



THE UNITED REPUBLIC OF TANZANIA  
Prime Minister's Office - Regional Administration and Local Government  
Ministry of Finance

## **Background Paper on Local Government Finance:**

# **The Framework for the Financing of Local Government Authorities in Tanzania**

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# The Framework for the Financing of Local Government Authorities in Tanzania

## 1. Introduction

### Background

Fiscal decentralization is not a new theme in the policy agenda of the Government of Tanzania. Since the re-establishment of a decentralized public sector in 1982 (followed by the introduction 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.

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

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

### Motivation for the current policy paper

*Assuring a consistent policy framework.* In 2004, the Government of Tanzania determined that it would be useful to undertake a comprehensive review of the policy framework underpinning the structure of the financing of local government, to assure consistency among a number of reform initiatives impacting local government finance (including the harmonization and rationalization of local government revenues, the introduction of a formula-based recurrent grant system, and the introduction of a capital development grant system). Based on a thorough review of the existing approach to local government finance in Tanzania, sound principles of fiscal policy, and international best practices, this study (*Development of a Strategic Framework for the Financing of Local Governments in Tanzania*, June 2005) provides options and

recommendations for a consistent policy framework for financing local government authorities, including the assignment of expenditure responsibilities, the collection of own local revenues, the role of intergovernmental transfer schemes, as well as local government borrowing.

*Renewed policy commitment to the decentralization agenda by the fourth phase government.* Tanzania is seen by many in the global development community as a success story in the way it has managed its fiscal decentralization process since its adoption of the Local Government Reform Policy in 1998. Part of this success has been the recognition that fiscal decentralization is not a one-off reform, but in fact an ongoing process. Adoption of the financing framework for local governments would signal confirmation by the fourth phase government of the principle of “decentralization by devolution” and the important role that local governments would continue to play in Tanzania’s public sector. The financing framework would do so in the manner that emphasizes the fourth phase government’s priorities, including improving local compliance with financial processes and regulations; enhancing transparency, participation and accountability; and supporting economic growth and improved public service delivery.

*Clarification of legislative and regulatory framework.* Since 1982, the Local Government Finances Act (LGFA) has been periodically amended to reflect intermittent reform efforts. As a result, the Act and its implementing regulations no longer provide a well-structured legal and regulatory framework for guiding local government finances. Instead, the Act includes numerous unclear, duplicative, and in some cases contradictory clauses. Furthermore, the LGFA has never been properly reviewed and aligned with the Public Finance Act of 2001. Adoption of this Policy Paper on Local Government Finance would set the stage to update the LGFA and the regulatory framework for local government finance in a manner that is consistent with the evolving priorities of the Government of Tanzania.

*Encourage a further strengthening of institutional arrangements with respect to intergovernmental fiscal relations.* Management of a decentralized government system requires a great deal of institutional coordination between central and local authorities, as well as between central government stakeholders. In recent years, major strides have been made in inter-ministerial cooperation and coordination on local government finance issues. The RALG Section in MOF/BD is rapidly building its capacity to engage more effectively in budget monitoring and enforcing local fiscal compliance. Furthermore, a major reorganization of PMO-RALG was approved in January 2005 that strengthens the administration and supervision of LGA finances in Tanzania's public sector finances. A clear and consistent local government finance framework provides the appropriate context for further strengthening the institutional arrangements (both at the central government level, at the local government level, and between central and local government levels) which supports Tanzania's system of intergovernmental fiscal relations.

## **2. Taking stock of the state of local government finances in Tanzania**

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

fiscal relations, namely: (1) the assignment of expenditure responsibilities; (2) the assignment of revenue sources to local governments; (3) the allocation of intergovernmental fiscal transfers; and (4) the environment for local government borrowing.

The assessment provided by the local government finance framework study (June 2005) suggests that although the current system of local government finance has a number of weak areas that should be strengthened, the overall structure of the current system of local government finance –and many of its features- are quite sound. The study indicates that 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 are generally able to assure the delivery of the range of public services assigned to them. The facilitative role of the Regional Administrative Secretaries (as opposed to their previous more hierarchical role) is appropriate and is seemingly allowing local authorities greater control over their own affairs, while still maintaining their oversight and supervisory responsibilities.

The study further concludes that 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. Substantial progress has been made in recent years on transforming the previously highly discretionary transfer system into a more objective, transparent, stable and pro-poor funding mechanism for local governments. In contrast, the strengthening of the local government revenue system and the local borrowing framework are expected to take place in coming years.

### **3. The assignment of expenditure responsibilities to the local government level**

The Government’s assignment of expenditure responsibilities between different government levels is guided by the policy of “decentralization by devolution”, which is spelled out in the *Policy Paper on Local Government Reform* (MRALG, 1998). According to this policy, expenditure functions should be assigned to the local government level in accordance with the “subsidiarity principle”. This principle states that government services should be delivered by the lowest government level that can do so efficiently.

#### Recognizing different types of devolution

The functions and expenditure responsibilities of local government authorities in Tanzania are assigned in the Local Government (District and Urban Authorities) Acts; the Acts contain a list of functional responsibilities and public services to be provided by district and urban authorities, respectively.<sup>1</sup> The current expenditure assignments contained in the Local Government Acts are generally consistent with the concept of subsidiarity. However, since the public sector is never static, the Government should regularly review its portfolio of central public expenditure responsibilities and

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<sup>1</sup> Relevant sections are Section 111 and 118 of the Local Government (District Authorities) Act, and Sections 54, 55, and 59 of the Local Government (Urban Authorities) Act.

consider whether any of these public services could be delivered more efficiently and effectively at the local government level.

<b>Table 1</b> <b>The assignment of expenditure responsibilities in Tanzania</b>	
<b>Type of local government function</b>	<b>Local government activity</b>
Concurrent functions: locally provided “national” public services	<ul style="list-style-type: none"> <li>▪ Primary education</li> <li>▪ Local health services</li> <li>▪ Agriculture extension and livestock development</li> <li>▪ Water supply</li> <li>▪ Local roads and works</li> </ul>
Exclusive local government functions	<ul style="list-style-type: none"> <li>▪ Street cleaning</li> <li>▪ Local parks</li> <li>▪ Local markets</li> <li>▪ <i>Et cetera</i></li> </ul>
Local government administration	<ul style="list-style-type: none"> <li>▪ Council operations</li> <li>▪ Local planning</li> <li>▪ Local financial management</li> <li>▪ Village and Mtaa administration</li> <li>▪ <i>Et cetera</i></li> </ul>
Delegated central government functions	<ul style="list-style-type: none"> <li>▪ Outbreaks of infectious diseases</li> <li>▪ <i>Et cetera</i></li> </ul>

In addition, although Tanzania is pursuing “decentralization by devolution”, it is widely agreed that this concept means different things for different local government activities. This implicit understanding has not been documented explicitly in either the government’s local government reform strategy or in the respective laws. In principle, the framework for local government finance in Tanzania should recognize four different types of services or activities that may take place at the local level, which are summarized in Table 1.

#### The multi-dimensional nature of expenditure assignments

The manner in which expenditure assignments are incorporated into the local government financing framework should specifically take into account that expenditure responsibilities are multi-dimensional. Multi-dimensional expenditure assignments recognize that “being responsible” for delivering a public services can be broken down into the responsibility for (1) setting policy, regulations and standards; (2) funding the activity; (3) the responsibility for providing the public service (i.e., assuring that the service is provided); and (4) the actual production or delivery of a service (which may be produced by the LGA itself or contracted out). Under the concept that “finance should follow function”, each of the different types of local government activities noted in Table 1 should be funded through different funding modalities.

The most prominent category of local government responsibilities in Tanzania are concurrent functions: (national) public services for which the provision is devolved to the local government level. These services include the five grant-supported sectors (primary education; local health services; agriculture extension and livestock; water supply; and local roads). For these activities, the central government continues to bear responsibility for setting policies, regulations and norms, as well as for the financing.

As discussed further below, the local delivery of concurrent sector activities should be fully funded by sectoral block grants.

The second category of local government activities in Tanzania's framework for local government finance includes "exclusive" or "purely" local government services, such as refuse collection, street sweeping, and other such services. Since the benefits from these local public services befall only the local community, the entire responsibility for these activities (including policy direction, financing, provision and production) should be assigned to the local government level. These activities should be predominantly funded from own resources. However, to the extent that the local government revenue system provides inadequate resources –and in order to assure horizontal fiscal balance- part of these local government activities should be funded from the unconditional, equalizing General Purpose Grant.<sup>2</sup>

The third type of local government expenditure responsibility is local administration. The category "local administration" currently includes a number of minor local functions which are not deemed exclusively local, including community affairs, local environmental protection, and so on. Furthermore, local government authorities are an integral part of Tanzania's national system of public administration, and the predominant responsibility of local government authorities is to provide concurrent public services. In this context, it would be appropriate to fund local administration largely or wholly from central government resources. As discussed below, local government should receive resources for local administration through the General Purpose Grant. While the central government should set regulatory standards for local government administration (such as reporting requirements, and so on), it should refrain from interfering with managerial or administrative decisions of individual LGAs.

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

Finally, local capital development activities –whether for concurrent, exclusive, or administrative purposes- should be funded by a combination of own source revenues, local borrowing, and capital development grants. To the extent that these capital development activities fall within the concurrent sectors, the central government may impose policy guidance, regulations and norms. Whenever appropriate, again, local capital development responsibilities should be devolved to the village/mtaa level.

#### Local budget processes and local financial management

At the national level, the Public Finance Act (2001) and the *National Strategy for Growth and Poverty Reduction* (MKUKUTA) provide a framework for planning public expenditures in a transparent, participatory, pro-poor framework. In addition to assuring that expenditure responsibilities are assigned consistent with the subsidiarity

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<sup>2</sup> To the extent possible and appropriate under the subsidiarity principle, community-level services and activities should take place at the village level. As appropriate, the central government should provide regulatory guidance for the distribution mechanism of district resources to the village-level, commensurate with the expenditure responsibilities of the village level.

principle in a manner where “finance follows function”, a sound fiscal decentralization approach requires that mechanisms are in place to assure that local governments make expenditure decisions in a responsive and accountable manner, in a manner that integrates local government finances into the broader public sector management framework. In order for the expected benefits from decentralization to arise, local governments have to spend their resources in a manner that is responsive to the needs of the local community. This requires that local stakeholders are able to articulate their needs and priorities to their locally elected officials through a participatory local budget process, and it also requires that local government officials take the priorities of their tax-paying constituents seriously.

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

#### **4. Local government revenues and local tax administration**

##### Specific shortcomings of the current local revenue system

The local government revenue system in Tanzania is arguably the weakest component of Tanzania’s local government finance system. The government’s relatively “permissive” (open-list) approach to local taxation in Tanzania resulted in a local revenue system that virtually lacks any sense of uniformity. In particular, weaknesses of the current system include (1) local governments are mostly assigned low-yielding taxes which are among the least popular and politically acceptable revenue sources; (2) the fragmentation of the local tax system causes horizontal inequities and inefficiency; (3) the “benefit principle” is largely missing as a conceptual foundation for local government revenues; and (4) local revenues are hard to administer and hard to enforce, while compliance costs for local taxes are unnecessarily high.

##### Overall policy approach with respect to local government revenues

Concerned with the efficiency and equity effects of local government revenues, the Government pursued a rationalization of the local revenue system in 2003 and 2004 by abolishing a number of local revenues while restricting local rate-setting discretion over the remaining local revenue sources. As a result, recent years have witnessed a gradual decline in the role of local government revenues in the system of local government finance in Tanzania. However, increasing recognition is being given in Tanzania to the fact that local revenues form not only an important part of an efficient local government financing framework and play an important role in assuring local accountability, but are also a critical element of a sound national tax structure. As a result, the Government is preparing to transform the current local government revenue structure in a manner that balances an appropriate level of local revenue autonomy on

one hand with the desire for a clearly structured, transparent and efficient local revenue system on the other hand.

In achieving this policy objective, it is envisioned that the transformation of the local government revenue system will take place in a gradual process, which will incrementally improve and strengthen the local government revenue system over time. As a guiding principle in the transformation of the system of local government finance system, the current deficiencies in the local structure and local tax administration should not be addressed by eliminating local taxes without considering their impact on local revenue autonomy; rather, deficient local taxes should be transformed into sound revenue instruments.

#### Formalize the “closed list approach” to local government revenues

Until recently, Tanzania pursued local government revenue collections through a “permissive” or “open list” approach to local revenue collections, which allowed local authorities substantial discretion in determining their own revenue structure. This approach was a major contributing factor to the current fragmentation of the local government revenue system. Accordingly, this practice was reversed in June 2003, when the Local Government Finances Act was amended to define a specific list of revenue sources available to local authorities along with limits on their rates.

Despite the legislative introduction of a restrictive list of local government revenues in June 2003, neither PMO-RALG nor the Ministry of Finance clearly defined the exact nature of the allowed local government revenues. Formalizing the list of permitted local revenues would involve reviewing the revenue sources and classifying them according to the revenue classifications contained in the Government Finance Statistics Manual. The formalization of the permitted local government revenues would increase the overall legitimacy of the local government revenue system and would prevent onerous local revenue sources from re-emerging in the future. At the same time, despite restricting the local choice of revenue instruments, the local government revenue system would continue to provide local governments with the discretion to change local tax rates, albeit within centrally established limits.

#### Introduction of a standardized regulatory framework for local revenue administration

Despite the introduction of a “closed list” of permissible local revenue sources, no regulatory framework exists which consistently defines the taxable base for the permitted local revenues, or in which local jurisdictions these taxes should be paid. Likewise, little or no assistance was provided to local authorities in transforming their previous revenue structures consistent with the new “closed list” approach. As such, within PMO-RALG’s mandate for ensuring the proper management of the finances of local government authorities, PMO-RALG should pursue the introduction of a standardized regulatory framework for local revenue administration. Compliance costs and horizontal inequities would be reduced by the introduction of a nationally standardized framework for local revenue administration, which would assure that taxpayers across the country would face the some administrative processes and procedures in all local jurisdictions.

The regulatory framework should be developed in such a way that it provide flexibility to LGAs by allowing them to select from various different options how to administer local taxes as appropriate for local circumstances. For instance, the reform

of the local government revenue system could allow for asymmetries in revenue assignments. Furthermore, private firms or the Tanzania Revenue Authority would be allowed to act as revenue collection agents for local authorities whenever appropriate.

#### Prepare for the further harmonization of the local government revenue system

Efficient revenue systems rely on broad-based, low-rate revenue sources which can be efficiently administered. In the Government's long-run vision, the primary sources of local government revenue would be two such local taxes: first, a unified local tax on business activity, and second, a local tax on property ownership (imposed on land and buildings). Consistent with current practices, additional local revenues would be collected from a number of local levies, licenses and permits, as well as from user fees and charges, and other miscellaneous revenue sources.

The gradual transformation of the local government revenue system should focus on the further rationalization of the current local revenue structure by continuing the process of combining fragmented local taxes and levies into a smaller number of broader-based local tax instruments with a more significant revenue potential. In order to assure proper implementation of local government revenue reforms, any changes to the permitted local revenue list should be the result of consultations between PMO-RALG and the Ministry of Finance, and should be supported by a concrete implementation plan.

### **5. The intergovernmental fiscal transfer system**

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

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

The system of intergovernmental fiscal transfers should be consistent with the vision laid out in the Government's Policy Paper on Local Government Reform (MRALG, 1998), as well as with Government decisions in 2004 and 2005 to put in place a formula-based recurrent transfer system and a formula-based Local Government Capital Development Grant system. Most importantly, all transfers provided to the local government level should be allocated in an objective, formula-based, efficient, transparent and fair manner.

### Formula-based recurrent sectoral block grants

The most important funding modality in Tanzania's system of local government finance in terms of financing local government activities is the system of recurrent sector block grants. In accordance with current practice, five sectoral block grants should be included in the local government financing framework: one for each of the five main sectors that deliver concurrent services at the local government level, notably primary education; local health services; agriculture extension and livestock; water supply; and local roads. The purpose of each sectoral block grant mechanism is to fully finance the provision and maintenance of essential sectoral activities at the local government level. Each sectoral block grant provides funding both for PE and OC. Depending on local priorities and conditions, each local authority is responsible for determining the appropriate split between personnel spending and other charges within the available grant resources and within the guidance provided by the annual Budget Guidelines.

*Size of the transfer pools.* Over the past years, the central government has consistently allocated 17-18% of the central government's recurrent budget to local government activities in the grant-supported sectors through Votes 70-89 and Vote 95. As sectoral block grants exclusively fund pro-poor government activities at the local government level (which is both true under the sectoral approach of the first PRS, as well as under the cluster approach of MKUKUTA), the total pool of sectoral block grants should be expected to increase faster than the entire central government budget. Also, as sectoral pooled funds (such as PEDP capitation funds and the Common Health Basket Fund) are increasingly integrated into the regular sectoral block grant system, we should expect the overall percentage of recurrent transfers in the central government budget to increase to 25-30 percent in the medium term.

As the local government sector is currently expanding, it would be limiting to specify the size of transfer pool based on a fixed rule. Instead, for the time being, the size of each sectoral transfer fund could be determined on an annual basis as part of the budget process in the context of the Government's annual Budget Frame.

*Horizontal allocation of resources.* Once the size of the sectoral block grant pools are determined each year, sectoral allocation formulas are applied to these transfer pools in order to distribute these resources among all local government jurisdictions. These sectoral block grant formulas have been developed by the respective sector ministries through consultation with PMO-RALG and the Ministry of Finance. In order to assure stability in the system of local government finance, these formulas should generally be held constant for a period of three years after which their impact should be re-assessed. The inter-ministerial Local Government Finance Working Group should monitor that these sectoral formulas are accurately applied in determining the allocation of sectoral block grant resources to the local government level.

During the first few years of the formula-based recurrent block grant system in 2004, phasing-in and holding-harmless provisions were put in place to assure no major deviations from historical allocations would take place. As a result of these provisions, local governments may be receiving block grant allocations that are either above or below the particular amount determined by the formula during the first few years of the new formula-based grant scheme. However, these mechanisms were put in place as transitional features only. As a result, the Government should take

proactive steps to achieve convergence between the actual grant allocations and formula-based grant amounts with the goal of eliminating these transitional mechanisms.

*Use of transfers at the local government level.* The local government budget guidelines issued to LGAs provide policy guidance and conditionalities with respect to the manner in which transfer resources can be used at the local government level. These guidelines are intended to provide policy direction to local government authorities in making local spending decisions. The guidelines should do so in an objective and verifiable manner, that does not unnecessarily restrict the autonomy of LGAs to respond to local community needs. The LGA budget guidelines should be prepared annually by PMO-RALG in close collaboration with the Ministry of Finance and the Ministry of Planning, Economy and Empowerment, and the draft guidelines should be reviewed each year by the inter-ministerial Local Government Finance Working Group.

#### An unconditional, equalizing General-Purpose Grant.

The introduction of a formula-based General-Purpose Grant (GPG) commenced in FY 2005/06 to provide unconditional financial resources to local government authorities in order to assure that the local government level as a whole is provided with adequate resources. Given the coverage of the other transfer schemes and the incidence of own source revenue collections, the General Purpose Grant should be adequate to cover, first, the cost of local government administration, and second, part of the cost of non-grant-supported local government activities.<sup>3</sup>

The General Purpose Grant is disbursed in an equalizing manner, so that LGAs with higher local expenditure needs (outside the grant-supported sectors) and lower fiscal capacity receive a greater transfer.<sup>4</sup> The GPG allocation formula is designed to be responsive to the variations in economic base and the expenditure needs of local authorities. The formula should be subjected to review on a periodic basis to consider whether the formula continues to achieve its intended policy objectives and to assure that the formula relies on the best data sources available.

#### The Local Government Capital Development Grant System

In principle, the Local Government Capital Development Grant (LGCDG) system, which commenced in January 2005, provides a sound and well-integrated element of the overall strategic framework for local government finance. In principle, all capital development funding for expenditure responsibilities devolved to the local government level should be funded through the LGCDG system.

The allocation formula adopted for the CDG allocation is fully consistent with the recurrent transfer system that was adopted by Cabinet in February 2004.. The formula allocates greater resources to poorer local government authorities, as well as to geographically larger local government districts (in other words, rural district authorities). This is consistent with a needs-based equalization approach. As the

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<sup>3</sup> It might be desirable in the future to specify the size of the GPG pool through a vertical sharing rule as a percentage of total sectoral block grant allocations, or as a percentage of the central government's total recurrent budget.

<sup>4</sup> In this sense, the envisioned GPG is distinctly different from the current GPG/Compensation Grant, which was renamed the GPG in 2004 but which has an incidence which is decidedly not pro-poor.

CDG system evolves over time, the allocation formula should be reviewed from time to time to assure that the formula achieves the policy objectives that it is intended to secure.

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

The LGCDG in its current form is an important step in the process of arriving at a unified capital development funding mechanism in Tanzania. The next step for the LGCDG should be to widen the LGCDG system by incorporating potential sectoral “windows” for formula-based sectoral capital development transfers under the same overall mechanism. In that case, all capital development funding schemes -including sectoral capital development grants- could be planned and budgeted as part of the comprehensive local budget process, and could flow through the same budgetary mechanisms and accounts at the local level.

#### Sectoral funds and ministerial subventions

To the extent that intergovernmental transfers are intended to fund devolved delivery of services (such as the case in primary education, basic health care and so on), intergovernmental fiscal transfers should all be provided through (and not around) the regular recurrent sectoral block grant mechanism. Likewise, development partners should be discouraged from creating parallel financing structures that by-pass the regular intergovernmental transfer system.

Functional responsibilities which are delegated by a central government ministry to the local government level (as opposed to functions that are *devolved* to the local government level) may be funded through earmarking subventions which are funded from ministerial budgets. Such ministerial subventions should be clearly identified as transfers to LGAs; the allocation between jurisdictions is done in an objective, fair and transparent manner; and the Ministry of Finance and PMO-RALG are advised of the distribution (through the inter-ministerial Local Government Finance Working Group). The ministry’s annual budget will have to note the purpose for which these resources are earmarked, and confirm that the funding is for an activity that is indeed not a devolved function.

## **7. Local government borrowing**

As part of the evolving local government finance system in Tanzania, there is a need to cast a wider role for local government borrowing in Tanzania than is currently the case, as local government borrowing provides an appropriate means for funding certain types of local capital investment.

The way in which the Local Government Loans Board (LGLB) is currently capitalized is not appropriate, while the Board is viewed by many to favor poorer,

rural districts in its funding decisions. Although the current borrowing mechanism for small-scale local capital investment under the LGLB might continue to form an element of a future local borrowing framework, a single lending window will not adequately accommodate the borrowing needs of all local government authorities in Tanzania.

In due course, a separate (on-)lending window should be established with the purpose of providing creditworthy local governments access to loan funds. In order to prevent administrative duplication, if administratively feasible, it would be desirable to have the LGLB's Secretariat administer this new loan window. However, this may require a further re-orientation and strengthening of the LGLB, and will need close cooperation and concurrence from the Ministry of Finance.

Access criteria and limitations on borrowing levels should be imposed on the new loan facility to ensure that only creditworthy LGAs are able to access the new funding modality. Great care needs to be taken to assure that the local government borrowing framework operates as an integrated part of the larger local government financing system, rather than "competing" with other financing mechanisms for financial and human resources.

## **8. Areas of reform and next steps**

It was noted earlier in this document that although the current system of local government finance has a number of shortcomings, the overarching structure of the current system of local government finance is quite sound. The historical policy direction of the Government on local government finance has been prudent and is consistent with overall sound principles for decentralization reforms. While in most respects the overall structure is sound, specific steps need to be taken to transform the components of the current local government finance system that need sharpening and fine-tuning in order to arrive at a comprehensive local government financing framework that is well-integrated and internally consistent.

In line with the policy vision expressed in the current policy statement, four concrete areas of reform can be identified that should be pursued in order to achieve the desired strategic framework for local government finance. These four areas include, first, a review of the legislative framework for local government finances; second, continued policy support and institutional strengthening at the central government level; third, the gradual strengthening of the local government revenue system; and fourth, improvements of the financial management processes at the local level and strengthening of the role of LGAs and civil society in the decentralization process.

### Review of the legislative framework for local government finance

The Local Government Finances Act and its implementing regulations currently do not provide a complete and well-structured legal and regulatory framework for guiding local government finances. As such, the Act should be reviewed to conform to the Public Finance Act and to eliminate any outdated, duplicative or contradictory clauses. As needed, the Local Government Finances Act and its implementing regulations should further be revised and updated to be consistent with the Government's policy stance on expenditure assignments, local government revenues, and intergovernmental fiscal transfers.

#### Policy support and institutional strengthening at the central government level

Decentralized fiscal systems will not function efficiently without an appropriate degree of oversight, monitoring and coordination. Therefore, in addition to legislative and regulatory changes, changes are needed in the way in which local government finances are managed and administered by the Ministry of Finance and PMO-RALG. For instance, in line with the policy framework, the Government should complete the introduction of the formula-based transfer system (including the General Purpose Grant) so that all transfers to the local government level are fully determined on a formula basis and so that the allocation and disbursement of transfers is properly integrated into the central budget processes. In parallel, the monitoring of local government finances should be strengthened significantly consistent with the notion that fiscal decentralization requires the central government to have a strong monitoring role. More broadly, Tanzania's budget formulation and public expenditure management processes should make a clear distinction between MDAs and LGAs and appropriately integrate local governmental finances into the country's overall public finance management framework.

An area of significant progress over the past years has been the strengthening of institutional cooperation and coordination for local government finance, particularly through an *ad hoc* Coordinating Block Grant Implementation Team (CBGIT) which is jointly led by the Ministry of Finance and PMO-RALG. In order to consolidate the progress made in the area of inter-ministerial coordination, the Government should move to formalize the CBIT into a permanent inter-ministerial *Local Government Finance Working Group*.

#### Gradual strengthening of the local government revenue system

The current policy framework for local government finance gives a clear policy direction for the evolution of the local government revenue system in Tanzania. The first steps in addressing the current weaknesses noted in the local government revenue framework include (1) formalizing the list of permitted local revenues; (2) developing a comprehensive, standardized regulatory framework for local revenue administration; and (3) prepare for future harmonization and rationalization of the local revenue system by building the capacity of local governments to administer their revenue sources more effectively. The new LGA Finance Section within PMO-RALG should take a leading role in these efforts.

#### Improving the planning, budgeting and financial management processes at the local government level

Finally, no system of local government finance can function properly unless LGAs have proper systems in place for planning, budgeting and managing their finances. Since 1998, PMO-RALG has driven or supported the development of a number of planning, budgeting and financial management and accounting tools, including the local planning approach known as "Opportunities and Obstacles to Development" (O&OD); the local integrated financial management system (Epicor); the LGA Planning and Reporting system (PlanRep); and the emerging reporting and monitoring system for local government finances.

In light of the local government financing framework, there is a need to assure that these various local fiscal processes and systems appropriately complement each other

and conform to the overarching local government finance framework. Furthermore, there is a need to ensure that these various local planning, budgeting and financial management processes conform -and where appropriate, link- to central government public sector management systems and processes, including the central government's budget frame (including the appropriate budget classifications); MKUKUTA; the national MTEF approach, and the Strategic Budget Allocation System (SBAS).