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

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

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

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

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

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

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

4.1 Sound principles of revenue assignment

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

4.1.1 Objectives of revenue decentralization/ local taxation

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

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

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

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

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

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

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

4.1.2 Characteristics of a good revenue source

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

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

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

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

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

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

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

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

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

4.1.3 Principles of a good revenue assignment to the local level

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 4.1
Appropriate funding mechanisms for local government expenditures

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

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

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

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

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

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

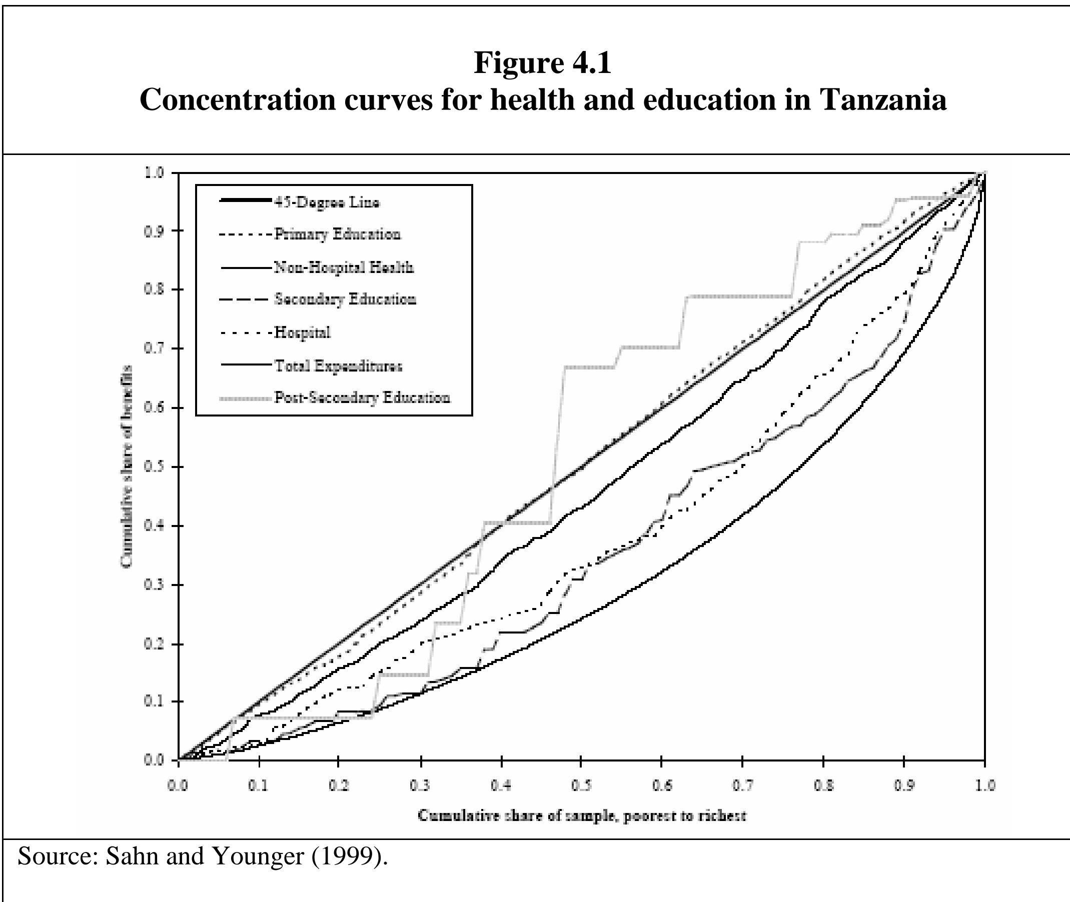
Although it falls beyond the scope of the current study, it is useful to consider the incidence of public services delivered at the local government level. Based on a recent study conducted by Sahn and Younger (1999), Figure 4.1 shows the concentration curves for benefits from public education and health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

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

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

Table 4.2 **State and Local Taxes Plus Federal Income Tax for Washington State as a Percentage of Household Income**					
	$25,000 HH Income	**$50,000 HH Income**	**$75,000 HH Income**	**$100,000 HH Income**	**$150,000 HH Income**
State and Local Taxes	8.5%	6.3%	6.3%	6.0%	5.8%
State, Local and Federal	12.3%	15.5%	17.8%	20.5%	23.3%
Source: Prepared for the Washington State Tax Structure Study Committee by the Department of Revenue (September 13, 2002)					

Figure 4.1
Concentration curves for health and education in Tanzania



Source: Sahn and Younger (1999).

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

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

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

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

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

4.2 Assessment of the current local government revenue system in Tanzania

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

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

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

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

4.2.1 General shortcomings of the local government revenues system

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

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

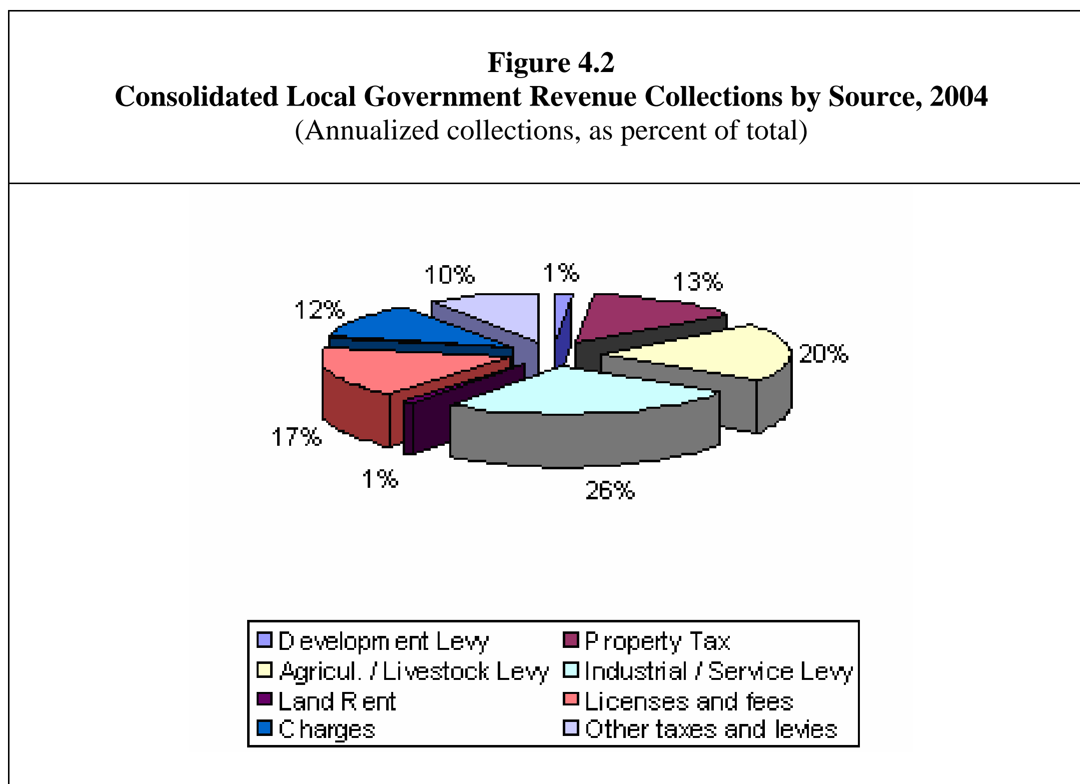
[6] From 2001 this was levied at TSH 3,000 per head. Before 2001, the Development Levy had some graduation in it. Everyone was subject to a minimum of TSH 3,000, but employees had to pay a levy between TSh 3,000 and TSh 8,000 according to their skills and employers were subject to a surcharge of 30 percent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

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

eliminated (see LGFR 2004; Chapter 3).

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1. 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 so much harder for local governments to have any substantial revenue source of their own. Unfortunately, Tanzania is not an exception in the international experience in this sense. However, critics of local revenue performance should duly take into account the quality and nature of revenue instruments assigned to the local government level.

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

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

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

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

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

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

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

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

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

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

efficiency of the public sector.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A more worrisome picture is revealed when we look at the share of local government budgets covered by own source revenues. Whereas the average share of local expenditures covered by own sources was approximately 20 percent in 2002, this figure is likely to fall below 10 percent during the current fiscal year (2004/05). In fact, for many poorer, rural districts, the share of own source revenues is in fact much lower, often-times approaching zero. As such, the sharp reduction in own budget resources spells potential trouble for the ability of local government revenue instruments to assure a minimum degree of revenue autonomy and to function as an accountability mechanism. Even if local authorities had control over the tax rates of all local revenue sources, they would only be able to affect a 10% deviation in local spending. We certainly would not want this ratio to fall any further. In contrast, local government budget autonomy could be enhanced by increasing the prominence of local revenues as a share of the local budget without posing an imminent risk of resulting in excessive revenue decentralization.

In the short-to- medium run, a contribution by local revenues to the local budget of 10-20% (i.e., the situation in 2002) might be a desirable target to aim for. However, the upper range of this target is unlikely to be achieved in the short term. With an estimated recurrent sectoral grant pool of TSh 474 billion for FY 2005/06, a 20% budget share would imply the need for local authorities to collect approximately TSh 100 billion in own source revenues compared to TSh 36 billion of the annualized total for the year 2004. As such, a more realistic (albeit still ambitious) revenue target for the short term would be to assure a minimum 10% aggregate contribution (TSh 53 billion) to the local budget from own local revenues. How such an increase (or actually, rebound) in local government revenues could be achieved through a stronger revenue assignment and better local tax administration practices is discussed in greater detail further in this section.

4.2.2. Local tax administration and efficiency of the local government revenue system

Two of the most prominent arguments that have led to the rationalization and elimination of local government revenues in Tanzania are, first, that local government taxes cause inefficiencies and are an obstacle to local economic growth, and second, that local government revenue administration is sufficiently inefficient to result in a suboptimal allocation of public resources at the local level. Proponents of these arguments largely base their case on conceptual arguments and anecdotal evidence; unfortunately, little hard evidence is available about the efficiency or inefficiency of the local tax system as a whole, or the (in)efficiency of local tax administration in particular. Although we concur that revenue assignments and local tax administration are quite likely the weakest dimension in the intergovernmental fiscal system in Tanzania, we do not believe it

prudent to accept the inefficiency arguments at face value.

There is a broadly shared assumption that local tax administration in Tanzania is consistently poor, and the study team certainly proposes that strengthening of the local capacity to administer taxes and revenues should be a central theme of future local tax reforms. However, it may be a mistake to singularly focus on local tax administration as the culprit for the dysfunction of local government reveneues.

Much of the evidence to support the contention is based on taxpayer surveys. For instance, 45.7 percent of survey participants agree that dishonest collectors form a major problem in tax collection, whereas harassment by tax collectors is considered a major problem by 38.2 percent (see REPOA, 1994; Fjeldstad, 2004). However, caution is needed in interpreting these studies, since survey results are notoriously sensitive to the exact formulation of questions. In fact, it can be hard to distinguish based on survey results to what extent we are measuring actual problems in local tax collection, or whether we are merely measuring the perceived problems.[14] In fact, opinions regard local tax administration may also simply be biased by a strong preference not to pay local taxes.

One potential indication that perception and negative bias may play an important role in the survey evidence is given by variations in perceptions across LGAS. While many councils in Tanzania have introduced new methods to increase revenues from existing sources by outsourcing some of the revenue collection to private collectors to increase revenues from existing sources, all own revenues in Iringa DC are collected by the council staff (REPOA, 2004). If outsourcing of tax collections were to improve the efficiency of collection, we would expect Iringa residents to have greater concerns about tax administration than elsewhere; in fact, survey results suggest that Iringa DC has the most honest tax collectors and have the least problems with harassment. Thus, even where local tax collection is outsourced, there is a negative attitude towards local taxes.

Another argument offered in support of the inefficiency of local tax administration is the relatively low degree of local revenue performance, measured as actual tax collections as a share of "potential" tax collections. However, as discussed in Annex 4.1, there might be a number of good reasons why local governments prefer not to maximize local revenue collections, especially considering the onerous nature of many of the tax sources assigned to the local level. As such, low revenue yield or poor revenue performance should not a priori be assumed to indicate poor local tax administration.

A point of concern raised by many stakeholders is the low "net tax take" at the local government level, which is defined as the share of revenue collections that remains available for spending on public services after subtracting the cost of tax administration. We should recognize that an inherent inefficiency of the public sector is that due the cost of revenue collection, outlays on public services will always be less than 100% of

[14] For instance, it appears that Fjeldstad (2004) asked respondents "What are major reasons why people pay taxes?" rather than "What are major reasons why YOU pay [(or do not pay) taxes?"

revenue collections due to the cost of collecting revenues. In an efficient local tax system, collection costs represent only 1-2 percent of total collections, meaning that 98-99% of public resources is available for the delivery of services. Unfortunately, to our knowledge, there is no empirical study available that attempts to quantify the net tax take of local governments (or the central governments) in Tanzania. While it is likely that the net tax take is substantially higher at the central government level, a valid question that yet remains to be answered is whether the cost of local taxation is indeed so prohibitive that it would cause serious suboptimal public finances.

While it is certain that efficiency gains can be made in the cost of local tax administration, we do not believe that local tax administration *per se* is the most significant source of inefficiency or perverse incentives in the local government finance system. In our view, a much more significant problem is the fact that a huge proportion of local revenue collections is actually used for local administration rather than the delivery of local services: sample evidence suggest that anywhere from 40% to upwards of 60% of local revenue collections are spent on local administration costs (Kobb 2001; REPOA 2004). As such, we can quantify that out of every TSh 100 paid by local taxpayers, 40-60 shillings is basically diverted to general local administrative overhead and therefore simply not available for funding of direct local government services. In Section 3 of this report we conclude that this is a fundamental shortcoming in the assignment of expenditure responsibilities.

A final potential source for inefficiency arising from local tax administration is in the compliance cost (including both time and actual outlays) needed to comply with local tax regulations in order to do business in a locality. Again, although compliance costs and bureaucratic hurdles are surely an obstacle for local economic growth, the actual efficiency impact of compliance costs is hard to quantify. Furthermore, if we were to argue that the high compliance cost for local taxes is a reason to centralize revenue collections, we would also have to show that the compliance costs at the central government are substantially lower.

4.2.3 Shortcomings of specific revenue instrument assigned to the local government level

The place to start for a detailed evaluation and reform of the local tax system is with a critical examination of the strengths and weaknesses of the taxes currently being used at the local level.[15] Instead of listing each one of the current local taxes separately we believe it is helpful to group them in several general categories, which among other things may point the way toward some possible consolidation and simplification of local taxes. These general categories are: taxes on personal income and business activity (including the Service Levy and agricultural taxes); property taxes; other local taxes and levies; non-tax revenues; and contributions and voluntary contributions.

[15] Recall that a quantitative analysis of local revenues is contained in Section 2 of this report.

Local taxes on personal income and business activity

There are a number of reasons why local taxes on the income of households and businesses are sound local revenue instruments. First, the direct nature of local income taxes provides a strong link between the tax instrument and how the money is spent at the local level: direct taxes tend to be more visible and therefore provide the strongest incentives for local participation and local accountability mechanisms.[16] Second, local income taxes have the potential for being somewhat adjusted in accordance with the ability-to-pay principle.[17] Third, local income taxes (both on households and firms) can be interpreted to some extent as benefit taxes in the sense that wealthier taxpayers typically benefit more from the public services provided by the local government level. Fourth, to the extent that taxpayers are nationally registered and the tax base is already nationally defined or clear (for instance, for households paying personal income tax at the central government level; or businesses paying VAT), local income taxes should be relatively easy to administer (possibly even as a piggy-back tax by the central tax administration authorities).

Development Levy (abolished). As we discuss later in the review of central government revenues (Section 4.4), the part of the national "fiscal space" that covers the taxation of incomes of households and smaller firms is a sound realm for local government taxation. However, with the abolition of the Development Levy and the virtual abolition of business license fees, LGAs essentially do not have currently any direct taxing instruments.

Local income tax for minor settlements. The only local income tax which currently still appears on the books is the local income tax for minor settlements, which is currently collected by the TRA (Section 9(a) of the Local Government Finance Act). This provision involves the taxation (at a fixed amount) of a number of small productive activities (such as retail, milling, butcheries, and so on) "within the boundaries of villages and non major trading centers." It is unclear to the study team whether this provision has survived the reforms of the LGFA and the Income Tax Act (2004), or whether the collection of these revenues has already been ceased at this time. Either way, this provision contributes to the unnecessary fragmentation of the local tax structure; this business tax on these selected activities could easily be integrated in a more comprehensive local business tax (as discussed further in Section 4.3).

Service Levy. The Service Levy is an important revenue source for local governments in Tanzania, particularly for urban local governments. The rate of the Service Levy is set by

[16] The phrase "no representation without taxation" would be appropriate here. A clear example of this concept is the loss of voice and legitimacy that was experienced by many taxpayers (particularly from marginalized groups) after the abolition of the Development Levy.

[17] This is particularly true for a local (graduated) income tax on households. However, it should be noted again –as suggested in Section 4.1- that the redistribution role of the public sector should be assigned to the national level, making it a secondary concern in the system of local government taxation. The issue of progressivity should be considered from the perspective of the entire tax system (central and local) and more correctly, from the perspective of overall fiscal incidence, combining the overall incidence of taxes with the overall (benefit) incidence of public expenditures.

central government directive and currently it equals 0.3 percent of the turnover of producers with turnover in excess of TSh 20 million.

A turnover tax is a type of a consumption or sales tax, which is imposed on the total turnover or sales of a company. However, the turnover tax has often been criticized as a poor (local) tax instrument. For instance, by definition a tax on consumption must be applied only to sales to households and should not be applied to sales to business, including sales of capital goods. Moreover, to comply with the benefit principles, local consumption taxes should be destination-based: that is, they should be paid to the jurisdiction where consumption takes place as opposed to the jurisdiction of production. The Service Levy is typically collected by the jurisdiction of production, although the lack of uniformity in Tanzania's framework means that a business that produces its product in one jurisdiction and sells it in another is potentially subject to taxation by both local governments.

By comparison to the VAT or a retail sales tax, a turnover tax applies to all sales, including those to business. This is because the turnover tax does not have the mechanism of removing taxes on business transactions through invoice-crediting (as with the VAT) or the use of suspension certificates (as with the RST). Taxing each transaction could potentially result in "cascading", with taxes compounding at each stage of production. Turnover taxes are notorious for their distortions of economic decisions and tax experts and international organizations, such as the IMF, frown upon their use. However, the ultimate degree of distortion depends on a number of factors, including the tax rate and the levels of production at which the tax is applied.

On one hand, the Service Levy provides an attractive revenue source for local governments with a high yield. A very attractive feature of the Service Levy is that its collection can be coordinated with the collection of the VAT by the TRA. This means that local governments can readily identify the taxpayers, as well as the turnover subject to the Service Levy. Such coordination is not possible for smaller enterprises, because many smaller firms are not subject to central government taxes.

On the other hand, a number of concerns have been raised with regard to the Service Levy:

- First, as noted above, turnover taxes such as the Service Levy have the potential to be perversely cascading. However, given that the Levy is only imposed high in the productive process (only for firms with a turnover in excess of TSh 20 million) and at a very low rate, the possible distortions and inefficiencies caused by potential cascading should be relatively limited.
- A second concern that has been raised is the notion that the Service Levy introduces the form of double taxation because the firms that are subject to the Service Levy are also subject to the national VAT. However, there is in principle nothing wrong with different levels of government sharing a tax base, as long as the combined tax rate is

not excessive.[18] Given the extremely low rate of the Service Levy, it is unlikely that the Service Levy will cause a reduction in economic efficiency.

- A third concern with the Service Levy is its limited scope, which contributes to the further fragmentation of the local tax system. The previous Industrial Cess (which was replaced by the Service Levy) was levied on the unit cost of finished goods of certain industries (aluminum products, cigarettes, beer, Konyagi, soft drinks, cement, wall tiles, etc), which made this tax arbitrary and discriminatory. While the uniform Service Levy is a step in the right direction, the Service Levy is still only applied to larger firms, thereby requiring a separate taxing mechanism for smaller productive enterprises. As argued in the next section, it would make a lot of sense to address taxes on business production and turnover in a more comprehensive fashion.

Box 4.2
"Ideal" approaches to subnational business taxation

In theory, the best form of business taxation is a broadly-based levy neutral to factor mix. Conceptually such a tax, sometimes called a business value tax (BVT), resembles VAT but has several important distinctions. Unlike VAT, BVT is origin-based and therefore taxes exports and not imports. This is because a local business tax is supposed to compensate local governments for services reducing costs of businesses, which accrue at the place of production and not consumption. Second, this tax is assessed by addition of payroll, interest, rents, and net profits (or subtraction of the cost of intermediate goods and services from gross receipts) based on annual accounts rather than on transaction (invoice-credit) method as in the case of VAT. This way it treats all factors of production equally and does not distort investment decisions. In the real world the closest approximation of BVT had been Italy's regional business tax (IRAP) before labor costs were partially excluded from the tax base in 2003.

Because BVT requires sophisticated accounting and record keeping and therefore developed tax administration capacity, it might be suitable only for regional (and larger metropolitan) governments. In addition, the costs associated with record keeping would discourage compliance by smaller businesses. Therefore, for lower-level local governments it would be more appropriate to tax businesses with fixed charges varying by type, size, and location. Broadening the tax base by reaching smaller businesses would restore the benefit principle by spreading the costs of government services to all businesses that benefit from it. Such a tax—called the Single Business Permit— was introduced in Kenya in 1999 to replace the preexisting license fees, which had been burdensome to businesses and conducive to corruption. A middle ground between BVT and fixed charges would be a low-rate gross receipts levy as in Tunisia.

Source: Bird (2003)

Taxes on agricultural production. The produce cess (previously reported together with the

[18] There are many examples internationally of tax base sharing among different levels of government. However, there are a number of countries that prohibit the share of tax bases, some times as a constitutional mandate.

livestock levy) is the highest yielding source of local revenues for most rural local governments in Tanzania. Rather than imposing the tax directly on agricultural producers, the crop cess (as well as a buyer's license fees) is collected indirectly from the crop buyer. Although the collection of the crop cess as an indirect tax (rather than as a direct tax collected from the grower, or at marker from the seller) is arguably intended to facilitate the administration and enforcability of crop cess collections, the indirect nature of the tax may also provide political acceptability (although local producers likely bear the lion share of the tax burden).

However, in reality, it is not altogether clear whether the archaic licensing, registration and transaction procedures currently used to assure compliance by the buyer indeed improve local revenue performance. It might in fact be much simpler (although probably much less popular) to collect a tax on the value of agricultural production directly from the farmer rather than the buyer. Shifting the legal incidence back to the farmer would re-establish the link toward the produce cess as a local benefit tax.

Indeed, Tanzania's approach to taxation of agricultural production has long been criticized as inefficient and impractical (for instance, see Bird 1971). In fact, agricultural producers (for instance, cashew nut producers) have been lobbying for further reductions in the Produce Cess by arguing that the tax imposes a high tax burden and is horizontally inequitable, as it disproportionately singles out the production of specific crops for taxation (Fynn, 2004). To the extent that the effective rate of taxation of certain businesses in certain LGAs may be quite out of line with the average effective rate for all businesses there is a valid argument in these positions, but it is simply not the case that the local tax system tax as a whole applies excessive tax rates to agricultural production. Although the effective tax rate surely varies between districts, total crop cess collections for cashew represent a mere 3.54 percent of the turnover value of cashew nut at the farm gate price.[19] As such, the argument of efficiency and horizontal unfairness should not be used as a pretext for the abolition of additional local taxes such as the crop cess; instead, improvements of horizontal equity should be addressed through a more uniform system of taxation.

However, often these arguments tend to suffer from a narrow perspective, failing to take into account the larger system of local government finance. In particular, it is frequently overlooked that taxes on agricultural production can be interpreted in essence as a local benefits tax, since agricultural producers benefit broadly for local services and local infrastructure both as residents of the local community as well as economic producers.

While the presence of a separate tax on agricultural production contributes to the appearance of an arbitrary and overly fragmented local tax system, it is important to note that taxes on agricultural production are in essence simply another form of turnover

[19] Computed by authors based on the data reported by Fynn (2004) for the cashew nut sector.This percentage contrasts starkly with the "effective tax rate on farmers" reported by Fynn (2004; Figure 10) in the range of 20-40%. Fynn's numbers are inflated by the inclusion of central government taxes, a license fee paid to the Cashew Nut Board of Tanzania, a charge covering the operational costs of Primary Societies as well as the purchase of certain inputs.

taxation, which is levied at the point-of-sale of agricultural products, with a maximum rate of 5 percent on the farm gate price. As such, the integration of the produce cess as part of a unified local tax on production or business tax would be a major step towards a more integrated local government tax system and toward improving the perception of fairness across different groups of taxpayers.

An additional element of local revenues on agricultural production that is often overlooked is the collection of license fees that are collected from wholesalers and purchasing agents of agricultural produce. To the extent that these license fees are set too high (e.g., TSh 60,000 per district per buyer per year), this licensing structure may actually limit competition in the agriculture sector by encouraging purchasers of agricultural output to only operate in a few local government areas. This has the potential for creating a series of local monopsonies for agricultural output (a situation in which there is only one purchaser for a crop in each district), which would have the potential of lowering the prices received by agricultural producers and inflating the profit margins of intermediaries. While this issue should be looked into further on a product-to-product basis (as this could form an important barrier to local economic growth), it falls beyond the scope of the current study.

Local property taxes and land rent

Currently, the local property tax is grossly underutilized in Tanzania as a local revenue source. Whereas in some countries property taxes contribute up to 30-50 percent of local revenues, the property tax in Tanzania only yields 13 percent of total local revenues. Even to the extent that property is being taxed, revenue performance for the property tax remains quite low. For example, in Dar es Salaam, collection rates remain less than 30-50 percent (Kelly 2004). Rural property is essentially untaxed.

Local property taxes. Property taxes are a good and commonly used local government source. First of all, taxes on real property (i.e., land and buidings) are a visible type of tax and thus are conducive to political accountability. When both property and population are generally homogeneous and ownership of property is widespread, a property tax complies with the benefits principle.[20] In other situations, property taxation can weaken the benefit link by moving the tax burden on to a few classes of property such as non-residential property. However, taxation of property in an equitable way requires costly revaluation of property on a regular basis. Property taxes further follow the ability-to-pay principle, although some liquidity problems may be present for those homeowners with valuable real estate assets and low income.[21] In principle, the property tax should be easy to administer since property is very visible and immobile across local jurisdictions, which

[20] The balance between the services received by property owners and the property taxes they pay on their real estate typically can be capitalized into property values. That is, property taxes do not have to reduce the market value of dwellings in the market if the general perception is that the quality of services provided by the local government is good.

[21] Being “house rich and income poor” can be a problem for elderly people. Some countries use special exemption schemes (“homestead exemptions” or “circuit breakers”) to increase equity in the implementation of property taxes.

should give local officials a strong “tax handle”.

The property tax applies only to buildings in Tanzania, with distinctions made between urban and rural LGAs. Although legally the base of a property tax should be the market value of the property, the Local Government Finance Act (1982) authorizes all local governments to levy a flat amount per building with possible adjustment for size location and use. For instance, the current flat rate for the property tax in Ilala Municipality is TSh 10,000 for residential properties and a standard rate of TSh 200,000 for businesses. Urban and township authorities are also authorized to impose an ad valorem property tax on buildings according to the Urban Authorities Act of 1983. However, individual valuations are costly and time consuming and so far have covered only selected properties in Dar es Salaam and selected other municipalities (which received specific project support for this purpose under the Urban Authorities Partnership Project, UAPP). Due to the lack of open market property transactions (and the separation of land and buildings), the depreciated replacement cost approach is still the most commonly used method of valuation. Since most of the properties are not valued, a differentiated flat rate is used in most cases.

Despite its potential as a local revenue source, property taxation seems to face a number of specific challenges in the context of Tanzania (for instance, see McCluskey et al 2003), which means that there is no simple and quick answer to fixing the property tax problem. A first issue facing property taxation is the separation of taxation on land and structures: while property taxes are assigned to the local government level, the collection of Land Rent is assigned almost completely to the central government (as discussed further below). Another part of the challenge may simply be administrative: local governments may lack the administrative capacity to produce an accurate cadastre of taxable structures and appropriately value these properties. Yet another issue may be the enforcement of the tax and the political viability of enforcement. If property taxes are enforced stringently, non-compliant taxpayers should be subject to forfeiture of their property for failure to pay their local property taxes. However, this enforcement mechanism may not be a viable option for local authorities, either for social, legal, political, or practical reasons. However, if property tax collections are not enforced (or indeed, not enforceable) then the property tax is essentially reduced to a voluntary contribution mechanism.

Although there are numerous challenges to be overcome in the structure, administration and enforcement of the property tax in Tanzania to make it a viable and substantial local government revenue source, there is no reason why property taxation (on both land and buildings) should not be the mainstay of local revenue through out Tanzania in the medium to long run. This is especially true for urban local governments (where most structures are located), but as well as for rural areas, where a simple flat rate on the occupancy of land and huts should be possible as well. The challenges with the administration and enforcement of the property tax could be resolved in part by separating and/or outsourcing the development of the cadastre, the valuation of

properties, and also potentially the billing and collection of the tax.[22] Outsourcing the administration of the property tax may limit the ability of local politicians to undermine its effectiveness by doling out politically-motivated exemptions.

Whereas local authorities are responsible for the entire administration of property taxes except for appeals, there is an important role for the central government. In many countries, the central government protects local taxpayers from local government arbitrariness by clearly defining the regulations for property valuation and ensuring that local governments accurately and fairly engage in valuations and collections.[23] The central government can also develop and maintain the fiscal cadastre for local governments lacking the adequate level of administrative capacity. Ultimately, there are a variety of approaches in the international experience to making the property tax work (see Box 4.3).

Box 4.3
International experience with property taxation

Taxes on property and land exist in virtually every country. Most countries tax both land and structures, usually together but sometimes separately. Some countries tax only land (e.g., Jamaica, Kenya, Bermuda and some parts of Australia and South Africa). Even fewer countries tax only structures (e.g., Ghana). Some countries also tax machinery and other tangible assets. There is a theoretical case for the taxation of only land, which would fall on location rents and have no discouraging effect on the development of property. At the same time taxing land alone based on market values is problematic because market prices capture both the structure value and its location. However, this argument is less relevant for developing countries, where due to the lack of property transaction information, valuation is done separately for land and structures based on land value map and replacement costs respectively.

International experience presents several approaches to determining the value of the taxable base— be it land or structures or both. Under an *area-based approach*, a charge is levied per square meter of land area, per square meter of buildings, or combination of the two. The assessment rate per square meter can be adjusted to reflect location, quality of the structure, or other factors. This approach is used in central and Eastern Europe, China, Chile, Kenya, and Tunisia. An alternative to an area-based approach is *value-based assessment*, which can be subdivided into capital and rental value approaches. Capital value assessment estimates the price that would be struck between a willing buyer and a willing seller in an arm's-length transaction. Under the rental value approach, property is assessed according to estimated rental value or net rent. In theory, a tax on market value is equivalent to a tax on rental value as the discounted net stream of net rental payments is approximately equal to market value. However, in practice the equivalence does not hold when the rental value does not allow for

[22] Note, however, that the ultimate enforcement of the tax (using fines, forfeiture, etc) is a public domain attribute, which fundamentally cannot be privatized.
[23] For instance, local governments in the State of Georgia that fail to maintain professional standards in the valuation of property and collection of property taxes (as determined by the State Department of Revenue) lose the right to collect the property tax.

deduction of all relevant expenses (e.g., maintenance, insurance, etc) or when the rental value is based on the current use rather than the highest or best use.

Source: Bird and Slack (2004)

In Tanzania, local councils (with the Minister's approval) may levy a special property rate to cover the costs of special capital works schemes which only benefit a limited number of properties in the ratable area. This is known in the local finance literature as a "betterment or improvement levy."[24] For instance, this could mean that LGAs could impose an additional surtax on properties in a certain neighborhood in exchange for localized benefits from a specific capital development (e.g., road improvements or street lighting). Despite the potential for increased correspondence offered by this local tax instrument, this option has not been used extensively by local councils in Tanzania up to now.

Land rent. As noted above, the local property tax is applied to structures only. The taxation of land is done through the payment of Land Rent. However, the taxation of land is greatly influenced by Tanzania's post-independence history of "common" (i.e., nationalized) land ownership. Although the 1995 Land Policy reintroduced the notion of private property and legalized market alienation of land, land ownership continues to be a highly politicized issue.[25]

Based on two separate Land Acts, there are essentially two systems of land tenure in Tanzania (Shivji 1998). First, there is a formal system of land registration and the issuance of land titles which is administered by the Ministry of Lands. Second, at the local level, there is an informal land tenure system which is administered at the village level, whereby village authorities are able to provide households the right to occupy and use land that is not nationally registered, typically against a nominal fee.[26] However, the informal land tenure system does not provide the same degree of protection as the formal registration of land.

For officially registered land, land charges are collected through a system of annual Land Rents administered by the Ministry of Lands.[27] The level of the rent is set by the central government but collected by local authorities, who are subsequently credited 20 percent of collections on a derivation basis as compensation for collecting the land rent. In Dar es Salaam region, the Ministry of Lands collects the land rent directly and thus local

[24] See Annex 4.5 for a discussion of the practice with betterment levies around the world.
[25] For instance, land ownership by foreigners is still prohibited. Furthermore, title to land is not indefinite; instead, owners are given occupancy rights for a number of years (for instance, 30 years). Strengthening land ownership is a fundamental ingredient for future economic growth and development in Tanzania, well beyond its implications for property taxation. (For instance, see Hernando de Soto, 2003). However, this broader issue falls beyond the scope of this study.
[26] Since these payments are made at the village level, they are not captured by the local government financial management system.
[27] Interestingly, the Ministry of Finance lists Land Rent as a non-tax source, but rather as property income.

authorities do not receive any share from the collections in the capital region.

The justification for the existence of the Land Rent harks back to the period of nationalized land ownership, with the land rent essentially serving as a lease payment for the land's full economic rent. In a way, land rent thus provided compensation to the community at large for excluding them from using the land. However, this justification is no longer valid under the current land policy, since the government has moved away from the notion of exclusive national land ownership.

Instead it would be a lot more appropriate in the current framework to assign the Land Rent (largely or exclusively) to the local government level. There are several basic reasons in favor of doing that. First, under the logic that formally registered land prevents other individuals from using the land, the greatest share of the opportunity cost is borne by people in the local community. Therefore, the compensation that is paid for the exclusive right to use the land (i.e., the Land Rent) should predominantly flow to the local community as well. Second, to the extent that local landowners benefit from local government services and infrastructure (including roads that provide access to the land), assigning revenues from the land rent to the local government level increase the correspondence in the tax system. Third, the current system of land rent collections only provides local governments with a weak incentive to collect the land rent, as they only get to keep 20% of the revenues collected. Local governments would have a much stronger incentive to collect land revenues if they would be entitled to keep a higher share of the collections.

Other local taxes

Many of the other taxes assigned to the local government level are appropriate local revenue sources, where a strong argument can be made based on the correspondence principle. For instance, this is the case for the guesthouse levy, as well as for other local taxes and license fees on specific types of local productive activities, such as plying fees, taxi licenses, and licenses on intoxicating liquors. Likewise, professional license fees are often a type of local income tax on professionals in the form of a license fee (see the discussion in the next sub-section) where there is a broader correspondence between the payment made and the benefits received from local services and infrastructure. Although these revenue sources are typically not among the highest yielding local revenue sources, the revenue potential from these taxes should not be underestimated.

Local non-tax revenues

To the extent that the main purpose of "real" licenses and user fees is to recover the administrative costs of issuing the licenses or the cost of providing the public services, it is important to price the service right. Requiring local governments to set the fee level below the actual cost of provision will cause a fiscal burden on the locality, and would give local governments an incentive, or actually force them for lack of cost recovery, to provide poor services. Setting fees above the costs for services provided would be suboptimal as well because of the induced lower consumption below optimal levels, and

would raise fairness issues to the extent that the public sector has a monopoly over certain services (e.g., the issuance of marriage licenses).

While user fees provide important efficiency benefits, it is important to balance the cost of collecting and administering user fees with the amount of revenues collected; since certain types of user fees involve many small transactions, such fees may be relatively costly to collect. In addition, the payment of user fees provides many opportunities for petty corruption (either through embezzlement of payments or through the need to provide informal "co-payments" in order to obtain services.) However, similar to the case of excises on utilities, it is possible to collect service fees together with other local government taxes that have a similar benefits incidence in order to reduce the administration cost. For instance, market fees may strictly be used for recovering the cost of operating the market. However, in addition to the costs of maintaining the market structures, there are costs of collecting the garbage generated at the markets, provision of water, latrines, and other measures to ensure some standard of hygiene. Given that the market fees provide a good tax handle (since failure to pay the market fee results in exclusion from the market), this offers a good opportunity to collect other legitimate local revenues in one harmonized instrument. Likewise, it is possible to collect refuse collection fees as a surcharge on property taxes.[28]

Contributions and Voluntary Contributions

The term "contribution" or "voluntary contribution" is used in a number of different ways for widely different local revenue instruments in Tanzania. The concern about voluntary contributions was raised after the abolition of the Development Levy, the abolition of the so-called nuisance taxes and the introduction of a 5 percent cap on the agricultural produce cess. In response to the slashing of the local revenue base and the introduction of a "closed list", some local authorities introduced several new contributions (i.e., surcharges or local taxes) on agricultural produce under heading that they are "voluntary" contributions.

The introduction of such (so-called) voluntary contribution is seen by the central government (especially the Ministry of Finance) as an attempt by local authorities to circumvent the closed list. Although some LGAs may in fact have introduced strictly voluntary contribution schemes, this should not be considered a sustainable approach to financing local services and infrastructure. It is a well-accepted principle by economists that unless there is some type of payment requirement or compliance pressure is imposed to fund a non-excludable good, taxpayers will generally become "free-riders" and rely on other residents to make contributions. If left unaddressed, this free-rider problem would result in a significant under-funding of local public goods, as all residents would count on the payment of their neighbors to pay for the good or service.

[28] There is no single "right" way to charge individual households for certain services, such as refuse collection. For instance, funding could be provided through separate user fees, or this service could simply be funded from general-purpose resources (e.g., funded from property tax collections). However, it appears that currently the law allows a special property rate (or betterment tax) only in areas where a certain capital work scheme has been undertaken by the authority and has benefited the people who own the properties in the area.

As such, in order to be practically viable any type of "voluntary contribution" must be something less than fully voluntary. It is likely that in most cases, voluntary contributions simply refer to *ad hoc* local taxes collected at the district or village level that were introduced for a specific purpose.[29] If communities want to engage in self-funded activities and you believe in decentralization, then such local initiatives should not be discouraged by the higher-level government. Instead, the collection of such "contributions" (whether in the form of a betterment levy or property tax surcharge, as a separate income tax, or in any other form) should be properly regulated to make sure that local governments do not over-tax their residents, and that the local tax instruments used by local governments are sound and fair. In contrast to the reduction in local revenue autonomy over recent years, this suggests that district and village authorities should be given *increased* revenue autonomy, particularly through greater rate discretion as well as greater access to new, sound local revenue sources.

Yet, an official definition of permissible voluntary contributions is currently lacking. As such, one could simply argue that any tax introduced by a District Council on its own accord –as the democratically elected representatives of a local government area- is in fact a voluntary contribution scheme, thereby rendering the entire closed list irrelevant. Alternatively, would a contribution scheme approved by a Village Council be considered a "voluntary" contribution? If the latter definition of "voluntary contribution" is applied, this would either result in double-taxation of residents by district and lower level local governments, and/or require significant coordination between the District and Village levels, since the district and village would have to jointly collect district taxes (e.g., crop cesses) along with the surcharges intended for the village level.

Finally, in some cases, the term "contributions" is applied to contributory payments made by households or firms for non-local government activities. For instance, in the case of the production of certain crops, LGAs act as collection agents for the local Primary Societies or grower's associations (Fynn, 2004). It is extremely important to recognize, however, that these "contributions" are fundamentally very different from other local taxes and contributions, as these resources do not fund local public goods or services. Although the collection of such contributions should be reflected transparently in the local government books of the government that acts as the collection agent, it is critical that such collections are accounted for in separate trust accounts (rather than through the local government's own revenue accounts).

4.3 Policy recommendations: Transforming the current system of local taxation

The TORs for this study task us to identify the most effective and efficient current

[29] This would be consistent with finding by the World Bank's PSIA study (2005), which suggested that development contributions had actually increased since the abolition of the Development Levy.

sources of revenue for Local Government Authorities, and what measures could be taken to optimize the revenues from each of these sources. To a large extent, this is accomplished in the discussion of the current revenue assignments in Section 4.2 and their shortcomings. In addition, the TORs request us to identify any current sources of revenue for LGAs that are reasonable candidates for elimination as inefficient or ineffective, or that require substantial reform in order to optimize their revenue potential. Finally, we are also asked to identify any significant and efficient taxes, fees and charges that as potential sound local revenue sources that are currently not being used at the local government level. Based on our assessment of existing local taxes provided in section 4.2 we identify those sources of revenue that require substantial reform in order to optimize their revenue potential.

The first step in the reform of the local tax system should be to clean and clarify the terminology and concepts currently being used. From the terminology currently in use it is not always clear what is a local tax, a cess, a fee, or a license, and what may be the differences between these concepts. Similarly, the categorization of local revenues in the Local Government Finance Act (as reflected in Table 4.3) is not particularly helpful in understanding the difference between different local revenue instruments. The interest of clarifying these concepts lies in making the system easier to understand for taxpayers and local government officials alike, thereby contributing to greater legitimacy of the system of local government revenues. Greater clarity and greater legitimacy should help to improve the administration of local government revenues and also to facilitate the monitoring of the performance of local tax systems.

In Table 4.4 we present a proposed set of standard terms –based on common internationally used definitions- that could help to clarify the different types of revenue instruments available at the local level. We specifically distinguish between four types of local revenue instruments: local taxes, local levies,[30] local fees and charges, and contributions.. Table 4.4 specifies defining characteristics for each of these terms and further provides examples for each of these revenue types. There may or there may not be agreement with this precise set of definitions that are presented in Table 4.4; what is important is that a clear and consistent set of definitions is adopted and used in formulating the local government revenue system in Tanzania.[31]

In addition to clarifying the nomenclature and classification of local government revenues, we believe that a sound local government revenue system in Tanzania has the following features:

[30] Many of the local revenue instruments that would fall in the category of “local levies” are currently referred as licenses (e.g., motor vehicle license or Liquor license). However, this current practice is not consistent with the concept of licensing adhered to the by the Ministry of Finance.

[31] In the remainder of this section, we will use this new terminology where appropriate, especially when referring to new local revenue sources. However, in order to prevent confusion, we will largely stick the terminology currently used in Tanzania to refer to existing revenue sources.

1. The mainstays of local government taxes should be the Local Property Tax and a Unified Local Business (ULB) Tax. These are broad-based local taxes collected from households and businesses that adhere to both the benefit principle as well as to the ability-to-pay principle. As described below (in subsection 4.3.1), the ULB Tax is envisioned as an amalgamation of the various general local business taxes, fees and charges imposed on local business activity. Efforts to strengthen and improve the Local Property Tax should continue (subsection 4.3.2).

Table 4.4
A consistent categorization of local government revenues in Tanzania

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

2. In addition to broad-based local taxes, there is a role in the local revenue system for a variety of Local Levies that are imposed on more narrow bases. Typically, these Levies are imposed on activities for which additional taxes are justifiable based on the correspondence principle (e.g., motor vehicle license/levy; plying fee/levy; local levy on the extraction of building materials, etc.) or for regulatory reasons based on negative externalities (e.g., local liquor license/levy).
3. A third broad category of local government revenues are local user fees and charges. Like Local Levies, fees and charges are imposed on a specific basis, but fees and charges are collected exclusively for cost recovery of the provided service. As

discussed further below, we believe that many of the current fees and charges which local governments are permitted to collect are appropriate sources of local government revenue.

4. Finally, we recommend that the legislative and regulatory framework for local government finance carefully defines the concept of "contributions" to prevent abuse of the current perceived loophole in the local revenue structure. We believe that the central feature of a "contribution" should be that the payment is not intended and may not be used for the funding of district-level government activities. Instead, contributions are payments that are made to fund village-level or community-based activities. Although Contributions may be collected by the district-level LGA on behalf of village authorities or a Primary Society, Contributions should not be considered as local government revenues and must flow directly into a Trust Account specifically set up for this purpose. Within this context, we further propose a standardization of the Village Contributions (subsection 4.3.3).

Box 4.4
Feedback from the Second Stakeholder Workshop (May 2005):
The "true" rationalization and harmonization of local government revenues

The second stakeholder workshop on the development of a strategic framework for local government finances –held in Dar es Salaam in May 2005- was presented with the following statement for discussion and debate: "True rationalization and harmonization of the current local government revenue system should focus on (1) unifying the various different business taxes; (2) continuing to strengthen the property tax; and (3) formalizing the framework for village-level contributions"

General agreement and consensus exists with regard to this statement, although support for this statement is qualified by a number of considerations.

Stakeholder feedback suggested that there was general agreement on the need for a unified business tax, as well as for a continued strengthening of the role of property taxation at the local government level. The role of formalized village contributions as part of the formal system of local government revenues was debated in greater detail. In addition stakeholders identified a number of additional issues to look at in the context of the further rationalization of local government revenues, including the need to assure a harmonization of the fiscal space of local governments and central government; potential mechanisms for revenue sharing; as well as a more detailed consideration of revenue administration issues. It was noted that the way forward for the transformation of the local government revenue system would include the detailed identification of specific local revenue sources (as part of the finalization of the local government financing framework); the determination of the appropriate tax rate levels for the identified taxes; careful consideration of the revenue administration; and the rolling out of these transformed local taxes. It was suggested that the identification of appropriate local tax rates should be determined among others by the desired revenue yield, the desire to minimize distortions, and the need to attain Pareto-optimality between central and local government revenues.

Concern was expressed regarding the degree to which village contributions could in fact be

transformed into a more formal local government revenue source at the village level. There was general agreement that it is appropriate for the central government to regulate the mechanism for contributions at the village level in order to prevent abuse, and the need to assure participation, fairness, and consistency in the administration of village level revenues. However, it was also noted that the use of the term "voluntary" created substantial confusion regarding the nature of village contributions, and that an excessive formalization of village contributions could hamper true bottom-up participation. For instance, careful consideration needs to be given to the decision whether or not village contributions should be formalized into an annualized budget cycle, or whether it should remain more *ad hoc* in order to be able to fund specific community projects as the need arises.

4.3.1 Harmonize the plethora of business taxes into a Unified Local Business (ULB) tax

We recommend introducing a Unified Local Business Tax which would absorb (eliminate) the following current local taxes: the Service Levy, taxes on agricultural production (including the crop cess and the forest produce cess), business income taxes for minor settlements, fees on extractive production, and any other local taxes on productive activities. The ULB will basically also absorb (eliminate) the Stamp Duty on receipts which until recently was assigned to the central level for firms below the VAT threshold.

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

Given that the introduction of the ULB would be a major reform of the local tax system, a first step would be to pull together the various existing business taxes and turnover taxes under a single "umbrella" tax instrument and to broaden the tax base to include all businesses and productive enterprises at the local level, including any business currently not taxed locally.[32] Broadening the local tax base by reaching smaller businesses would improve horizontal equity in accordance with the benefit principle and would allow the rate structure to be set low by spreading the costs of local government services to all businesses that benefit from it, rather than by burdening only a narrow base of local

[32] The concept of the ULB Tax as an "umbrella tax instrument" is similar to the Income Tax. The Income Tax Act recognizes different types of income (wage income, interest income, and so on), and uses different collection techniques (including withholding at various stages of income generation or income transfers) for different types of income. Different rate regimes are also applied depending on the type of income and type of taxpayer (e.g., presumptive rates versus the graduated rate schedule).

businesses. Even at a small rate, such a broad-based tax is expected to have considerable revenue yield thus enhancing revenue autonomy of local governments.

The introduction of a single, standardized ULB tax across all LGAs would allow the key features of local business taxation to be harmonized across all local government jurisdictions. Regulations and definitions –including the definition of the taxpayers subject to the tax, in which jurisdictions firms should pay the ULB tax, a general definition of the tax base, the general collection procedures, and sanctions for local tax evasion- would be uniform across the national territory. However, as a broad-based tax on business activity, the specific procedures for estimating the tax base and collecting the ULB tax could not be "one approach fits all". The presumptive methods to estimate the value of the firm's tax base would likely vary between firms of different sizes and different sectors. Likewise, the actual points of collections would likely vary between industries in order to maximize the different respective tax handles. This would allow the introduction of a standardized business tax across all LGAs, while maintaining sufficient flexibility for LGAs to collect local taxes in a manner that assure compliance and revenue yield.

A subsequent step in the introduction of the ULB tax would be to harmonize the effective tax rates (and the schedular charges) applied to gross turnover across the different business activities and categories. Currently, the main tax rates range from 0.3 percent of turnover for the Service Levy and 2 percent for the Stamp Duty to 5 percent for agricultural products. However, given that the relationship between gross turnover and net income may vary across industries and sectors, it is not necessarily the case that the tax rate imposed on turnover for each type of productive activity under a presumptive local business income tax is necessarily the same. As part of the harmonization of local tax rates applied to different business types and activities, it would also be appropriate to take into account the fact that the central government imposes different tax burdens on different types of local business activity; for instance, larger businesses above the VAT threshold already face a significant central tax burden (and probably withholds income taxes for its employees), whereas a small agricultural producer likely pays no central taxes whatsoever. Further study will be needed to determine the appropriate relative tax rates between different types of business activity in order to assure a reasonable degree of horizontal equity within the ULB tax.

It will not be easy to construct such a tax right without improved tax administration. For enforcement purposes, the local authorities could issue an annual "*business permit*" as proof of payment of the ULB tax which businesses would be required to display on a permanent basis within their premises.

4.3.2 Continue to pursue strengthen and reform of the local property tax.

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

of the tax, including valuation, assessment, administration and collection, as well as enforcement.

With respect to the manner in which the tax base for the property tax is defined, we propose allowing local government's to select an approach for the valuation of properties that it deems most appropriate for the conditions at hand, from the legal assessment at market value, and the use of flat rates for all residential and business properties, to adopting an *area-based* methodology for assessing values, according to square meters of built space and neighborhood location of the building. An area-based assessment schedule could differentiate between rural and urban areas and within urban areas could distinguish between three to four value categories. In this case, the assessment tables would be determined by the central government but local governments would have authority to set the property tax rates between minimum and maximum rates to be applied to the area-based assessed values. The range of permissible rates should be legislated at the national level, while local governments would be allowed to select the tax rate and the valuation approach from the legislated options, and could choose to outsource the development of the fiscal cadastre and their classification of properties for valuation purposes, as well as the billing and collection of the tax.

Alternatively, under contract between the TRA and the local authority, the central administration can also develop and maintain the fiscal cadastre for local governments lacking the adequate level of administrative capacity or unable to outsource these activities. Failure to comply with the property tax will subject taxpayers to forfeiture of their property provided the local governments obtain the proper court order. Such enforcement mechanisms need to be applied consistently in order to be effective. The new property tax will replace the existing property taxes, including the current *ad valorem* property tax on buildings in the Urban Authorities Act of 1983.

We suggest two additional measures should be pursued in the realm of property taxation. First, assign the Land Rent exclusively to the local government level or shift revenue sharing from the current 80/20 sharing (in favor of the Ministry of Lands) to 20/80 in favor of district. Second, strengthen the environment for imposition of Betterment Levies by allowing local councils, without the Ministry of Finance approval but subject to rules and conditions set in the reformed Local Government Finance Act, to levy a special property rate to cover the costs of capital infrastructure developments with identified localized benefits for a limited number of properties in the ratable area, such as street lighting, sidewalks, and so on.

Box 4.5
Existing efforts to reform property taxation

Our recommendations on the continued strengthening of local property taxation should not be considered in a vacuum. Substantial work on property taxation was done under the UAPP, and more recently under the World Bank's Local Government Support Program, with the latter being aimed at revenue enhancement in Dar-es-Salaam. The key work done so far is reflected in Mcluskey et. Al (2003); Franzsen and Semboja (2003; 2004); and Faber (2004).

While the work on Dar-es-Salaam emphasizes common themes of simplification and rationalization, there are points of agreement as well as points of disagreement between the previous work and the current study's recommendations. Nonetheless, it will be important to ensure alignment between the reform of the local tax system in general and revenue enhancement in Dar es Salaam in particular; as such, the next steps in the work on developing a local government fiscal framework for Tanzania should work closely with the Dar-es-Salaam project.

With respect to property taxation in Tanzania, Franzsen and Semboja focus considerably on valuation, arguing that the current dual system whereby a flat rate system is maintained in some areas alongside assessments based on valuation of parts of the residential sector is not optimal. They argue for a single, integrated system based on individual valuation and assessment of all non-residential property based on mass valuation. In contrast, McCluskey (2003) identifies that the cost of developing even rudimentary local property cadastres would basically be unsustainable given the current revenue yield from property taxes. We concur that the complexities of mass appraisal (even only for non-residential properties) are likely to be excessively complex in Tanzania's context and run contrary to the theme of simplification. While the valuation techniques chosen may vary from council to council, the cost and complexity of the valuation approach should certainly be taken into consideration in the selection process.

In contrast to Franzsen's work, Faber focuses more on maximizing revenue yield from the property tax, suggesting an approach whereby higher valued residential properties are prioritized in valuation and collection enforcement, with more accurate data being collected in these cases to enable more accurate valuation. Accordingly, Faber recommends that the lowest 30% of properties be exempted from paying property taxes, although properties would still need to be identified and valued sufficiently in order to identify them as falling below the threshold. While we are sympathetic to Faber's focus on administration and revenue yield, we are concerned that exempting 30% of the lowest-value properties would be viewed as inherently unfair by the wealthier taxpayers, who might respond by further reducing their compliance. Certainly, separating the valuation function from the collection function (which might be achieved by contracting out the collection function under tight contractual arrangements) would be consistent with Faber's on revenue yield.

One area that has received relatively little attention is the low effective property tax in Tanzania. For instance, the work on Dar es Salaam refers to the very low tax rate that is effectively applied - ranging between 0.2% and 0.15% of value. While the link with service provision is crucial it should be possible to envisage higher rates alongside better services. Taxation at these very low levels results in administration costs accounting for an overly large proportion of total revenue. A doubling or even tripling of rates could result in a major increase in revenue collections.

While sharp rate increases would likely no be politically feasible if all else is held constant, such a move might be politically acceptable if the urban local governments simultaneously announce popular public works projects and improved public services that they will be able to fund from the increased resources. The introduction of neighborhood-specific "betterment levies" and sensitization campaigns (i.e., marketing) could further boost voluntary compliance.

Additionally, the horizontal equity of the tax should be improved by assuring more consistent valuation, consistent administration, and consistent enforcement with credible and consistent penalties and consequences in case of evasion. In fact, the failure to achieve consistency in the administration of local property taxes is an important factor in the lack of credibility of the local property tax. While it is ultimately a local responsibility to assure the sound collection of local

property taxes, the central government may have a responsibility here as well. In many developed countries, it is in fact the central government that monitors the valuation and collection of local property taxes. In fact, in order to protect local taxpayers, some countries punish the failure by local governments to systematically and fairly assess all property values or local failure to enforce tax collections adequately by removing the locality's authority to collect local property taxes altogether.

There are three basic administration components that affect the revenue yield, efficiency and equity of the property rates systems, (Kelly, 1999) notably collection and enforcement (collection ratio: CR), the property information (coverage ratio, defined as the share of taxable land captured by the cadastre) and the valuations (valuation ratio: VR, measured by the total valuation of the tax rolls relative to the total market value of the properties on the roll), where we can define Tax Revenue = Tax Base * CR * VR * TR * ClR. TR indicates the local tax rate, while ClR represents the collection ratio (tax revenues collected divided by billed tax liabilities). Although further work is required on strengthen the property tax subsequent to adoption of the overall local government finance framework, the study team believes that the key to increasing revenue buoyancy in Tanzania is largely improved administration, and possibly higher effective property tax rates.

Since the different administrative features of the property tax are multiplicative, it is essential to get every administrative step right in order to assure revenue collections; the failure of any one step has the potential to result in drastic revenue losses. Thus, the government must ensure that all property is captured on the tax rolls, that property is valued based on transparent and objective valuation mechanism, that tax is assessed accurately, that revenue is collected and enforcement undertaken against noncompliance. Thus, the coverage, valuation and collection ratios are the critical administrative variables that ultimately determine effective tax rates, the tax burden for each property, the total revenue yield, economic efficiency and overall equity.

Annex 4.1 discusses local tax administration issues in Tanzania in greater detail, including the administration of the local property tax in Tanzania.

4.3.3 Consider the introduction of a formalized Village Contribution scheme

During the 2003 Budget Speech, the Minister indicated that the abolished Development Levy would be replaced with a more appropriate village-level revenue instrument. However, as of yet, no formal village-level revenue sources has been introduced. Instead, village councils rely on all sorts of informal and "voluntary" village contributions (which are permitted –but not well-defined- under the current "closed list").[33] A formalized Village Development Contribution scheme could have the following features:

- The administration of an annual Village Development Contribution (VDC) tax would be guided by an official (yet simple) administrative manual issued by PO-RALG.

[33] Given that village-level contributions currently exist, we classify this revenue source as an existing local revenue instrument. However, given that current contributions schemes are not formalized, one could also consider the Village Development Contribution as a new local revenue source.

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

A village-level tax with aforementioned features could bring increased transparency and fairness to the present system of "voluntary" contributions. Requirements of participatory procedures will enhance autonomy and accountability at the village level. However, it does not need to be done in a way that is too formalistic, so as not to stifle village traditions

4.3.4 Non-tax revenues, including business and professional license fees

Of all the business and professional license fees currently on the books, we propose that the Government reconsider the implications of imposing a license fee on private health facilities. Given the trend in public health provision in Tanzania to move away from user fees and given the desire to assure broad-based access to health care services, it might be appropriate to eliminate the license fee on private health facilities. The study team recommends keeping the following Business and Professional License Fees:[34]

[34] Depending on the exact formulation of the ULB tax, some of these license fees/levies might actually be integrated into the ULB tax instead of continuing as separate Local Levies.

- Commercial fishing license fee
- Intoxicating liquor license fee
- Taxi license fee
- Plying (transportation) permit fees
- Forest produce license fees
- Building materials extraction license fee
- Hunting licenses fees
- Muzzle loading guns license fees
- Scaffolding permit fees

Depending on the prevailing sentiment, the new system of local government revenue might wish to move away from the terms "license" and/or "license fee" since these terms imply a regulatory tool and/or a charge that is intended to cover the cost of issuing a license. Instead, the nomenclature of these revenue instruments may be adjusted to be consistent with the categorization presented in Table 4.4.

The fee for billboards and posters (which is currently listed as a user fee) should be considered a Local Levy instead, as the fee charged for the permission to mount billboard and posters is not intended as a cost-recovery device. The regulations for the Billboard Advertising fee should allow for graduation by type of billboard and size.

With the exception of the billboard fee (as noted above), we recommend keeping the current administrative fees listed in Table 4.3.[35] The fee schedule imposed by each local government for these user fees should be guided by the principle of cost recovery for the specific activity. While this means that LGAs might set different rates for these local administrative fees and charges based on cost variations, these local fees may not exceed levels necessary for cost-recovery.

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

4.4 Potential new revenue options

If the Government of Tanzania decides to expand local revenue autonomy, there are two ways to do so. First, local revenue yield and autonomy could be achieved by increasing the yield of existing instruments assigned to the local level by optimizing their structure and administration. As discussed in subsection 4.2.3, whereas improvements in tax administration may result in some revenue improvements, it is unlikely that

[35] The fees should be reviewed on a case by case basis whether they are eligible to become levies.

administrative reforms alone will be sufficient to cause a significant reversal in local revenue trends. The second way to achieve greater local revenue yield and autonomy is to expand tax instruments available to local governments. Thus, in addition to the reform or elimination of current local taxes, the TORs also request us to identify any significant and efficient taxes, fees and charges that are potential sound local revenue sources and are currently not being used at the local government level.

Therefore in this section we broaden our "universe" of options beyond the current local revenue sources. It would be inappropriate to consider alternative local revenue options without considering the concept of "fiscal space" (subsection 4.4.1) and without discussing the revenue sources currently assigned to the central governments and assessing whether each of these revenue sources is assigned to the central government in accordance with the conceptual principles of sound revenue assignment and best international practice (subsection 4.4.2). In order to explore all options for potential reforms, we subsequently consider other revenue sources that are currently not being collected in Tanzania but that hold promise as local revenue sources (subsection 4.4.3).

4.4.1 The concept of "fiscal space" and the division of fiscal space in Tanzania

The structure of any local tax system is determined within the context of the revenue assignment problem: how are different taxes assigned among different levels of government? There are two general approaches to revenue assignment in the international practice. In the first approach, different levels of government are assigned exclusive fiscal spaces, defined by tax bases or even full tax structures. This approach would give each level of government exclusive authority to tax certain tax bases. These fiscal spaces can be specified in a law or, as is the case often times, in the country's constitution. In the second approach, different levels of government are allowed to use the same fiscal space, in which case different government levels could "share" tax bases. In this case, limitations on local government taxes tend to be the prohibition of taxes that would restrict internal or domestic trade. [36]

Although these two approaches go back many years in different countries, in principle, there is nothing wrong about two levels of government levying a tax on the same base as long as the combined tax rate is not excessively high (McLure 2000).[37] In this case, local fiscal space would mean, for example, some room for a supplementary rate for local governments. Potential fiscal space can be also identified when the current application of the legal definition of a tax base does not reach a certain class of economic activities, for example those below a certain threshold.

The general principle that has been followed in Tanzania for revenue assignments has been that of largely separate fiscal spaces for the central and local government. The central government has almost exclusively been given the right to tax larger taxpayers

[36] Such is the case with the "commerce clause" in the United States Constitution.
[37] The use of the same tax base by different levels of government nevertheless can be associated with some externalities at one level of government.

that are part of the formal economy (importers and exports, VAT-registered businesses, salaried employees, and so on), whereas LGAs have predominantly been assigned the fiscal space to tax smaller businesses (mostly outside the formal economy) and poor households. There are some limited areas of overlap between the realms of fiscal space occupied by the different government levels. For instance, local governments are allowed to impose Service Levy on VAT-paying enterprises (albeit at a very low rate), whereas the central government has started "intruding" on local governments' fiscal space by introducing a presumptive income tax on smaller businesses below the VAT threshold, which was historically more the fiscal realm of local authorities.

In our opinion, the application of this principle of exclusive fiscal space in Tanzania (and frankly, the disregard for the need to create minimally viable fiscal space for local governments) has introduced unnecessary rigidities in tax assignments. We also believe that this is the right time to carefully examine the fiscal space occupied by the central government in Tanzania and how some of this fiscal space may be shared with local governments.

4.4.2 An assessment of the fiscal space occupied by the central government in Tanzania

The proper place to start for an assessment of revenue assignments in Tanzania is to review the quantitative significance and relative importance of the revenue instruments currently used at the central and local levels, and whether or not some of the fiscal space exclusively held by the central government at the present time offers some advantageous possibilities for it to be shared with local governments.

The level of revenue mobilization. One particular issue in the discussion of fiscal space (at the different levels of government) is whether the overall tax pressure in the country is already too high or conversely whether some of the identified fiscal space may actually be used because the overall level of tax effort in the country is relatively not that high .In this section we discuss what it is meant by these concepts and how they are quantified for the case of Tanzania.

Domestic revenue is targeted to reach TSh 1,739.3 billion in FY 2004/05.[38] This represents about 13.8 percent of the Gross Domestic Product (GDP). An important background question is whether this is an adequate level of revenue mobilization for Tanzania. In general terms, this is not an easy question to answer. Tanzania, or any other country for that matter, is sovereign to decide what share of GDP should be channeled through the public sector via taxes and what should be left in the private sector.

However, Table 4.5 suggests that Tanzania's degree of tax effort (13.3%) is quite low by international standards when considering the tax-to-GDP ratio compared to selected countries in Eastern, Central and Southern Africa (average 18.5%). Yet, the more relevant question is whether Tanzania has enough resources to finance the desired level

[38] See *Budget Digest for 2004/05*, (Ministry of Finance, 2004)

of public expenditures without sustained fiscal deficits. From this perspective, with fiscal deficits of around 6 percent of GDP (before external grants) and with a dependency of external funding of around 3.5 percent of GDP, it would seem that revenue mobilization in Tanzania might be lower than needed (or else that public expenditures are too high). From a different perspective, the level of revenue effort is related to the questions of whether the international competitiveness of the Tanzanian economy is weakened by high tax burdens or by expenditures that are too low to provide adequate levels of infrastructure and public services. These are much harder questions to answer.

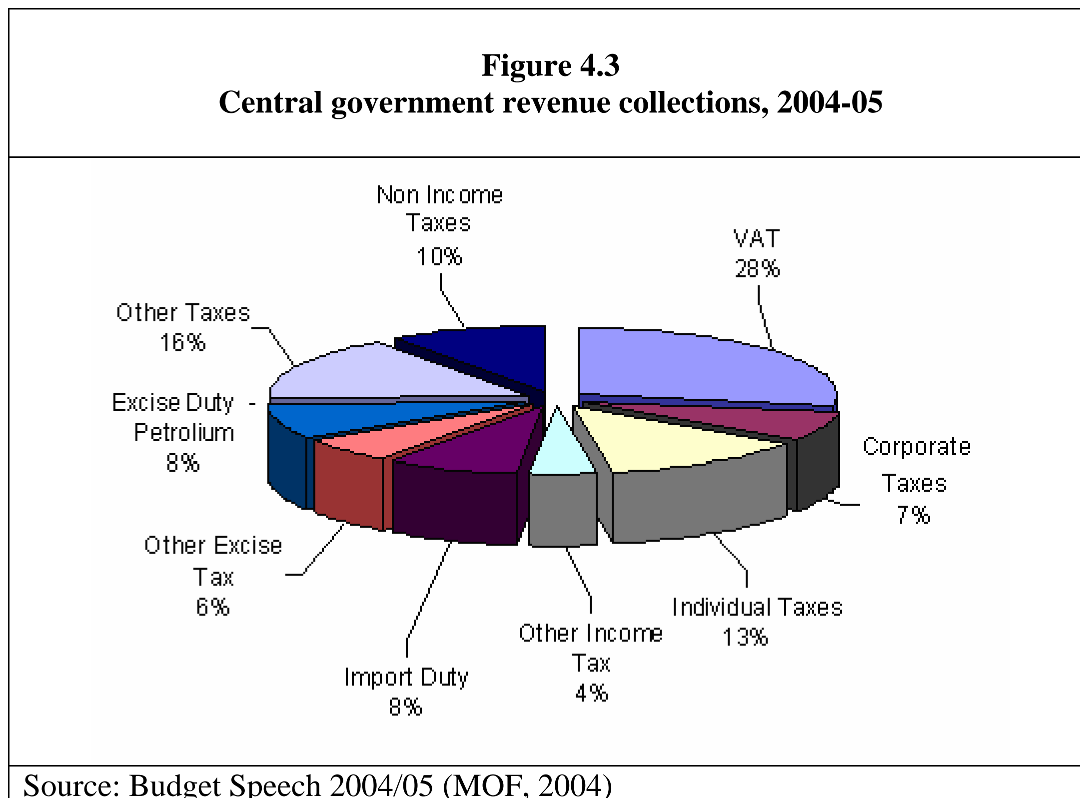
Table 4.5
Tax Effort in Tanzania and Across Selected African Countries, 1990s

Country	Actual Tax Ratio to GDP
Botswana	33.8
Burundi	15.2
Central African Republic	8.4
Congo	13.3
Ethiopia	10.4
Kenya	22.6
Malawi	15.5
Mozambique	18.0
Namibia	30.2
Rwanda	8.0
South Africa	27.7
Swaziland	29.7
Tanzania	**13.3**
Uganda	8.8
Zambia	17.5
Zimbabwe	23.6
Unweighted Average	**18.5**
Source: Annex 4.2	

One piece of evidence that might be brought to bear on these questions has to do with whether Tanzania taxes are at a high level relative to other countries, particularly relative to other countries that have similar per capita income levels and other characteristics. To answer this question we perform a comparison using a regression method, which allows us to go beyond simply comparing the tax-to-GDP ratio (see Annex 4.2). In a summary fashion, the analytical method used in Annex 4.2 consists of comparing the actual revenue collections in Tanzania with the country's "expected" revenue effort predicted from a regression equation. In this last step for predicted revenues, we use features of

Tanzania's economic structure and coefficients from a regression based on data for 115 countries that tell us how on average (for all those countries) those features of the economic structure could be exploited to raise tax revenues. The results in Annex 4.2 show that Tanzania squares well with a tax effort coefficient of 1.2 (Table A.4.2.1). This can be interpreted as saying that Tanzania raises revenues that are above the average, after we take into account income levels and other economic characteristics. However, these quantitative results need to be taken with a grain of salt. It is likely to be the case that tax liabilities are high for some and low for others. In fact, as shown in Annex 4.2, the available estimates are that the shadow or informal economy in Tanzania represents more that half of GDP around year 2000, and that the relative size of the shadow economy has been significantly growing in the past years. By the estimates in Table A.4.2.2 the size of the shadow economy as a percent of GDP was 45.6 in 1990-1991 and reached 58.3 percent in 1999-2000.

Figure 4.3
Central government revenue collections, 2004-05



Source: Budget Speech 2004/05 (MOF, 2004)

The composition of central government revenues. Moving from the overall level to the composition of revenues in Tanzania, a breakdown of central government revenues expected for FY 2004/05 is provided by type in Figure 4.3 (Budget Speech 2004/05). The revenue structure at the central government level shows a similar pattern as the local level, with a limited reliance on income taxes, and more extensive reliance on indirect taxes. At the central level, consumption taxes (VAT and excises) account for 42 percent of central government revenues, with the VAT by itself accounting for 28 percent, and excises the remaining 14 percent. Corporate and individual income taxes are expected to

account for 24 percent of central tax revenues, more than half of which derives from taxes on individuals' income. Import duties are still expected to account for 8 percent of central tax collections. The remainder of collections (24 percent of revenues) derives from other smaller taxes or from non-tax revenues (other sources of income).

Tanzania's tax structure is pretty much in line with the norm in other countries, although there is less dependence on income taxes than is generally the case in the international experiences. Tanzania's reliance on indirect consumption taxes and taxes on international transactions is closer to the international norm (although also a bit below the norm), while the role of other taxes and non-tax income tends to be more prominent in Tanzania.[39] Table A.4.1.3 in the Annex 4.2 shows the international experience for a large number of countries using IMF (2003) data for 2000.[40]

Review of Individual Taxes. We now proceed to examine in more depth the different tax sources as they are currently assigned to the central government. Since the focus of the current report is the implications of the overall revenue assignment for the local revenue structure of taxes currently assigned to the central government, in particular from the perspective of whether there is some fiscal space available for local governments. Therefore our discussion focuses more on aspects and features of central government taxes related to local taxation either as potential revenue sources or how indirectly they relate to local revenue issues, and much less on structural issues concerning those central government taxes.[41] We must note that virtually all central government revenues, as discussed below, are collected by the Tanzania Revenue Authority (TRA).

Personal income taxes

A new Income Tax Act was introduced in June 2004, which in some ways simplified the previous income tax. Tanzania's personal income tax is levied on the world-wide annual income of residents and Tanzania's source income for non-residents. The taxable base includes wages and salaries, profit dividends, capital gains and interest income. The basic rate structure is progressive with four brackets starting at 18.5 percent for incomes over TSh 600,000 and ending at the maximum marginal tax rate of 30 percent for incomes in excess of TSh 6,480,000. In many cases taxes are withheld at source. Employees' incomes are subject to monthly withholding by their employers, while the self employed have to file annual returns and quarterly estimated payments. Besides the withholding of taxes on salaried income, there are a number of other withholding taxes, including on interest income; dividends royalties, and other types of income. [42]

Although there are several issues that we could discuss on the current structure of the

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[39] Note that the fact that taxes on international trade are lower in Tanzania than the norm in other developing countries is a positive factor because of the continuing need for trade liberalization.

[40] The table divided taxes into four groups: income taxes, property taxes indirect taxes and taxes on international trade. The category "other" includes both other taxes and those that could not be allocated. Social security taxes have been excluded from this computation. Mean values are reported in the last row of the table.

[41] Information on the structure of current taxes is available from the Tanzania Revenue Authority website.

[42] See TRA. 2004. *Taxes And Duties At A Glance 2004 / 2005*, for a complete picture of all income tax provisions and withholding rates.

personal income tax, the most significant one from the perspective of local revenue mobilization is the relatively high threshold for exempted income. In effect, a threshold of TSH 600,000 leaves most individuals exempt from the central government's personal income tax. Even though there are many angles to this policy -such as reinforcing progressivity or reducing administration costs- we believe that it sets a bad precedent in trying to establish a good tax culture where everyone contributes to financing public services no matter how little. Narrowing the pool of potential taxpayers (while effective in maximizing revenue yield) promote tax avoidance by higher-income taxpayers, and more important from the perspective of this report, it tends to preempt the possibility of using some form of personal income taxation as a source of local revenues.

To some extent, with the introduction of the new Income Tax Act (2004), the TRA is starting to pursue a presumptive type of income taxation for individuals below the regular income tax threshold. While on a positive note this broadens the tax net for the personal income tax, on the downside this development may be considered a further incursion by the central government on the already-limited local tax space of local governments.

Before we explore what possibilities may exist at the local level with respect to that "fiscal space," it must be left clear that the current progressive income tax is rightly assigned to the central government level and it must remain there. In accordance with the normative principles of taxation, a progressive income tax should be assigned to the central government owing to: (i) its redistributive nature; income redistribution is a central government objective and in general should not be pursued by local governments given the mobility of taxpayers; and (ii) its automatic economic stabilizer nature; again, macroeconomic stability is a central government objective and in general should not be pursued by local governments given the porous nature of local economies.

Yet, now that the Development Levy has been abolished, basically no local personal income tax exists.[43] But given that most individuals below the income tax threshold are not taxed by the central government personal income tax, this creates a "fiscal space" with possibilities for a new instrument for local governments financing. There are several possibilities for the taxation of personal income at the local level relevant to Tanzania. The most commonly used one in the international experience is a flat-rate income tax as a surtax or "piggyback" tax on the central government personal income tax, which is collected by the central government tax administration. (See Box 4.6 for a general description of piggyback taxes). To enhance revenue autonomy, local governments may be allowed discretion in setting the flat rate between minimum and maximum rates, which are centrally legislated.[44] Because, local governments may be quite diverse in terms of tax bases and levels of economic development, it is also possible to have an asymmetric implementation of this type of tax, so that only larger cities or only urban areas are assigned such a tax.

[43] It must be recalled here that prior to being made a poll tax, the Development Levy had a progressive nature akin to a rudimentary or simplified personal income tax.
[44] Other forms of tax autonomy, such as the ability to modify the base of the tax by providing more or less deductions, exemptions and so on do take place in the international experience but they are much less attractive because they make tax administration and enforcement so much harder.

Box 4.6
Local piggyback taxes

In the most common practice piggy-back local taxes are collected by the central government as a surtax to a central government tax, but local governments are allowed to set the rate for the surtax and receive the proceeds from the subnational surtax on a derivation basis.

The most common type of piggyback taxes is a flat rate local income tax. However, the international practice also shows cases of piggyback sales taxes and piggyback excise taxes. Consistent with the principles of revenue assignment, the overall attractiveness of piggy-back taxes as a fiscal policy tool can be summarized by its three main benefits: (1) Piggyback taxes allow a relatively high degree of centralized control over revenue sources.; (2) Piggyback taxes with rate setting give local governments an excellent degree of tax autonomy; (3) Piggyback taxes are administratively simple and feasible.

Some tax practitioners object to the notion of imposing multiple taxes based on the same tax base. The main argument is that imposing multiple tax rates on the same tax base could lead to excessively high tax rates. Of course, this could easily be prevented by coordinating the range of tax rates that can be applied by the different government levels. Given that tax payers (both households and firms) receive services from various levels of government, there is conceptually nothing wrong with taxing the same tax base, particularly when this can be done in an efficient and effective manner through a piggy-back style tax.

A flat rate local piggyback income tax is a good local tax because it satisfies the benefit principle and being quite visible it promotes political responsibility and accountability. This is also an elastic tax with revenues increasing commensurable with income, so that as the demand for local services increases with income, so do tax revenues.[45] Most international examples of a local income tax represent piggy-backing on the central governments income tax. (See Annex 4.3 for a discussion of the international practice.) The problem with following the conventional practice is that in Tanzania the central government income tax has a rather narrow base, due in large part to the high minimum exemption currently in the law. There is also the issue in Tanzania of the schedular final withholding taxes on dividends, interest, and rental income. Should the piggyback tax include these incomes or should instead fall exclusively on the general withholding and return filing regimes for wage and other labor income? Technically, there should be no difficulty by adding small flat piggyback rates for local governments to the schedular

[45] There is one technical issue that we need to mention and will probably be of not much importance in Tanzania. Conceptually, a local income tax should be levied at the place of residence where the taxpayer receives most of the local government services. However, for administrative reasons the piggyback tax is withheld at source at the place of work. Therefore there needs to be a mechanism through the tax administration to allocate revenues to the jurisdictions where the workers reside. This is done reasonably well in many countries and it is only an issue in large metropolitan areas where individuals may reside and work in different jurisdictions.

taxes on dividends, interest, and rental income, and have the current withholding agents for the central government to also withhold the piggyback tax for local governments. But because these types of income are likely to be concentrated in a small number of local jurisdictions and because the taxation of capital income involves many other considerations beyond the benefit principle applicable to local financing (capital mobility, international competition for foreign direct investment and so on), it may be desirable to limit the local piggyback taxes to wage and salary incomes.

The first avenue, perhaps the most desirable in technical terms but not the easiest in political terms, would be to reform the current national personal income tax by significantly lowering the exemption threshold. Alternatively, an alternative presumptive income tax (for individuals below the regular threshold) may be able to expand the tax net for the national income tax. Either way, expanding the income tax net would help a local piggyback personal income tax become a more significant source of revenue for more local governments. Without this change a local piggyback personal income tax would likely generate a significant level of local revenues in only a very small number of local governments. A major advantage of this approach is that the introduction of a local piggyback personal income tax would not require any tax administration effort on account of local governments, and would involve little administration effort by the Tanzania Revenue Authority.

Even without expanding the national income tax base, a flat-rate local surtax on income could generate significant local revenues. Based on reported national income tax collections for 2002/03, we informally estimate that a uniform 2 percent flat-rate local surtax on PAYE income would have yielded approximately TSh 14 billion.[46] This compared to actual Development Levy collections in that year of TSh 11.2 billion (see Table 2.3). However, when compared to the Development Levy, the municipalities in Dar es Salaam would likely receive a much greater share of a piggy-back income tax than under the Development Levy. Whereas LGAs outside of the Dar es Salaam regions collected TSh 9.2 billion from the Development Levy (almost 90%), they would likely only receive TSh 3 billion if they imposed a 2-percent piggy-back personal income tax on PAYE income (less than 30%).

A second, much harder alternative to occupy the fiscal space left by the current absence of income taxation on lower and middle-income households would be the introduction of a strictly local flat-rate income tax, again with nationally legislated minimum and maximum rates, but fully administered by the subnational governments. But clearly, without administrative assistance from the central government, assessment of individual income represents a significant challenge for local government. Given the current challenges with local tax administration (and the absence of a good tax handle at the local government level), this would not likely be a practical local revenue option.

A third alternative would be the re-introduction of the old Development Levy into a graduated tax on the basis of profession or some other visible characteristic of taxpayers'

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[46] This assumes that all LGAs in Tanzania would choose to select a 2 percent local surtax rate.

income. This is not likely to be a politically acceptable option in the current policy climate in Tanzania.

Corporate income taxes

Tanzania's central government corporate income tax (CIT) is a conventional tax. It is paid at a flat rate of 30 percent on all corporation taxable profits of all companies carrying out business in Tanzania, with deductions of operation costs, depreciation allowances for capital investment, and bonus investment allowance in the priority sectors of hotels, industry and agriculture.

Currently the corporate income tax is appropriately assigned to the central government level. First of all, the corporate income tax affects macroeconomic stabilization and, to the extent that corporations are owned by wealthy individuals, this tax also affects income redistribution. These two characteristics alone suggest that corporate income tax should be levied by the central government. In fact even when levied by the central government, the corporate income tax hardly meets sound principles. There are no reasons to believe that incorporated businesses benefit more from public services than unincorporated ones or that the benefits received vary with profits. The main reason for existence of CIT is to prevent avoidance of individual income tax through incorporation and to withhold tax on foreign shareholders, who otherwise only may have to pay tax in their countries of residence. Clearly, it is administratively easier to tax profits at source rather than as individual income after being distributed among shareholders. But using this facility means that there should be adequate integration of the corporate income tax and the personal income tax. In many cases this integration is non existent, or as in the case of Tanzania only partial.

This imperfect tool to tax individual income becomes even more problematic when levied at the local level as it would be very difficult to attach corporate profits to the residence of shareholders or to apportion profits among several localities where a multi-jurisdictional business might operate. Some countries that allow corporate income taxes at the subnational level attempt to divide or apportion the nationwide profits of a corporation among subnational jurisdictions using a formula. These apportionment formulas tend to use a weighted index of several factors such as payroll, assets, or sales. But even with these formulas the allocation of profit income tends to be quite arbitrary. In some other countries central governments share corporate income tax revenues with subnational governments through either a formula or on a derivation basis. The formula approach, which is more correct, still presents the same issues just mentioned above. In the case of sharing on a derivation basis, the apportionment of profit income among jurisdictions becomes much more arbitrary and in some cases it stays in the very few jurisdictions where companies have their headquarters. See Box 4.7 for a discussion of revenue sharing issues.

Box 4.7
Revenue sharing as an option

A way in which many countries provide subnational governments with unconditional resources is through revenue sharing. This means that revenues generated at one level of government are transferred to finance a portion of expenditures carried out by another level of government. This is common in Germany, Russia, and in many other countries, particularly transition countries.

Two basic options exist in revenue sharing: sharing on a derivation basis, and sharing on a formula basis. Although there can be some advantages to derivation-based revenue sharing, excessive reliance tends to cause horizontal fiscal imbalances in developing economies and require extensive fiscal capacity equalization. To the extent that we would want to provide general-purpose resources (as opposed to sectoral grants, etc.), sharing on a derivation basis would not be a good option in Tanzania; it would unnecessarily worsen local fiscal inequalities. As such, we recommend against derivation-based revenue sharing as an option for funding local governments in Tanzania at this stage. Sharing on a formula-basis would be possible, but then this takes on the nature of a transfer. (For instance, the pool for the General Purpose grant in Tanzania could be defined as X% of VAT collections).

In summary, a corporate income tax is not an option for local governments either in the forms of a separate local corporate income tax, nor as a piggyback corporate income tax, nor a shared tax source.

However, a good case can be built for having some sort of local business tax or business license fees at the local level. Conceptually there are two major justifications for local governments to tax businesses. First, it represents an indirect but administratively easier way to tax income of business owners. In particular, local business taxes could be a feasible way of taxing non-wage income of individuals. The other rationale for local business taxes is that to the extent that businesses benefit from the services and infrastructure provided by the local government, which reduces the costs of doing business, local governments should be compensated according to the benefit principle. Ideally, businesses should be charged specific user charges for specific public services benefiting businesses. However, where it is not feasible to recoup costs of local government services through user charges, some form of broad-based levy on general business activity is warranted. To avoid economic distortions this broad-based levy should be neutral to the factor mix (meaning that the tax should apply both to labor (payroll) and capital (assets), in order to avoid distortions).

One challenge to be overcome for a local business tax in Tanzania would be the administration of such a tax, particularly given the limited coverage of productive activity by smaller firms under the central government's tax system. A presumptive local business income tax based on simplified measures of profitability or business value could be appropriate in this regard, as discussed in Section 4.3.

As a matter of fact, Tanzania just recently practically eliminated the business license fees, which in some ways acted as a local business tax (with the local business license as an effective enforcement tool). Without going back in those reforms, there are two ways to make sure businesses continue to contribute to local government revenues. The first

would be to increase the existing turnover taxes. This is not a desirable plan given that these taxes tend to be distortionary at high rates and the fact that there is already the perception by some that the rates of these taxes are already too high. A second more desirable approach would be to introduce a simple, broad-based, low-rate local business tax to at least replace the income lost by license fees as we propose in subsection 4.3.2.

Value-Added Tax (VAT)

Tanzania relies quite heavily on consumption or indirect taxation.[47] The VAT accounts for the single-largest revenue source at the central level, and collections from VAT and other major indirect taxes (import duty, excise duty on petroleum, and other excises) represent half of all central government revenues.[48] Likewise, at the local level, turnover taxes account for almost half of local revenues.

The current VAT falls on imports and on most domestic transactions by registered business at a single rate of 20 percent. The tax base for VAT on imports is the CIF value plus customs duty and excise duty and for domestic transactions the sale price or the open market value of the goods and services. Exports are zero-rated, thus they are exempted from VAT and registered traders can reclaim a credit for the tax paid on inputs. Most basic goods and services with a high representation in low-income household budgets are exempted from VAT.

The VAT in Tanzania is appropriately assigned to the central government level. The VAT is not generally speaking a good tax to assign to the local government level or to share by the central government with local governments on a derivation basis. The introduction of subnational VATs to provide subnational tax autonomy is a complex issue. Basically, only a number of large federal countries have attempted to introduce a subnational VAT (e.g., Brazil, Canada and India) and the international experience shows that it can easily lead to chaotic situations, as the experience of Brazil has shown in recent years (see Annex 4.4 for a discussion of international practices with subnational VATs). In pure technical (administrative) terms, the VAT is also a poor tax to be shared with subnational governments on a derivation basis. The crediting and debiting of VAT in different jurisdictions make it absolutely unsuitable for direct revenue sharing on a derivation basis. Besides the arbitrariness of crediting and debiting the VAT across jurisdictions, the tax in this case tends to be paid according to the place of registration or the location of the headquarters of business firms.

However, the proceeds of a central government VAT can be perfectly shared with

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[47] Originally the term "indirect taxes" was introduced to denote taxes whose burden is expected or intended to be ultimately shifted to someone other than the subject who pays these taxes. In practice this term is used to denote charges on occasional and particular events (e.g., purchases) regardless of the ultimate incidence of the burden.

[48] The import duty will not be discussed in this section any further. Import duty is levied on imported goods usually at an ad-valorem rate on CIF value. There are five rates ranging from 0 percent (for fertilizers etc.) to 30 percent for consumer durables. Tanzania has adopted the Harmonized Tariff System for classification of goods for tax purposes as well as for trade statistics compilation. Imports from COMESA states are generally charged lower rates. Currently, import duty revenues are properly assigned to the central government level.

subnational governments according to some formula, ranging from a pure per capita or population criterion, to estimates of aggregate consumption, or according to an equalization formula that takes into account fiscal capacity and expenditure needs of subnational jurisdictions.[49] The sharing of VAT proceeds according to a simple formula (e.g., population) may be an option for Tanzania (see Box 4.7). However, it must be recalled that revenue sharing, although it can effectively address the issue of vertical imbalances, it is not a solution for the question of how to build revenue autonomy at the local level.

Excises

Tanzania levies excise taxes on traditionally excisable goods (for imports and domestic production) with negative externalities to society, such as alcoholic beverages, tobacco and petroleum products. There are also excise taxes on soft drinks and the import of cement, consumer luxuries, vehicles and cosmetics for pure revenue raising reasons. Excise duties are levied at specific and/or ad-valorem rates ranging from 10 percent to 30 percent.

Excise taxes, in general, are appropriately assigned to the central government. However, unlike in the case of the VAT, excises have potential as piggyback taxes or special taxes at the subnational level. The main reasons are that excises tend to be more politically acceptable, can be easily administered in coordination with national wholesalers as withholding agents, and allow for rates differentiated by region. For example, many OECD countries allow subnational government surcharges on excises.[50] Moreover, the benefit principle accords with the assignment of (destination-based) excises on alcohol and tobacco to the subnational level (to the extent that the latter is responsible for health care) and on vehicles and fuel (to the extent of subnational governments' involvement in road construction and maintenance). The ability to charge differential rates across subnational jurisdictions is of course limited by the possibility of cross-border trade and smuggling. Also what extent excise piggyback surtaxes can be used at the local level depends on the technology of product distribution and points of sales.[51]

Tanzania does engage in the sharing of the Fuel Levy between different government levels through the Roads Board. While the majority of the Fuel Levy (70 percent) is

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[49] Policy options and international experiences regarding such transfer mechanisms was discussed as part of the Intergovernmental Transfer Study (GSU, January 2003).

[50] For example, in the Netherlands, provinces impose a surcharge on the motor vehicle tax levied by the central government. Provinces are free to set the rate of the surcharge, subject to a ceiling imposed by the central government.

[51] For example, a surtax on the fuel levy generally is thought not to be feasible because this excise tax is typically levied on fuel supplied in bulk from bonded warehouses or refineries to fuelling stations. Since collection is usually made at source, the geographical incidence of revenue is not related to the benefits provided with these funds, that is, road repairs and construction. However, this tax may be suitable for piggy-backing or even revenue sharing on the derivation principle if the technology exists for the wholesalers to withhold the tax for the local governments on the product shipped to their jurisdictions. Obviously this can be much simpler for a few regional governments than for a myriad of local governments.

retained by central government for expenditure on trunk and regional road maintenance and rehabilitation, the remaining 30 percent is transferred (supposedly by formula) to local authorities for expenditure on district and local road maintenance and construction. Given that the Fuel Levy takes on the nature of a special transfer program, it is discussed in greater detail in Section 3 of this report. While the revenue sharing of the Fuel Levy provides local governments with additional resources, it does not provide local governments with the ability to increase or decrease the excise tax. Given the administrative complications that differing local fuel excise rates would introduce, combined with the geographical distribution of fuel sales across the national territory, it would likely be an undesirable complication to introduce variations in local fuel excises at this point in time.

An interesting aspect of excise taxation in Tanzania is that there are apparently no excise taxes on the provision of public utility services imposed either at the central or at the local level. However, there is significant revenue potential in some of these services and these taxes should be easy to collect from the utility companies, especially in the cases of electricity and phone services (possibly including mobile phones). The rationale for these taxes goes beyond revenue potential and administrative ease. If we invoke the benefit principle, there is a strong correlation between electric consumption and phone services and general economic activity, which are good proxies for the demand of local public services by both households and productive enterprises. Compared to other commodities, taxation of public utilities would be associated with relatively low distortions, as most utilities have been shown to have relatively low price-elasticity of demand. Also, the demand for public utilities has been shown to be income elastic, which brings two additional benefits: progressivity and revenue buoyancy (Linn 1983).

The big attraction of excises on public utilities at the local level is that generally they are easy to administer as utility enterprises are already engaged in collection of consumption fees, so that adding local excises to the utility bill should be relatively easy. The inclusion of a surcharge on utility consumption also provides a very convenient and effective enforcement mechanism; consumers who fail to pay their utility bill are subject to immediate termination of services. In fact, local governments in a variety of developing countries (especially in Central and South America) collect some other local taxes by attaching their bills to the public utility (most often, electricity) bill. The same is the case in South Africa, where until recently municipal revenue collections were piggy-backed onto electricity bills. In summary, assigning excise *ad valorem* taxes at the local level on the consumption of electricity, and possibly phone services, is an option that should be considered by the Tanzanian government.

Stamp Duty

Although a VAT was introduced in 1998 for larger enterprises, until 2003 the central government collected a Stamp duty on receipts, which essentially was a substitute tax for the VAT on small businesses (below the VAT threshold). The Stamp Duty was levied on businesses which are not VAT registered, with duty collected at a rate of 2 percent of the turnover for the traders with a composition agreement with the TRA, while those using adhesive stamps affixed on cash receipt pay 3.6 percent of the sale value.

More generally, the former Stamp Duty on business receipts could be considered a form of a presumptive tax on small businesses (see Box 4.8 for a discussion of presumptive taxation). The stamp duty on receipts is a tax that has significant potential for being assigned to local governments although still administered by the TRA. There is also the possibility of transforming the Stamp Duty into a more general presumptive tax for small businesses covering not only the VAT but also other taxes, in particular income taxes.

Box 4.8
International experience with presumptive taxation

Developed tax systems involve relatively complex structures which utilize sophisticated accounting, record keeping, and tax administration. In many cases, it is easier for individual taxpayers and small enterprises (versus large corporations) to remain outside of the tax net for the simple reason that they can remain inconspicuous to the tax administration. For these types of entities, complicated and administratively burdensome tax systems further discourage compliance with the tax laws. Additionally, complicated tax systems make it difficult and expensive for start-up firms (particularly small enterprises) to act in good faith in terms of tax compliance due to the costs associated with record keeping and the need for specialized information to comply with complex tax laws. In many countries, simplified regimes based on imputed or presumptive taxation has traditionally been used as a way to get some tax revenue from these taxpayers, which might otherwise go completely untaxed (see Annex 4.5).

There are about as many different simplified systems as countries that have used them. Differences are due to taxes that are folded into the system (in some countries only income and wealth taxes are rolled in, in other countries consumption taxes are also part of the simplified system); tax bases (some countries use assets, others turnover or gross receipts, others simply define by the type of business and industry); tax levies (lump-sum, or flat or even progressive rate structures); and eligibility requirements (size of taxpayer defined by assets, turnover, gross sales or receipts, number of employees, etc.). It is difficult to conclude a set of consistent lessons from countries that have used simplified tax systems. One of the primary benefits exhibited by presumptive tax systems on small entrepreneur is bring these taxpayers into the tax net, which besides yielding additional revenue, increases perceived fairness of the system and thus compliance in other sectors. However, one important lesson from the international experience is that there should be a clear eligibility requirement associated with an enterprise's scale of operation. If this is not done, then the presumptive or imputed scheme becomes a hard-to-eliminate alternative tax structure.

Source: Wallace (2002)

***Motor vehicle taxes*.**
Tanzania has a wide array of taxes and fees on motor vehicles and none of them assigned to local governments. Apart from taxes on importation, motor vehicles are subject to various other taxes collected by the TRA. These include:

- *Motor vehicle registration* collected on the first registration of motor vehicles in the country. After the one-time registration fee (levied at a flat rate of TSh 95,000 per registration for motor vehicles and TSh 32,000 for motor cycles), there is an annual fee of TSh 10,000.
- *Transfer tax* which falls on the transferring the ownership of a motor vehicle with the new owner paying a transfer fee of TSh 55,000.
- *Car Benefit tax* paid by all commercial private companies not involved in transport business at TSh 100,000 per vehicle owned per annum.
- *Foreign Motor Vehicle Permit and Transit Charges* paid by all non commercial foreign motor vehicles temporally imported into Tanzania.

Generally speaking, the assignment of vehicle taxes to the central government is incorrect because there is typically a strong link between the ownership of vehicles on one hand, and the use of local services and infrastructure (particularly roads) on the other hand. In addition, local taxes and charges on vehicles can counteract the negative externalities associated with local traffic congestion and local air pollution. Although local governments in Tanzania are notionally assigned some revenues from vehicle registration, we believe that vehicle taxation is an area that calls for a reassignment of revenue sources among different levels of government in Tanzania.

Taxes on extraction of natural resources

Mining taxes and taxes on extraction of natural resources provide a potential solid source of revenues for the public sector in Tanzania. Other than the sharing of hunting fees, local taxes on extractive activities are basically nonexistent in Tanzania. However, there is a good rationale for this type of taxation at the local level.

There is at least a partial link of taxes on natural resource extraction with the benefit principle at the local level. This type of taxes can be justified at the local level to the extent that extraction activities use local infrastructure (e.g., roads needed to transport heavy machinery and mined resources), place stress on other local infrastructure (temporary worker camps, hospital facilities required to treat injuries incurred by those working in this industry, and so on), and –depending on the type of extraction- may be polluting or cause other negative externalities increasing health costs of local residents even those not engaged in the extractive industry. There is an extensive literature in the theory and practice of fiscal decentralization on the pros and cons of the assignment of natural resource revenues to subnational governments. Notwithstanding the arguments for some form of local taxation of natural resources, there are two major arguments against local taxation of natural resources. Firstly, in the case of geographically concentrated natural resources, local taxation could cause extensive horizontal fiscal imbalances (e.g., the recent cases of Indonesia, Nigeria, and Russia). Secondly, given the high volatility of world commodity prices, local taxation of natural resources would not constitute a stable source of revenue. These two arguments are more valid in the case of the very political issue of oil and gas production and less valid in the case of common natural resources.

Although excessive reliance of local governments on extractive revenues should be

avoided, sharing different forms of mining-type revenues with local governments, especially in the presence of negative externalities of the extraction process, could be considered in Tanzania.

4.4.2 Potential new local revenue sources

Based on our appraisal of the appropriateness of the entire spectrum of revenue assignments in Tanzania and identification of fiscal space not currently occupied by any level of government, we suggest a number of possible local revenue sources. In considering whether the introduction of new local revenue sources are needed as part of its strategic framework for local government finance, the government should carefully balance the additional local revenue yield and increased local revenue autonomy with the political and administrative costs that the introduction of new local revenue instruments would hold both for central and local governments alike.

Local Personal Income Tax Surcharge. A possible appropriate new local revenue source is the introduction of a local surcharge (or piggyback tax) on the central government's personal income tax. Such a surcharge would be collected by TRA and would be credited regularly (e.g., monthly) to the respective local government accounts, desirably on a residence basis (as opposed to the place of work). The local surcharge income tax would be levied on the exact tax base of the central government personal income tax, although local governments would have discretion to set a flat (proportional) rate. National legislation would set the minimum and maximum rates that can be applied by the local governments. Such a surcharge would provide local government with a sizeable and buoyant source of revenue. Moreover, being administered and enforced by TRA, it would be easy to implement. However, Tanzania lacks a tradition of piggyback taxes. Uneven distribution of tax base might warrant asymmetrical assignment of such a surcharge, depending on the level of tax base development. Consideration must be given to reforming the current national personal income tax by significantly lowering the exemption threshold. This would bring revenues to smaller communities and at the same time would enhance revenues for the central government. In effect, this tax would likely end up being a local withholding surtax on PAYE income.

The primary advantage of a piggyback local income tax would include the sizable and elastic revenues that such taxes could yield. A secondary advantage of the tax would be the low administrative cost, as its collection would be piggybacked unto the collection of the national personal income tax by the TRA. A (piggyback) local income tax generally adheres both to the ability-to-pay principle as well as to the benefit principle. Disadvantages of this option include the lack of tradition in Tanzania with tax base sharing and piggyback taxation; in fact, the central government may simply be unwilling to share this tax base with the local level. Another potential disadvantage of this potential new local revenue source would be the urban bias in its incidence. However, this would be an unlikely feature of most local revenue sources (particularly ability –to-pay taxes) and could be mitigated by the introduction of an equalization grant.

Local excise tax (Levy) on utilities. We recommend considering the introduction of a Local Excise Tax on Electricity Consumption (and/or telephone service, potentially for both land line and mobile services). Such an excise tax would conform to both the benefit principle as well as the ability-to-pay principle. The tax would be collected by the utility companies at rates set by the local governments from a range with maximum and minimum rates determined by central government regulations or legislation. This would provide a good tax handle and potentially a high yielding and elastic source of revenues used in other countries. However, given that electric tariffs are already considered too high in Tanzania, there are certain limits to the usage of this tax both in terms of political feasibility and efficiency concerns.

Local Motor Vehicle Fees. We recommend reassigning the Motor Vehicle Registration and Annual Permit that are currently collected by the TRA to the local government level. This would be a good benefit tax for local governments. Given that new cars are registered centrally, it may be expedient to leave the first time registration centralized, with the annual renewal fee (which is collected by the TRA district office) reassigned to the local government level. The *Transfer tax,* the *Car Benefit tax,* and the *Foreign Motor Vehicle Permit and Transit Charges* would remain assigned to the central government.

Revenue sharing from extractive industries. A final recommendation -if the government wishes to explore new potential local revenue sources- is to consider some degree of revenue sharing of taxes on extractive industries with local governments. Whereas this option is not likely possible in the near future, its adherence to the benefit principle and correspondence as well and its potentially high revenue yield make it an option that cannot be ignored in the medium-term. Further discussion and analysis would be needed to determine whether this option is both administratively feasible and fiscally desirable in the future, as the distribution of natural resources across the national territory may result in undesirable horizontal fiscal imbalances.

4.5 Recommendations and the way forward

The objective of this chapter has been to offer a comprehensive examination of the local tax system; based on this assessment, we suggest what reforms need to be implemented to enhance the contribution of local government revenues to the broader system of local government finance, including revenue adequacy and accountability at the local level. Our approach has been first to focus on what is now in place and how it can be reformed and improved in the pursuit of increased local revenue adequacy in an efficient and accountable manner. Second, we have also examined the issue of whether there is some additional fiscal space for local governments within the context of centrally assigned taxes and if so, what new taxes could be introduced or reassigned to local governments if the Government considers it desirable to increase the revenue capacity of local governments.

Overall policy stance and policy effectiveness.

On the issues of local government revenues, the policy stance of the Government of Tanzania has been somewhat ambiguous. While there was a recognition that the local revenue system performed poorly, stakeholders within the central government lacked consensus on the way forward. On one hand, the Ministry of Finance was greatly troubled by the impact of local taxation on economic development and was eager to rationalize the local revenue system through a process of eliminating local revenue sources. On the other hand, PO-RALG emphasized the importance of local revenue autonomy, and was hesitant to forcibly restrict revenue discretion at the local government level. Given that both concerns are valid in the design of a local revenue system, the government's policy stance should combine the desire for a clearly structured, transparent and efficient local revenue system on one hand with the desire for local revenue autonomy on the other hand in the context of a well designed local government revenue system.

Our assessment concludes that multiple factors contributed to the shortcomings of the current local government revenue system, excessive local discretion in defining the framework for local government revenues; the resulting excessive fragmentation of the local revenue system; significant horizontal inequities; the lack of legitimate, standardized processes and procedures in collecting local revenues; limited tax administration capacity at the local level, and poor incentives for local governments to collect own revenue sources caused by a variety of cross-cutting local government finance issues (faulty expenditure assignments; lack of correspondence; soft budget constraints, and so on).

The first step in the reform of the local tax system should be to clean and clarify the terminology and concepts currently being used. The interest of clarifying these concepts lies in making the system easier to understand for taxpayers and local government officials alike, thereby contributing to greater legitimacy of the system of local government revenues. Greater clarity and greater legitimacy should also help to improve the administration of local government revenues, improve taxpayer compliance, and also facilitate the monitoring of the performance of local tax systems.

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

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

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

Adopting and implementing the new policy framework

Building broad understanding and policy-level consensus for the recommended transformation of the local government revenue structure is a critical first step in the process of transforming Tanzania's local government revenue framework. Upon the formal adoption of a broader framework for local government finance (a draft of which is presented in Section 8 of the report), a concerted effort will be needed to ensure that the transformation of local government revenues proceeds in a deliberate manner. The FDTF, in close collaboration with the TRTF, should instigate a participatory process to finalize the "closed list" structure of the new local government revenue system; this process should include central government stakeholders, local government representatives, as well as private sector stakeholders and civil society. After a consensus reform package is attained, LGRP should take the lead in implementing the reforms, including (1) revising the legal framework; (2) strengthening central government institutional and regulatory framework; (3) strengthening of the local government institutional and regulatory framework; and (4) ensuring participation by civil society and the private sector.

- Constitutional and legal framework. After achieving policy consensus of the final shape of the fiscal space for local governments, the LGFA needs to be revised to reflect the more structured environment of local government revenues. While the Local Government Finance Act was revised in 2003 and 2004 to introduce a "closed list" approach to local revenue, the closed list appears to have been introduced "through the backdoor" (as a footnote to a Schedule) rather than by consistently revising the key sections dealing with local revenues. As such, the Act ought to be

reviewed and revised in such a way that it is wholly consistent with the intent and practice of a new "closed list" approach of local government revenues.

- Central government institutional and regulatory framework. Two key reforms are needed at the central government level in order to assure a sound local government revenue framework.[52] First, the central government should develop a nationally standardized set of local tax regulations and a local tax administration manual. The regulatory framework should provide definitions of the universe of taxpayers that are subject to local taxes (and in which jurisdictions), a general definition of the tax base for each tax, the general collection procedures for local revenues, and sanctions for local tax evasion, to assure uniformity in practices across the national territory. At the same time, the regulations for individual local taxes should be sufficiently flexible to allow different LGAs to follow different administrative approaches (within options set forth in the regulatory framework) as may be dictated by local circumstances. For instance, different property valuation approached may be appropriate for local governments under different circumstances, so that the regulations should specify several permissible approaches. Substantive technical support –as well as extensive interaction and possible piloting- will likely be needed to develop the regulatory framework and administrative manuals.

  Second, in order to provide an enabling institutional framework for local government revenue collections, the central government needs to align its institutional framework by introducing a focal point within PO-RALG (ultimately within the LGA Finance Section) for local government revenues. It would be the job of this unit not only to monitor local government revenue practices, but also to support local governments on an ongoing basis in improving their local revenue administration practices.

- Local government institutional and regulatory framework. As already noted, in order to assure that the regulatory and administrative framework for local revenues is appropriate for the variety of local conditions in Tanzania, involvement of local finance officials from a spectrum of LGAs across the country will be needed to assure the development of a sound regulatory framework. In fact, as part of the development process, the new regulatory framework should be rolled out and tested in a select number of LGAs first. This will allow the fine-tuning of the framework itself as well as the development of explanatory materials that will accompany the roll-out of the new regulations.

  Rolling out of the new regulatory framework for local government revenues should be accompanied by an intensive series of seminars and capacity building workshops for local government officials. The transformation process should involve every LGA going through a process by which they identify gaps between their current local revenue structure and the new permitted list of local revenues, as well as any gaps between their local revenue administration practices and the regulatory guidance

[52] This is in addition to resolving any cross-dimensional issues with the local government finance system that may be effecting local government revenues. These issues are addressed in the other sections of this report.

contained in the nationally standardized regulatory framework for local revenues. Local governments should then be provided sufficient time (and possibly limited external support) to develop and implement reforms to come into compliance with the new local government revenue system. In order to assure the orderly introduction of the new local revenue system, sanctions should be put in place for LGAs that fail to comply with the new revenue system after a transition period. Appropriate sanctions should include loss of the privilege to collect (certain types of) local government revenues and/or loss of the privilege to receive (or reductions in the allocation of) the Local Government Capital Development Grant.

- Participation by civil society and private sector. A final element that cannot be overlooked is the role of civil society and private sector in the transformation of the local revenue system. In order for a transformed local government revenue system to work, the new local tax system needs to be well-understood by taxpayers across the country. The sensitization of civil society and the private sector will require a broad range of sensitization activities, including the development of brochures explaining the new local tax system to all citizens; communications about the reforms through the media; as well as requirements for local governments to hold information sessions for local businesses, CBOs and other local stakeholders.