Section 1

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

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

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

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

In order to gain insights from a broad variety of viewpoints on the current system of local government finance, the study team engaged in discussions with key stakeholders, including officials from PO-RALG, the Ministry of Finance, ALAT, TRA, and relevant donor and technical advisory programmes.[1] Based on these discussions held with key stakeholders during the Inception Mission in November 2004, we identified four themes around which much of the debate on local government finances is centered. Section 1.3 provides a discussion of four misconceptions which were held by some stakeholders surrounding these four issues in local government finance. The study team felt that it was important to clarify these misconceptions early-on in order to create a neutral starting point on the discussions surrounding a sound strategic framework for local government finances in Tanzania.

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

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

1.1. Background of the Study

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

1.1.1 Purpose of the Study

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

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

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

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

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

1.1.2 Policy Agenda of the Government

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

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

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

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

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

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

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

1.1.3 Legislative Framework[3]

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

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

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

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

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

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

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

<u>1.2.1 Expenditure Assignments to Local Authorities</u>

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

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

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

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

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

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

1.2.2 Revenue Assignments

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

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

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

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

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

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

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

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

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

As a result of the perceived negative efficiency and equity impacts of the local tax system, the central government introduced a series of local government reforms in 2003 and 2004 in order to rationalize and harmonize the local revenue system. This has resulted in the introduction of a restrictive, closed-list approach to local taxation; the elimination of some local revenue sources (including, most prominently, the Development Levy); and the sharp reduction of other local revenue sources (including business licenses and agricultural cesses).[5]

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

1.2.3 Intergovernmental Grants

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

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

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

[5] These revenue measures are discussed in greater detail in Chapter 3 of the Local Government Fiscal Review (2004).
[6] Similarly, a decision was made in 1999 that land block hunting fees should go to those councils where the fees are collected.

Table 1.1
Sectoral Allocation Formulas

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

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

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

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

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

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

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

---

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

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

1.2.4 Local Government Borrowing

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

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

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

1.2.5 Role of the village level

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

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

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

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

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

Financial management practices at the village level are weak, and village-level budgets (revenues and expenditures) are not aggregated into higher-level fiscal accounts, so there is no accurate financial picture of the overall size of village-level financial activities. An analysis of financial management practices in 26 lower-level local governments (conducted in 2003) provides limited insight in village level finances. Even for the sample villages, limited data was available on village expenditures or revenues. Village expenditures typically fell in the range of TSh 1,000,000 – 1,500,000, and more than half of village and ward expenditures were allocated for administration (i.e., VEO, WEO, etc.). Since the legislated expenditure assignments for the village level are quite vague, it is virtually impossible to determine whether the available resources are adequate to meet the relative fiscal needs of villages (compared to the available resources in the public sector, and the relative needs of districts and the central government).

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

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

Table 1.2
Financial management practices at the village level

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

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

In addition to the legally assigned own revenue sources, village officials had been entitled by PO-RALG circular to retain 20% of the Development Levy collected within the village area as an incentive to improve collections.[9] This revenue retention scheme also provided funding for the salaries for VEOs and WEOs. Since the abolition of the Development Levy in 2003, such revenue sharing ended, practically starving village councils of revenues. Since the “closed list” of local revenues introduced in 2003 does not accommodate any village-level taxes (other than strictly voluntary contributions), villages have essentially been starved of any real revenue sources.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

While it is true that each local government revenue instrument yields relatively little revenue and even taken together local revenues are only a small share (currently about 3 percent) of national revenue collections, the primary cause of the low revenue yield of local governments is the fact that all major revenue sources (such as the personal income tax, corporate taxes, the VAT, and so on) are assigned to the national level. Furthermore, recent local revenue reforms have not improved the overall fragmented nature of local own revenue sources. While the "rationalization" of local government taxes eliminated a number of trivial, pesky and low-yielding local tax instruments, the process of rationalization also eliminated (or sharply reduced) three of the highest-yielding local revenue sources, including the Development Levy, business licenses and crop cesses.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

---

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

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

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

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

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

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

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

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

Box 1.1
Feedback from Stakeholders' Workshop on Principle 1

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Box 1.2
Feedback from the Stakeholders' Workshop on Principle 2

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

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

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

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

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

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

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

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

At this stage, it is important to note that several features may make a tax a "local" tax, including whether (1) the tax is defined in local by-laws; (2) whether local governments define the tax base; (3) whether local governments are able to set the tax rate; and (4) whether local governments administer or collect the tax. However, economists consider a tax a local tax if –and only if- the local authority has control over the local tax rate. Thus, economists argue that for a local tax, it is not important whether the central government defines the tax base or whether the central government collects the tax, as long as the local council is able to set the tax rate. This is true because as long as the local government is effectively allowed to set its own tax rate (even if within a band defined by the central government), this gives the local government effective revenue autonomy by giving the local government control over the marginal size of its resource envelope. As a result, in reviewing and transforming the local tax system (as part of the remainder of this study), we need to keep in mind that a stronger role by the central government in legislating local tax structure and defining local tax bases will reduce the compliance costs associated with local taxation without hurting local revenue autonomy. Furthermore, whenever appropriate, transformation of local revenues may consider shifting the responsibility to collect local revenues to the Tanzania Revenue Authority, which again would not hurt local revenue autonomy as long as the TRA is clearly identified as a collection agent and local councils are empowered to determine the local tax rate.

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

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

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

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

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

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

Box 1.3
Feedback from Stakeholders' Workshop on Principle 3

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

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

[22] For instance, since many local taxpayers do not have formal business books, a LGA may impose a "proxy" Service Levy on smaller producers by estimating the value of their turnover on a presumptive rule of thumb. As a result, a nominal levy per truck may be imposed on a quarry as a proxy for its output, while a different nominal levy is imposed locally on cashew nut producers as a proxy for the value of turnover of the cashew nut producer.
[23] In fact, as noted earlier, the central government is itself moving to introduce a presumptive tax as part of the national income tax.

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

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

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

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

Box 1.4
Feedback from Stakeholders' Workshop on Principle 4

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

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

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

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

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

In many ways, it is the role of the current study to fill the existing gaps in the financing framework for local government in a manner that is consistent with the vision set out in the Policy Paper. Neither the devolution of expenditure responsibilities, nor the system of local government revenues or the intergovernmental grants system are stand-alone issues. While the first steps in formulating an overall framework for local government finances were to evaluate the current state of the policy debate on the issue (Part 1 of this report) and to consider the current profile of local government finance (Part 2), the next step is to sketch out the "big picture" and broadly relate the resource needs of Local Government Authorities (also referred to as local expenditure needs) to the sources and levels of resources (own source revenues, intergovernmental grants and loans) available to LGAs.

1.5.1 The analytical framework for assessing the local government finance system

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1.5.2 An overall assessment of the current local government finance system

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1.5.3 Structure of the remainder of the study

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

Section 2. A revenue profile of LGAs in Tanzania. Although some data regarding local government resources and local revenue collections are collected on a regular basis, the available data are often incomplete and lack specificity. No systematic analysis is performed on these data. Based on the first comprehensive, detailed data set for local government revenues collected by LGRP, Chapter 3 of the Local Government Finance Review (2004) conducts a basic analysis of local revenue patterns in Tanzania. The quantitative assessment of the current system of local government finance is an important input into the new strategy, as the revenue profile helps in identifying bottlenecks in the current approach to financing local governments that ought to be resolved.

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

Specifically, the local government resource profile includes:

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

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

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

Concluding comments. Before we proceed, we should be clear that the current study is intended to assess the overall *framework* of local government finance and intergovernmental fiscal relations in Tanzania. Of course, it is impossible to assess the overall framework without taking on board a relatively high level of detail of the various mechanisms that constitute the overall system of local government finance (i.e., local government revenue sources, intergovernmental transfer schemes, and so on). As a result, we describe, assess and (as appropriate) make reform suggestions for each of these component parts of the overall system of local government finances in Tanzania in order to assure that the local government finance system as a whole is able to function optimally. However, the reader should bear in mind that this study is intended to develop the overall framework (i.e., the "big picture" of the system) for local government finances in Tanzania. It is not the intention of the current study to conclusively address all the technical issues (i.e., "the nuts and bolts") of the myriad of local government financing instruments used at the local government level. As such, this study seeks to provide a comprehensive framework within which to transform local government revenue instruments (and introduce new intergovernmental transfer schemes) rather than arriving at specific technical recommendations to reform specific local government revenue sources. Follow-on activities are needed to finalize the detailed transformation of the local revenue system and the system of intergovernmental transfers in the context of the overall strategic framework.