Section 5
Tanzania's intergovernmental fiscal transfer system

Intergovernmental transfers play an important role in the system of intergovernmental relations. A detailed discussion of the current transfer system is provided in Chapter 4 of the Local Government Fiscal Review. The transfer system is of substantial importance to the central government budget, as almost 20 percent of budget resources are devolved to the local government level through the regional votes (Votes 70-95) in the budget (LGFR 2004; Table 4.2). The transfer system plays an even more important role at the local level, as transfers provide over 80 percent of resources to the local level (LGFR 2004: Table 1.1). In fact, Section 2.4 of this report notes that this figure may in fact even understate the role of intergovernmental transfers in local government finance, since indirect transfers to the local government level are not captured in this figure.

Based on the inception report and the discussion held during the stakeholders' workshop in January 2004, broad consensus was reached on the principle that the intergovernmental transfer system will continue to play a key role in the framework for local government finance. Indeed, it was agreed that there is an important future role for sectoral block grants, equalization grants and capital development grants in Tanzania's system of local government finance (Principle 4).

The Government's initial vision of the country's intergovernmental transfer system is clearly set forth in its Policy Paper on Local Government Reform (MRALG, 1998), although the document fails to provide many details on the exact specification of the transfer system. The Intergovernmental Transfer Study (GSU, January 2003) commissioned by PO-RALG and the Ministry of Finance provided a detailed strategy towards a comprehensive transfer system, which was adopted by Cabinet in February 2004. The GSU study on the recurrent grant scheme took place almost in parallel to the development of the capital development grant system under the preparation for a World Bank credit under the Local Government Support Program.

As for the overall assessment of the current local government finance system, the study team believes that the current intergovernmental fiscal transfer system is on sound footing. In accordance with the big picture assessment of Tanzania's local government finance system in Table 1.4 in Section 1, we come to the following conclusions regarding the role of the intergovernmental transfer system in Tanzania:

- *Overall policy stance and policy effectiveness*: The government is in principle committed to a formula-based grant system that is objective, fair, and results in the efficient delivery of local services. Nonetheless, political and institutional constraints prevent the immediate and full implementation of the formula-based transfer system. The evolving system of intergovernmental grants is fully consistent with broadly agreed-upon universal principles for the design of a sound transfer system.

- *Constitutional & legal framework*: The current Local Government Finance Act (1982, as intermittently revised) provides an adequate legal basis for the transfer system. However, as the Act was modified from time to time, it contains duplicative provisions which may reduce the law's clarity and transparency.

- *Central government institutional and regulatory framework*: Much has been done in recent years to improve the institutional framework for intergovernmental transfers. A Coordinating Block Grant Implementation Team (BGIT) as well as Sectoral BGITs were set up in order to coordinate the sectoral block grants between the various central government stakeholders. On the regulatory side, integrating the formula-based block grants into the national budget processes is still very much a work in progress. The grant system needs to be linked more carefully to the central government's budget processes, including the PER, the MTEF and government's PRS II (now NSGRP). Also, it is critical to assure consistency between the block grant system and the regulatory framework for the administration of local service staff.[1]

- *Local government institutional and regulatory framework:* The budget guidelines which are issued to the local government level are increasingly aligned with the Budget Frame drafted by the Ministry of Finance. As such, these guidelines provide clear guidance on how LGAs are expected to spend these transfers. The monitoring and reporting framework is still inadequate to systematically verify compliance with the budget guidelines.

- *Participation by civil society and private sector:* The current budget arrangements at the local level are not very transparent and do not allow for the consistent monitoring of grant-funded programs, either within or outside the government's financial management structures. Ongoing work is needed to improve the transparency and accountability with which transfer resources are spent at the local government level.

Box 5.1
The legal framework for intergovernmental fiscal transfers in Tanzania

[1] Under the current regulatory processes, central government officials can appoint or transfer local government staff to the payroll of an LGA without express consent of the Council Director. Since such actions are beyond the council's control, councils cannot be forced to pay for such additions from their formula-based grant allotment and require additional grants. This obviously defeats the entire purpose of having a formula-based grant system. Such central government intervention should cease immediately for the formula-based block grant system to become effective.

The current Local Government Finance Act and the relevant regulation provide an adequate framework to proceed with the introduction of a formula-based block grant scheme. The Local Government Finance Act and applicable regulations require the Minister of RALG to allocate earmarked grants for core local government functions (education, health, roads, water, agriculture and local administration), but also provide the Minister discretion to allocate block grants in these same policy areas which "may vary from one local authority to another depending on the grades and standards as may be prescribed by the Minister" (i.e., based on a formula). While in practice no distinction is made between the earmarked grants and the block grant referred to in the legislation, the regulatory framework in place for the block grant system would provide a sound basis for a formula-based block grant scheme. Local Government Finance Act Regulations (Government Notice 281, 2000) specify with regard to block grants that:

- Funds received by LGAs should be used economically, diligently, efficiently and effectively
- Transfers should promote efficient mobilization and use of resources
- The allocation should guarantee equitable access by the population to basic services
- The approach should ensure that there is objectivity, transparency, and accountability in the system of managing public finances

The remainder of the assessment on Tanzania's intergovernmental transfer system is structured as follows. First, we discuss the nature or structure of the overall transfer system: what types of grant programs should the grant system consist of? Should there be a single subvention scheme, or should local governments receive several types of grants? This issue is discussed in subsection 5.1. Then, the remainder of this section discusses the four recommended grant mechanisms that together would constitute the entire system of intergovernmental grants, namely (1) the recurrent sectoral block grant mechanism (subsection 5.2); (2) the unconditional, equalizing General Purpose Grant (subsection 5.3); the Capital Development Grant mechanism (subsection 5.4); as well as transfers from ministerial budgets, donor-financed activities, and other parallel funding mechanisms (Subsection 5.5). Concluding remarks and recommendations are captured in Section 5.6.

5.1 Overall structure of the transfer system.

The first key decision to be made regarding the transfer system is the basic structure of the transfer mechanism: should local governments (predominantly) be funded through a single recurrent block grant, or should local governments receive separate grants for different activities? Different countries have answered this question differently, and the answer depends to a large degree on historical and institutional factors, as well as on the expenditure assignments that the transfer mechanism intends to fund.

5.1.1 A single transfer mechanism, or different grants for different purposes?

As a first approach, some countries provide subnational governments predominantly or exclusively with general-purpose resources (either revenue sharing or equalization transfers) that flow into the general account of each local government in addition to local own revenue sources. Local governments are then required to fund their services from these general resources. For instance, this is the general approach in countries such as Japan, Germany, South Africa, Indonesia, and many transition countries in Eastern Europe and the former Soviet Union. This approach does not mean that local governments are necessarily free to spend their general resources as they wish; it simply means that the transfer mechanism is not used in itself to earmark these resources. However, even though the transfer mechanism provides these funds as general resources, nothing prevents the central government from effectively dictating how local governments spend their resources, for instance, through local budget guidelines or by establishing national minimum standards for the delivery of local government services. This approach has advantages as well as disadvantages. On the plus side, it may be easier to manage and more transparent to provide only a single grant to each local government. If no other conditions are put on the resources provided to local governments, a single unconditional grant scheme would also allow for greater local autonomy, enabling local authorities to move resources between different sectors and programs. On the negative side, it can be difficult to design a grant scheme that assures that every local government jurisdiction receives adequate resources to fund the services that it is supposed to provide, as the single grant scheme is trying to fulfill a number of different objectives. If the transfer system fails to provide adequate resources to the local government level to fund the mandated responsibilities of the local government level, this gives rise to unfunded mandates.

In contrast to the single-scheme approach, under a transfer approach with multiple grant schemes, different funding flows are established for different purposes, so that the different grant schemes are earmarked (or "ring-fenced") for specific purposes (although one of the funding flows typically included in a multi-scheme transfer system is typicallly an unconditional / equalization grant scheme). Although international practices vary widely between countries, the different grant flows may originate from different votes or sections in the national budget, and/or may flow into different accounts at the local level. The stringency of the conditionalities imposed by the central government also varies greatly between countries and in fact even between grant schemes in the same country, from very broad and general (e.g., "these resources should be spent on the provision of primary education") to highly detailed and extremely rigid (e.g., "this grant is being provided to build a bridge at the following specific location with the following specifications: …"). Most countries that rely on multiple transfer programs have separate funds for different sectoral programs (local education; health; social programs; and so on). Almost all grant systems separate recurrent grants from capital development grants.[2]

[2] Strictly from an administrative point of view, it might be even more straightforward to rely on a single subvention to be used both for recurrent and capital purposes. However, there are good economic reasons why a central government might wish to provide capital development funds to the local government level, as separate from local recurrent resources. As such, combining recurrent and capital development grant scheme would thus violate the maxim in local government finance that "finance should follow function" and that a single local government grant scheme would not be practical in assuring that local governments set aside resources for local capital development purposes. Some recurrent grant schemes allow recurrent

Countries that rely on multiple transfer streams with targeted grant programs vary from more centralized countries –such as the Netherlands- to much more decentralized countries such as the United States and Australia.[3] Of course, a transfer system with multiple grant schemes also has a number of advantages and disadvantages, depending on the exact implementation of the system. Among the potential advantages is the closer linkage between specific mandated local responsibilities (such as primary education) and the funding for those activities. A potential negative could be the excessive imposition of conditionalities, which would reduce local government autonomy. Depending on one's viewpoint, the inability to move resources between different forms of funding mechanisms (if local governments play by the rules) could be either a positive or a negative; local governments may see this as limiting their ability to move resources towards their (local) priorities, while the central government may consider that this provides an assurance that each local government will at least spend a certain amount on specific government services.

It is important to note that the choice for either a single grant mechanism or an approach that relies on a number of transfer schemes does not necessarily result in a more centralized or decentralized system. In fact, depending on the conditions imposed on the local level through budgetary regulations and sectoral standards, both approaches could, in principle, be structured to result in exactly the same outcome. However, a more targeted transfer system with multiple transfer schemes may provide a greater degree of central control over local spending, particularly when local governments lack spending discipline and have weak financial management systems.[4]

As discussed further in Section 7 of this report, from a financial management perspective, it is preferable that all transfer funds flow into the general account of the local governments, even if they are earmarked for different uses. Theoretically, a single treasury account is the best approach to managing finances, both at the central as well as at the local government level. In practice, however, multiple fund accounts may be used as a financial management and control mechanism. However, there are ways to reconcile the desire for a single treasury account approach with the desire to have different accounts for different purposes.

The formula-based recurrent grant system proposed by GSU in 2003 and adopted by Cabinet in February 2004 maintained the previous structure of local government grants: the system of intergovernmental grants continued to be separated into five sectoral funding mechanisms. Although, for administrative purposes, each sectoral grant scheme

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resources to be used for capital purposes, but local governments are typically prohibited from using capital grants for recurrent purposes.

[3] Whereas the vertical political structure in the U.S. is extremely decentralized, and revenue sources are highly decentralized (both at the federal-state and state-local levels), the U.S. federal government as well as state governments rely almost exclusively on targeted, conditional transfers.

[4] However, the provision of different grants for different purposes by no means guarantees budget execution in accordance with grant conditions, especially in the case of weak central monitoring. International practice is rife with examples where conditional grants are diverted for practices outside their intended use.

continues to be divided into PE and OC streams, the sectoral formula is applied to a grant pool that combines resources for both PE and OC. As such, the funding which each LGA would receive for each of the six sectors would be strictly determined by formula. Although central government officials would continue to have a role in guiding the local budget formulation process, they would no longer have discretionary control over setting the amounts received by each LGA. Despite the sectorally segregated structure of the transfer system in Tanzania, public expenditure tracking studies (PETS) report significant under-spending at the local level on primary education and health care services, suggesting that substantial resources are diverted from the respective sectoral OC accounts.

Given the financial management challenges at the local level in Tanzania; the different functional assignments at the local level; and the limited capacity of the center to monitor local spending, the study team believes that it is appropriate to maintain the current structure of the transfer system, which includes separate block grant schemes for different sectors. Although –as noted above- using numerous budget accounts is not considered a "best practice" in local financial management, it is felt that the use of different local accounts for different purposes provides a certain degree of budgetary control in Tanzania at the current time. Introducing a singly cross-sectoral transfer to LGAs (even in the presence of minimum sectoral spending guidelines) would not be politically acceptable in Tanzania given the current policy environment.

5.1.2 "Finance follows function" and the recommended structure of the transfer system

The conceptual basis for the "right" system of intergovernmental fiscal transfers is the assignment of expenditure responsibilities; Section 3 set out that there is a need for local government financing to follow the functional responsibilities assigned to the local level. In the context of the expenditure assignments as discussed in Section 3, a combination of transfer schemes is deemed the most appropriate.

As guided by the TORs for the current study, the policy framework for the transfer system fully integrates the work which has already been done by GSU as part of the Intergovernmental Transfer Study (Boex, Bahl, Martinez and Rutasitara, January 2003). In this context, the study team recommends that the overall structure of the emerging transfer system should include the following elements:

1. Formula-based sectoral block grants. Formula-based sectoral block grant schemes should form the primary (and exclusive) mode for funding the local provision of national public services in the five main priority sectors (primary education, local health, agricultural extension and livestock, water sector and local roads).

2. Unconditional grants. Unconditional grants should be provided to the local level to (1) provide funding for local government administration and (2) provides equalizing funding for other, non-priority-sector local activities to supplement own local revenue sources. These objectives may be achieved through the

implementation of a single, unconditional and equalizing General Purpose Grant mechanism.

3. Capital development grants. Given the local government financing framework in Tanzania, it is appropriate for funding of capital development to be primarily provided through a Local Government Capital Development Grant scheme.

4. Earmarked ministerial subventions. While there are currently a number of allocations made indirectly to LGAs –either from donor resources through the development budget or through ministerial votes-, most of these parallel funding mechanisms are providing funding for functions that are devolved to the local level. To the extent that the provision of services is devolved to the local government level (through full devolution or devolution of provision), no funding should be provided through ministerial budget votes. As such, most existing earmarked subventions within ministerial budegts should be integrated into the government's formula-based system of intergovernmental grants with all deliberate speed. The only permissible earmarked ministerial subventions to LGAs should be transfers that are provided for delegated (rather than devolved) functions.

5.1.3. Vertical fiscal balance: expenditure assignments and the vertical allocation of intergovernmental transfers

As explained in Section 3 of this report, we advocate considering a "relative approach" (as opposed to an absolute approach) to establishing local expenditure needs. This means that in determining the size of transfer pools, policy makers should determine the aggregate level of local expenditure needs for a sector by first taking into account the total amount of resources available to the public sector as a whole.

One of the main advantages of relying predominantly on a transfer system that is based on a relative approach to estimating local expenditure requirements is that the resources allocated to the local government level through the transfer system are by definition available in the national budget. As such, the system of local government finance does not run the risk of structurally over-funding local governments relative to the central government level and thereby causing fiscal imbalances and fiscal crisis at the central government level. At the same time, LGAs should be protected from unfunded mandates by assuring that the service delivery standards set for local governments are affordable under the resources made available by the transfer system. This is one of the reasons why the previous National Minimum Standards approach failed in Tanzania.

To the extent that the local government finance system in Tanzania relies on own source revenues and general-purpose funding (rather than sectoral or earmarked funding), vertical fiscal balance is assured to some degree by the absence of binding expenditure norms for local government activities outside the priority sectors (see Box 3.3).

As noted earlier, the central government is currently setting aside approximately 18% of its recurrent resources for sectoral transfers to the local government level. For comparative purposes, it is interesting to note that Tanzania's degree of expenditure decentralization is well above the average level for developing economies (14%), although local authorities in many developing countries have fewer functional expenditure responsibilities than LGAs in Tanzania. In this respect, local governments in Tanzania are much more like local governments in transition or developing countries; the comparative figures for expenditure decentralization in transitional and developed countries are 26% and 32%, respectively (Bahl, 2004). Thus, based on international experiences, we would expect the degree of expenditure decentralization to gradually increase over time as Tanzania's economy continues to develop, as we would expect local government services to play an increasingly important role in the public sector as the economy grows.[5] As such, it would not be unrealistic to expect that the share of local government spending as a percentage of central budgetary resources would gradually increase to around 25% over the coming five to ten years.

5.1.4 The pro-poor nature of the formula-based block grant system

At first glance, it may appear that clinging to a transfer system that has sectoral funding mechanisms runs contrary to the new poverty reduction strategy. The major clusters of poverty reduction included in the NSGPR are (i) promotion of economic growth and reduction of income poverty; (ii) improvement of quality of life and social well being (through responsive and efficient public services); and (iii) governance and accountability. Yet, it is important to recognize that the introduction of the cluster-based approach should be understood to supplement a sectoral break-down of public expenditures, rather than replace the sectoral divisions in the budget.

The logic behind the new PRS approach is that merely increasing spending in a certain sector is not by definition pro-poor, unless it is spent on a pro-poor activity within that sector. While the previous (exclusively sectorally-based) PRS approach failed to recognize this, the new NSGPR approach recognizes that it is necessary to consider whether spending within each sector is "pro-poor" and/or "pro-growth" by determining if the spending falls within one of three clusters of pro-poor/pro-growth activities. In principle, all public services provided by LGAs within the five "priority" sectors (primary education, basic health services, and so on) continue to be critical under the new cluster-based NSGPR classification. In fact, it would be fair to require of LGAs -as part of the local budget guidelines- that sectoral block grants should be spent fully in accordance with the national strategy.

Furthermore, within each recommend transfer mechanism, the process of defining formula-based sectoral block grants is more than "just coming up with a formula". The process of allocating local government grants in a pro-poor manner affects each of the three stages of the design of an intergovernmental transfer scheme:

[5] This is consistent with the notion that virtually all government services currently provided at the local level are considered priority services in the context of the cluster approach of the PRS II.

1. Determination of the size of each sectoral grant pool (to which the formula will be applied). Since the sectoral budget priorities (i.e., the size of sectoral grant pools) are explicitly determined as part of the budget frame informed by the PRS (before dividing grant resources among local governments), the central government budget frame should fund local government activities in a pro-poor manner.

2. Formula-based allocation of resources. The allocation of the sectoral grant pools between local government authorities should occur on the basis of a transparent, objective formula. The formula-based division of resources assures that resources are divided among local government authorities consistent with their relative service delivery needs, again consistent with the PRS II approach.

3. Use of block grant resources at the local level. Local governments are provided with guidelines and conditionalities in order to ensure that they spend the block grant funding in pursuit of PRS objectives. In this context, an adequate monitoring and reporting is being set up to allow the central government to keep local governments accountable for the use of central government resources.

Correspondingly, the discussion of each transfer mechanism in the following sections follows the same basic break-down, where each grant scheme is broken down into its three basic elements: (1) determination of the size of the grant pool; (2) the horizontal distribution of the pool among eligible local government jurisdictions; and (3) conditions or restrictions on the use of resources at the local level.

5.2 Formula-based sectoral block grants

As part of the recurrent grant system, the central government provides LGAs with five formula-based sectoral block grants: one for each of the five main priority sectors (primary education, local health, agricultural extension and livestock, water sector, and local roads). According to the legislated and *de facto* assignment of expenditure responsibilities, local governments have been assigned the responsibility to provide these public services of national significance (i.e., devolution of provision). Local governments do not have adequate revenue autonomy to fund any significant portion of these expenditures, and should be expected to under-fund these programs given their national (rather than local) nature. Since the national government has policy-setting and regulatory control over these sectors, it should provide "ring-fenced" funding for these sectors through sectoral block grants. The level of funding for these sectoral block grants should be in proportion to the service level that the central government wishes to achieve.

As fully developed by the Intergovernmental Transfer Study (GSU, 2003), the horizontal allocation of these sectoral grant formulas should be based on the relative demand for the local government service (for instance, the number of clients for the service) in each LGA (see Box 5.2). The exact sectoral formulas were developed by each sector's Block

Grant Implementation Team, and adopted by the Coordinating BGIT as being consistent with the overall transfer system.

Each recurrent sectoral block grant provides local governments resources jointly for PE and OC in that sector, and allows local authorities to distribute their resources between these categories within that sector, as long as the local authority complies with the constraints imposed by the local budget guidelines.

Box 5.2
Reforming Tanzania's intergovernmental transfer system:
Moving from discretionary, input-driven grants to a formula-based, demand-driven approach

The current formula-based sectoral block grant approach entailed a shift away from the supply paradigm inherent in the previous national minimum standards (NMS) approach. Assuring that funding is driven directly by (a proxy for) the level of demand for government services rather than indirectly through the cost of inputs may seem a trivial difference, but it reflects a major shift in the philosophy of local government service delivery. The NMS approach treated local governments largely as passive agents of the central government, in which success was not defined by the efficient and successful delivery of government services but rather by the degree of conformity to national norms. As such, the previous NMS approach was dogmatic and inflexible.

In contrast, a demand-driven grant system provides an incentive for local governments to respond to local communities' needs in a creative and flexible manner in a way that a more centralized system is generally not able to do (and which the current system discourages).

Size of grant pools. Currently the resources set aside for local government activities are determined on a year-to-year basis in the context of the annual budget process. The amounts determined each year are supposed to be guided by the government's longer-term view of its poverty alleviation strategy, as well as the Cross-Sector Medium Term Expenditure Framework (MTEF) and the Public Expenditure Review (PER). As noted in the Local Government Fiscal Review (2004: Table 4.2), intergovernmental transfers as a percentage of the national budget has remained nearly constant for the past five years. However, if one takes into account the earmarked funds that have been provided to the local government level through ministerial votes, the percent of national budgetary resources that is transferred to the local government level may actually have increased over the past five years (see Section 2.4 for a further discussion).

One potential problem with determining the size of transfer funds on an annual basis is that the budget processes guiding budget formulation (MTEF, PER, NSGPR) are not working in an integrated manner in actually determining the amounts that are being budgeted for specific activities (for instance, see Oxford Policy Management 2005). Since the budget policy documents only give guidance for the upcoming budget year, this

allows sectoral ministries to strategically increase the amount of sectoral funding available to the line ministry at the expense of local government funding. For instance, during the budget preparations for FY 2005/06, the Ministry of Education and Culture sharply reduced the amount of ministerial PEDP funding for local governments that it had set aside for primary education capitation spending; instead, MOEC's budget revealed a sharp increase in spending on secondary education (SEDP). While the government argued that this moving of resources was a "policy decision" made by the government, this policy decision was clearly not made in the context of the MTEF, PER and NSGRP, leading some to believe that the local level was the victim of a politically motivated decision by the central government that effectively resulted in local governments receiving fewer resources for the delivery of a key public service, whereas MOEC increased the share of sectoral resources under its control. This example reveals that local governments are at a distinct disadvantage when their vertical share of resources is not protected by a funding rule, since (unlike sector ministries) local governments lack their own voice at the central government level during the budget process ending Cabinet.[6]

Rather than determining the size of the sectoral block grants from year to year as part of the annual budget process, vertical funding rules may be specified in a number of ways that protect local governments against such opportunistic cuts in the level of intergovernmental grants by the central government. For instance, one could specify a rule that a block grant pool has to be at least a certain percentage of the budget: for instance, the Primary Education Block Grant should receive at last 12 percent of the national budget resources. Alternatively, the funding rule may guarantee a minimum increase from year-to-year, such as the rate of inflation.

While there are many advantages to having a vertical funding rule to determine the pool(s) of resources made available to local governments, introduction of such a funding rule could also be counter-productive in the near future if sectoral transfer pools might possibly increase over the coming years. As such, the study team recommends –for the time being- continuing the current approach of adjusting the size of transfer pools annually as part of the budget process, in line with the budget priorities of the public sector (see Box 5.3). However, it will be critical for PO-RALG and the Ministry of Finance to closely monitor the resources provided to local government level to prevent sectoral ministries from arbitrarily "clawing back" resources provided to the local level in order to increase the ministry's own budget. In this light, the government may wish to revisit the vertical allocation approach every few years, as it may be appropriate to introduce a vertical funding rule at some point in the future.

Box 5.3
Determining government priorities and establishing the size of transfer pools

[6] To be fair, PO-RALG noted the reallocation of education funds during the finalization of the government budget, but was unable to reverse the so-called "policy decision" made by MOEC with the apparent approval of the Ministry of Finance.

The central government's budget process is supposed to drive spending changes from year to year in line with the government's strategic priorities. For central government agencies, the Budget Frame (which is prepared from October-December for the next budget year) determines the relative sectoral policy priorities for the country, guided by the PRS, PER and MTEF frameworks. This process of prioritization is currently being modified with the introduction of PRS II (or the National Strategy for Growth and Reduction of Poverty, NSGRP) to more closely align government spending practices with its policy priorities. GSU (2003) recommended that the Cross-Sectoral MTEF should separately identify sectoral transfer schemes in the multi-year budget estimates.

Even though the activities funded by local government transfers are national priority (both under the sectoral approach of the PRS I, as well as under the thematic approach of PRS II), local government transfers for sectoral programs have not increased as a percent of the national budget (LGFR 2004: Table 4.2). The proportional increases from year to year may reflect the incremental nature of the national budget process in Tanzania.

Under the new poverty reduction strategy (PRS II or NSGRP), sector ministries are supposed to prepare their budget requests in the context of a poverty-focused "performance-based" budget analysis, by which the increased budget request is supposed to be tied to expected increases in public service outputs and, ultimately, NSGRP outcomes. A customized software was introduced by the Ministry of Finance as part of the FY 2005/06 Budget Frame to guide sector ministries in prioritizing their spending programs. Unfortunately, the sectoral block grants were considered in the Budget Frame as part of PO-RALG's programs rather than being considered in the context of sectoral allocations, thereby creating a sectoral disconnect. As such, the budget formulation and its implementation should be fine-tuned, which will enable the size of the sectoral grant pools (i.e., the vertical allocation) to be determined as part of the broader budget frame.

This would lead to a situation where sector ministries –as part of the budget formulation process- would recommend the size of each respective sectoral Block Grant pool in light of their sectoral priorities, with consultation with PO-RALG. This approach is not free of risk: in a constrained budget environment, sectoral ministries might start to behave strategically by down-playing the need for transfers to fund sectoral services delivered at the local government level and emphasize centrally-run sectoral expenditure programs instead. Careful attention needs to be paid by the LG-FA&CG to prevent such vertical fiscal imbalances from arising. If such strategic behavior is noted (as reflected by a declining share of sector transfers as a percent of the national budget), then this would suggest the need to introduce a funding rule to protect the local government's share of the national budget.

Horizontal allocation. On July 1, 2004, formula-based allocations were introduced for primary education and health care, although during implementation some deviations away from the formula-based amounts occurred.[7] Formula-based allocations for all

[7] One of the reasons for the deviations from the formula-based allocations was the fact that line ministries had posted more staff at the local government level than provided for in the budget plan. These discrepancies are discussed in greater detail in a Technical Memorandum. *Strengthening The Allocation Of Sectoral Block Grants Within Tanzania's Budget Process.* (Jamie Boex, September 2004)

remaining priority sectors have been agreed upon (see Table 5.1) and are to be introduced with the beginning of FY 2005/06.

Table 5.1
Sectoral Block Grant Allocation Formulas (FY 2005/06)

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

Even though the benefits of introducing a formula-based allocation mechanism are unmistakable, it would have been a mistake to introduce the new formulaic approach overnight. Instead, a gradual phasing-in of the formula-based approach was put in place to prevent large sudden increases in resource allocations to previously under-resourced districts, which could potentially result in inefficient allocation or even misappropriation of public resources by local governments. Second, during the transition from the previous approach, all districts are held harmless against decreases in their resource allocations. This means that –as part of the computation of the coming budget year's grant allocations-, no single local government authority receives fewer resources than the amount established by the "hold-harmless baseline".

The hold-harmless baseline –which is reviewed and approved by the Coordinating Block Grant Implementation Team-, is based on the previous year's budget allocations, but some adjustments are made, particularly to assure that no PE goes unfunded.[8]

In practice, during the first years of the formula-based budget approach, a number of technical adjustments are made to the baseline against which LGAs are held harmless compared to last years' budgeted allocations. These adjustments reflect changes in

[8] This exact computation of the block grants is discussed further by LGRP/GSU. 2003. Technical Notes on Local Government Finance Reform in Tanzania: How does the new system of formula-based sectoral block grants work? (Technical Note 12).

budgetary allocations made during the budget year, and are predominantly caused by weak budgetary controls and poor budgetary execution at the central government level. For instance, if a local authority is not actually spending the amount of resources allocated to it, it does not need to be held harmless against the higher budgeted amount.[9] Likewise, if local government spending is allowed to increase beyond its budgeted allocation (for instance, since the central government posts additional teacher trainees to each LGA, such deviations need to be accounted for in the hold-harmless baseline. A small proportional increase in the baseline may also be justified in order to assure that all local governments receive a minor year-to-year increase in resources.

A significant problem affecting the hold-harmless baseline was identified during the finalization of the government budget for FY 2005/06.[10] It was uncovered that although PO-RALG and the Ministry of Finance were preparing local government budgets in accordance with the formula, PO-PSM was continuing to engage in "business as usual" by approving staffing positions at the local government level irrespective of the financial resources made available under a formula-based system. As shown in Section 2 of this report (Table 2.14), the fact that PO-PSM was not yet fully on board with the formula based approach significantly reduced the probe toward the nature of local government transfers. Discussions have been initiated between LGRP/PO-RALG and PO-PSM in order to resolve this problem with all deliberate speed, but attention is needed from the highest levels to assure that this problem is indeed resolved in time for the next budget year. As soon as local governments are given veritable control over local hiring and firing, it will no longer be necessary to make such adjustments to the hold-harmless baseline, since it will be possible to hold local governments accountable for assuring that they execute their budgets fully within the context of the formula-based funding constraints.

Finally, with respect to the horizontal allocation of sectoral block grants, we should note that the phasing-in and hold-harmless provisions that were adopted as part of the introduction of the new system of formula-based sectoral block grants should be seen as transition provisions, and it is important for the transparency of the system of local government finance to converge towards a system that is fully determined on a formula-basis. In order to achieve this, the current holding harmless regime may have to evolve in the coming years in order to eliminate any historical imbalances and to assure convergence towards the formula-based approach. The review of current phasing-in and holding-harmless practices, and how to modify them in order to move towards a system

[9] The reader should bear in mind that the "appropriate" allocation to each council is determined by the formula. The "hold harmless" process merely assures that no LGA suffers a decline in service delivery. If the resources are not actually being spent, there is no decline in local services.

[10] Another problem identified as part of the FY 2005/06 budget formulation process was the emergence of a number of small earmarked amounts for sectoral purposes alongside the formula-based grant. In some cases, these earmarked funds are appropriate as they are basically intended to fund delegated functions such as special primary schools). In many other cases, these earmarked funds simply appear to be an attempt by central government ministries to continue to exert control over the allocation of resources to the local level outside the formula based approach.

that is fully formula-driven (without addition transitional provisions) is the focus of a technical note produced by LGRP and GSU.[11]

Active steps will need to be taken in order to assure that the phasing-in and holding harmless provisions are indeed a transitional feature of the new formula-based system of intergovernmental grants. This is particularly and unequivocally true in the agriculture, water and roads sectors. Even in the primary education and health sectors, the phasing-in and holding harmless regimes need to be reconsidered in order to assure convergence towards the formula-based approach and eliminate any structural imbalances in the allocation of local government resources.

Local use of resources. A key feature of the formula-based approach is that the formula-based allocation eliminates the need for budget negotiation between the local authority on one hand and regional and central government officials on the other hand. Since the formula-based allocation is determined objectively, local governments now have greater stability in their budget allocations and should be better able to engage in their financial planning and budgeting processes.

In the budgeting and spending of block grant resources, local authorities have to comply with a number of general conditions; for instance, local authorities shall abide by all financial standards and budget procedures as mandated by PO-RALG in the Local Authorities Accounting Manual, and all local authorities should abide by all technical and professional standards in the delivery of local services as set forth by the respective sectoral ministries. Furthermore, LGAs have to comply with specific sectoral block grant conditions specified by the respective line ministries in the local budget guidelines.

In order to assure the central government and the development community that sectoral block grants are indeed used for their intended purpose (and not diverted to alternate uses), the system of local government finances should be more closely monitored. A first stage in the process is to assure that transfers (both for PE as well as OC) are actually disbursed by the treasury system as planned. Currently, at no stage of the budget process does the Ministry of Finance or PO-PSM actually check whether the disbursement of PE plus OC to each local council match with the budgeted allocations.

Box 5.4
Diversion of sectoral transfers and the lack of a hard budget constraint

A number of public expenditure tracking surveys (PETS) have been conducted in Tanzania to analyze whether sectoral transfers in primary education and health are actually being spent within the intended sector. These studies have generally found that a significant share of OC resources (in the region of 40-60%) is being diverted away from sectoral purposes, especially in the case of primary education.

[11] LGRP/GSU. 2005. Technical Notes on Local Government Finance Reform in Tanzania: The implementation of the formula-based grant system in Tanzania: Convergence of phasing-in and holding harmless provisions? (Technical Note 2005-2).

This diversion of sectoral resources has an impact on the local government finance system beyond merely reducing OC spending for service delivery in the particular sector. In fact, to the extent that local governments are diverting sectoral grants to fund other local government activities, the central government is in fact providing local governments with a "soft budget constraint". This soft budget constraint provides local governments with a disincentive to collect own source revenues, as local government officials apparently find it easier to divert sectoral grants away from primary education and health rather than collecting taxes and other revenues from local taxpayers.

While the results from the PETS have led the governments to take certain steps (such as the publication of grant disbursements to the local level), the response by the government to these PETS results were not as thorough as elsewhere (for instance, in Uganda). For instance, the provision of the unconditional grant or permission to collect certain local revenue sources could be made subject to proof (provided by the annual audit process) that sectoral resources are not being diverted. In addition, local financial management processes should be reviewed to ensure increased transparency of the local budget process (as discussed further in Section 7).

Monitoring and reporting of local government finances –as well as the monitoring of compliance with financial conditionalities- should be facilitated by two local fiscal management tools. First, the introduction of local Epicor (integrated financial management) systems –spear-headed by LGRP- sharply reduces the time-cost and effort for LGAs to prepare the needed monthly, quarterly or annual budget reports. In addition, the LGA Plan-Rep (planning and reporting) system which is currently being rolled out by LGRP is meant to function as a single-channel reporting mechanism from LGAs to the central government level.[12] When fully implemented, Plan-Rep should be able to extract the necessary data automatically from the local Epicor systems, consistent with the mantra of "eyes on, hands off." See Box 5.5 for a more detailed discussion on how local government grants and local government finances should be integrated into the central government budget processes and central government budget documents.

Box 5.5
Integrating the finances of decentralized local governments in the central government's budget process

The manner in which local government finances are currently included in Tanzania's central government budget processes reflects the past practices of a highly centralized, top-down budget structure. For instance, the national budget document (Volume III, Estimates of Public Expenditure Supply Votes (Regional), Details on Urban and District Councils Grants and Subventions) includes highly detailed expenditure estimates for local government allocations.[13]

[12] As noted in Section 3.5, the new organizational structure of PO-RALG includes a data-gathering and processing unit for this purpose.

[13] It is important to note that this volume is actually truly part of the budget estimates voted on by parliament, since the volume is produced after the budget vote. Instead, these local budget estimates are

For FY 2003/04, local expenditure details are included at a GFS sub-item level for every local council.[14] However, this inclusion of local budget expenditures in the national budget documents provides a false illusion of central control: the local expenditure items are limited to centrally-funded spending programs (i.e., it excludes all spending from local own resources) and there is no systematic mechanism in the national budget process to reconcile the local budget plans with actual local spending.

Since significant administrative resources are dedicated to this seemingly ineffective system of monitoring of local government budgetary resources, a technical note was prepared that reviews current practices. This review arrived at five key recommendations for the monitoring and reporting of Tanzania's local government finances:

1. Emphasize the philosophical shift away from centralized control

The current national budget process fails to reflect that under the Government's policy of "decentralization by devolution" local governments have the final responsibility for delivering certain services. As such, the central government (neither the executive branch nor parliament) should micro-manage local government finances in a discretionary manner.

2. Discontinue the practice of including detailed local budget estimates in the national budget

With the introduction of formula-based grants, there is no reason to include a high degree of detail on local expenditures in the national budget. Indeed, the entire practice of disbursing sectoral grants through "regional" votes should be questioned; it would be much more pragmatic that local government resources are included in the budget by assigning a separate vote for each transfer program. Rather than including a detailed breakdown, the budget would include the formula applied to each transfer program, and the resultant allocation of resources among local government authorities. The reform would recognize that once a transfer is released by the national treasury, the central government is no longer able to monitor its usage through the treasury system. As a matter of the central budget accounting, each sectoral transfer to the local government level should be identified as just that: a sector transfer to the local government level (and not as a specific expenditure).

3. Continue strengthening the capacity of local governments to manage local finances in a sound and transparent manner

While Tanzania's central government has a well-functioning Treasury system, local government authorities rely on a local treasury function. While local financial management is currently not as strong as the central treasury function, there are strong reasons not to centralize the administration of local government finances. Nonetheless, we should also recognize that the current weakness of local financial management capabilities (including the lack of local fiscal transparency and the limited degree of local accountability) could jeopardize the potential benefits of a decentralized system of government. In response, Tanzania's Local Government Reform Program (LGRP) is

tabulated by the Ministry of Finance from local budget sources after parliament approves the overall size and distribution of local government allocations among local jurisdictions by sector.

[14] There is some suggestion that the Ministry of Finance includes this high level of detail for local government allocations at the request of –or as a condition imposed by- the International Monetary Fund. It is unclear whether this is a misunderstanding or not. However, as evidenced by the international experiences presented later in this document- the IMF generally does not ask or receive such a high level of local budgetary detail of either developed or developing countries.

working systematically to improve the capacity of local governments to manage their financial resources in a sound, transparent and accountable manner primarily through the introduction of a local integrated financial management system.

4. Strengthen the systems for reporting, monitoring and analysis of local government finances

Current efforts in Tanzania to monitor local government finances are fragmented between the Ministry of Finance and PO-RALG. On one hand, whereas the Ministry of Finance has the best technical capacity to tabulate and to systematically analyze the condition of local government finances, the Ministry lacks the mandate and the institutional positioning to systematically gather the necessary local government budget data. On the other hand, whereas PO-RALG has the necessary institutional set-up to gather local government budget reports (on budget plans and budget outcomes) on a systematic basis, PO-RALG lacks the human resources and the technical capacity to tabulate the data and engage in basic comparative analyses of local financial data. A concerted effort should be made to establish a joint reporting and monitoring system that allows both PO-RALG and MOF to achieve their respective functions: PO-RALG is responsible for monitoring and overseeing the budget execution of each individual LGA on a one-by-one basis, whereas MOF is responsible for assuring the overall fiscal integrity of the local government finance system.

5. Produce an annual Local Government Fiscal Review

The central government has a legitimate interest in monitoring the overall state of local government finances. This effort would obviously be complicated if the national budget would no longer include detailed local expenditure data (although there is currently no assurance that local governments indeed spend their resources consistent with the budget plan laid out in the national budget). Instead, a policy-analytical document (a Local Government Fiscal Review) could be produced by the central government based on more aggregate local revenue and expenditure data (rather than the false sense of detail currently provided by the budget). Such a document would allow national policy makers, local government officials and other stakeholders to track the overall financial status of the local government sector, and would allow stakeholders to compare the fiscal performance (and compliance with grant conditions) of individual local governments. The first Local Government Fiscal Review was produced in 2004, and included a statistical annex, which should evolve in future years to include additional useful comparative analyses.

Source: LGRP/GSU. 2003. Technical Notes on Local Government Finance Reform in Tanzania: Linking local government budget reporting and the national budget process (Technical Note 2003-11).

5.3 Formula-based, unconditional equalizing General-Purpose Grant

In addition to the formula-based sectoral grants, we believe that a formula-based, unconditional equalizing General-Purpose Grant should be an indispensable part of Tanzania's system of local government finance. The General-Purpose Grant (GPG) is intended to provide funding for two purposes. First, the GPG would provide unconditional funding for local government administration purposes. Box 5.6 discusses

why the current funding mechanisms for local administration and general-purpose funding are inadequate and inappropriate. Second, the GPG would provide equalizing funding for fully devolved (purely local) activities for local governments for which own local revenue sources provide inadequate revenues.

Box 5.6
What is wrong with the current funding mechanisms for local administration and general-purpose funding?

Currently, the central government provides local governments with funding for local administration through Local Administration allocations. In addition, the central government provides LGAs with an unconditional grant for general-purposes (in compensation for the elimination of a number of local revenue sources in 2003 and 2004). What is wrong with the current approach of funding local government administration and other (non-priority sector) local government activities?

- Local control over the financing of local administration is needed. Consistent with the subsidiarity principle, the responsibility for local government administration in Tanzania is assigned fully to the local government level. This means that local government administration is best funded by local government's "own" resources, which includes locally-raised revenues as well as unconditional, general-purposes resources. Local control over funding would allow LGAs appropriate control over activities in their own realm of responsibility. Currently, the central government has full discretionary control over the amount of local administrative funding that each LGA receives. It is undesirable to fund local government administration by a grant mechanism over which central government could exert discretion.
- Local administration should not be funded from local revenue collections. Until 2003, local governments were required to spend upwards of 60% of own source revenues on local administrative costs, since the central government failed to provide any unconditional resources to the local level and only provided salary support for local administration. As discussed in Section 3, this is an improper assignment of expenditure responsibilities because local authorities are part of the national public sector and predominantly manage the delivery of national public services. The current assignment provides a major negative incentive for local revenue collections, as local revenue collections are shifted away from funding local services to funding local administration instead. This could be resolved by funding local administration from unconditional grants.
- The local administration grant is currently not allocated in an objective manner and is counter-equalizing. The allocation of the current administration grant is almost exclusively driven by existing local administrative payroll. Current allocation patterns display large variations in allocations between LGAs which cannot be explained in an objective manner. In fact, it appears that the impact of the local administration grant is currently counter-equalizing, with wealthier, urban councils generally receiving greater transfers than poor, rural councils.
- The incidence of the current Compensation Grant/GPG is not objective and not equalizing. To some extent, the introduction of the current Compensation Grant/GPG mitigated the problem that hitherto LGAs had not received any unconditional resources for the funding of council operations and/or for funding local activities outside the priority sectors. However, the incidence of the current GPG (ostensibly in proportion to revenues lost by the rationalizations of 2003 and 2004) is highly erratic and (more likely than not) counter-

equalizing. Instead, it is important that such unconditional funding is allocated in a transparent and pro-poor manner, consistent with the government's policy objectives.

In any system of local government finance, there will be fiscal disparities between local governments. These disparities between local governments arise, first, because the expenditure requirements for delivering a certain standard of local services vary from district to district (due to variations in cost, demographics, and other local factors), and second, because the ability to collect own source revenues tend to vary between different local governments. Attempts by the central government to reduce these horizontal fiscal imbalances are known as equalization.[15] Equalization can be divided into two types: equalization of expenditure needs, and fiscal capacity equalization (equalization based on the ability of local governments to collect revenues).

In countries that rely heavily on own source or retained tax revenues at the local government level (which cause substantial horizontal imbalances), an equalization grant mechanism is often an important component of the local government finance system. The need for an equalization scheme is often much less important in countries such as Tanzania where there is no large-scale derivation-based revenue sharing and where own source local government revenues only play a minor role. The fact that a large proportion of local government expenditures in Tanzania are funded by sectoral block grants already assures a substantial degree of needs-based equalization, consistent with the Local Government Finance Act Regulations (Government Notice 282, 2000) which specifies that "the allocation [of block grants] should guarantee equitable access by the population to basic services." This is a clear mandate for the government to engage in the equalization of local government resources based on local expenditure needs.

Yet, in addition to recommending the reform of discretionary sectoral allocations into formula-based sectoral block grant schemes, the intergovernmental transfer study conducted by GSU in 2002 also recommended the introduction of an unconditional equalization grant in the medium term. The purpose of the equalization grant would be to provide supplementary funding for LGAs in an equalizing manner (i.e., to local governments with higher needs and lower own revenue potential) in order to fund activities outside the priority sectors.

Indeed, according to the Local Government Finance Act (1982), PO-RALG is authorized to allocate equalization transfers in Tanzania that provide equalization grants to local governments with limited revenue-raising capabilities. The vision of the intergovernmental transfer study was to introduce an unconditional, equalizing grant (which would integrate the current administration grant along with additional resources) into an unconditional general-purpose grant in order to provide local governments with greater autonomy over their budgetary resources. In order to prevent local authorities from using these unconditional resources in an inefficient manner, it was originally

[15] This issue is discussed by LGRP/GSU. 2003. Technical Notes on Local Government Finance Reform in Tanzania: The Role of Equalization in Tanzania's System of Intergovernmental Grants (Technical Note 5).

envisioned that only councils who achieved certain minimum access conditions would receive the unconditional grant.

Despite this recommendation, in 2003, the introduction of an unconditional equalization grant seemed far off as the Ministry of Finance did not strongly support the provision of unconditional resources to the local level. However, with the introduction of a Compensation Grant in 2003 as a result of the elimination of the Development Levy and the other so-called nuisance taxes, a *de facto* unconditional grant was introduced. By 2004, this transfer program had been renamed the General-Purpose Grant, and as part of the budget formulation process for FY 2005/06, preparatory steps are being made to introduce a comprehensive, formula-based, equalizing general-purpose grant.

Size of grant pool. The determination of the size of the unconditional grant pool will be one of the major challenges in the specification of the General-Purpose Grant. Unlike the sectoral block grants –where the respective line ministries and PO-RALG have an institutional/sectoral interest in supporting additional funding for local governments-, there is no "natural" coalition of central government champions to advocate for the size of the General-Purpose Grant pool. This means that technical guidance on the appropriate size of the grant pool is essential. As noted earlier, there are several ways to determine the appropriate size of the grant pool:

- The first way to determine the appropriate size of the grant pool would be to look at historical grant patterns, including historical trends in the administration grant and the compensation grant, as well as trends in local expenditures on administration and other local (non-sectoral) activities. In 2002/03 (the year before the revenue reforms), local authorities received TSh 15 billion in Administration Grant and collected almost TSh 58 billion in own source revenues, for a total of TSh 73 billion in general-purpose resources. In 2004/05, local governments were budgeted to receive TSh 20 billion and TSh 25 billion in Administration Grant and General-Purpose Grant, respectively, and are estimated to collect approximately TSh 36 billion in own sources (total of TSh 81 billion). In the budget frame for FY 2005/06, a combined TSh 60 billion is set aside for administration and the general purpose grant.

  In this regard it needs to be noted that -unlike suggestions by many local government officials- the compensation grant in fact provides local governments with equal or more resources than the local revenue instruments that were terminated. In providing general-purpose grants to the local level, we should also bear in mind that requiring local governments to spend a majority of their own resources on administrative activities greatly reduced the willingness of residents to pay local taxes and had a major negative impact on the overall system of local government finance.

- Another way to determine the appropriate vertical allocation for unconditional grants would be to somehow quantify the absolute need for local administration and other

non-sectoral local public services.[16] The required size of the General-Purpose Grant pool could then be set equal to the total absolute local expenditure needs minus total (potential) own local government revenues. In particular, this approach would be possible for the administration component of the general-purpose grant, as a valid argument could be made that those costs should be fully borne by the center. Calculations of this nature were made by the study on local government finances based on national minimum standards (PWC, 2000). In contrast, it would be virtually impossible to compute an absolute expenditure need for "truly local" expenditure functions, such as local infrastructure needs, parks, and so forth.

- A third approach or consideration in determining the size of the equalization grant is the degree of horizontal inequity caused by local government revenues. Obviously, the size of the equalization grant pool needs to stand in some proportion to the fiscal inequities created by own revenues. In this regard, we need to recognize that the size of the current general-purpose grant (currently budgeted at TSh 37 billion for FY 2005/06, excluding the Administration Grant pool of TSh 23 billion) is almost equal to the size of total own source revenues collected by local governments in Tanzania (estimated at TSh 36 billion). In other words, the current unconditional grant would have substantial capacity to equalize for the variations in revenue-raising potential across local government jurisdictions.

The grant pool for both the administration grant and compensation grant are currently determined in a discretionary manner as part of the annual budget process as part of the "regional" budget votes (Votes 70-95). Some additional "general purpose" local resources are set aside through parallel funding mechanisms, including budgetary resources earmarked in the budget of PO-RALG for the funding of salaries of Ward and Village level officials. These resources should also be integrated into the general purpose grant and added onto the size of the grant pool.

When taken together, this would suggest that the General-Purpose Grant should have a transfer pool somewhere in the range of TSh 60-70 billion (for FY 2005/06). The study team believes this to be an adequate starting point for the grant pool of the general-purpose grant. However, in order to safeguard the relative size of the unconditional grant over time, the study team further recommends that the annual increase of the general-purpose grant should be guaranteed to be at least proportional to the increase in the national budget. Alternatively, the size of the GPG specified as a percentage of the national budget (say, for instance, the GPG could equal 1 percent of national budget resources), or the size of the GPG could be linked to the total size of sectoral block grants (for instance, the size of the GPG each year could be determined as equal to 15% of the sum of all sectoral block grant pools). Whatever vertical allocation rule is ultimately chosen, it would be wise to enshrine this principle in the Local Government Finance Act. This would greatly enhance the stability and predictability of the local government

[16] Note that although we could take on board the guidance provided by "absolute" expenditure needs, we realize –and argued earlier in this section- that public needs should always be considered relative to the availability of public resources.

finance framework, and would reduce the potential for shirking or "clawing back" by the central government.

Horizontal allocation. The "horizontal allocation" of a transfer scheme considers the manner in which transfers are distributed between eligible local jurisdictions. In other words, what formula or criteria should be used to apportion the transfer pool among the different local governments? Historically, the administration grant has been distributed in a highly discretionary and unequal manner; to a large extent, the allocation of the administration grant followed proportionally to where the central government decided to post local government staff. As a result, wealthier (typically urban) local jurisdictions generally received a disproportionately greater share of these resources. Likewise, the compensation grant was originally distributed in proportion to the revenue yield of the eliminated revenue sources, so that wealthier jurisdictions received a greater share of these resources as well. Although the Administration Grant and the General-Purpose (Compensation) Grant provide a natural basis for an equalizing General-Purpose Grant, the current incidence of these two grant schemes are clearly inconsistent with the government's poverty reduction strategy and the stated intent of the law about providing equal access to local government services.

Given that the purpose of the general-purpose grant mechanism is two-fold (first, to provide resources for local administration and second, to provide funding for general (non-sectoral) local purposes in an equalizing manner), it is important to design the formula in accordance with these funding objectives. Consistent with the need for transparency and in order to assure that "finance follows function", the GPG could be designed to have two "windows", with a separate window for each objective.

In order to be truly equalizing, the formula would have to include measures of local needs and local fiscal capacity, and to provide greater resources to local governments that have greater expenditure needs and a more limited ability to raise own revenues. However, as suggested by the previous studies, the data to adequately measure local fiscal capacity in Tanzania are currently lacking.[17] As such, a theoretically superior "first best" equalization formula that carefully measures the expenditure needs and fiscal capacity of local governments is unlikely to materialize in the near future. The loss in accuracy due to measurement problems that would ensue if we would try to actually measure local expenditure needs and fiscal capacity with very imperfect data would likely be much greater than the loss in accuracy from pursuing a less sophisticated approach.[18]

As a feasible and more practical alternative (but conceptually as a second-best option), the allocation formula for the general-purpose grant could be built around a number of basic fiscal needs measures for which data is available, such as population, land area, and

[17] In order to come up with an objective measure of fiscal capacity (which measures the revenue raising potential of a local government rather than the actual revenues raised), we would not only need to be able to measure the actual revenue collections of a jurisdiction, but also the size of the local economy or the size of the local government's tax base.

[18] For a fuller discussion of the measurement of fiscal capacity and fiscal needs, see Boex and Martinez-Vazquez (2005).

the poverty incidence, with the knowledge that fiscal capacity in Tanzania is inversely related to land area and poverty. As such, a good starting point for the discussion of the general-purpose grant formula could be the current formula used for the capital development grant system: population 70%, poverty 20%, and (capped) land area, 10%.[19] Introducing such a formula would mean that although the GPG formula would provide additional resources to all local governments, it would assure that poorer, rural local governments would receive a larger allocation from the grant mechanism. Such a formula based approach would be a significant improvement over the current discretionary (and counter-equalizing) allocation of general-purpose resources.

Although the study team believes that the LG CDG formula provides an appropriate starting point for the General-Purpose Grant formula, the exact nature of the formula should be a topic for further debate once the overall strategic Local Government Financing Framework has been agreed upon.[20]

As a final consideration, as better data comes available in the future with regard to the fiscal capacity of local authorities, the formula could be revised to more specifically take into account the revenue raising capacity of local governments as well as the fiscal needs of the local governments.

Box 5.7
Using the GPG as incentive for better revenue collection?

In addition to funding local administration and other local activities, the central government could design the GPG in order to pursue another policy objective as well. Since the GPG in fact replaces the revenue lost from ineffective local revenue instruments, it would be highly undesirable if local governments would further reduce their revenue effort in response to the introduction of to GPG. This raises the question of whether the GPG should be used to stimulate own source revenue collections at the local government level?

In order for the GPG to be part of a sound local government finance system, the first thing policymakers would have to assure is that the GPG does not provide a <u>dis</u>incentive to local revenue collections. Such a disincentive is much more likely when the transfer mechanism is discretionary and not formula-based, as the discretionary mechanism would encourage local officials to reduce own source collections with the expectation of negotiating greater transfers in the future. As such, the most important step in ensuring a sound GPG is to remove the discretionary element in determining the size of the transfer.

As argued in the intergovernmental transfer study (GSU, 2003), the transfer mechanism is not

[19] In principle, the first "window" for financing local government administration would most likely be based predominantly or exclusively on population. Poverty and land area would be appropriate allocation factors to enter into the equalization window of the formula. Further work would need to be done in order to complete the formula, so as to arrive at a sound and well-formulated GPG equalization formula.
[20] The introduction of a formula-based General-Purpose Grant would have to consider appropriate mechanisms to phase-in and hold harmless, particularly as local governments may not yet be able to rationalize their local administration staff.

necessarily an appropriate tool to stimulate revenue effort or fiscal performance by local governments. It is likely that there are numerous reasons that contribute to poor fiscal effort at the local government level, many of which are beyond the control of local authorities themselves. Section 4 of this study recognizes numerous factors that have contributed to the poor fiscal performance of local governments in Tanzania. None of these issues would be resolved simply by a financial stimulus through the transfer mechanism. Furthermore, there is no economic argument why it would increase efficiency or equity for the collection of local revenues to be stimulated in the long run.

Another problem noted by the GSU study (2003) is the challenge of accurately measuring fiscal performance by local governments in the absence of data on local fiscal capacity. The data availability to address this problem has not improved in recent years. Finally, it should be noted that the local capital development grant system (LGCDG) already provides local governments with a number of incentives for sound local governments through the imposition of minimum access conditions.

This being said, using the transfer system to stimulate local revenues can be an effective policy tool to resolve certain problems with local revenue administration in the short run. For instance, it would not at all be inappropriate to link the receipt of (part of the) unconditional grant to certain revenue performance indicators that are specifically designed to improve local revenue collections. For instance, one could imagine that local revenue collections might improve in response to an incentive by which all local authorities with a collection ratio for the property tax above a certain threshold (say, 75%) would receive a 10 percent increase in the size of their GPG grant.

Local use of resources. Although the General-Purpose Grant is intended to be basically an unconditional grant, some restrictions on the use of this funding have already emerged. For instance, the administration grant is currently specifically earmarked for administrative purposes while it also includes an earmarked component for funding firefighting equipment. Likewise, when the Compensation Grant was introduced, the guiding circular instructed local governments that these resources should be allocated in the same manner as the eliminated own revenues, but then proceeded to mandate that a certain share of the grant (currently 50%) should be shared with the Village-Level.

Box 5.8
Feedback from the Second Stakeholder Workshop (May 2005):
The need for an equalizing, unconditional General Purpose Grant

The second stakeholder workshop on the development of a strategic framework for local government finances –held in Dar es Salaam in May 2005- was presented with the following statement for discussion and debate: "The local government finance system needs an equalizing, unconditional General Purpose Grant to complement recurrent sectoral block grants, the LG Capital Development Grants, and own local revenue sources"

Unanimous agreement and consensus exists with regard to this statement.

Recognition was given to the fact that local government authorities face substantial differences in local tax bases (as well as differences in local expenditure needs). However, careful consideration should be given to the exact purpose for which general-purpose funding is provided, and the resulting transfer mechanism should clearly respond to that relevant policy objectives. In fact, to the extent that unconditional funding is provided for two distinct purposes (namely administration and equalization), the horizontal allocation formula might indeed pursue these two different objectives through two different windows. Looking forward, it was noted that measurement of fiscal capacity and local expenditure needs would be an important challenge. In addition, concern was raised that unconditional funding should not end up being a reward for inefficiency in local government administration, and that the further development of the general-purpose grant should potentially provide incentives for improved local administration.

The study team believes that any specific conditions on the General-Purpose Grant should be removed, so that the general-purpose grant takes on the nature of a true unconditional grant. Any general conditions on sound local government administration should be introduced as part of the overall Local Government Financial Management Manual. Likewise, any resource-sharing arrangement between the district and the village level should not be limited to the GPG, but should more widely consider all (non-sectoral) district resources, again, as part of the overall financial management guidelines.

To the extent that the central government ministries seek to encourage the delivery of a specific local government service (e.g., the encouragement of urban fire-fighting service) or to the extent that a central government ministry may wish to rely on local governments to implement a specific central government function at the local government level (i.e. delegating the implementation of a service), the central government ministry should provide earmarked, cost-reimbursement transfers for these purposes in their own budgets. To the extent that the delivery of such central government activities are delegated to the local government level, the ministerial budget should clearly identify the amount of resources flowing to the local government level, as well as how these resources are distributed among local government units. The provision by line ministries to PO-RALG and Ministry of Finance during the budget formulation process of detailed data on how subventions will be distributed among local government councils is critical (a) for local governments to develop comprehensive local budget plans, (b) to monitor that these resource do not get diverted at the central government level and indeed correctly flow to the local government level, and (c) to monitor that these resources are appropriately spent by local government authorities on their intended purpose.

5.4 Formula-based capital development grants

In order for local communities to be fiscally empowered with respect to their development activities, the government is moving towards devolution of the development budget through the introduction of a formula-based system of Local Government Capital Development Grants. The CDG is described in greater detail in Box 4.3 of the Local

Government Fiscal Review (2004). In addition, there are a number of (typically donor-funded) sectoral programs which provide resources for sector-specific capital development at the local level; for instance, PEDP has a separate window for the funding of classroom construction and rehabilitation. As we note below, we believe that such sectoral programs should be harmonized into the broader Capital Development Grant system.

Although Tanzania should be pursuing a unified budget approach (that more closely integrates the recurrent budget and the capital / development budget), it is appropriate to separate the capital development grant funding mechanism from the recurrent block grant mechanism, since the two mechanisms serve different purposes.[21] In principle, the Local Government Capital Development Grant scheme provides a sound and well-integrated element of the overall strategic framework for local government finance.

Size of grant pool. Based on thorough analysis of the investment needs and costs, the LGA absorption capacity, experiences from other programs and grant schemes, and the supply side (the availability of the funds), it is planned to have an average annual allocation of capital grants of US$1.50 per capita. The optimal size of the capital development grant was determined using qualitative analysis based on international experiences, balancing the available resources from the donor community and the government with the expected absorptive capacity of local government authorities.

Once the CDG system is fully rolled out to all districts, the total size of the capital development grant system will be approximately TSh 55 billion. This stands in contrast to sectoral grants of approximately TSh 400 billion and unconditional grants (GPG and Administration Grant) of roughly 60 billion for FY 2005/05. Although this seems like a limited amount, it needs to be kept in mind that hitherto local governments basically did not receive any capital development funding. In addition, there is a serious concern among policy experts, that local governments should have adequate resources (from own resources or transfers) to maintain and operate the capital development infrastructure that is being put in place. In comparison to the current own source revenue base of TSh 36 billion, the current size of the CDG does not appear to be inappropriate for the initial years of the system.

Horizontal allocation. It has been decided that the following formula and weighted elements will be used in distributing the CDG capital grant funds:

- Population (70%)
- Poverty indicator (20%)
- Land Area (10%)

The allocation formula adopted by the CDG is fully consistent with the sound principle of transfer design as laid out by the intergovernmental transfer study (GSU, 2003). The formula advocates greater resources to poorer local government authorities, as well as to

[21] Section 6 provides additional insights into why it is not appropriate or efficient to fund capital development activities with recurrent finances.

geographically larger local government districts (in other words, rural district authorities). This is consistent with needs based equalization. Although the CDG formula is pro-poor, a potential criticism of the formula is that it fails to recognize that some districts already have a greater capital stock than other districts. However, it would be almost impossible to subjectively quantify the value of existing capital stock in different local government areas with the current data available. As the CDG system evolves over time, the allocation formula should be reviewed from time to time to assure that the formula achieves the policy objectives that it is intended to secure.

Local use of resources. The capital grant will cater for a broad range of investments in infrastructure and service provision within the mandates of the LGAs. The grant will be a non-sectoral discretionary capital transfer to LGA for capital investments in new infrastructure and rehabilitation of the existing stock. Councils that do not meet the performance conditions for capital development funding but do meet (lower) minimum conditions will receive a capacity building grant. LGAs can use these resources according to their own priorities for improvement of their performance and enhancement of their capacities.

While the CDG is an important step in the process of arriving at a unified capital development funding mechanism, the current design of the CDG simply lumps together capital development spending for the key priority sectors (e.g., building classrooms, clinics, and so on), and capital projects that are truly local in nature (e.g., minor roads, local markets, other local infrastructure, and so on). While the unconditional nature of the current CDG allows local governments substantial budget autonomy, at the same time the CDG system in its current form does not allow the central government to use the CDG system to steer resources as may be needed to national priority sectors, such as classroom construction, clinic rehabilitation, local roads construction, and so on.

Thus, in addition to the implementation of the current "general-purpose" window to the LG CDG, the study team recommends that the next step for the CDG system should be to widen the CDG system by incorporating potential "windows" for formula-based sectoral capital development transfers under the same overall mechanism. In that case, all capital development funding schemes -including sectoral capital development grants- could be planned and budgeted as part of the comprehensive local budget process, and could flow through the same budgetary mechanisms and accounts at the local level.

Box 5.9
The capacity building component of the CDG

One weakness of the current capital development grant system is the capacity building grant. Although the original design of LGSP envisioned the development of institutions to supply training and capacity building to local governments, this component of local capital development system was never fully developed. As a result, there is an institutional vacuum in the area of local capacity strengthening as part of the CDG system. If unaddressed, the distinct possibility arises that local government capacity strengthening grants will be allocated in an ineffective manner.

This should be addressed in improvements to the institutional framework as discussed in Section 3 .5.

Having a unified capital development grant system should reduce the current fragmentation, duplication and loss of transparency associated with the existence of parallel funding mechanisms. For instance, the current PEDP capital grants are currently routed to the local level through each LGA's Education OC account. Such mixing of funding sources greatly reduces the transparency of the local budget and complicates expenditure tracking, thereby reducing the accountability both of local as well as central government officials. Instead, all capital development grant should be transferred to the local government level through the Local Development Account. Improved budgeting practices should enable the local budget process to identify how much of the various development resources were spent in each sector.

5.5 Transfers from ministerial budgets, donor-financed activities, and other parallel funding mechanisms

Earlier we noted that in some cases, the funding of functional responsibilities which are delegated by central government ministries to the local government level (as opposed to "devolved" to the local government level) may be appropriately achieved by earmarking transfers within ministerial budgets, as long as these resources are clearly identified, the allocation between jurisdictions is done in an objective, fair and transparent manner, and the Ministry of Finance (ACB/RALG) and PO-RALG (through the LG FA&CG) are advised of the distribution.

However, to the extent that intergovernmental transfers are intended to fund devolved delivery of services (such as is the case in primary education, basic health care and so on), these resources should all be provided through (and not around) the sectoral block grant mechanism. One further case in point (as further discussed in Box 5.10) is the local share of the Roads Fund, which is currently funded through the PO-RALG budget. Likewise, it does not make sense to have an earmarked ministerial subvention mechanism in the PO-RALG budget to fund VEOs and WEOs, which is clearly a responsibility assigned to the local government level. This funding mechanism should clearly be folded into the envisioned GPG mechanism.

Box 5.10
Providing funding from the Roads Board / Fuel Levy to the local government level

There are currently two mechanisms by which LGAs receive transfers from the central government for the maintenance of local roads. First, local governments receive a relatively small sectoral block grant for local road maintenance. This block grant is transferred directly from the treasury to the LGA like all other sectoral block grants. Second, local governments also

receive a substantial transfer from the Roads Board, which is funded from the Fuel Levy; the relevant legislation sets aside 30% of Fuel Levy collections for the local government level. However, unlike the sectoral block grant for local road maintenance, the funding from the Roads Board is transferred to PO-RALG, which administers these resources. Although in principle the distribution of these resources among LGAs is determined by a formula, PO-RALG appears to administer these resources in a highly discretionary manner, which opens the door for possible inequity, inefficiency, and possible malfeasance.

Having two parallel mechanisms to fund local road maintenance reduces the transparency of the local government finance system and would potentially allow local governments to double-bill for the same activity. The parallel structure is further inefficient by causing substantial administrative duplication and by necessitating unwarranted administrative overhead at the central government level. The manner in which the Fuel Levy funds reach the local government further unnecessarily interjects central government bureaucrats in local decisions and thus unnecessarily restricts local government control and local autonomy.

As such, the study team argues that the Fuel Levy should be transferred directly to local authorities by standing order based on the actual application of a horizontal allocation formula, without the intervention of PO-RALG. Only in the case that a specific local governments is shown to have misallocated the Roads Board grant or it is unable to account for the resources, should the standing order be revoked for that individual local authority.

The same argument should be made for donor-driven projects: the donor community should avoid creating parallel financing structures (either within the context of the central government budget, or completely around the public budget) that by-pass both central government and/or local government budgets.

There is substantial direct donor support to local governments, both in the form of district-level development aid as well as in donor support for specific local-level projects. Although well-intentioned, to the extent that such aid by-passes the central government's allocation mechanism, this practice risks undermining the existing system of intergovernmental fiscal relations. Indeed, the Letter of Sector Policy encourages donor programs to recognize local governments as legitimate representatives of the people for the purpose of allocating public resources at the local level, and to move away from area-based and sectoral programs as modalities to fund the delivery of local government services. For the most part, donors have been extremely supportive of this policy, and many development partners have integrated their existing ABPs into the LG CDG.

The record on this point is not perfect, however. For instance, with support from the World Bank as well as the Government itself, the Tanzania Social Action Fund II (TASAF II) continues the practice of working basically as an extra-budgetary fund, going around LGAs and working outside local budgetary accounts. Likewise, development initiatives pop up regularly that –typically for purposes of expediency to the donor agency- envision financing structures outside the larger system of local government

finance. A case in point might be an envisioned community-funding mechanism to be provided to the village-level for HIV/AIDS activities.

The obvious concern with such extra-budgetary funding modalities is that direct aid to communities (around their local governments) could bring substantial horizontal fiscal imbalances (with certain LGAs receiving more than others) and also greatly reduces the degree of fiscal transparency at the local government level. Discretionary donor funding (much like discretionary and *ad hoc* central government transfers) also softens any hard budget constraint on local government, may provide negative incentives for local governments to raise their own revenue sources, and could prevent local governments from achieving real local buy-in from their local communities in their service delivery role. Furthermore, such parallel funding mechanisms often ignore the link between capital development activities and the impact for the local recurrent budget.

In many ways, the reforms of the recurrent transfer system that the government has adopted over the past several years combines the positive features (such as objective formulas, transparency, and rule-based conditions) of sectoral programs such as the PEDP and the Common Health Basket Fund. Since the government has applied these lessons by making them a central feature of the entire government transfer system, the time is right to integrate PEDP and Health Basket and other similar funding streams into the government's own transfer system. In fact, maintaining separate parallel funds will reduce transparency and accountability, since LGAs are able to "play" with different funding sources (potentially opening the door for double-counting and other malfeasance). Furthermore, integration of these parallel funding streams into the government's main transfer system reduces duplication in monitoring and reporting, and allows the public sector to reduce the reporting burden on local government by stream-lining the monitoring and reporting system of local government finances.

5.6 Recommendations

Progress towards a formula based system of intergovernmental transfers over the past few years has substantially improved Tanzanian system of local government finance. Although substantial progress has already been made, continued progress is necessary in order to ensure that the current improvements in the allocation of local government resources is consolidated and remain sustainable.

Consistent with the recommendations made as part of the intergovernmental transfer study (GSU, 2003), the study team recommends a further tightening of the intergovernmental transfer system which would limit the ability of central government officials to make arbitrary allocation decisions. Section 5.1.2 recommends a clear four-pronged structure for the transfer system, based on the notion that "finance should follow function". Further streamlining and standardization of the intergovernmental transfer system would make the system of local government finances easier to administer, more

efficient, more transparent, more equitable, and would reduce the opportunity for potential corruption (both the local government level as well as the central level).

Overall policy stance and policy effectiveness.

The first step in further strengthening the transfer system would be the unequivocal commitment by the central government that formula-based grants (as opposed to discretionary grants) should be used for the funding of devolved functions. As noted at the beginning of this chapter, the Government of Tanzania is in principle committed to a formula-based grant system that is objective, fair, and results in efficient delivery of local services. Nonetheless, political and institutional expediency sometimes prevail and prevent the immediate and full implementation of the formula-based transfer system.[22] In order to overcome such obstacles, the President, Cabinet, and all involved stakeholders should reaffirm their commitment to a formula-based system of local government transfers.

Constitutional and legal framework.

While the current Local Government Finance Act (1982, as intermittently revised) provides an adequate legal basis for the transfer system, the Act contains numerous duplicative provisions which reduce the overall clarity and transparency of the local government finance system. The law contains many redundant clauses which provide the minister responsible for local government with excessive discretion over the allocation of transfers. Accordingly, the legal framework should be revised in line with the recommendations made in this section, which will provide for a more carefully structured system of intergovernmental fiscal transfers.

Central government institutional and regulatory framework

Although substantial progress has been made in recent years with respect to the institutional and regulatory framework that guides the allocation of intergovernmental transfers, this area will continue to require substantial attention.

The major challenge with respect to the formula-based sectoral block grants is to resolve how these grants should be properly included in the national budget process. The current structure in which local government allocations are budgeted for is a vestige from a centralized past and makes no sense in the current decentralized framework. Now that local government allocations are determined based on the formulas, the division of sectoral block grants over 21 regional votes hinders proper planning and reduces transparency. Although there is broad consensus that it is ultimately the local government that should determine the balance between PE and OC for government services delivered at the local government level, the current budget process still imposes separate aggregate requirements on local PE and local OC. The extent to which the budget formulation

[22] Examples of such bottlenecks and constraints include (1) the lack of operational convergence by PO-PSM in approving local government staff posts consistent with the formula-based system; (2) the increased practice in the FY 2005/06 budget of earmarking sectoral funds in addition to the formula-based allocations; (3) the apparent strategic re-budgeting of sectoral resources in ministerial budgets away from devolved sectoral functions provided by the LGA level, towards sectoral functions directly under the responsibility of the central government ministry.

process for transfers to local level should be modified should be determined by an inclusive series of discussions between involved stakeholders, which include the Ministry of Finance, PO-RALG, the PER working group, public finance management reform experts, and other stakeholders.

A common objective of the institutional and regulatory forms of the central government level should be the comprehensiveness and transparency with which the central government budget captures transfers to the local government level. A major improvement in the local government finance system would have been made if the central government's budget plans would systematically and transparently reflect the amount of transfer resources that are planned to flow to the local government level.

A more systematic inclusion of local government transfers in the central government's budget process will enable the central government to better monitor the actual spending of transfer resources, both by more closely monitoring of actual disbursements of PE and OC to the local government level, as well as by analyzing (self-reported) local government expenditures, which are largely funded with transfer resources.

Local government institutional and regulatory framework and participation by civil society (CS) and private sector.

As noted throughout this report, the benefits from decentralization will fail to materialize unless local governments spend public resources in accordance to the wishes and needs of the residents in their communities. As such, local financial management that promotes local participation in local accountability is a critical feature of any sound local government finance system. This issue is discussed further in Section 7 of this report.