THE UNITED REPUBLIC OF TANZANIA

President's Office - Regional Administration and Local Government
Ministry of Finance

Draft Policy Paper on Local Government Finance:

The Framework for the Financing of Local Government Authorities in Tanzania

Preamble to Section 8
The Framework for the Financing of Local Government Authorities in Tanzania

The first seven sections of this study contain all the ingredients for a strategic framework for local government finance in Tanzania. The current section of the *Final Report* pulls together the conclusions and recommendations from the previous sections in a clear and concise manner, and integrates them into a proposed strategic framework for local government finances.

The draft strategy document clearly indicate how each level of local government should be funded (i.e., with what mix of own revenue sources and national transfers) and how each source of local revenues could be optimized. Section 8 is drafted in such a fashion that -while also being an integral conclusionary section of the Final Report- the section can also be read as a stand-alone document, and possibly be used as the basis for the Government's Policy Paper on the Financing of LGAs in Tanzania.

As a result of its structure, Section 8 of this report concurrently functions as the Executive Summary of this Report.

The Framework for the Financing of Local Government Authorities in Tanzania

1. Introduction

Fiscal decentralization is not a new theme in the policy agenda of the Government of Tanzania. Since the reintroduction of democratically elected local governments in 1984, the Government has been systematically expanding the roles and financial responsibilities of Local Government Authorities in a well-structured and considered manner.

As noted in the Local Government Fiscal Review (2004), local governments are an important and an integral part of public sector finances of Mainland Tanzania today, as local governments have significant responsibility in the delivery of key government services such as primary education and basic health care. While local government authorities collect roughly 3-5 percent of all public sector revenues, they are responsible for over 20 percent of public sector spending. As such, a sound framework for local government finance is a key factor in assuring that the public sector delivers quality public services; provides an enabling environment for economic growth; and pursues an aggressive agenda of poverty reduction.

The Government's vision of the country's local government system is clearly set forth in its Policy Paper on Local Government Reform (MRALG, 1998), which was developed in a deliberative and consultative process. The vision is based on the principle of "decentralization by devolution" by which autonomous local governments are empowered with political and administrative control and provided with the financial resources to assure the effective delivery of services to the public. While the Policy Paper provides the broad outlines for the system of local government finances, the document falls short from defining a comprehensive strategic framework for local government finances.

In 2004, the Government of Tanzania determined that it would be useful to undertake a comprehensive review of the policy framework underpinning the structure of the financing of local government, in light of a number of ongoing reform initiatives impacting local government finance. Based on a thorough review of the existing approach to local government finance in Tanzania, sound principles of fiscal policy, and international best practices, this documents sets forth the Government's strategic framework that will henceforth guide its policy decisions on the framework for financing local government authorities, including the assignment of expenditure responsibilities, the collection of own local revenues, the role of intergovernmental transfer schemes, as well as local government borrowing. As such, the current policy framework for the financing of local government authorities is a complementary extension of the Policy Paper on Local Government Reform.

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

Any system of local government finances covers a broad range of fiscal issues. Given the breadth of the topic, it is useful to subdivide the discussion of local government finance in Tanzania into four main dimensions of intergovernmental fiscal relations, namely:

(1) the assignment of expenditure responsibilities: what are the functions and expenditure responsibilities of each level of government?.
(2) the assignment of revenue sources to local governments: which tax or non-tax revenue sources will be made available to subnational governments, and how are these local revenues administered?.
(3) the allocation of intergovernmental fiscal transfers: what type(s) of intergovernmental fiscal transfers will be provided to local governments? This includes decisions on how the size of the grant pool is determined; how the resources are to be distributed among local governments, and what the allowed uses of these funds are at the local level.
(4) the environment for local government borrowing: are local governments allowed to borrow? What mechanisms for borrowing are available, and what are the restrictions on borrowing and debt by local governments?

To a large extent, the current document follows the structure of these four pillars of fiscal decentralization. Two additional broad topics that are addressed (whenever relevant) in this current policy document are the appropriateness of the overall local government structure, and the institutional mechanisms for intergovernmental fiscal relations in Tanzania, including coordination among central government agencies as well as coordination and communication between different government levels.

<u>Fundamental principles of a sound local government finance system</u>
During the preparation of the current policy document, a number of misconceptions were identified that were held by some stakeholders in Tanzania regarding the framework for local government finance in Tanzania. In order to resolve these misconceptions and establish a positive starting point for the development of local government finance framework in Tanzania, four principles were proposed around which this strategic framework for local government finance was developed. During a joint stakeholder workshop –jointly chaired by PO-RALG and the Ministry of Finance- in January 2005, broad-based consensus was reached on these principles. These principles form the foundation for the strategic policy on local government finance:

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

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

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

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

An assessment of the current local government finance system

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

Local government structure. The first row of Table 1 provides a brief assessment of Tanzania's current structure of subnational government, considering the number of government levels, the size of subnational jurisdictions, and so on. The subnational government structure was considered a given (exogenous) factor during the formulation of the local government finance framework.

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

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

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

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

Expenditure assignments. The current assignments of expenditure responsibilities in Tanzania are generally sound, as reflected by the second row in Table 1. The government's policy position of "decentralization by devolution" is unambiguous; the legal framework for decentralized provision of services is in place and sectoral laws to a large extent respect this decentralized mode of service delivery; and the services assigned to the subnational level generally follow the subsidiarity principle.

The predominant way in which the central government interferes with local governments' ability to provide public services is through its control over (the hiring and transfer of) local government staff. Although outside the direct scope of intergovernmental fiscal relations, serious problems will arise in the local government finance system unless the local service system is properly aligned with the local government finance system by allowing local governments to make their own hiring and firing decisions (and to eliminate central government intervention in local public service decisions).

However, some of the more serious weaknesses of the local expenditures process lie in local budget formulation and execution. Planning and budget processes at the local government level tend to be weak. The local budget process further involves only limited civil society participation and oversight of budget planning, formulation and execution. While the computerization of local financial management processes is currently being rolled out, the local financial management processes should be reviewed and strengthened to assure greater participation, transparency and local oversight.

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

While there is widespread agreement that the previous local revenue system as well as the manner in which local taxes were administered were wholly inadequate, there is now an

increasing realization (both at the central government as well as at the local government level) that local revenues are an integral part of a sound system of local government finance. This leaves the Government with the difficult challenge to transform the current, inadequate and imperfect system of local government revenues into a sound and well-administered system of local government revenues.

Intergovernmental fiscal transfers. Once expenditure responsibilities and revenue sources have been assigned to the local government level, intergovernmental fiscal transfers are needed to achieve vertical and horizontal fiscal balance in the system of intergovernmental fiscal relations. The transfer system in Tanzania plays an extremely important role in financing local governments, as most councils rely for 80-90% on intergovernmental transfers to fund their activities. A study on the intergovernmental transfer system in Tanzania (GSU, 2003) identified a number of serious shortcomings with regard to the manner in which intergovernmental transfers (local government allocations) were allocated; the allocation of local government allocations was done in a highly discretionary manner, lacked objective standards for allocating resources, failed to provide local governments with a predictable stream of resources, and was generally counter-equalizing. As such, transformation of the transfer system has taken center-stage in the reform of local government finances in recent years. The positive steps taken by the Government to reform the intergovernmental transfer system has been one of the major successes of local government reform in recent years (JGDR, 2004).

The broader vision for a formula-based system of intergovernmental transfer was developed as part of the Government's Local Government Reform Policy. Detailed proposals for a system of formula-based recurrent sectoral block grants were adopted by Cabinet in February 2004. The system of formula-based sectoral block grants is currently in the process of being implemented: formula-based grants for primary education and local health services were introduced in July 2004; formula-based grants for the remaining priority sectors are being introduced as part of the FY 2005/06 budget.

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

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

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

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

In addition to the need for horizontal coordination at the central government level, there is also a need to assure that adequate coordination takes place between different government levels, as well as between the public and private sector. A sound fiscal decentralization approach cannot be driven from the center alone; ultimately, a sustainable decentralized system requires civil society (NGOs, local chambers of commerce and other interest groups) to be involved in the local decision-making process, just like a sound decentralized system requires local governments to have a real voice in the national policy debate on local government reform issues. Since the focus in recent years has been on addressing some main fundamental challenges in local government finance, this has been an area that has received less attention. However, now that the overall framework for local government finance is on an increasingly sound footing, these institutional concerns are becoming increasingly important for a sustainable local government system.

Overall assessment. When taken together, it would be fair to state –based on the assessment summarized in Table 1- that although the current system of local government finance has a number of shortcomings, many of the features of the current system of local government finance are quite sound. The overall policy direction of the Government on local government finance has been prudent and is consistent with overall sound principles for decentralization reforms. In general, the legislative framework provides appropriate guidance, although the relevant laws should be revised to eliminate outdated, duplicative or contradictory clauses. Although the local government revenue system has not received adequate attention in recent years, substantial progress has been made on transforming

the previously highly discretionary transfer system into an objective, transparent, stable and pro-poor funding mechanism for local governments.

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

3. Overall structure of local government finance and expenditure assignments

Based on the overall assessment of the current system of local government finance in the previous section, this section and subsequent sections in this policy document develop the strategic framework for local government finance in Tanzania which the government intends to pursue in future years. Again, the discussion will broadly follow the four main pillars of fiscal decentralization (expenditure assignments, revenue assignments, intergovernmental transfers, and local government borrowing).

The Government's assignment of expenditure responsibilities between different government levels should be guided by its stated policy strategy of "decentralization by devolution", which is clearly set forth in the Government's Policy Paper on Local Government Reform (1998). Expenditure functions should thus be assigned in accordance with the "subsidiarity principle" which states that government services should be delivered by the lowest government level that can do so efficiently. The existing expenditure assignments (which are set forth in the Local Government Acts) are basically consistent with the concept of subsidiarity.[1]

<u>The multi-dimensional nature of expenditure assignments</u>

The manner in which expenditure assignments are included in the appropriate legislation should specifically take into account that expenditure responsibilities are multi-dimensional. Multi-dimensional expenditure assignments recognize that "being responsible" for delivering a public services can be broken down into the responsibility to (1) set policy, regulations and standards; (2) funding the activity; (3) providing the service (i.e., assuring that the service is provided); and (4) the actual production or delivery of a service (which may be produced by the LGA itself of contracted out).

Although Tanzania is pursuing "decentralization by devolution", it is widely agreed that this concept means different things for different local government activities. However, this implicit understanding has not been documented explicitly in either the government's local government reform strategy or in the respective laws. In principle, the framework

[1] Possible exceptions to a sound expenditure assignment are secondary education (the provision of which could be assigned to the local government level) and urban fire-fighting services (which could be fully devolved to the local government level).

for local government finance in Tanzania should recognize five different types of services or activities that may take place at the local level, which are summarized in Table 2.

Finance should follow function

Under the concept that "finance should follow function", each of the different types of local government activities noted in Table 2 should be funded through different funding modalities.

Table 2
The assignment of expenditure responsibilities in Tanzania

Local government functions	Policy, regulation and standards	Finance	Provision	Production / Delivery
Locally provided "national" public services	CG	CG: sector block grants	LGAs	LGAs
Local government administration	CG	CG: GPG	LGAs	LGAs
Pure local government services	LGAs	CG / LGAs: own sources and GPG	LGAs	LGAs
Capital development activities	CG / LGAs	CG / LGAs: LGCDG, loans, own sources	LGAs	LGAs
Delegated central government functions	CG	CG: ministerial subventions	CG	LGAs

The most prominent category of local government responsibilities are (national) public services for which the provision is devolved to the local government level. These services include the five priorities sectors (primary education; local health services; agriculture extension and livestock; water supply; and local roads). For these activities, the central government continues to bear responsibility for setting policies, regulations and norms, as well as for the financing. As discussed below, the local delivery of priority sector activities should be fully funded by sectoral block grants.

The second type of local government expenditure responsibility is local administration. It is appropriate to fund local administration from central government resources since local governments are an integral part of Tanzania's national system of public administration, and since the predominant responsibility of local government authorities is to provide nationally-mandated public services. As discussed below, local governments should receive resources for local administration through the General Purpose Grant. While the

central government should set regulatory standards for local government administration (such as reporting requirements, and so on), it should refrain from interfering with managerial or administrative decisions of individual LGAs.

The third category of local government activities in Tanzania's framework for local government finance includes "truly" or "purely" local government services, such as refuse collection, street sweeping, and other such services. Since the benefits from these local public services befall only the local community, the entire responsibility for these activities (including policy direction, financing, provision and production) should be assigned to the local government level. These activities should be predominantly funded from own resources. However, to the extent that the local government revenue system provides inadequate resources –and in order to assure horizontal fiscal balance- part of these local government activities should be funded from the unconditional General Purpose Grant.

To the extent possible and appropriate under the subsidiarity principle, purely local services and activities should take place at the village level. The central government should provide regulatory guidance for the distribution mechanism of district resources to the village-level, commensurate with the expenditure responsibilities of the village level.

Fourth, local capital development activities should be funded by a combination of own source revenues, local borrowing, and grants (Capital Development Grant system). To the extent that these capital development activities fall within the priority sectors, the central government may impose policy guidance, regulations and norms. Whenever appropriate, again, local capital development responsibilities should be devolved to the village level.

Finally, there may be a number of central government activities which (statutorily or otherwise) may be delegated to the local government level. These activities should be fully funded by earmarked ministerial subventions to the local level. These ministerial subventions should be clearly identified in the central government budget. The prevention of contagious illnesses may be considered such a delegated responsibility.

Local budget processes and local financial management

In addition to assuring that expenditure responsibilities are assigned consistent with the subsidiarity principle in a manner where "finance follows function", a sound fiscal decentralization approach requires that mechanisms are in place to assure that local governments make expenditure decisions in a responsive and accountable manner.

In order for the expected benefits from decentralization to arise, local governments have to spend their resources in a manner that is responsive to the needs of the local community. This requires that local stakeholders are able to articulate their needs and priorities to their locally elected officials through a participatory local budget process, and it also requires that local government officials take the priorities of their tax-paying constituents seriously. Given that apparently the largest factor in the low levels of local tax compliance is the absence of corresponding benefits, local government officials and

local stakeholders may need to be sensitized about their overall roles in the process of local service delivery and local economic development.

In order for local communities to ultimately benefit from devolved expenditure assignments, they have to be able to monitor their local government's budget in a manner that allows them to hold local officials accountable if they fail to deliver the right services. Such local empowerment requires a clear and transparent system of local government financial management that allows local communities to track local spending and monitor key local performance measures. A serious effort needs to be made to review the entire local financial management process, to ensure that the local budget classifications and budget summaries and reports that are produced are not only relevant for central government budget monitoring purposes, but also that these documents are meaningful inputs into the "horizontal" monitoring of local government activities and finances by the local communities.

Box 1
Legislative reform of expenditure assignments in Tanzania

The assignments of expenditure responsibilities set forth in this policy document are consistent with current practices and the current legal framework. To a large extent, the legal and regulatory modifications that are needed to implement these expenditure assignments reflect a sharpening or clarification of the existing situation, rather than a radical overhaul of existing expenditure assignments.

In fact, the basic legal framework for decentralized provision of services in place in Tanzania is quite sound. Unlike many other decentralizing countries, sectoral laws for the most part respect the decentralized mode of service delivery. Continued vigilance is needed, however, to ensure that sectoral practices continue to be consistent with the government's local government reform agenda. For instance, the central government's control over local water boards is inconsistent with its overall vision of decentralization by devolution (as opposed to deconcentration or delegation).

The Local Government (Urban and District Authorities) Acts and the Local Government Finance Act do need to be reviewed and revised in order to clarify the current expenditure assignments. Instead of the current list (or lists) of local functional responsibilities, the Act should reference the different dimensions of expenditure assignments and clarify the distinction between different types of expenditure responsibilities to the local government level.

Furthermore, a number of revisions in the Local Government Acts could simplify and clarify the Acts by eliminating duplicative and redundant clauses pertaining to the local government structure, including a single assignment of expenditure responsibilities across urban and rural districts (which can be relegated to a Schedule); clarification of the expenditure responsibilities of DSM City Council; and clarification of the expenditure responsibilities of the village level.

4. Local government revenues and local tax administration

The realization that a significant overhaul of the local revenue system needed to take place –and the realization that this reform should take place in the context of the broader local government finance system- was an important impetus for the formulation of a Policy Paper on Local Government Finance. These discussions show that the main shortcomings of the current local revenue system are as following:

1. LGAs are mostly assigned low-yielding taxes. It is a fact that the central government has reserved itself the most important and elastic tax bases in the economy, making it so much harder for local governments to have any substantial revenue source of their own.
2. Fragmentation causes horizontal inequity. The local tax system has seen a proliferation of small taxes, which has led to significant horizontal inequities between local taxpayers.
3. The benefits principle is misunderstood or missing as a conceptual foundation for local government revenues. The benefit principle of taxation (especially as applied to the local level in Tanzania) seems to be poorly understood by some stakeholders and missing as a foundation for the system of local government revenues.
4. Excessive focus on the redistributive impact of local revenues. There appears to be an excessive focus in Tanzania on the redistributive impact of local government revenues.
5. Most taxes currently assigned to the local level are hard to administer and hard to enforce. A sound revenue assignment (and well-designed local taxes) should take into account the relative ability of local governments to administer local taxes. There is clearly a mismatch between the tax structure at the local level (many low yielding taxes which offer relatively limited tax handles) and the generally weak capacity of local tax administration.[2]
6. Compliance costs for local taxes are high. Compliance costs for local government revenue sources are quite high, among others due to the fragmentation and lack of uniformity of the local tax system. Because the high compliance costs for local taxpayers have a potential negative impact on economic growth, the reduction of such compliance costs should weight heavily in the design of future reforms.

[2] Some observers consider weak local tax administration as perhaps the single-most important weakness of the current local tax system. Although weak local tax administration (and the concept of "net tax take") is certainly one of the factors contributing to the low revenue performance at the local level, the cost of local revenue administration is likely not the major cause of inefficiency in the local revenue system. Potentially a more important failure of the local revenue system is the heavy burden borne by local governments for local administration with up to 60% of local revenues spent on administrative overhead (as discussed in Section 3, and in Section 3.2 of the Final Report). This sharply reduces the value-for-money received by local taxpayers and has a major negative effect of local tax compliance.

7. Local governments are assigned the least politically acceptable revenue sources. It must also be recognized that local governments have been handed down the task of implementing and enforcing sources of revenue that tend to be particularly unpopular.
8. Cross-cutting problems with the system of local government finance. The incentives for local revenue collections are impacted by a number of cross-cutting problems with the system of local government finance, including a lack of trust by local residents, inadequate local financial management, the absence of a hard budget constraint, and the heavy burden of local administration.

On the issues of local government revenue structure, the policy stance of the Government of Tanzania has been somewhat vague. While there was a recognition that the local revenue system was substantially flawed, stakeholders within the central government lacked consensus on the way forward. On one hand, there was great concern over the impact of local taxation on economic development, spurring the Government to rationalize the local revenue system through a process of eliminating local revenue sources. On the other hand, government officials recognized the importance of local revenue autonomy, leading to hesitance to forcibly restrict revenue discretion at the local government level.

Given that both concerns are valid in the design of a local revenue system, the government's policy stance should combine the desire for a clearly structured, transparent and efficient local revenue system on one hand with the desire for local revenue autonomy on the other hand in the context of a well designed local government revenue system. Broad agreement was reached that as a guiding principle in the transformation of the system of local government finance, the deficiencies in the local structure and local tax administration should not be addressed by eliminating local taxes without consideration of their revenue impact; rather, deficient local taxes should be transformed into sound revenue instruments.

In the shorter term, the goal should be to at least recover the level of self financing that local governments had before the "rationalization and harmonization" reforms that took place in 2003 and 2004. This would mean restoring local revenue collections to about 5 percent of national revenue collections or about 15-20 percent of total local government resources. In the longer term, revenue autonomy at the local level should be high enough to allow richer (fiscally better-off) local governments to self-finance their own expenditure responsibilities. The increased fiscal disparities that will inevitably accompany higher revenue autonomy, especially between rural and urban areas, should be addressed through a system of formula-driven unconditional equalization grants.

The first step in the reform of the local tax system should be to clean and clarify the terminology and concepts currently being used (see Table 3).[3] The interest of clarifying

[3] We specifically distinguish between four types of local revenue instruments: local taxes, local levies, local fees and charges, and contributions. There may or there may not be agreement with this precise set of

these concepts lies in making the system easier to understand for taxpayers and local government officials alike, thereby contributing to greater legitimacy of the system of local government revenues. Greater clarity and greater legitimacy should also help to improve the administration of local government revenues, improve taxpayer compliance, and also in facilitate the monitoring of the performance of local tax systems.

Table 3
A consistent categorization of local government revenues in Tanzania

Category	Defining Features	Examples of local revenue sources included
I. Local Taxes	▪ Broad-based local revenue source ▪ No *quid pro quo* involved ▪ Primary function is to raise revenues	▪ Local Property Tax ▪ Unified Local Business Tax
II. Local Levies	▪ Local revenue source levied on a specific tax base ▪ Although levies may be used for regulatory purposes, primary function is to raise revenues (i.e., tax revenues should exceed cost recovery) ▪ No *quid pro quo* involved, although proof of payment may be needed to engage in specified activities	▪ Hotel / Guest house levy • Levy on motor vehicles and plying • Levy on fishing vessels • Levy on liquor establishments
III. Local Fees and Charges	▪ There is a specific *quid pro quo* ▪ Fees and charges are collected exclusively for cost recovery of the provided service	▪ User fees ▪ License fees • Market fees
IV. Contributions	▪ Payments that do not flow to the accounts of District-level LGA for the purpose of funding local government activities	▪ Village Contributions ▪ Cash or in-kind contributions to community projects ▪ Primary society contribution

As a second step in transforming the local revenue system, local revenue autonomy should be pursued within the context of a "closed list" of local taxes in order to achieve both objectives (a standardized, more efficient framework for local taxation, as well as local revenue autonomy and flexibility),. The existence of a "closed list" would ensure the overall legitimacy of the local government revenue system and would prevent onerous local taxes from re-emerging. Yet, the closed list approach would nonetheless provides local governments with the discretion to change local tax rates (within centrally established limits); the closed list approach should be defined in such a way that it provide flexibility to LGAs by allowing them to select from various different options of

definitions that are presented in Table 3; what is important is that a clear and consistent set of definitions is adopted and used in formulating the local government revenue system in Tanzania.

how to administer local taxes. As such, the reform of the local government tax system would allow for asymmetries in revenue assignments. For instance, the right to collect certain revenues might be subject to certain centrally-defined minimum conditions.

The reform should focus on the simplification of the current structure by combining several fragmented local taxes and levies into a small number of broad-based local tax instruments with a more significant revenue potential; the prime sources of local revenue would be the Unified Local Business Tax and a Local Property Tax. Compliance costs and horizontal inequities would be further reduced by the introduction of a nationally standardized framework for local revenue administration, which would assure that taxpayers across the country would face the some administrative processes and procedures, including the same local tax forms. Additional local revenues would also be collected from a number of Local Levies (local taxes with a specific tax base) as well as from User Fees. The framework for local government revenues would further be tightened by clearly defining the role of Contributions in the local government finance system, and providing additional context for village-level revenues.

In addition to the transformation of the current local revenue framework, the Government should also consider enhancing the fiscal space of local governments, which have the capability of providing considerable room for enhanced revenues and accountability at the local level. Possible new local revenue sources could include a “piggyback” Local Personal Income Tax Surcharge; the introduction of local excise taxes on utilities; or reassignment of annual Local Motor Vehicle registration fees to the local level.

Based on the objectives and desirable elements of the local revenue system, the local government financing study considered measures that could be taken to optimize the revenues from local sources. The specific recommendations are organized into, first, the reforms of the current system of local taxation (immediately below) and second, possible new revenue options.

Introduce a Unified Local Business (ULB) tax

The Local Government Finance Study (Section 4) recommends introducing a Unified Local Business Tax which would absorb (eliminate) the following current local taxes: the Service Levy, taxes on agricultural production (including the crop cess and the forest produce cess), business income taxes for minor settlements, fees on extractive production, and any other local taxes on productive activities. The ULB will also absorb (eliminate) the current Stamp Duty which is currently assigned to the central level.

The ULB tax is envisioned to be a broad-based presumptive tax on business income based on gross turnover. For smaller businesses or businesses that cannot produce turnover information the local government will assess fixed charges according to a centrally legislated schedule that will allow variations by type, size, and location of the business. These fixed charges by construction will make it a more expensive alternative for taxpayers than the general regime based on turnover. Tunisia’s local gross receipts tax

and Kenya's Single Business Permit provide examples of how the ULB might be formulated.

Given that the introduction of the ULB tax would be a major reform of the local tax system, a first step would be to pull together the various existing business taxes under a single "umbrella" tax instrument and to broaden the tax base to include all businesses and productive enterprises at the local level, including any business currently not taxed locally. Broadening the local tax base by reaching smaller businesses would improve horizontal equity in accordance with the benefit principle and would allow the rate structure to be set low by spreading the costs of local government services to all businesses that benefit from it, rather than by burdening only a narrow base of local businesses.

For enforcement purposes, the local authorities could issue an annual "*business permit*" or a "*certificate of payment*" as proof of payment of the ULB tax which businesses would be required to display on a permanent basis within their premises.

A subsequent step in the introduction of the ULB would be to harmonize the effective tax rates (and the schedular charges) applied to gross turnover across the different business activities and categories. Currently, the main tax rates range from 0.3 percent of turnover for the Service Levy and 2 percent for the Stamp Duty to 5 percent for agricultural products. However, given that the relationship between gross turnover and net income may vary across industries and sectors, it is not necessarily the case that the tax rate imposed on turnover for each type of productive activity under a presumptive local business income tax is necessarily the same. Furthermore, the ULB tax rate schedule should be harmonized with the differential rates imposed by central government taxes. Further study will be needed to determine the appropriate relative tax rates between different types of business activity in order to assure horizontal equity.

Continue strengthening the role of the local property tax

The property tax has been identified by many previous studies as one of the local taxes in Tanzania that has not lived up to its revenue potential. Numerous improvements should be made to the structure and administration of the property tax over time, across all facets of the tax, including improvements to the valuation, assessment, administration, collection, and enforcement of the property tax.

Two additional measures in the realm of property taxation are to be pursued. First, assign the Land Rent exclusively to the local government level or (perhaps more politically viable) shift revenue sharing from the current 80/20 sharing (in favor of the Ministry of Lands) to 20/80 in favor of districts. Ultimately, the Land Rent should be fully integrated into the property tax. Second, the environment should be strengthened for imposition of Betterment Levies by encouraging local councils (subject to rules and conditions set in the reformed Local Government Finance Act) to levy a special property rate to cover the costs of capital infrastructure developments with identified localized benefits for a

limited number of properties in the ratable area, such as street lighting, sidewalks, and so on.

Local levies (licenses) and User Fees and Charges

With respect to local levies (licenses) and local user fees and charges currently on the book (including the business and professional license fees not absorbed into the ULB tax), the assessment recommends generally keeping these revenue sources and realigning them in accordance with the proposed new local revenue classification. Of all the business and professional license fees currently on the books, the Government should reconsider the implications of imposing a license fee on private health facilities. Given the trend in public health provision in Tanzania to move away from user fees and given the desire to assure broad-based access to health care services, it might be appropriate to eliminate the license fee on private health facilities.

With the exception of the billboard fee (which should become a variable business license, not based on the cost recovery principle), the current administrative fees currently provided in Schedule 1 of the LGFA should be kept. The fee schedule imposed by each local government for these user fees should be guided by the principle of cost recovery for the specific activity. While this means that LGAs might set different rates for these local administrative fees and charges based on cost variations, these local fees may not exceed levels necessary for cost-recovery.

Consider the introduction of a formalized Village Contribution

During the 2003 Budget Speech, the Minister indicated that the abolished Development Levy would be replaced with a more appropriate village-level revenue instrument. However, as of yet, no formal village-level revenue sources have been introduced. Instead, village councils rely on all sorts of informal and "voluntary" village contributions (which are permitted –but not well-defined- under the current "closed list").

Box 2
A formalize Village Contributions scheme

A formalized Village Contribution scheme could have the following features:

- The administration of an annual Village Contribution would be guided by an official (yet simple) administrative manual issued by PO-RALG.
- The Village Contribution would have a simple, graduated structure. Village councils would have discretion over the rates, within the limits set by the guidelines. The contribution scheme would be optional; instituted only on the action of the Village Council.

- The collection, administration and use will be fully entrusted to the village level (VEO). As a condition to use this funding source, villages would be required to follow basic participatory procedures in determining the tax rate and keep a book of accounts. The District Treasurer would annually audit the village accounts.
- The Village Contribution could have a simple, three-tiered structure. The Village Council could set the standard charge per adult of working age in a pre-determined range (e.g., from TSh 100 to Tsh 1000 per person). In addition, the contribution would be subject to a maximum of, say, TSh 2000 per household.
- For poor households, a zero-rated tier would be introduced. Qualification for this rate would be based on a "pauper certificate" issued by VEO with public notification and Village Council approval. Those with a "pauper certificate" may be required to provide an in-kind labor contribution (based on predetermined criteria).
- The Village Council will optionally be able to impose a higher rate on wealthy household based on assessment of "conspicuous consumption". Conspicuous consumption would be assessed by the VEO based on a list of specific criteria (ownership/use of automobile or motorcycle; children attending a private school; salaried employees above certain threshold, and so forth). The higher rate for the Village Contribution would be set at twice the standard rate (subject to a per-household maximum twice higher as well).
- Certificates (or tokens that could be affixed to residences) could be provided to households to signify compliance. While village tax collectors would have discretion to administer the tax in a flexible manner, the enforcement of the tax would be community-based.

In addition to the reform or elimination of current local taxes, there are also a number of significant and efficient taxes, fees and charges that could serve as potential sound local revenue sources that are currently not being used at the local government level. Our suggestions include the following possible local revenue sources, which adhere to the principles associated with sound local revenue sources:

- ***Local Personal Income Tax Surcharge.*** A possible appropriate new local revenue source is the introduction of a local surcharge (or piggyback tax) on the central government's personal income tax. Such a surcharge would be collected by TRA and would be credited regularly (e.g., monthly) to the respective local government accounts, desirably on a residence basis (as opposed to the place of work). The local surcharge income tax could be levied on the exact tax base of the central government personal income tax, although local governments would have discretion to set a flat (proportional) rate within nationally defined minimum and maximum rates.

- ***Local excise tax on utilities.*** The Government could consider the introduction of a Local Excise Tax on Electricity Consumption (and/or other utility services). Such an excise tax would conform to both the benefit principle as well as the ability-to-pay principle. The taxes could be collected by the utility companies at rates set by the local governments from a range with maximum and minimum rates determined by central government regulations or legislation.

- ***Motor Vehicle Registration***. We recommend reassigning the Annual Permit

associated with the motor vehicle registration that is currently collected by the TRA district offices to the local government level.

- ***Revenue sharing from extractive industries.*** For consideration in the medium to long run, the Government should explore some degree of revenue sharing of taxes on extractive industries with local governments. Further discussion and analysis would be needed to determine whether this option is administratively feasible and desirable.

As noted above, in order to promote a legitimate local government revenue system, provide a stable local business environment, and minimize the compliance burden faced by taxpayers from local government taxes, the administrative of local revenues should be guided by detailed set of nationally standardized local revenue administration guidelines. For each local tax, these guidelines should provide a clear definition of the taxpayer and the tax base; the valuation of the tax base; the administrative procedures in collecting the revenue (including the tax forms to be used); as well as any enforcement and appeals procedures. Standardization of local tax administration will also enable central government officials to more systematically monitor the collection of local government revenues and to assist in building local government tax administration capacity. Significant capacity will have to be built at the central government level to guide local government taxation, while the rolling out of the new local revenue system should incorporate extensive capacity building support for local revenue administration officials.

Given that one of the most noted reasons for low levels of local revenue compliance is the absence of a link between local revenues and local expenditures, other steps to be taken to encourage greater local revenue performance including, first, an increase in the participatory nature of the local budget process and greater transparency in how local resources are spent, and second, the introduction of a general-purpose grant to cover local administration expenditures (enabling LGAs to provide better value-for-money for local services). Rolling out of the new regulatory framework for local government revenues should be accompanied by an intensive series of seminars and capacity building workshops for local government officials. The transformation process should involve every LGA going through a process of identifying gaps between their current local revenue structure and the new permitted list of local revenues, as well as any gaps between their local revenue administration practices and the regulatory guidance contained in the nationally standardized regulatory framework for local revenues. Local governments should then be provided sufficient time (and possibly limited external support) to develop and implement reforms to come into compliance with the new local government revenue system.

A concerted effort will be needed to ensure the transformation of local government revenues into a sound local revenue system. The FDTF, in close collaboration with the TRTF, should instigate a participatory process that includes central government stakeholders, local government representatives, as well as private sector stakeholders and civil society to determine the final structure of the new local government revenue system. After a consensus reform package is attained, LGRP should draft the necessary revisions

to the LGFA, develop standardized local tax regulations and a local tax administration manual, and roll out the reforms to the local government level. Technical assistance will be needed to not only develop the policy framework (including legislative changes and the drafting and the regulatory and administrative manuals) but also to orchestrate and support the rolling-out of the reforms to the local level.

5. The intergovernmental fiscal transfer system

In addition to own revenue sources, the intergovernmental transfer system plays a central role in the framework for local government finance in Tanzania. The transfer mechanism has provided –and should continue to provide- a large majority of local government resources. The intergovernmental transfer system should be structured to provide four different types of intergovernmental transfers, notably:

1. A set of recurrent sectoral block grants for priotiy sectors, including primary education; local health services; agriculture extension and livestock; water supply; and local roads.
2. A General-Purpose Grant (combining the current administration grant and the existing Compensation Grant/GPG).
3. A Local Government Capital Development Grant system
4. Where appropriate, ministerial subventions should be provided in a transparent manner for delegated functions

The system of intergovernmental fiscal transfers should be consistent with the vision laid out in the Government's Policy Paper on Local Government Reform (MRALG, 1998), as well as with the principles of sound transfer design formulated by GSU (2003) (see Box 3). Most importantly, all transfers provided to the local government level should be allocated in an objective, formula-based, transparent and fair manner.

Box 3
Principles in the Design of a Formula-Based Allocation Mechanism

Universal principles of sound transfer design

- Provide revenue adequacy: A transfer formula should provide a source of adequate resources to local governments to achieve its policy objectives.
- Preserving budget autonomy: A transfer system should balance budget autonomy at the local level with the constraints provided by national priorities
- Enhancing equity and fairness: The transfer mechanism should support a fair allocation of resources.
- Stability: Transfers should be provided in a predictable manner in a dynamic sense.
- Simplicity and transparency: Transfer formulas should be simple and transparent, and should pursue one objective at a time.
- Incentive compatibility: The transfer system should not create negative incentives for local

revenue mobilization, and should not induce inefficient expenditure choices.

- Focus on service delivery: Transfer formulas should focus on the demand (clients or outputs) rather than the supply (inputs and infrastructure) of local government services.
- Avoid equal shares: Reliance on the "equal shares" principle as a major allocation factor should be avoided in the design of an allocation formula.
- Avoid sudden large changes: The transfer system should avoid sudden large changes in funding for local governments during the introduction of the new transfer mechanism.

Desirable characteristics of allocation factors

- Accuracy: The variable should accurately reflect the specific characteristics and should be statistically sound.
- Regularly updated: The variable should be regularly updated in the future.
- Independent source: The variable should come from an independent source respected by all stakeholders
- Free of local manipulation: The variable should be drawn from a source that cannot be manipulated by local governments (unless the central government has an adequate capacity to monitor and verify locally reported statistics).
- Reflect needs or demands: The variable should reflect needs or demands for public goods (for example, the number of clients) rather than outputs such as infrastructure.

Source: Intergovernmental Transfer Study (GSU, 2003).

Formula-based recurrent sectoral block grants.
The most important funding modality in Tanzania's system of local government finance in terms of financing local government activities is the system of recurrent sector block grants. Five sectoral block grants should be present: one for each of the five priority sectors that deliver services at the local government level, notably primary education; local health services; agriculture extension and livestock; water supply; and local roads. The purpose of each sectoral block grant mechanism is to fully finance the provision and maintenance of essential sectoral activities at the local government level. Each sectoral block grant provides funding both for PE and OC.

Size of the transfer pools. Over the past years, the central government has consistently allocated 17-18% of the central government's recurrent budget to local government activities in the priority sectors. As sectoral block grants exclusively fund pro-poor government activities at the local government level (which is both true under the sectoral approach of PRS I, as well as under the cluster approach of PRS II), we would expect for the total pool of sectoral block grants to increase faster than the entire central government budget. Also, as sectoral pooled funds (such as PEDP and the Common Health Basket Fund) are increasingly integrated into the regular sectoral block grant system, we should expect the overall percentage of recurrent transfers in the central government budget to increase to 20-25 percent in the medium term.

As the local government sector is currently expanding, it would be limiting to specify the size of transfer pool based on a fixed rule. Instead, for the time being, the size of each sectoral transfer fund could be determined on an annual basis as part of the budget process in the context of the Government's strategic policy objectives, as reflected in the MTEF, PER and NSGPR (see Box 4).

Box 4
Determining government priorities and establishing the size of transfer pools

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

Under the new poverty reduction strategy (PRS II or NSGRP), sector ministries are supposed to prepare their budget requests in the context of a poverty-focused, clustered "performance-based" budget analysis, by which the increased budget request is supposed to be tied to expected increases in public service outputs and, ultimately, NSGRP outcomes. Customized software was introduced by the Ministry of Finance as part of the FY 2005/06 Budget Frame to guide sector ministries in prioritizing their spending programs.

Unfortunately, the sectoral block grants were considered in the Budget Frame outside the context of other sectoral allocations, thereby creating a disconnect between sectoral spending and goals at the central government level, and sectoral activities at the subnational level. As such, the budget formulation and its implementation should be fine-tuned, which will enable the size of the sectoral grant pools (i.e., the vertical allocation) to be determined as part of the broader budget frame.

Horizontal allocation of resources. Once the size of the sectoral block grant pools are determined, sectoral allocation formulas are applied to these transfer pools in order to distribute these resources among all local government jurisdictions (see Table 4). In order to assure stability in the system of local government finance, these formulas should be held constant for a period of three years after which their impact should be re-assessed. The Fiscal Analysis & Coordination Group should monitor that these sectoral formulas are accurately applied in distributing sectoral block grant resources to the local government level.

During the first few years of the formula-based grant system in 2004, phasing-in and holding-harmless provisions were put in place to assure no major deviations from historical allocations would take place that would derail the reforms. This means that

during the first few years of the new formula-based grant scheme, local governments may be receiving a block grant allocation that is either more or less than the particular amount determined by the formula.[4] However, these mechanisms were put in place as transitional features only. As a result, the Government should take proactive steps to achieve convergence between the existing allocation levels and formula-based allocations with the goal of eliminating these transitional mechanisms by FY 2007/08; it should be the intention of the government that by this year, all LGAs receive their formula-based amount. Particularly in the agriculture and livestock sector, as well as in water supply and local roads, significant sectoral adjustments will need to occur to achieve convergence of local sectoral resources in accordance with the formula-based sectoral block grant system.

Table 4
Sectoral Allocation Formulas

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

Use of transfers at the local government level. The local government budget guidelines issued to LGAs provide policy guidance and conditionalities with respect to the manner in which these resources can be used at the local government level. These guidelines are intended to provide policy direction to local governments in making local spending decisions. The guidelines are intended to do so in an objective and verifiable manner, that does not unnecessarily restrict the autonomy of LGAs to respond to local community needs. The local budget guidelines should be prepared annually by PO-RALG in close collaboration with the Ministry of Finance; the guidelines should be reviewed each year by the Fiscal Analysis & Coordination Group.

[4] See LGRP/GSU. 2005. The implementation of the formula-based grant system in Tanzania: Convergence of phasing-in and holding harmless provisions. Technical Note 2005-2.

Box 5
Inclusion of intergovernmental transfers in the central governments budget processes

As the initial introduction of sectoral block grants is taking place, a number of subsidiary challenges is arising with regard to the inclusion of intergovernmental transfers in the central governments budget processes. In order for the system of local government finance to work, the transfer system has to be well-integrated into the central government's budget formulation and execution processes.

- As already noted in Box 4, intergovernmental transfers have to be integrated into the central budget formulation process. For instance, sectoral block grants should be identified as separate items in the MTEF. The Local Government Fiscal Review could be absorbed into the annual PER/PRS processes.
- The current budget structure for intergovernmental transfers (organized around 21 regional votes) was appropriate in a centralized, deconcentrated public sector, but may not be appropriate for a more decentralized, formula-based system of local government finance. Different approaches to inclusion of sectoral block grants in central government budget should be considered.
- The current level of detail with which local government spending from transfers is included in the central governments budget document is excessive and impractical. The manner in which intergovernmental transfers are documented by the central budget process needs to be reconsidered. This may have an impact on the budget classifications and budget approach that local governments are supposed to follow (MTEF, PRS clusters, etc.)
- The current budget process allows for a lapse in budget control at the central government level to the extent that local governments are able to increase their personnel emoluments beyond the resources available to them through the formula.
- Efforts need to be made to monitor that intergovernmental transfers are indeed disbursed as planned. Likewise, a financial reconciliation needs to take place at the end of the year.

These steps will be critical is assuring the efficient and transparent allocation of intergovernmental fiscal transfers, as well as for consolidating the progress made thus far in the reform of the intergovernmental fiscal transfer system.

An unconditional, equalizing General-Purpose Grant

The objective of the General-Purpose Grant (GPG) is to provide unconditional financial resources to local government authorities in order to assure that the local government level is provided with adequate resources (vertical fiscal balance). The General Purpose Grant should be disbursed in an equalizing manner, so that LGAs with higher local expenditure needs (outside the priority sectors) and lower fiscal capacity receive a greater transfer.[5]

Size of the transfer pool. Given the coverage of the other transfer schemes and spending from own source revenues, the General Purpose Grant should be adequate to cover, first,

[5] In this sense, the envisioned GPG is distinctly different from the current GPG/Compensation Grant, which was renamed the GPG in 2004 but which has an incidence which is decidedly not pro-poor.

the cost of local government administration, and second, part of the cost of non-priority local government activities. It was earlier noted that it is appropriate to fund local administration from central government resources since local governments are an integral part of Tanzania's national system of public administration, and since the predominant responsibility of local government authorities is to provide nationally-mandated public services.

Based on current spending patterns for local government administration, the size of the GPG transfer pool should be at least TSh 50 billion, as the overall cost of administering local governments lies approximately around this amount (the figure of TSh 50 billion is based on roughly TSh 20 billion which is currently provided by the Local Administration Grant and approximately TSh 30 billion -about 50% of Tsh 60 billion- of local own source revenues that are currently spent on administration). To the extent that the GPG is also provided as a supplement to own source revenues for funding non-priority local government spending, the GPG should exceed this minimum threshold. In the budget frame for FY 2005/06, a combined TSh 60 billion is set aside for administration and the general purpose grant. A possible vertical sharing rule for the GPG could be determined as 15% of total sectoral block grant allocations.

Horizontal allocation of resources. Given that the purpose of the general-purpose grant mechanism is to provide resources for local administration and general (non-sectoral) local purposes in an equalizing manner, it would be important to include measures of local needs and local fiscal capacity, and to provide greater resources to local governments that have greater expenditure needs and a more limited ability to raise own revenues. However, as suggested by the previous studies, the data to adequately measure local fiscal capacity in Tanzania are currently lacking.[6] As a feasible and more practical alternative, the allocation formula for the General Purpose Grant could be built around a number of fiscal needs measures, such as population, land area, and the poverty incidence, with the knowledge that fiscal capacity in Tanzania is inversely related to land area and poverty.

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

Use of transfers at the local government level. Although the General-Purpose Grant is intended to be basically an unconditional grant, some restrictions on the use of this

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

funding have already emerged. For instance, the administration grant is currently specifically earmarked for administrative purposes while it also includes an earmarked component for funding firefighting equipment. Likewise, when the Compensation Grant was introduced, the guiding circular instructed local governments that these resources should be allocated in the same manner as the eliminated own revenues, but then proceeded to mandate that a certain share of the grant (currently 50%) should be shared with the Village-Level. Any specific conditions on the General-Purpose Grant should be removed, so that the general-purpose grant takes on the nature of a true unconditional grant. Any general conditions on sound local government administration (such as the resource-sharing between district and village level) should be introduced as part of the overall Local Government Financial Management Manual, and should apply broadly across all general-purposes resources at the disposal of local governments (i.e., both unconditional grant as well as own source revenues).

Capital development grants

In principle, the Local Government Capital Development Grant scheme which was developed with support from the World Bank's Local Government Support Project (LGSP) and rolled out in April 2005 provides a sound and well-integrated element of the overall strategic framework for local government finance.

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

Horizontal allocation. It has been decided that the following formula and weighted elements will be used in distributing the CDG capital grant funds: population (70%); poverty indicator (20%); and land Area (10%).

The allocation formula adopted by the CDG is fully consistent with the sound principle of transfer design as laid out by the intergovernmental transfer study (GSU, 2003). The formula allocates greater resources to poorer local government authorities, as well as to geographically larger local government districts (in other words, rural district authorities). This is consistent with a needs-based equalization approach. As the CDG system evolves over time, the allocation formula should be reviewed from time to time to assure that the formula achieves the policy objectives that it is intended to secure.

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

according to their own priorities for improvement of their performance and enhancement of their capacities.

While the CDG is an important step in the process of arriving at a unified capital development funding mechanism, the current design of the CDG simply lumps together capital development spending for the key priority sectors (e.g., building classrooms, clinics, and so on), and capital projects that are truly local in nature (e.g., minor roads, local markets, other local infrastructure, and so on). The next step for the CDG system should be to widen the CDG system by incorporating potential sectoral "windows" for formula-based sectoral capital development transfers under the same overall mechanism. In that case, all capital development funding schemes -including sectoral capital development grants- could be planned and budgeted as part of the comprehensive local budget process, and could flow through the same budgetary mechanisms and accounts at the local level.

Ministerial subventions and private donations

To the extent that intergovernmental transfers are intended to fund devolved delivery of services (such as the case in primary education, basic health care and so on), intergovernmental fiscal transfers should all be provided through (and not around) the sectoral block grant mechanism. Likewise, the donor community should avoid creating parallel financing structures (either within the context of the central government budget, or completely around the public budget) that by-pass both central government and/or local government budgets.

The funding of functional responsibilities which are delegated by central government ministries to the local government level (as opposed to "devolved" to the local government level) may be appropriately achieved by earmarking transfers within ministerial budgets, as long as these resources are clearly identified, the allocation between jurisdictions is done in an objective, fair and transparent manner, and the Ministry of Finance (BD/RALG Section) and PO-RALG (through the LG FA&CG) are advised of the distribution. The annual budget will have to note the purpose for which these resources are earmarked, and confirm that this activity is indeed not a devolved function.

7. Local government borrowing

There is a need to cast a wider role for local government borrowing in Tanzania than is currently the case. The Local Government Loans Board views its own role in a very narrow manner; its current mode of operations gives the Board substantial discretion in selecting local projects to be funded, and is viewed by many to favor poorer, rural districts in its funding decisions. While the current borrowing mechanism for small-scale local capital investment under the LGLB might continue to form an element of the local

borrowing framework, a single lending window will not adequately accommodate the borrowing needs of all local government authorities in Tanzania.

As such, a separate on-lending window ought to be established with the purpose of providing loans to wealthier local governments. In order to prevent administrative duplication, if administratively feasible, it would be desirable to have the LGLB's Secretariat administer this new loan window. However, this may require a further re-orientation and strengthening of the LGLB, and will need close cooperation and concurrence from the Ministry of Finance. There should be access criteria (based largely on the minimum access conditions for the CDG scheme), and limitations on borrowing levels to ensure that only creditworthy LGAs are able to access the lending mechanism. Great care needs to be taken to assure that the local government borrowing framework operates as an integrated part of the larger local government financing system, rather than "competing" with other financing mechanisms for financial and human resources.

8. Institutional framework for local government finances

Decentralized fiscal systems are unlikely to function efficiently without an appropriate degree of oversight, monitoring and coordination among the different levels of government. Coordination is needed in the various aspects of intergovernmental relations: coordination between the central government and local governments (so-called vertical coordination) on the execution of local government responsibilities; coordination between central government tax system and the local tax system (involving the Ministry of Finance, the Tanzania Revenue Authority and PO-RALG); coordination between PO-RALG, Finance, and the various line ministries regarding the structure of the system of intergovernmental transfers, coordination in the development of the framework for local government borrowing. Coordination between central government agencies on intergovernmental fiscal issues can be referred to as "horizontal" coordination.

Although significant progress has been made in strengthening the institutional framework on local government finances (particularly through the Coordinating Block Grant Implementation Team, CBGIT), the institutional context is becoming increasingly important in order to consolidate the progress in local government finance reform made over the past several years. Specific observations and recommendations include:

- There is a need to continue to strengthen the management of local government finances at the central government level, including strengthening the ability of both the Ministry of Finance and PO-RALG to fulfill their respective responsibilities in the realm of local government finance. For PO-RALG, this will require building stronger capacity in the new LGA Finance Unit (including in the area of local government revenues). The Ministry of Finance could significantly benefit from attracting a Local Government Finance Expert who could assist the Ministry in refocusing its fiscal processes surrounding local governments across the Budget Department and Policy Analysis Department.

- At a technical level, there is a need to continue strengthening inter-ministerial cooperation, in particular through the formalization of the CBGIT into a permanent inter-ministerial Fiscal Analysis and Coordination Group.
- As PO-RALG is moving to introduce a Directorate of Sector Coordination, it is becoming increasingly clear that sector ministries are not well-structured to deal with local governments. Whereas previously in the centralized system local sectoral offices were simply a deconcentrated extension of the line ministries (so that all line ministry directors were free to interact with local sectoral officers), now a sectoral Director or Coordinator for Local Government Services would better facilitate coordination and communication between central and local government levels.
- Whereas the Fiscal Analysis and Coordination Group provides a coordinating mechanism at a technical level, there is a need for a more formal coordinating mechanism at a policy level. Rather than creating additional parallel structures such as a Local Government Finance Commission, it is recommended that PO-RALG convenes an annual Local Government Fiscal Consultative Forum (possibly in October of each year). The annual Local Government Fiscal Review can be presented at this time to help identify the government's priorities pertaining to local government finance issues early on in the budget process.
- In order to make the benefits from decentralization sustainable, there is a need to significantly improve communication with the private sector and civil society, as well as strengthen the role of local governments (individually and through their associations) as well as NGOs and civil society in the debate surrounding local government finance.

9. Areas of reform / Next Steps

It was noted earlier in this document that although the current system of local government finance has a number of shortcomings, the overarching structure of the current system of local government finance is quite sound. The historical policy direction of the Government on local government finance has been prudent and is consistent with overall sound principles for decentralization reforms. In general, the legislative framework provides appropriate guidance, although the relevant laws should be revised to eliminate outdated, duplicative or contradictory clauses. Although the local government revenue system has not received adequate attention in recent years, substantial progress has been made on transforming the previously highly discretionary transfer system into an objective, transparent, stable and pro-poor funding mechanism for local governments.

While in most respects the overall structure is sound, specific steps need to be taken to transform the components of the current local government finance system that need sharpening and fine-tuning in order to arrive at a comprehensive local government financing framework that is well-integrated and internally consistent.

Broadly, three concrete areas of reform can be identified that need to be pursued in order to achieve the desired strategic framework for local government finance. As detailed in

Table 5, these three areas include, first, continued policy support and institutional strengthening at the central government level; second, the transformation of the local government revenue system (including local tax administration); and third, improvements of the financial management processes at the local level and strengthening of the role of LGAs and civil society in the decentralization process.

Table 5
Proposed next steps for the implementation of the strategic framework for local government finance

Reform Component	Activities to be undertaken
I. Continue policy support and institutional strengthening at the central government level	▪ Finalize the introduction of a formula-based transfer system (include equalizing GPG) ▪ Assure the proper integration of transfers in the national budget process ▪ Formalize and strengthen the LG FA&CG, and continue strengthening PO-RALG, MOF, and other stakeholders ▪ Review and revise the legal framework on expenditure assignments, transfers and other fiscal issues ▪ Develop and introduce a Supplementary Loans Mechanism (through LGLB)
II. Transformation of local government revenues and local tax administration	▪ Determine the final composition of the local government revenue structure and an implementation plan ▪ Develop a comprehensive, standardized local revenue administration manual ▪ Implement the new local government revenue structure and build the capacity of local governments to administer the new revenue sources
III. Improvements of financial management at the local level and strengthening of the decentralization process outside the central government	▪ Systemic review and reform of LG budgeting process and financial management procedures, including monitoring and reporting mechanisms ▪ Develop the institutional framework for supporting local government finance outside central government (e.g., support to ALAT, the development of an Institute of Local Government Studies for Local Government Finance Officers Association)

Achieving the strategic framework for local government finance envisioned in this document is an achievable objective. Most importantly, achieving this policy vision will first require consensus among all involved central government agencies –and ultimately Cabinet. Once such consensus has been achieved, coordination within and between the various stakeholders (including PO-RALG, the Ministry of Finance, PO-PSM, as well as other agencies) is needed to assure that the different components of the local government finance system fits together in an integrated manner. Whereas the Fiscal Decentralization Task Force is well-positioned to oversee the overall implementation of the various reform efforts, close coordination is needed with a variety of other reform programs, including the Tax Reform Task Force (with regard to the transformation of the local government revenue system); Public Service Reform (with regard to the coordination between budget planning processes and the planning and implementation of the PE budget); and the Public Finance Management Reform Program (with respect to the integration of local government finances into the national budget formulation, execution and reporting processes).