidence of local public services in Tanzania, Sahn and Younger (2000) analyzed the distribution of benefits for a number of different local public services in Tanzania using the concept of "concentration curves".[6] According to the analysis performed by Sahn and Younger, wealthier households indeed benefit more from local government services that are funded from own local revenue sources. In contrast, the benefits from primary education are found to be wealth-neutral, reflecting that households benefit equally from the provision of primary education regardless of their income level. At the same time, Sahn and Younger's results suggest that other social services (including health services) are somewhat regressive, but nonetheless more pro-poor than government services funded from own source revenues. As such, these empirical findings coincide quite well with the theoretical expectations based on the traditional public finance literature. These findings also seem to correspond well with the variations in the levels of public satisfaction for different local government services (as presented in Table 3.2), with more regressive local public services generally receiving lower satisfaction ratings.

Establishing the net fiscal incidence of local government services can be complicated and not entirely intuitive. For example, even though a particular local revenue source may be identified as being regressive, such revenues may have significant positive effects on the efficiency of local public service provision or on the ability to undertake local public expenditures with positive effects on poverty reduction. For instance, although user fees are generally regressive, residents, regardless of income status, would be better off in a community that provides public access to potable water funded by regressive but relative low user fees, especially compared to a community where no public water is provided. In the counterfactual scenario, all households (including poor households) either would have to rely on more expensive privately provided drinking water or would be forced to use unsafe water sources.

In contrast, when considering the impact of local revenues on poverty reduction, even progressive local revenue sources could be considered anti-poor if the local taxes form an obstacle to economic growth, local employment growth, and sustainable poverty reduction. While there is a broadly shared assumption that the local tax system in Tanzania is inefficient, there is limited analytical support that identifies the exact source of such anecdotal inefficiencies. For instance, even when considered in a cumulative manner, local tax rates are substantially lower than central government rates and should not be expected to provide major incentives to reduce economic production. Likewise, while local revenue administration compliance rates are low and local revenue performance is poor, this is not *a priori* evidence that the local revenue system has a negative impact on local economic growth. In truth, local taxation is only one of many factors determining variations in local economic growth. Instead, the speed of local economic development is likely determined to a much larger degree by a combination of underlying economic characteristics such as geographic location, agricultural potential, the availability of skilled labor, access to credit markets, land ownership and the enforcement of property rights, the regulatory environment, and the quality of local public services and infrastructure (World Bank, 2005b). Although local revenue assignments and local tax administration are considered the weakest dimension in the intergovernmental fiscal system in Tanzania (LGRP/GSU, 2005), it would simply be disingenuous to abolish local government revenues based on the argument that local revenues form an obstacle to long-run economic growth and poverty reduction.

The final consideration, perhaps even more important than the direct equity effects of local government revenues, is the fact that local taxes greatly strengthen the accountability of subnational governments to their constituency, by generally enhancing local taxpayer awareness of taxes and their interest in assuring the quality and level of local services delivered. A number of recent studies suggest that the ability of a country to achieve the benefits of a decentralized system depends 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.[7] In other words, local revenue autonomy is important for subnational governments to assure greater accountability of public officials; to enhance the efficiency of expenditures; and for local governments to mobilize revenues in order to expand or contract the budgets at the margin, as a healthful degree of revenue autonomy at all levels of government is the only certain way to address vertical fiscal imbalance.

10.4 Moving forward: Local government finance reform in the context of Tanzania's development vision

In moving forward, how does Tanzania's system of intergovernmental fiscal relations fit into the country's broader development vision? In order to better answer this question, and to assure consistency among various aspects of the local government finance system, the President's Office—Regional Administration and Local Government (PO–RALG) and the Ministry of Finance conducted a comprehensive assessment of the local government finance system. The assessment concludes with a draft Policy Paper on Local Government Finance which outlines the role of the local government finance system within Tanzania's public sector, as part of the government's broader policy vision. It is expected that this policy paper will be taken forward after the presidential elections of December 2005.

Although the current system of local government finance has a number of shortcomings, the overall structure of the current system of local government finance is quite sound. The draft policy document recommends steps to transform specific components of the 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 consistent with the country's overall economic development and poverty reduction strategy (LGRP/GSU, 2005). The main recommendations include the following:

1. The expenditure assignments contained in the Local Government Finance Act could be fine-tuned by recognizing that most social sector services delivered at the local level in Tanzania are in fact pro-poor. The responsibility for these functions should therefore be shared between the central and local government levels in a concurrent fashion and financed in a manner that assures that finance follows function.
2. Although the local government revenue system in Tanzania has not received adequate attention in recent years, local revenues play an important role not only in the system of intergovernmental fiscal relations but also in a sound tax system. A well-structured, simplified, and harmonized local revenue system would predominantly rely on revenue sources that follow the benefit principle, such as local property taxes, a unified local business tax, and appropriate local non-tax revenues such as licenses and user fees.
3. Substantial progress has been made in transforming the previously highly discretionary transfer system into more objective, transparent, stable, and pro-poor funding mechanism for local governments. The implementation of the formula-based transfer system should be completed and fine-tuned to assure that the transfer system finances local government activities consistent with the policy objectives contained in the NSGPR.
4. While current local government borrowing only plays a minor role in the local government finance system, the government should gradually develop an environment that allows for increased local government borrowing. Until then, the policy framework should make sure that local borrowing is regulated in such a way that it does not provide local governments a soft budget contraint.
5. In order for local government finance to play a sound role within the broader public finances of Tanzania, there is a continuing need to develop the institutional framework for central–local fiscal relations. Strengthening of the institutional framework will include the development of reporting and monitoring mechanisms to assure that local financial resources are spent efficiently and effectively in a way that allows the central government to track the nation's progress on its poverty reduction objectives.

These five tenets lay out a clear vision for the evolution of Tanzania's local government finance system in the medium term. But, the environment for local government finances is never static. As local governments evolve over time—as they gain technical strength, mature in their political role, and adopt more effective, transparent, and accountable financial management mechanisms—the relationship between center and local should evolve as well. But for now, this is for the future.

11

Lessons from Tanzania's Local Government Finance Reform Experience

In recent years, Tanzania has been lauded by the international development community for its commitment to an ambitious program of economic reforms, resulting in strong growth and low inflation (IMF, 2004). Due to these structural reforms, the country's economic growth has increasingly been driven by higher productivity, which should assure that its growth path is more sustainable over the medium term. In addition, Tanzania's economic growth and poverty alleviation strategy have resulted in a significant decline of poverty since the mid-1990s, thereby making the country's prospects of attaining its poverty reduction objectives for 2015 quite favorable (Treichel, 2005).

As part of its broader program of public sector reforms, Tanzania has made substantial progress on its local government finance reform agenda. In 1998, its system of local government finance was highly centralized, local governments were essentially treated as deconcentrated extensions of the central government, and local financial management capabilities were extremely low. Although its local government finance reform process is ongoing and it is too soon to pass final judgment on the success of the program, it is fair to say that Tanzania's progress is placing the country at the forefront of local government finance reform in sub-Saharan Africa. If the government continues on its current path of reform and is able to complete the implementation of its formula-based transfer system, we believe that Tanzania's experience could soon be considered an international best practice in decentralization and local government finance reform.

What milestones were achieved in Tanzania to make us believe that the reform of local government finances in Tanzania is indeed a success? Despite a history of highly centralized governance, Tanzania has shaped a progressive vision of the role of decentralized local governments in the public sector during the various waves of decentralization reform that have taken place over the past two decades. The concept of "decentralization by devolution" has broadly gained acceptance as the *modus operandi* for providing key public services, including primary education, basic health services, and other social and economic services. The overarching policy question asked nowadays is not *whether* such public services should be delivered in a devolved manner, but rather *how* these public services could best be delivered and funded in a devolved manner. More recently, the government has been able to arrive at a consensus on how the different elements of local government finance fit together as an integrated system. As far as the reform of specific local financing mechanism, the reform of the transfer system is moving ahead across the board, and has already started paying dividends in terms of a substantially more pro-poor allocation of transfer resources. Although the local government finance system admittedly has many weak points, the government is recognizing these weaknesses and has policy mechanisms in place to address them in a systematic fashion.

A review of international experiences suggests that failures in local government finance reform are probably much more common than success stories. The fundamental importance of intergovernmental fiscal relations to the structure of the public sector, the technical complexity of local government finance reforms, and the large number of stakeholders involved in assuring success all contribute to making fiscal decentralization reform an extremely fragile process. Therefore, it is relevant to ask: What factors have contributed to making the recent series of local government finance reforms in Tanzania an apparent success, and perhaps equally important, what are the lessons that others can learn from Tanzania's experience?

We believe that there are perhaps five basic lessons embedded in Tanzania's recent experience with local government finance reform. In fact, a confluence of these five factors has contributed to the success of the reforms, and it is likely that the absence of any of these factors would have substantially diminished the chances of success of the fiscal decentralization reform process.

The first lesson is that Tanzania's recent fiscal decentralization reforms would surely have failed in the absence of a broad-based political will to pursue these reforms. The second factor contributing to the success of the reform is that Tanzania pursued a sound technical approach. The third lesson is that Tanzania—sometimes by design, sometimes by luck—got the overall sequence of its decentralization reforms about right. A fourth lesson is that the reform process needs to be institutionally owned by the government itself, and that the development of sustainable institutions and linkages between these institutions is a fundamental part of achieving a working system of intergovernmental fiscal relations. The fifth and final lesson is that the process of decentralization reform is never finished. Despite the progress being already made, there are still significant challenges yet to be overcome in Tanzania's local government finance reforms, and the local government finance system should be expected to evolve as Tanzania's economy continues to develop.

11.1 The importance of political will in Tanzania's local government finance reform

One of the fundamental challenges of decentralization reforms is that, as a direct consequence of the empowerment of local governments in providing public services, central government line ministries often perceive that their own role is diminished. While it might be politically incorrect for line ministries to openly oppose decentralization reforms, their sectoral responsibilities and expertise give them the ability to passively resist and even actively sabotage devolution reforms and the provision of greater local fiscal autonomy during the implementation phase of local government finance reforms. This means that, in the absence of political will and commitment at the highest levels, line ministries and agencies have a *de facto* veto over decentralization reforms.

Beyond merely having champions in support of local government reform, we would argue that successful decentralization reforms indeed require a convergence of political will to stave off and overcome the expected resistance against the reforms. Indeed, Tanzania's local government finance reforms received support from a variety of different stakeholders who, at times for self-interested reasons, championed the fiscal empowerment of local governments.

Decentralization is a grassroots movement, which means that voters and elected politicians, including the president, will be the natural champions (Bahl, 1999). Indeed, President Benjamin Mkapa, as the elected representative of all Tanzanian people, has been a strong champion of local government reforms. Presidential support for the local government reform agenda resulted in the strengthening of the Ministry of Regional Administration and Local Government by having the ministry moved into the President's Office in 1999.

Likewise, parliament should be expected to embrace programs that voters embrace, and therefore should be a potential champion of decentralization. However, members of parliament are also interested in assuring that government programs benefit their own constituencies, and therefore may be less enthusiastic about assuring an objective, transparent, and equitable allocation of fiscal resources. Yet, frustrated by a lack of transparency and the high degree of discretion exerted by the executive branch over the allocation of local government resources, members of parliament in Tanzania had an incentive to exert pressure on the Ministry of Finance and PO–RALG in support of the introduction of a transparent, formula-based transfer system.[1]

Although one might expect the ministry responsible for local governments to be an unambiguous supporter of local government finance reforms, experiences around the world suggest that the support for decentralization by the Ministry of Local Government can be tempered by institutional self-interest; it is not unusual for a Ministry of Local Government to support increases in the share of budgetary resources made available to local governments, while the Ministry has an institutional interest in controlling the distribution of these resources itself. To some extent, this pattern has been true in Tanzania. At a policy level, the PO–RALG has generally been a strong supporter of fiscal decentralization, and PO–RALG's Local Government Reform Programme has been instrumental in achieving a formula-based transfer system. However, despite the broad support at the policy level, some individual units within PO–RALG have been slow to relinquish their own role in managing local government financial affairs.[2]

Another stakeholder that plays a critical role in determining the success or failure of local government finance reform is the Ministry of Finance. Since finance ministries have the broader mandate of guiding public expenditures and revenues and assuring the efficient use of these public resources, they tend to take a much more cautious approach to fiscal decentralization reforms than some of the other stakeholders. While in some countries excessive caution has led the ministry of finance to block any attempt toward decentralization, the Tanzanian Ministry of Finance has generally been open to pursuing sound decentralization reforms under the dictum of "eyes on, hands off".

A final dimension in considering champions for decentralization and political will—one that cannot be ignored in the context of a developing country such as Tanzania—is the international development community. Although donor agencies can advocate, persuade, and provide technical assistance in support of sound decentralization reforms, international donors and financial institutions cannot become true champions of decentralization in a way that might mitigate the absence of true political will within government. Despite this limitation, the donor community can be, and in Tanzania, has been, highly effective in engaging its government counterparts in support of local government finance reform. Not only has the international donor community in Tanzania effectively supported the reform of the local government finance system through its financial and technical support for the Local Government Reform Programme, but the reform process has benefited significantly at a technical and operational level from the presence of a joint government–donor Fiscal Decentralization Task Force. The Task Force has proven to be an effective vetting mechanism for reform proposals and has served as an effective focal point in discussions on local government finance reform between the government and the development community.

11.2 The importance of a sound technical approach

The second factor contributing to Tanzania's success in establishing a sound local government finance system is the fact that the country has pursued a sound technical approach in its reforms. While there is no single "right way" to do fiscal decentralization reform in order to achieve the benefits of a decentralized government system, there are a number of guiding principles and rules that need to be followed to maximize the chances of getting the reform right.[3] Within the context of these sound fiscal decentralization principles, each country needs to establish a comprehensive vision of the role that local governments are expected to play in the public sector and develop appropriate funding mechanisms that fit within the institutional, political, and administrative context of a country.

Although in practice there is no such thing as a perfect local government finance system, Tanzania's reform process has consistently been guided by a sound technical approach, first put forth in its Policy Paper on Local Government Reform in 1998 (MRALG, 1998), and later expanded on as part of the development of a strategic policy on local government finance in 2005 (LGRP/GSU, 2005). Each dimension of the local government finance system has generally incorporated the main technical principles and best practice for local government finance, and in addition consistent efforts have been made to assure that the various components work together as a comprehensive system.

For instance, in pursuing "D-by-D", Tanzania's local government finance system follows the subsidiarity principle in its assignment of expenditure responsibilities. While government functions that are strictly local in nature are generally exclusively assigned to the local government level, other expenditure responsibilities—which are deemed national priorities, such as primary education, basic health care, and so on—are correctly made concurrent responsibilities, which provides the central government with regulatory control and the responsibility to provide funding, while local governments are responsible for the actual provision (delivery) of these services. Accordingly, the transfer system was designed not only to meet the universal principles for sound transfer design (as discussed in Chapter 6) but also to closely follow the expenditure responsibilities assigned to the local government level. Clearly, "finance follows functions" in Tanzania's local government finance system.

Perhaps the single biggest technical issue that Tanzania conceptually "got right" as part of its reforms was the shift in the orientation of the transfer system from an input-focused, norm-driven funding system to a funding mechanism that is driven directly by the level of demand for local government services (Alm and Martinez-Vazquez, 2002). By separating the transfer system into wage grants and non-wage grants, the previous grant system was highly centralizing and treated local governments largely as passive agents of the central government. The cost-reimbursing nature of personnel transfers encouraged local governments to engage in inefficient accumulation of local personnel, while the separation between wage and non-wage financing failed to allow local governments to efficiently reallocate resources between personnel and other charges. In contrast, the new formula-based grant system provides a funding envelope personnel and non-personnel expenditures in a comprehensive fashion, driven by objective measures for local expenditure needs. As such, it provides an incentive for local governments to respond to local communities' needs in a flexible and efficient manner in a way that a more centralized transfer system is generally not able to do.

Although local revenue collections and borrowing play a much more limited role in Tanzania than the transfer system, the design of these financing mechanisms, as well as their place within the local government finance system, also conforms to the requirements of a sound technical approach. The ongoing rationalization and transformation of the local government revenue system recognizes the important role that local revenue autonomy plays as part of a sound local government finance system, while at the same time acknowledging that local revenue sources need to be collected in a way that promotes efficiency, equity, and local economic growth. Similarly, the local government borrowing framework assures that local governments comply with the "golden rule" of public borrowing, while generally providing local governments with a hard budget constraint by preventing non-creditworthy local government from obtaining loans. Yet, as the administrative capacity and fiscal capacity of local authorities gradually increase over time, the importance of local revenue collections and local borrowing within the broader local government finance system should be expected to evolve and increase as well.

11.3 The importance of sequencing in Tanzania's local government finance reform

The presence of true political will and a sound technical approach are only two of the ingredients that explain Tanzania's apparent success in implementing its local government finance reform strategy. The third lesson that can be learnt from Tanzania's experience is that—sometimes by design, sometimes by luck—the country got the overall sequence of its decentralization reforms right.

A normative ("textbook") framework for sequencing decentralization would follow a number of sequential steps, where each next step logically builds on the previous steps (Bahl and Martinez-Vazquez, 2005). For example, a well-sequenced decentralization reform process might start with the deconcentration of central government services to the local government level, followed by a national debate on decentralization reform. Subsequently, the policy design for devolution might be accomplished through the development of a policy paper on decentralization, after which a decentralization law ought to be passed along with its implementing regulations. With the legal and regulatory framework in place, the implementation of the decentralization program can proceed, after which the local government finance system should be monitored and evaluated on a regular basis to allow for the fine-tuning and retrofitting of the system as appropriate.

Although such a normative reform sequence ignores the real-world political and administrative constraints which will certainly prevail in practice, this textbook sequence might nonetheless serve as a reasonable baseline against which to compare the real-world practices. In particular, failure to adhere to a sound sequence in pursuing decentralization reforms can have adverse consequences for the outcome of the reform process, ranging from ineffective local government services and subsequent failing public support for decentralization efforts to major vertical fiscal imbalances and macroeconomic instability. While Tanzania's decentralization process has not necessarily been as linear as the textbook approach outlined above, nonetheless Tanzania has been able to avoid the pitfalls that accompany poorly sequenced decentralization reforms by abiding by the main axioms of a properly sequenced reform process.

The local government reforms in Tanzania highlight that decentralization is not a one-off reform. Instead, Tanzania's experience suggests that it is often a gradual, iterative process. The first phase of its decentralization reforms (1982–1995) focused on re-establishing local authorities and deconcentrating expenditure responsibilities to the local level. Once expenditure functions were deconcentrated, the later waves of reform promoted the concept of decentralization by devolution (1996–2001) and then implemented the fiscal mechanisms to finance devolved local government functions (2002–present). Each phase was generally kicked off by an assessment study and discussion among stakeholders, followed by the formulation of a government policy document, legislative and regulatory reform, and policy implementation. The different waves of decentralization are indicative of an iterative process of evaluation which seeks to identify and address at each stage the main shortcomings of the local government finance system.

Despite the overall adherence to a sound sequencing of local government finance reforms, Tanzania's progress has not been as linear as the normative scenario would suggest. For instance, while in 2002 the policy environment was not receptive to a broad review of the entire local government finance system, reform of the intergovernmental fiscal transfer system was effectively used as the technical entry point for the "third wave" of fiscal decentralization reforms. According to the normative sequence, this was rather premature as the government's draft local government finance policy (which comprehensively addressed all local financing mechanisms) was not formulated until three years later. Likewise the rationalization of local revenues in 2003 took place in a process that has not been characterized by a unified approach. In fact, prior to the policy document prepared in 2005, lack of policy consensus between the PO–RALG and Ministry of Finance resulted in a number of uncoordinated, stepwise reforms of the local government revenue system.

The fact that Tanzania's sequencing of fiscal decentralization reforms has largely complied with the normative benchmark should not be considered evidence that the country pre-planned its decentralization reforms over a period of two decades. In fact, while the main elements of the reform agenda were sequenced by design in an iterative process, the timing of other reforms seems to have come about more by chance. For instance, while in 2002 the Ministry of Finance was conceptually opposed to the introduction of unconditional grants to supplement sectoral earmarked grants as a way to expand local budgetary autonomy, an unconditional grant mechanism (the Compensation Grant, later renamed the General Purpose Grant) was introduced a year later as a side effect of the local revenue reforms implemented in 2003.

Nonetheless, in its sequencing of reforms, Tanzania has been able to avoid fundamental inconsistencies in the design of its local government finance system that would have jeopardized the stability of the system as a whole. Part of the explanation how Tanzania has been able to prevent the derailment of its reform sequence over time is due to its recognition that the reform of local government finance is essentially an evolving, ongoing process.

11.4 The importance of building sustainable institutions and linkages

A fourth factor that we believe has contributed to the success of Tanzania's local government finance reforms is the recognition that the reform process needs to be institutionally owned by the government itself, and the development of sustainable institutions and linkages between these institutions is a fundamental part of achieving a functioning system of intergovernmental fiscal relations.

At the policy level, a strong institutional framework was already in place to coordinate inter-ministerial reforms. The Local Government Reform Programme was established within PO–RALG to take the lead in developing and executing specific policy reforms in accordance with the Policy Paper on Local Government Reform (MRALG, 1998). Although the LGRP has its own governing structure, the Finance Component receives policy guidance from the joint government–donor Fiscal Decentralization Task Force. If policy reforms have implications for other central government ministries, a high-level Inter-Ministerial Working Group coordinates reform activities across sectors. This working group is comprised of the Permanent Secretaries (the most senior civil servants) of all ministries, and meets on a regular basis to discuss cross-sectoral reform issues. This structure has provided a sound, formalized mechanism for inter-ministerial discussion and coordination at a policy level on decentralization issues.

Since the existing policy-level coordination mechanisms were deemed to be relatively effective, the country has (as of now) not adopted a Local Government Fiscal Commission. Although the introduction of such a commission is an approach that has been followed in several other developing countries, it was felt that the introduction of such a commission would have formed an unnecessary parallel institution in Tanzania. However, this does not mean that the institutional environment for local government finance is static. A major reorganization of PO–RALG was approved in 2005, which is set to create a new LGA Finance Section within the Directorate for Local Government. The review of the local government finance framework conducted in 2005 pointed out that a similar focal point on local government finance issues is also needed within the Ministry of Finance (LGRP/GSU, 2005). Finally, in order to make policy reforms surrounding local government finance more participatory, there is a need for broader involvement of local government representatives and civil society organizations in guiding the country's fiscal decentralization reforms.

In contrast to the effective coordination mechanisms at the policy level, institutional cooperation and coordination between central government agencies at a technical level has not always been strong. As is the case in many countries, differences in institutional cultures and divergent mandates in the past caused a failure in communications between PO–RALG and the Ministry of Finance. However, with the introduction of formula-based grant system, consistent efforts were made to bring together not only PO–RALG and the Ministry of Finance but also relevant sector ministries through a Coordinating Block Grant Implementation Team (CBGIT). Meeting on a quarterly basis, the CBGIT has significantly strengthened institutional coordination and transparency by providing a sustainable link between PO–RALG, the Ministry of Finance, and other key stakeholders.[4] The current intention is to transform this temporary implementation team into a permanent inter-ministerial Fiscal Analysis and Coordinating Group.

In fact, the previous absence of coordination at the technical level in some sense may have facilitated the introduction of the formula-based transfer system in Tanzania. When a single central government stakeholder is given a strong mandate over the financing of local government activities (whether it is the ministry responsible for local governments, the Ministry of Finance, or sectoral ministries), this stakeholder has an institutional incentive to oppose the introduction of a transparent allocation formula. Yet, the introduction of the formula-based transfer mechanism in Tanzania met with little institutional resistance because none of the key stakeholders felt significant institutional ownership over the resources that were allocated to the local government level. In contrast, the new formula-based process allowed every stakeholder to contribute to the decision-making process in an effective manner. As such, the introduction of CBGIT has provided Tanzania with a sustainable structure for information sharing and coordination on local government finance issues at a technical level within the central government, which is a critical step in assuring that sound intergovernmental fiscal decision-making takes place.

11.5 Recognizing the ongoing challenge of the local government finance reform agenda

The fifth and final lesson from Tanzania's experience is the realization that even a relatively successful reform program comes with shortcomings, and that, in fact, a decentralization process is never complete. The fact that Tanzania's local government finance reforms are considered a success does not mean that the reforms have resulted in a perfect local government finance system; one could even debate whether there is such a thing as a perfect local government finance system. However, as already noted in the previous chapter, while Tanzania's local government finance system may be imperfect, the institutional framework exists to incrementally improve and fine-tune the system of local government finance in an iterative process, thereby assuring that over time the system will continue to be perfected.

There are a number of specific challenges in the ongoing reform of Tanzania's local government finance system. Perhaps most importantly, the introduction of the formula-based transfer system is yet to be completely finalized. Some of the outstanding implementation challenges include assuring that the budget process for personal emoluments and other charges are harmonized, so that the total transfer amount to each local government is in fact equal to the formula-based allocation. Likewise, there is a need to phase out the special transitional rules that were put in place during the introduction of the formula-based recurrent transfer system, so that every local government indeed exactly receives its formula-based amount.[5] Finally, a formula-based, equalizing General Purpose Grant is yet to be introduced to complete the new transfer system. Beyond completing the reform of the transfer system, the remaining dimensions of Tanzania's local government finance framework (including both the local government revenue system and a policy framework for local government borrowing) still have most of their reform ahead of them.

Likewise, the non-fiscal dimensions of decentralization shall continue to be part of the ongoing reform agenda, as the fiscal aspects of decentralization cannot be considered separate from the administrative and political aspects. In order to assure adequate local autonomy over its expenditure responsibilities, there is an ongoing need to integrate the concept of decentralization into other public sector reform programs, including sectoral programs (recognizing the proper roles of line ministries and local governments in decentralized service delivery), public service reform (assuring local management of local human resource development), and public sector financial management reforms. Similarly, in order to reap the possible benefits of fiscal decentralization, renewed consideration should be given to the political aspects of decentralization, including the degree of local participation and downward accountability achieved by local electoral rules and political processes.

Finally, since the financial relationships between a central government and local governments evolve on an ongoing basis, reform of the local government finance system cannot be considered a time-bound program. Even though the current local government reform agenda does not extend beyond 2008, by their very nature many elements of the intergovernmental fiscal system will continue to evolve, as the structure of the local government finance system is closely tied to other economic and fiscal developments. For instance, national policy priorities may change and affect local financing over time; economic growth and development may prompt changes in the local tax system; changes in fiscal disparities among local governments over time will require review and possible revision of the allocation formulas; and the technical capacities of local governments to manage their own affairs should also be expected to evolve over time. The local government finance system and the institutional framework for central–local relations must have the flexibility to adapt to such changes in the policy environment. Thus, in order to assure that local governments are financed in a way that allows them to fulfill their functions in an effective, equitable, and efficient manner, there is an ongoing need for the review and strengthening of intergovernmental fiscal institutions, systems, and processes.

Notes

1 An overview of local government finance reform in Tanzania

1. For instance, see Boex *et al.* (2005) and Smoke (2003).
2. The bias of central government and donors in favor of sectoral projects and programs is easy to explain. It is more practical for a donor agency to engage a single central government ministry rather than possibly hundreds of local government authorities. Furthermore, the international experts that design such sectoral development programs tend to be sector experts (not decentralization experts). The donor agencies' counterparts tend to be central government line ministries that tend to have centralist biases and have an institutional interest in assuring centralized provision of public services.
3. Nonetheless, the tension between centralist poverty reduction agendas and (fiscal) decentralization reforms continues to characterize today's international practice. With respect to the current relationship of decentralization to the Poverty Reduction Strategy Paper (PRSP) approach, Watson (2002) identifies a tendency to simply ignore the conflict between the 'top-down' pursuit of poverty-relief goals and the often concurrent policy aim of decentralization; while many PRSPs in Sub-Saharan Africa pay lip-service to the importance of decentralization, there is often little discussion of how central–local relationships will be harmonized in practice.
4. See, for instance, Alderman (1998).
5. In contrast, skeptics of decentralization suggest that decentralization may be less efficient than centralized provision of services, since local governments are less capable in terms of human resources; they may be corrupt; and they may be prone to elite capture. Proponents of decentralization reform would likely respond that government officials such as teachers and doctors do not become less capable when their posts are decentralized; there is no evidence to suggest that central government officials are less prone to corruption; and central governments are equally (if not more) prone to elite capture.
6. For instance, Crook (2003) makes a strong argument for the negative impact of local elite capture. Bardhan (2002), Bardhan and Mookherjee (2004), and Mansuri and Rao (2003) arrive at more balanced conclusions with regard to the potential impact of local elite capture on local government finances. This issue is discussed in greater detail in Chapter 3.
7. For an overview of political economy issues, including a discussion Nyerere's "decentralization" (deconcentration) reforms, during this period, see Townsend (1998).
8. Direction and guidance on policy issues is further provided to the LGRP from a number of other sources, including the Inter-ministerial Coordination Committee (for overall policy guidance from Government to LGRP), consultations with donor agencies, and LGRP's Common Basket Fund Steering Committee for fund-raising and financial management oversight.

9. As discussed in greater detail in Chapter 2, although self-reported figures on local government expenditures are available for 2004, these data are not deemed reliable (URT, 2004a: 10). As such, local expenditures are approximated as the sum of intergovernmental transfers, local own source revenues, and local borrowing.

2 The assignment of expenditure responsibilities to the local government level

1. In order to implement the country's local government reform policy, PO–RALG established the Local Government Reform Team located in Dar es Salaam (as opposed to the official capital, Dodoma) that, as part of PO–RALG, has been carrying out reforms, including introducing computerized financial management systems at the local level and spearheading other local government reforms, including the introduction of formula-based block grants.
2. This total takes into account Manyara Region, which was formed in 2003 by splitting off a number of districts from Arusha Region.
3. Urban Councils can be further subdivided into Town Councils (8), City Councils (2), and Municipal Councils (12). It should be noted that Das es Salaam City Council covers the same geographical area as the three municipalities that makes up Dar es Salaam Region (Kinondoni, Ilala, and Temeke).
4. Under the Public Service Act of 2002 and its regulations, the District Executive Director is actually selected by the Council but employed by PO–RALG. This provision of the Act is currently being reconsidered, since it is feared that this structure could limit the autonomy of local authorities.
5. There is no common terminology in Tanzania to describe lower-level local governments—such as villages, wards or neighbourhoods. For clarity, the term "sub-district governments" is used to signify all local government units below the district level.
6. Legislative reforms planned for 2005 would give mitaa the same legal status.
7. This section relies in part on Martinez-Vazquez (1998).
8. There is a difference between providing and producing a service. For instance, a local government may provide garbage collection services to local residents. This service may in fact be delivered by a private firm which has been contracted by the local government.
9. The central government's fiscal year runs from July through June. Until 2004, local governments operated based on the calendar year.
10. The hiring of teachers and other local government staff is subject to approval from PO–PSM. Local decisions in the delivery of primary education are primarily constrained by the (conditional) financing provided to the local government level. This is discussed in greater detail later in this chapter, as well as in Chapters 7 and 8.
11. Part of this increase is artificial, since until FY 2001/02 agricultural grants were included as part of the local administration grant.
12. For instance, much of the block grant for local water activities is intended to cover the recurrent cost of monitoring local access to potable water and implementing new local water schemes to unserved communities. Once put in place, the actual operation and maintenance of water schemes is handed over to autonomous local water providers (such as user groups, local water boards, or incorporated water authorities), which fund operation and maintenance from user fees or community resources.
13. However, starting in FY 2003/04, the central government provided LGAs with a Compensation Grant to compensate them for the loss of local revenues due to the rationalization of local government revenues. This grant was subsequently

renamed as the General Purpose Grant, and is intended to evolve into a permanent unconditional, equalizing grant. See the discussions in Chapters 7 and 8.

14. In addition to the main themes identified here, there are a number of minor concerns in the area of expenditure assignments that should be considered. Although these problems may be serious in their own right, these problems are not likely to have system-wide effects on local government finances. These concerns include the consideration of whether the responsibility for secondary education should be devolved to the local level; the division of responsibilities between the district level versus the village level; and the special role of Dar es Salaam City Council in relation to its three constituent municipal councils.
15. 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 (for example, contagious diseases). Nonetheless, it would be desirable for the Local Government Acts and the Local Government Reform policy to recognize these distinctions.

3 The management of local government finances: Local planning, budgeting, and service delivery

1. This section draws in part on LGRP/GSU (2005). We would like to thank Philip van Ryneveld for his contributions to this section.
2. To the extent that parallel funds are provided outside the context of a comprehensive local budget process, local authorities could potentially divert funds by "double-billing" the same capital development project or expenditure item to different funding sources.
3. In this regard, Julius Nyerere noted that "to the mass of the people, power is still something wielded by others, even if on their behalf" (Townsend, 1998: 148).

4 Local government taxes in Tanzania: Weaknesses of the current system of local government revenues

1. We refer to the ability to change tax rates because it is the simplest and more desirable form of revenue autonomy at the local government level.
2. See Tiebout (1956), Musgrave (1959), Buchanan (1965), Oates (1972) and McLure (2000).
3. See Martinez-Vazquez (2001) for a discussion of the concept and measurement of (net) fiscal incidence.
4. The fact that locally raised revenues are mostly used to finance local government administration is a major factor that prevents local government from using locally generated revenues for services that provide direct and tangible benefits to local residents.
5. Since these payments are made at the village level, they are not captured by the local government financial management system.
6. Fynn (2004) reports payment of local produce cesses on cashew nut production in the amount of TSh. 1725 million and turnover at farm-gate prices of approximately TSh. 37.2 billion, resulting in an effective tax rate of 4.6 per cent.
7. The effectiveness of local government spending—to ensure that local taxpayers receive value for money—is discussed further in Chapter 3.

5 The proposed transformation of the local government revenue system in Tanzania

1. Given that new cars are registered centrally, it may be expedient to leave the first time registration centralized. All other fees and charges on motor vehicles, including the Transfer tax, the Car Benefit tax, and the Foreign Motor Vehicle Permit and Transit Charges would remain assigned to the central government.

6 Principles for developing a sound intergovernmental fiscal transfer system

1. This section is based on Bahl (2000), Martinez-Vazquez and Boex (2001a), and Bahl, *et al.* (2001).
2. See Martinez-Vazquez and Boex (2001b) for a discussion of revenue sharing in Russia and the funding of Russia's equalizing Fund for the Financial Support of the Regions.
3. In fact, discretionary transfers might even be determined in an *ex post* fashion (for instance, in the case of budget loans that are forgiven at the end of the fiscal year).
4. Nevertheless, it is quite common for central government to define these forms of revenue sharing as local taxes and for local governments to see them as their own taxes as opposed to transfers from the central government.
5. In practice, no transfer scheme is completely unconditional in the purest sense of the word, as local governments in every country have to meet certain basic conditions, either as part of a broader budgetary and regulatory framework (such as annual budget guidelines for local governments) or as a general contractual obligation associated with the receipt of transfer funds. For instance, local governments are generally expected to keep books of account in accordance with national regulations and observe technical standards and conditions in the construction of public infrastructure and the delivery of public services.
6. One could interpret the vertical allocation spectrum more broadly by incorporating the notion that the degree of local fiscal discretion is not only defined by the methodology used by the central government to determine the vertical allocation of resources but also by the actual size of the transfer pool. Drastically underfunded local governments will have no *de facto* control over spending decisions.
7. In reality, again, the binary distinction between "conditional" and "unconditional" truly represents a spectrum from completely conditional earmarked grants to totally unconditional grant resources.
8. This section specifically relies on Martinez-Vazquez and Boex (2001a).

7 Intergovernmental fiscal transfers in Tanzania: An assessment of the previous system of local government allocations

1. The use of financial resources (including transfers) at the local government level was discussed in Chapter 3.
2. For instance, the budgetary requests for primary education were supposed be set in accordance with the following norms: (1) fixed costs for DEO Office at TSh. 35.6 million per district; (2) a pupil–teacher ratio of 45:1, with a target enrolment ratio of 80 per cent; (3) ten days of in-service training per teacher per year; (4) all pupils

undergo examinations in Standards IV and VII; and (5) three pupils per text book (PWC, 2000).

3. There is a potential caveat in the argument made above. If one takes into account the earmarked funds that have been provided to the local government level through ministerial votes and sectoral donor-funded programs, the per cent of national budgetary resources that is transferred to the local government level directly and indirectly may in fact have increased over the past five years.
4. The *coefficient of variation* is defined as the standard deviation divided by the average.
5. This section is based on Boex (2003).
6. The use of regional (as opposed to local) measurements for these variables introduces some form of observation error, which in fact reduces the true variation of the explanatory variables, biasing the estimated coefficients toward zero. Therefore, the limitations on the data impose a stricter test on the respective roles of the explanatory variables.

8 The new system of formula-based grants in Tanzania

1. 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. Conceptually, a single treasury account is the best approach to managing finances, both at the central and at the local government level. In practice, however, multiple fund accounts may be used as a financial management and control mechanism. However, there are effective ways to reconcile the desire for a single treasury account approach with the desire to have assured that funds are used for their intended purpose at the local government level.
2. Although, as noted in the previous note, 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 single 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. Yet, despite the sectorally segregated budget structure of the transfer system in Tanzania, public expenditure tracking studies (PETS) report significant underspending at the local level on primary education and health care services, suggesting that substantial resources are diverted from the respective sectoral OC accounts despite having separate budget accounts.
3. The legislation states that the amounts of block grants may vary from council to council depending on the "grades and standards" that are prescribed by the Minister.
4. There is an institutional division in the central government between the PO–PSM (which manages personnel spending) and the Ministry of Finance (which manages non-wage spending) that forces this administrative division between PE and OC. Although local governments are supposed to have control over local staffing decisions, PO–PSM currently retains ultimate control over local staff management. In practice, this means that the amount available for OC in each sector is determined as the difference between the local government's formula-based grant amount and the locality's personnel budget to assure that salaries continue to be paid.
5. The majority of sectoral block grant formulas are based on demand measures (such as proxies for the number of clients) as well as cost indicators. It should be noted

that the funding formula agreed to for local road maintenance continues to be supply-side driven.
6. In addition to the phasing-in and holding-harmless procedures, some deviations away from the formula-based amounts occurred during the first two years of implementation. One of the reasons for the deviations from the formula-based allocations was the fact that central government line ministries regularly posted more staff at the local government level than provided for in the budget plan. These discrepancies are discussed in greater detail below, as well as in Section 8.5.
7. In practice, local authorities are actually "held harmless" against a baseline which, while based on the previous year's block grant allocation, also takes into account a number of other (upward and downward) adjustments for factors such as inflation as well as spending decisions imposed on local governments by central line ministries.
8. In this regard, it should be noted that, in contrast to anecdotal evidence provided by many local government officials, the GPG/Compensation Grant in fact provides local governments with equal or more resources than the local revenue instruments that were terminated.
9. An earlier PO–RALG circular mandates that district-level governments should share 20% of local revenues with lower-level local governments (Kragh *et al.*, 2003).

9 The role of local government borrowing in Tanzania's system of local government finance

1. If local governments borrow from an intermediary financial institution such as Tanzania's LGLB, the moral hazard problem 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.
2. This section draws in part on URT (2004a) and LGRP/GSU (2005).

10 Moving forward: Local government finance and Tanzania's poverty reduction strategy

1. See Boex *et al.* (2005).
2. The sectoral nature of the NSGPR goals and target is illustrated by the first three goals of Cluster 2 (Improvement of quality of life and social well-being).
3. The primary instrument being developed for this purpose is a software tool known as SBAS (Strategic Budget Allocation System). SBAS is essentially a performance-based budget tool that requires sectoral budget planners to develop their expenditure plans in the context of strategic objectives, goals, and targets. The first version of SBAS (which was used during FY 2004/05) was limited in its scope; it only allowed the prioritization of non-wage recurrent expenditures made at the central government level. In order to be effective, SBAS will have to be expanded to cover all public resources including personnel spending, other charges, and development resources, both at the central government level as well as funding provided to the local government level through the transfer system.
4. For instance, see Bahiigwa *et al.* (2004) for a discussion of local revenues in Uganda.
5. See Martinez-Vazquez (2001) for a discussion of the concept and measurement of (net) fiscal incidence.

6. Like a Gini-coefficient (a common measure of income inequality), these concentration curves reveal who benefits more from local public services by plotting the cumulative benefits from local expenditures against the population, which is arranged from poor to wealthy households.
7. For instance, see Ter-Minassian (1997) and Ebel and Yilmaz (2002).

11 Lessons from Tanzania's local government finance reform experience

1. It is generally not a good practice for parliamentarians to play a role in local government decision-making processes. However, the fact that members of parliament are statutory members of the local authority which they represent may have promoted the goal of vertical fiscal balance in the intergovernmental fiscal system.
2. For instance, PO–RALG continues to play a highly discretionary, top-down role in the allocation and management of resources from the Road Fund Board (funded by Fuel Levy collections).
3. For instance, see Bahl (1999), Martinez-Vazquez and Boex (2001a), and Bahl and Martinez-Vazquez (2005).
4. The establishment of this inter-ministerial technical team was supplemented by institutional capacity-building activities and the provision of technical training on fiscal decentralization issues within PO–RALG, the Ministry of Finance, and other institutional stakeholders.
5. As discussed in Chapter 8, during the introduction of the formula-based transfer system, local governments were "held harmless" for any declines in transfer amounts from year to year. Likewise, a "phasing in" provision was applied to ensure that no radical, sudden increases in transfers occurred.

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