

# **Local government taxation and tax administration in Tanzania**

Odd-Helge Fjeldstad and  
Joseph Semboja

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# Summary

Local taxes represent less than 5 per cent of total tax revenues in Tanzania. However, the large number of these taxes, together with their unsatisfactory nature, means that their economic, political and social impacts are considerably more significant than their figure implies. This report reviews the main characteristics and impacts of the existing local tax system. It discusses how the present tax system emerged, and why it has been maintained for such a long period in spite of all its weaknesses. Furthermore, it considers options for reform. An important component of the ongoing decentralisation reform in Tanzania is to increase the fiscal autonomy of local authorities. This policy is encouraged and partly initiated by the donor community. The above findings suggest that care must be taken in implementing this policy. It is unrealistic to expect that the present administration in many local authorities has adequate capacity and the required integrity to manage increased fiscal autonomy. In fact, there is a real danger that in the absence of substantial restructuring of the current tax system combined with capacity building and improved integrity, increased autonomy will raise mismanagement and corruption.

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Bergen, July 1999

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# Contents

Map	v
Executive summary	vii
1. Introduction	1
2. The current local government revenue system	3
2.1 Introduction	3
2.2 The revenue structure	3
2.2.1 Revenue bases	3
2.2.2 Tax rates	5
2.2.3 Tax revenues per capita	8
2.2.4 Revenue fluctuations	9
2.3 Tax administration	10
2.3.1 The institutional set-up for tax collection	10
2.3.2 Collection procedures	12
2.3.3 Procedures for reporting and submitting tax revenues	12
2.3.4 Recording revenues	13
2.3.5 Auditing	14
2.3.6 Budgeting	15
2.4 Summary	17
3. Qualitative characteristics of the local government revenue system	18
3.1 Introduction	18
3.2 Principles of taxation	18
3.3 Evaluating local revenue bases	20
3.3.1 Development levy	20
3.3.2 Produce cess	21
3.3.3 Business licenses	22
3.3.4 Market fees	23
3.3.5 Property and land taxes	23
3.3.6 Hotel levy	24
3.3.7 Bicycle tax	25
3.3.8 Advertising board fees	25
3.3.9 Sand fee	25
3.3.10 Abattoir fee	25
3.3.11 Other taxes, licences, charges and fees	26
3.4 Summary	26
4. How the current revenue system emerged	28
4.1 Introduction	28
4.2 By-laws	28
4.3 Criteria for tax design	29
4.4 Co-ordination between central and local government	30
4.5 Summary	31
5. The gap between the statutory and the effective revenue system	33
5.1 Introduction	33
5.2 Administrative costs	33
5.3 Problems of revenue collection	37
5.3.1 Capacity	38



5.3.2	Resistance from taxpayers	38
5.3.3	Corruption	40
5.3.4	Political pressure	45
5.3.5	Negligence	46
5.4	Why the current revenue system has been maintained	47
5.5	Summary	48
6.	Options for fiscal reforms	49
6.1	Introduction	49
6.2	Tax compliance and service delivery	49
6.3	Redesigning the current revenue structure	50
6.3.1	Abolishment of unsatisfactory local taxes	51
6.3.2	Improvements to remaining taxes	51
6.3.3	Cost recovery through user charges	53
6.4	Intergovernmental fiscal transfers	54
6.4.1	Revenue sharing	55
6.4.2	Grants	56
6.5	Summary	58
7.	Concluding remarks	59
	References	60
Appendix 1:	Objectives and coverage of the 1996-1998 field studies	65
Appendix 2:	Some alleged cases of corruption at the local government level	66
Appendix 3:	The administrative structures of central and local government	68
Appendix 4:	Central government taxation and tax administration	69
	<b>Tables</b>	
2.1	Current local government revenue sources	4
2.2	Local government own revenue sources 1995-1998	5
2.3	Examples of rates in Kilosa DC and Kibaha DC	7
2.4	Local market prices and cess rates in Kilosa DC and Kibaha DC	8
2.5	Tax revenues per person above the age of 18 in district councils 1992-1995	8
2.6	Tax revenues in wards in Kibaha DC 1996	9
2.7	Tax revenues in villages in Kibaha DC 1996	9
3.2	Business licences in Kibaha and Kilosa DC	23
3.3	Review of the performance of local government revenue bases	27
4.1	The role of different stakeholders in tax design and collection	32
5.1	Perceptions on the quality of public services	39
	<b>Figures</b>	
2.1	The institutional set-up for tax collection in district councils	11
2.2	The gap between budgeted and actually reported revenues Kilosa DC	16
5.1	Tax revenues and wage bill Kilosa DC	35
5.2	Tax revenues and wage bill by wards in Kibaha DC	35
5.3	Relative size of wage bill to tax revenues, by wards in Kilosa DC	36





# Executive summary

## 1 Introduction

- 1.1 This report is aimed at contributing to the ongoing debate on fiscal decentralisation – the devolution of taxing and spending powers to lower levels of government - in Tanzania. It explores the main characteristics and performance of the existing local revenue system, and presents options for reform.
- 1.2 Improved understanding of the reasons and mechanisms that lead to deteriorating fiscal situations of local governments is important for the ongoing reform exercise. This knowledge is also relevant to aid policy, especially in the areas of institutional support for strengthening public administration, including tax administration.
- 1.3 The report draws on the findings of research carried out through 1996 to 1998. The fieldstudies were conducted in Kibaha District Council, Coastal Region, and Kilosa DC, Morogoro Region. These studies aimed at providing primary data and analyses of the capacities and constraints of the local tax administrations, especially in relation to tax design, revenue collection, incentive problems and service delivery. In addition, data on tax revenues for about 50 councils were collected from the Ministry of Local Government in Dodoma. Data on central government taxes were acquired from the Ministry of Finance and Tanzania Revenue Authority.
- 1.4 In the following sections we briefly summarise the findings of the study and their implications for the ongoing local government reforms.

## 2 The current local government revenue system

- 2.1 Local authorities levy a large number of taxes, licences, fees and charges. For instance, in one council studied more than 60 different revenue bases were applied, not including the various sub-groups of individual taxes and the various tax rates in use. Moreover, large variations exist among councils with respect to the number of revenue sources.
- 2.2 The distinction between taxes, licences, charges and fees is often unclear. A number of levies are referred to as charges although they are really more like taxes, since no service is rendered directly and exclusively to the payer. In addition, a wide variety of fees for forms and permits exist. The primary purpose of such permits is for regulation, although in many councils they have become mainly a source of local revenue rather than a control mechanism.
- 2.3 In spite of the large number of revenue sources, four main sources are crosscutting almost all district councils. These are *development levy*, *crop and livestock cess* (agricultural cess), *business licences* and *market fees*. In 1997 these sources accounted for, on average, about two-thirds (66 percent) of the tax revenues in 42 district councils studied. Development levy dominated by contributing 30 percent of total own revenues, followed by agricultural cess (22 percent), business licences (about 9 percent) and market fees (5 percent).

- 2.4 In a sample of 10 urban councils, the major own revenue bases in 1997 were licences (33 percent), property tax (21 percent) and development levy (19 percent).
- 2.5 Large annual fluctuations in the revenue generation of councils are observed. For rural councils, these variations may partly be explained by fluctuating weather conditions since produce cesses are important revenue sources. In addition, we found indications of revenue shortfall in some councils in election years, particularly with respect to development levy. This may be due to the influence of politicians (both of the local and central governments) who advise (or order) the local tax administrators "to relax on tax collection" and "not to harass taxpayers" during election years.
- 2.6 The trend describing fluctuations in local government own revenues does not follow a linear path, but is better described by a polynomial function (i.e., wave-like or undulating). However, in contrast to other studies which argue that there is a general declining trend in the real value of local government own revenues, we find no general trend. From a sample of about 50 councils the trend during the period 1992-95 was declining for some councils, while it was increasing in real terms for others.
- 2.7 The offices of the council treasury (revenue section in particular), the ward executive officer (WEO) and the village executive officer (VEO) are the official tax collection centres. In principle, revenues are recorded at all three collection points, and the books are subject to auditing. In practice, records are often inaccurate and poorly organised. Data on specific revenue-generating activities at particular collection sites are rarely kept. Inconsistencies were found between the revenues recorded by the village executive officers and the records at the ward level. There were also inconsistencies between the records of the ward and district levels. In general, budgeting, reporting and auditing practices are weak in the councils studied.

### **3 Qualitative characteristics of the local government revenue system**

- 3.1 Many local taxes perform poorly with respect to the basic principles of taxation. However, these issues do not appear to be recognised by most local governments, whose main concern simply seems to be to increase local tax revenues - at almost any cost. This concern has been encouraged by calls from the central government to local authorities to try harder to collect enough revenues to cover the council's wage bill.
- 3.2 Some councils have imposed high local taxes on export crops, in conflict with the national government's development policy to stimulate export production. In Kibaha DC, for instance, the cess rate on cashew nuts in 1997 represented 20 percent of the price paid to producers, creating disincentives for producers.
- 3.3 The effective rates for the same tax item (for instance crops) may differ significantly among councils. Therefore, producers living in councils with high taxes, transport and sell their products in "low tax councils" where they can obtain higher after tax prices. In border areas, smuggling has become extensive due to relatively high cess rates on some crops, for instance on tea and coffee. Thus, peasants dodge and manoeuvre to avoid the deprivation inflicted upon them by public policy.

#### **4 How the current revenue system emerged**

- 4.1 The by-law system gives local authorities quite a wide discretion to introduce new local taxes and to set tax rates, subject to ministerial approval. Due to lack of capacity and poor co-ordination between the central and local government only limited restrictions are in practice imposed by the central level on local governments' tax design. Therefore, the local revenue systems have developed without much interference from above. This has led to large variations in the revenue structures of local authorities, and to duplication of local and central government taxes.
- 4.2 Presently all the relevant decision making levels lack the required tax expertise for designing an appropriate tax system. At the local level the serious shortage of qualified staff at the treasury and planning departments has been noted across almost all councils. Even the available staff lacks expertise on tax issues. At the ministerial level, experience shows that the main concerns with respect to local tax design are raised by the Legal Department; the ministry has no tax experts. However, even if it contained any they would easily be over-flooded by influx of proposals from more than 110 councils.
- 4.3 The stakeholders involved in local tax design reinforce the variations observed between councils. In particular, the emphasis by local politicians on equity considerations has led to a fine-tuning of the tax structure in councils where politicians have the power to influence tax design. Thus, the present local revenue structure are partly a result of the different interests of the stakeholders involved in tax design, and partly a consequence of the councils' and the ministry's inability to understand the financial, economic and social implications of the local tax system.

#### **5 The gap between the statutory and the effective revenue system**

- 5.1 Large gaps exist between the revenue potential and what actually is reported to the council treasury. Thus, the ratio between reported and projected revenues differs significantly both between councils and between areas within councils. From a sample of 27 councils, the effective development levy rate in 1995 varied from TSh 40 (Kilwa DC) to TSh 967 (Makete DC), indicating large variations in effective tax enforcement. The ratio between actual reported levy and projected revenue in wards in Kibaha DC in 1996, varied from 8.9 percent to 38.7 percent. The corresponding figures for Kilosa DC were 13 percent and 97 percent.
- 5.2 The costs of administering the complicated tax structures are high. In some wards in Kilosa DC the administrative costs of tax collection are far higher than the tax revenues remitted to the council.
- 5.3 The costs of tax enforcement vary between the different revenue sources. Some revenues are relatively easy to collect because there are clear ways to deal with defaulters. If, for instance, businesspeople fail to pay a licence fee they can be refused services or closed down. Some revenues are not even collected directly by the council. For instance, civil servants pay the development levy through a withholding system, where the employer acts as the collector. Many taxes are, however, relatively difficult to collect. Tax collectors at the ward and village levels in Kibaha DC and Kilosa DC considered development levy to be the most problematic tax to collect, followed by crop cess and livestock cess. Tax officials at the district headquarters also ranked

development levy as the most problematic tax to collect, followed by property and land taxes.

- 5.4 Taxes are widely perceived to be unfair. Taxpayers see few tangible benefits in return for the taxes they pay. Virtually no development activities are undertaken through councils' financial sponsorship and, even the existing capacities are not producing the expected services due to lack of operation and maintenance funds. The deterioration and in some cases non-existence of public services raises taxpayers perceptions of exploitation from an unequal contract with government.
- 5.5 Taxpayers' resistance to pay adds to the enforcement costs. Collectors often have to use harsh methods and violence. Roadblocks and the local militia are frequently used as instruments of tax enforcement. For instance, manned barriers are used to control buyers of certain crops like cashew nuts in the Coastal Region. The buyer has to produce the cess receipt before he is allowed to take any cashew nuts from the district.
- 5.6 Severe sanctions (including strict enforcement and harassment of taxpayers), and discontent with what people feel they get in return from the government promote tax resistance, and contribute to explain the widespread tax evasion observed. Thus, tax authorities' unresponsive, disrespectful and unfair treatment of taxpayers may foster disrespect for and resistance against tax authorities and tax laws. Accordingly, harsh enforcement and harassment by collectors may induce tax evasion, especially if no expected services are provided in return. This also contributes to undermine the legitimacy of the government both at the local and national levels.
- 5.7 Fiscal corruption is extensive in the councils studied, facilitated by the complicated and non-transparent tax system. Corruption takes many forms and varies by types of taxes, methods of tax collection and location. It cuts across all levels of the local government, from the village to the district council headquarters. Magnitude in terms of the amounts of money involved seems to rise by the level of the council.
- 5.8 Our findings show that the most common type of corruption (also involving large amounts of money) is embezzlement of revenues by tax collectors. Embezzlement is the form of tax revenues that does not accrue to the accounts of local governments, but is siphoned off by tax collectors and administrators.
- 5.9 In one council studied, evidence was found that large numbers of tax receipt counterfoils were not returned to the council headquarters as required by the financial regulations. It is reasonable to assume that the counterfoils not returned are used to embezzle tax revenues. A note from the district chief executive supported this hypothesis. For development levy, we found that the amount embezzled in this way in 1995 corresponded to more than 35 percent of the council's actual revenues from development levy. The corresponding figure for 1996 was about 15 percent. In another case, which we followed over a period of three months, we found evidence that less than 5 percent of maize cess collected was reported to the council, or to put it differently, more than 95 percent of the revenues were embezzled.
- 5.10 Embezzlement also take place through collusion between staff of the council's treasury department and bank officials, leading to the non-banking of tax revenues: Bank officials issue a receipt on the correct amount to the treasury official. The receipt is brought back to the council's revenue office for control, and is consistent with the money remitted. However, only a part of the tax revenues is actually

deposited into the council's account. The rest is shared between the bank officials and the collectors involved. This method may be sustained over time since what actually is deposited in the council's bank account is rarely controlled. In early 1998, the Controller and Auditor General uncovered cases from 31 councils where cashbook-receipts were not reflected in the bank statements.

5.11 Prolonged embezzlement of large amounts of tax revenues requires the involvement of relevant senior officials from the councils' headquarters. In one council we found evidence of a corruption network involving the head of district treasury, the district revenue inspector, the district accountant and ward executive officers. Furthermore, the prolonged existence and performance of such corruption networks requires that:

- (i) the tax collectors and tax inspectors are stationed relatively permanently in their positions, i.e., they are rarely transferred;
- (ii) the network is limited to a relatively small number of people in the tax administration; and
- (iii) taxpayers are not directly involved.

5.12 The exclusion of taxpayers from the embezzlement corruption network is possible because the tax collectors may indeed provide genuine receipts to taxpayers on taxes paid. In some cases two sets of similar receipt books are used.

## **6 Options for fiscal reforms**

6.1 Although local taxes represent less than 5 percent of total tax revenues in Tanzania, the large number of these taxes, together with their unsatisfactory nature means that their economic, political and social impacts are considerably more significant than their figure implies.

6.2 There is undoubtedly room for improved fiscal and financial management in local authorities, and improved co-ordination between the different levels of government. Measures may include capacity building, including training programmes for all actors involved in revenue mobilisation and collection. Building local administrative capacity may contribute to reduce revenue losses caused by inefficiencies and corruption. However, attempts to squeeze additional revenues from poorly designed taxes may have negative effects on the economy and the society in general. In general, improved tax administration cannot compensate for bad tax design. Thus, reforming the tax structure should precede the reform of tax administration since there is not much merit in making a bad tax system work somewhat better.

6.3 The capacity of local governments is very weak in tax design, and the resource requirements for building this capacity at the local level are high. Therefore, in the short run, very clear guidelines and limits should be given by the central government regarding tax design. Furthermore, the current system of approving tax by-laws should be strengthened. In particular, there is an urgent need to improve co-ordination with the national tax system. Thus, one may consider establishing an expert committee (a "Finance Commission") to advise both the Ministers of Finance and Local Government on the local government tax system. This committee should advise the two ministers before the by-law is approved.

6.4 Given the poor performance of many local taxes, any reform programme should include the abolition of a large number of these taxes. In particular development



levy should be abolished. This is a tax that we have found to be costly to enforce. The levy is extremely unpopular among taxpayers and tax resistance is widespread. Furthermore, the levy represents an extra income tax on formal sector employees.

- 6.5 A reform should also include the abolition of nuisance taxes like bicycle tax, livestock levy, entertainment levy, etc.. Many of the licences should also be abolished since they rarely have a regulatory function. This should also be the fate of many fees that simply have a high nuisance value and that costs more to enforce than what they yield in terms of revenues, including push cart fees, cattle trekking fee, bicycle registration fee, etc..
- 6.6 In particular, there is a need to simplify the licence and fee structures by reducing the number of rates and coverage. Charges should in principle only be levied when services are provided. For instance, advertisement board fee, sand fee and business licences may be retained since they have a certain regulatory function. To avoid double taxation, fees and licences should be harmonised with central government revenue sources.
- 6.7 The establishment of uniform rates on some major crop cesses at the national level should be considered. In this context one may consider the appointment of revenue collection agencies, including the possibility to centralise the collection of certain taxes. For instance, cess on export crops could be collected at their points of export by Tanzania Revenue Authority.
- 6.8 Export taxes should, in general, be discouraged. However, at present many local cess rates are very high, and thereby discouraging export production. Thus, by abolishing all local cesses and imposing a lower (flat) national cess rate on export crops across all councils, the effective tax rate on these products can, in general, be reduced. For instance, a 10 percent tax on the border value of export crops would levy TSh 21 billion, equivalent to 3.7 percent of total central government tax revenues in 1997/98. This amount is slightly less than the total own revenues currently reported by local governments.
- 6.9 The distribution of these revenues among local governments can be made on a derivation basis, with each council getting the same share of the cess originating from its district. In this way revenue sharing avoids the problems associated with local government tax administration and policy harmonisation.
- 6.10 Land and property taxes have some attractions as local bases since they are imposed on immobile resources, and therefore are difficult to avoid - at least in principle. However, they also have some weaknesses that need to be taken into consideration before too heavy reliance is placed on them as major local government revenue sources. These weaknesses are partly of political and partly administrative character, manifested in problems of valuation and tax enforcement. In particular, it is important to seriously consider the administrative capacity to maintain assessments of property value. Furthermore, the enforcement mechanisms must be carefully designed to avoid a mushrooming number of court cases from angry property and land owners.
- 6.11 In general, a fundamental requirement when redesigning the local tax system is a greater concern with the cost-effectiveness of revenue collection, taking into account not only the direct costs of tax administration, but also the overall excess burden to the economy, including the compliance costs to the taxpayers. To these aims increased

staff productivity and reduced losses through corruption are needed. Such improvements may take a long time to achieve, although a simplification of the local revenue system should be a positive contribution towards these aims.

- 6.12 Tax resistance is likely to increase without improvements in service delivery, necessitating costly and coercive methods of tax enforcement that will further undermine the legitimacy of the government. Improvement in service delivery - a major objective of public sector reforms in Tanzania - is therefore a necessary condition to improve tax compliance. Thus, the challenges facing the government are to improve public service delivery, and to secure funding to provide basic services. However, whatever is done to improve the local government revenue system, the reality is that local authorities in Tanzania will continue to be heavily dependent for their sustenance on fiscal transfers from above. Transfers should therefore be considered an important component of the decentralisation programme.
- 6.13 A key element in the ongoing decentralisation reform in Tanzania is the provision of conditional block grants from the centre to local authorities. These are planned to be introduced as a pilot project in 35 local authorities in January 2000. Conditional block grants are earmarked to finance major nationally defined services, such as primary education, primary health, water supply, agricultural extension and roads, rather than specific programmes. The conditionality refers to earmarking to certain broad-based services (education, water, etc.), but not to particular budget lines (personal emoluments, etc.).
- 6.14 The grants will be based on minimum standards of service to be defined by the sector ministries in negotiation with representatives of local governments. These grants relate only to recurrent costs. Such earmarking of grants will of course limit the autonomy of local governments, and thereby partly negating the arguments for decentralisation. However, imposing conditions may be justified by distributional considerations, such as the need to ensure minimum nation-wide standards for the provision of services of national concern.
- 6.15 Stability and transparency considerations call for formula-based revenue-sharing and other general-purpose transfer systems. However, in this process of fiscal decentralisation it is important to be aware of the risks for macroeconomic management and fiscal discipline. Mechanisms of fiscal transfers may impose considerably rigidity to the central government budget. Therefore, substantial devolution of revenues and spending responsibilities to local authorities can affect the central government's ability to carry out stabilisation and macroeconomic adjustment through the budget.
- 6.16 The destabilising potential of local governments' is greatest when they face no *hard budget constraint*. Expectations of bail-out in case of financial trouble weaken the incentives to economise on costs, and thus generate resource waste and rigidity within local authorities. These inefficiencies, in turn, may spill over into macro-economic imbalances. Thus, short-run macro-economic management considerations call for effective limits on local governments' deficits, consistent with national objectives for growth, inflation and balance of payments.

## **7 Concluding remarks**

- 7.1 An important component of the ongoing decentralisation reforms in Tanzania is to increase the fiscal autonomy of local authorities. This policy is encouraged and partly initiated by the donor community. The above findings suggest that care must be taken in implementing this policy. It is unrealistic to expect that the present administration in many councils has adequate capacity and the required integrity to manage increased fiscal autonomy. In fact, there is a real danger that, in the absence of substantial simplification and restructuring of the current revenue system combined with capacity building and improved integrity, increased autonomy may raise mismanagement and corruption in many councils.
- 7.2 It is particularly important for the time being to impose hard budget constraints on the local authorities, through a design of intergovernmental fiscal relations that ensures for the local governments an adequate balance between expenditure responsibilities and their own revenues, in addition to clearly defined transfers from the centre.
- 7.3 It is beyond doubt that large and dramatic changes are necessary to improve performance and to re-establish legitimacy of the local government system. However, the present speed with which the decentralisation programme seems to impose reforms may prove counter-productive. Furthermore, substantial decentralisation is likely to make it more complicated for the central government to carry out macroeconomic stabilisation through budgetary policies. Therefore, due to Tanzania's acute fiscal imbalances and its aid dependency, decentralisation should probably progress more slowly and cautiously.

# 1 Introduction

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Fiscal decentralisation – the devolution of taxing and spending powers to lower levels of government - has become an important theme of governance in many developing countries in recent years (Fukasaku et al., 1999; Manor, 1999; World Bank, 1999; Shah, 1998; Devas, 1997). As a consequence of much dissatisfaction with the results of centralised economic planning, reformers have turned to the idea of decentralisation as a reform that would break the grip of central government and induce broader participation in democratic governance (Oates, 1998; Smoke, 1994).<sup>1</sup> Being closer to the people, it is argued local authorities can more easily identify people's needs, and thus supply the appropriate form and level of public services (Semboja and Therkildsen, 1991; Rondinelli et al., 1989; Oates, 1972). In turn, it is argued, communities are more likely to be willing to pay taxes locally where the amounts they contribute can be related more directly in their eyes to services received (Livingstone and Charlton, 1998; Westergaard and Alam, 1995). As a result, it is expected, the level of tax revenue raised without excessive public dissatisfaction may be increased.

Yet, both the approach and the results of decentralisation have varied widely between countries. According to Smoke and Lewis (1996:1281), the limited success is attributed to two factors. First, the decentralisation process has been resisted or undermined by central government institutions fearful of losing power and rationale. Second, many initiatives have been donor driven, over-ambitious, and not taking into consideration the complex institutional realities that govern the extent to which, and the pace at which, decentralisation can occur in a particular country. Oates (1998) argues that the case for decentralisation has often been made in a very general and uncritical way with little systematic empirical support. Predictably, the argument for decentralisation has provoked response from some observers who assert that the case for fiscal decentralisation is much-overstated (Prud'homme, 1995).

Despite the mounting concern, Tanzania is now implementing a local government reform, within the framework of the reform of the Civil Service.<sup>2</sup> Both share a common goal: to improve services delivery (URT, 1996). The first phase of decentralising responsibilities and resources from the centre to local institutions begins in January 2000 when 35 local authorities will be given additional responsibilities and decision making powers for public service delivery (Price Waterhouse, 1998). A key element in this process is the provision of conditional block grants from the centre to local authorities. Additional reforms include measures to strengthen local governments' revenue raising, and measures of revenue sharing between local and central government.

This report is aimed at contributing to the ongoing debate on fiscal decentralisation in Tanzania. It explores the main characteristics and performance of the existing revenue system, and presents options for reform. The paper draws on the findings of studies carried out through 1996, 1997 and 1998. The fieldstudies were conducted in Kibaha District Council, Coastal Region, and

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<sup>1</sup> As a "Financial Times" commentator has observed, "If "rolling back the frontiers of the state" was the policy mantra of the 1980s, then the creed of the 1990s is to roll them downwards" (Flanders, 1995, quoted in Devas, 1997:351).

<sup>2</sup> The new Local Government Act was approved by the Parliament in February 1999.

Kilosa DC, Morogoro Region. These studies aimed at providing primary data and analyses of the capacities and constraints of the local tax administrations, especially in relation to tax design, revenue collection, incentive problems and service delivery. The studies covered all three council levels, namely the district headquarter, the wards and the village levels. Information was collected from a variety of sources and through different methods, and covered staff members of the tax administration, local politicians and taxpayers.<sup>3</sup> In addition, data on tax revenues for about 50 councils were collected from the Ministry of Local Government in Dodoma.<sup>4</sup> Data on central government taxes were acquired from the Ministry of Finance and Tanzania Revenue Authority, where we also interviewed officials on the relationship between local and central government taxation. Furthermore, representatives from the donor community were interviewed.

The paper is organised as follows: Chapter 2 reviews the general characteristics of the local government tax system. The importance of various revenue sources is discussed and the institutional set-up for revenue collection examined. In chapter 3 the performance of the main local taxes is reviewed according to the standard public finance criteria. Chapter 4 explores how the present revenue system emerged. It examines the role of the by-law system, and discusses the criteria used for tax design. Chapter 5 attempts to explain the gap between revenue potential and what actually is reported to the local government treasury. Both administrative and political factors are examined, including the administrative capacity to enforce taxes, tax evasion, fiscal corruption and political pressure. In chapter 6 the outline for a new local government revenue system is presented. Finally, chapter 7 concludes.

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<sup>3</sup> See appendix 1, and Fjeldstad and Semboja (1998) for details.

<sup>4</sup> Until 1998, the Ministry of Local Government was incorporated in the Prime Minister's Office. In September 1998 a new, independent "Ministry of Regional Administration and Local Government" was established.

