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Local Government Reform in Tanzania: Considerations for the Development of a System of Formula-Based Grants

Jameson Boex and Jorge Martinez-Vazquez *

Since 1999, Tanzania has been actively pursuing reforms of way in which the central government finances local government activities. Although local government authorities in Tanzania play a significant role in the delivery of key government services, the resources which the central government provides to the local level are tightly controlled by the central government. Based on the unique context of Tanzania's local government reforms, the purpose of the current study is to propose a more efficient, equitable and transparent mechanism to allocate local government resources among the different local government authorities with the purpose of improving the delivery of local government services.

Local government finance reform in Tanzania is garnering increasing interest in policy circles. Although Tanzania's neighbor Uganda is often been considered one of the big reformer in local government finance in Africa, Tanzania is well-positioned to surpass Uganda in the depth of their reforms in the near future and become the next "success" in local government finance reform in Africa.

This paper structured as follows. Section 1 provides a brief summary of local government finances in Tanzania and summarizes the policy-relevant findings and considerations which are the basis for our considerations. The first section further contains a general outline of a possible formula-based transfer system and considerations regarding the sequence of reforms. Section 2 considers issues related to the vertical allocation of resources in Tanzania. Section 3 presents considerations regarding the conceptual approach for the horizontal allocation of resources among LGAs in Tanzania. Sections 4

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through 6 contain specific considerations for sectoral allocation formulas, including primary education (Section 4), primary health care (Section 5), and road maintenance, water, agricultural extension and local administration (Section 6). Finally, Section 7 contains considerations for the implementation of the new formula-based system of intergovernmental grants.

1. *Designing an overall system of intergovernmental transfers in Tanzania*

Based on an assessment of the policy context (Section 1.1), and after considering the spectrum of policy options available to the Government of Tanzania in designing a system of formula-based local government grants (Section 1.2), this section presents some considerations for the overall design of a new, formula-based system of intergovernmental transfers in Tanzania. Since the introduction of a new formula-based system will have to be carefully sequenced, our discussion differentiates between possible reforms that can be implemented in the short run (Section 1.3) and proposed reforms for the medium-to-long term (Section 1.4).

1.1 Local government finance in Tanzania: An assessment of the current policy context

Each country is unique in the considerations leading up to the reform of its fiscal system of the development of a formula-based transfer system for local governments. Although there are universally applicable principles that guide the development of transfer systems, one should never take a “cookie cutter” approach, and impose one country’s experience on another country without taking into consideration the differences in history, institutional environment, fiscal conditions, and geographic and demographic patterns.

Since reintroduction of a system of local governments in Tanzania in 1982, local governments play an important role in the delivery of government services, providing such key government services such as primary education, basic health care, and other government services that are generally considered to be typical “local” services. A main concern in the assignment of expenditure responsibilities in Tanzania is the limited level of discretion that local governments have in implementing their responsibilities; local governments are substantially constrained in responding to local needs due to the presence of inflexible central government guidelines and conditionalities attached to the centralized financing of local government services. Since local governments are highly dependent on allocations from the central government to fund their core responsibilities, the system of intergovernmental fiscal grants plays a crucial role in assuring the adequate, efficient, and equitable delivery of local government services.

The structure of Tanzania’s current system of local government allocations is straightforward: there are six sectoral recurrent local government allocation schemes in the central budget, one for each of five national policy priority areas (education, health, water, roads, and agriculture), plus an allocation scheme for local administration. Each sectoral allocation scheme is further divided into personal emoluments (PE) and other charges (OC). Capital development resources are funneled to local governments through a separate mechanism; these allocations are quite small and highly irregular. No formula-based approach is used to divide the available local government resources among the different local government authorities in Tanzania. Instead, local government units are essentially treated the same as central government agencies in the budget formulation process. At the beginning of the central government’s budget formulation cycle, budget guidelines are circulated among local governments, tasking local governments to prepare budget requests based on a framework of “national minimum standards” (NMS). The NMS framework comprises a set of sectoral standards and norms that are supposed to assure a minimum level of service delivery across Tanzania’s national territory.

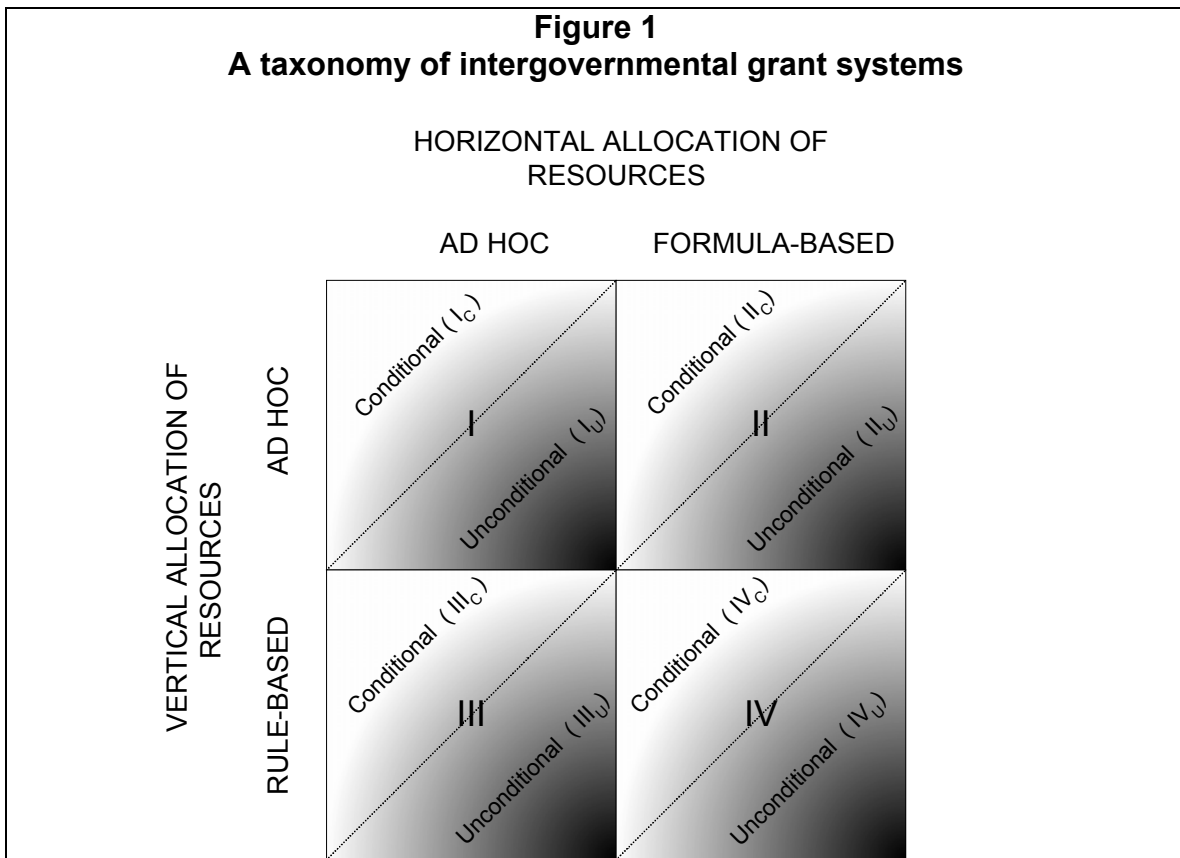
Several key themes in the current policy context in Tanzania are extremely relevant in shaping our considerations in the proposed overall design of a new formula-based system of intergovernmental transfers in Tanzania, including:

- There is a broad consensus among stakeholders that the “National Minimum Service Standards” that currently drive the vertical and horizontal allocation of public resources in Tanzania are inadequate. The way in which the mechanism of minimum service standards has been implemented has clearly failed to bring about an efficient, equitable and transparent allocation of resources
- The mechanism by which local governments are currently funded provides the Ministry of Finance with a substantial degree of discretion over local government funding decisions. Even though the mantra “eyes on, hands off” is heard often in the Ministry of Finance in regard to local government finance, its discretion in the budget formulation process over the allocations of individual local governments result in a resource allocation mechanism that lacks transparency and objectivity.
- There continues to be a substantial degree of ambiguity over the role that local governments should play in a decentralized system of government, as central government agencies continue to have substantial control over local government activities. For instance, even though local government authorities are legal entities which vote on their own budgets, central government allocations to local governments (which comprises over 80 percent of local government resources) are included in the national budget on a line-item basis. Similarly, the regulatory framework continues to consider local governments as essentially being contractors to the central government to deliver government services locally. Treatment of local governments merely as contractors of the central government – without considering the improvements in service delivery and the increased accountability that result from greater local involvement- reveals a lack of true understanding of the benefits of decentralization reform.

- Consensus is forming among key stakeholders that in order to achieve more effective and efficient service delivery by local governments, it is essential that the resource allocations of local governments no longer should be negotiated as part of the budget process. Instead, a formula-based mechanism is needed to divide available resources among the different local government units.

1.2 Reviewing the spectrum of policy options

There are a number of ways to classify intergovernmental transfers. However, arguably the three most important characteristics of intergovernmental transfers upon which they could be classified and categorized are: how the size of the transfer pool is determined (the vertical allocation of resources); how the pool of available resources is distributed among different local government units (the horizontal allocation of resources); and the conditions imposed on local governments in order for them to receive the funding.



The taxonomy of intergovernmental grants represented in Figure 1 (which for convenience shall be referred to as the Boex-Martinez taxonomy) captures the three-dimensional nature of the policy choices facing countries in developing a system of intergovernmental fiscal transfers. The horizontal axis and vertical axis of the policy matrix represent the policy choices to use an *ad hoc* approach versus a formula-based approach in the horizontal and vertical allocation of resources, respectively. This gives rise to four quadrants, numbered as quadrants I, II, II and IV. In addition, however, the taxonomy in Figure 1 divides each quadrant into two sections, allowing indication whether the transfer scheme is unconditional (denoted here by subscript U) or conditional (subscript C). This yields a total of eight policy options.

Based on the policy matrix in Figure 1, the current approach to allocating local government resources in Tanzania could be classified as **Type I_C**: a highly conditional transfer system in which both the size of the overall transfer pool as well as the distribution of resources among local governments are determined in an *ad hoc* fashion. In contrast, the stated long-term policy objective of the government is a **Type IV_U** transfer scheme: a largely unconditional transfer mechanism in which both the size of the overall transfer pool as well as the distribution of resources among local governments are determined by formulas. This means that the mechanism should be moving over time from the most centralized system of grants (the top-left hand corner of the policy matrix) to the most decentralized transfer mechanism possible (the bottom-right hand corner of the policy matrix).

1.3 Considerations in the design of the system of intergovernmental transfers in the short run

A gradual process should be followed to move from the current approach to allocating local government resources towards the ultimate policy objective of a largely unconditional system of local government finance.¹ Given the highly conditional nature of the current system of local government finance, we propose that in the short run (the next one or two years), the system of local government finance should move towards a **Type II_C**, in which the local government resource envelope (for the time being) is still determined on a year-to-year basis, but where horizontal allocation formulas are used to disburse conditional transfers to local governments.

¹ The stated policy objective of the is government to move towards a largely unconditional system of local government finance. While this objective is reflective of the government's desire to yield substantial fiscal discretion to the local government level, there are sound reasons why the central government might wish to retain some control over local government activities through its financing instruments, even in the long run. For instance, the central government has a legitimate interest in assuring that local governments provide a certain minimum level of education and health care. In fact, it is highly unusual for local governments to exclusively be given unconditional grant resources. A more appropriate long-term objective for the system of intergovernmental grants might combines an unconditional local general purpose fund with local sectoral funds for key sectors such as primary education and health.

Vertical allocation of resources in the short run. Currently the resources set aside for local government activities are determined on a year-to-year basis in the context of the annual budget process. The amounts determined each year are guided by the government's longer-term view of its poverty alleviation strategy, as set forth in the government's Poverty Reduction Strategy Paper (PRSP 2000) as well as the Cross-Sector Medium Term Expenditure Framework (MTEF 2002). As a result of increased donor support, central government funding for local government activities (particularly basic education and basic health care) has increased consistently over the past few years. Although it would be preferable to have a vertical funding rule in the medium term to determine the pool(s) of resources made available to local governments, introduction of such a funding rule might be counter-productive in the immediate future since the pool of local government resources is currently non-stationary and increasing. Issues related to the vertical allocation of resources are discussed in greater detail in Section 2.

Horizontal allocation of resources in the short run. The current approach of distributing subnational resources between different local governments based on national minimum service standards has clearly failed to result in an objective, efficient, fair and transparent allocation mechanism. As a result, the largest opportunity for reform in Tanzania in the short run lies in the introduction of a formula-based horizontal allocation mechanism.

In order to facilitate the introduction of a formula-based approach to local government resource allocations, the proposed approach would maintain the current structure of local government grants: each of the six main local government sectors would continue to have their own local funding mechanism. However, under the proposed new system, each local sectoral fund would be distributed among the eligible local government units by a client-based, financial-norm driven allocation formula. Each formula would be applied to the total recurrent sectoral resource pool (i.e., to the total of resources available for PE and OC). Under the new approach, the determination how resources would be divided between PE and OC in each sector would depend on the policy decisions made by individual local government in accordance with the local government budget guidelines and other relevant regulations and conditions.

Of course, as the national minimum standards framework is envisioned to be set aside, the local government budget guidelines would become more advisory in nature (giving administrative guidance as to the formulation of budget plans), as opposed to the highly deterministic nature of the current local government budget guidelines.

Phasing in. There is a need to carefully phase in reforms to the system of intergovernmental grants, particularly the introduction of a horizontal allocation formula. A combination of two features should ensure that the reforms minimally disrupt local service delivery. First, we suggest phasing in the formulas over a period of three years. This will assure that those districts that gain resources will do so gradually, allowing them time to come up with sound budget plans for using these additional resources.

Second, local governments who would potentially lose resources under the new formula could partially or fully be “held harmless,” meaning that no local government would face a decrease in the amount of resources compared to the amount that they currently receive. Holding all local governments financially harmless would prevent any disruption of service: no local government staff would have to be fired or transferred, and local governments would continue to receive sufficient funding to operate all existing local government facilities.

Local government service reform.

Whereas under the current system PE expenditures are driven by actual local government staff levels (as approved by the Civil Service Department, or CSD), under the proposed reforms the amount of resources available to each local government to pay for either personal emoluments or other charges would be determined by each sectoral formula. As a result, under the proposed approach, the number of local government staff that each LGA would be able to hire using intergovernmental grants would be based on the availability of adequate resources rather than based on specific approval from central government officials. Thus the introduction of a formula-based approach would require the government to move forward with the reform of the manner in which the Civil Service Department (CSD) approves local government staff positions. Under the new approach, CSD would have to perfunctorily approve and register local government staff positions upon the request of LGAs as long as local government authorities have resources available to fund the positions.

1.4 Consideration in the design of the system of intergovernmental transfers in the medium term

A possible reform sequence for the system of intergovernmental fiscal transfers in Tanzania is one where local governments are gradually given increased space to make fiscal choices as their capacity to manage their own resources in an accountable manner increases. As such, in the medium term (possibly in the next three to five years), the system could move towards a **Type II** *U/C* transfer system (by gradually increasing local fiscal autonomy and by introducing an unconditional grant component in the system) and eventually become a **Type IV** *U/C* system in which the overall local government resource envelope is determined by a funding rule, and where horizontal allocation formulas are used to disburse conditional and unconditional funds to local governments.

Vertical allocation in the medium term. In the medium term, once funding levels of local government activities stabilize, vertical funding rules could be introduced. Such funding rules would fix the overall levels of funding that would be made available to local government for a multi-year period, for instance as a percentage of national budget resources. Again, vertical allocation of resources is discussed in greater detail in Section 2.

Proceed slowly to introduce greater local fiscal discretion. While the benefits from decentralization are only brought to bear when local governments are allowed to make real decisions in the delivery of local government services, there is a need to proceed with caution in the process of giving local governments increased fiscal autonomy in Tanzania. Currently, financial management, accountability, and transparency at the local government level are generally below par, especially in comparison to the relatively transparent and accountable central government treasury (IFMS) system. The approach envisioned for the medium term is for increased fiscal discretion to be accorded to districts that meet certain minimum conditions of accountability. Two dimensions of additional financial discretion should be considered in light of the transfer system:

- Increased intra-sectoral discretion. Despite inconsistent application of the NMS framework, local governments are currently guided by this framework in determining how to divide their resources between personal emoluments and other charges. While this framework would obviously fall away in the proposed reforms, it is anticipated that some set of centrally-imposed conditions would continue to be imposed in guiding local governments how to divide resources between PE and OC.² However, local governments that meet certain “minimum conditions of accountability” might be accorded the discretion to move resources around between PE, OC, and capital development within each sector.
- Increased inter-sectoral discretion and/or the introduction of a general purpose fund. As local governments become increasingly accountable over time, local governments might further be accorded greater discretion to move resources between sectoral funds. For instance, it might make sense to reform the current local administration allocations into an unconditional general purpose grant scheme. Possibly, the resources from the three smaller sectoral funds (water, roads, agriculture) could be merged into such an unconditional pool. However, legislative and regulatory reforms would likely be required to provide local governments with such increased control over inter-sectoral allocations. While it would be beneficial to allow local governments to have greater flexibility in allocating resources, at the same time we believe it would be proper to safeguard that certain key public services (particularly those with cross-jurisdictional externalities and major social impacts, such as education and health) continue to receive adequate funding. If local governments would be accorded full discretion to allocate resources between the different sectors, the transfer system would essentially have become one large unconditional grant scheme.

Local capital development funding in the medium term. Local capital development funding is currently only a minor portion of central-local transfers. A key theme that will need to be addressed in the medium term is how to assure increased resource-availability

² If nothing else, the center might initially impose the condition that local governments cannot reduce the number of staff positions during the first year(s) after the new grant system is introduced.

for local capital development.³ This issue is likely best addressed in the context of the Local Government Support Facility which is currently in the design phase (World Bank 2001) and alternative donor-funded mechanisms for local government capital development.

2. The vertical allocation of resources among LGAs in Tanzania

2.1 The Vertical Allocation of Resources in Tanzania: Current Conditions and Policy Directions

Whereas the introduction a formula-based “horizontal” allocation mechanism is a priority for local government finance reforms (JGDR 2001), the way in which resources are distributed between different levels of government (the so-called “vertical” allocation of resources) is equally important in arriving at a stable, efficient and equitable system of intergovernmental fiscal relations. Considerations regarding the vertical fiscal balance in Tanzania include:

- The large majority of local government resources for recurrent expenditures are derived from the intergovernmental transfer system. Little systematic data is available for local own source revenues, but own source revenues certainly contribute less than 20 percent to local government resources.
- There exists general consensus among stakeholders that the “minimum standards” framework has failed as a mechanism to determine the pool of resources that should be allocated to local governments. In reality, the budget pool that is made available for sectoral activities executed by local governments is determined in the annual budget process in the context of the Sectoral Medium Term Expenditure Framework (MTEF) and the Poverty Reduction Strategy Paper (PRSP).
- In practice, Tanzania’s record in decentralizing resources is relatively good. Approximately 19 percent of on-budget government spending (or 2.7 percent of GDP) is done at the local level with resources provided to them through the transfer mechanism (Boex 2003). Resources allocated for local government activities are increasing over time as a percent of the national budget, as well as when expressed as a percent of GDP. However, some sectoral ministries (for instance, the Ministry of Health) continue to control resources for activities that should fall within the realm of local government responsibility.

³ A related policy concern is the need for a unified budget approach at the local government level, which would potentially allow greater flexibility for local governments to reallocate “recurrent” resources towards on capital expenditures.

- While the current *ad hoc* approach to vertical allocations assures a reasonably sizeable flow of funds to the local government level, it does not assure a stable planning environment for local governments. As such, there is a need for more transparency and stability in vertical allocations, which would provide local governments with greater resource stability and which would allow local government a longer planning horizon.
- A particular concern in the context of Tanzania has been the inconsistency between the central government’s fiscal year (which runs from July to June) and the local government budget year (which follows the calendar year). In the absence of a stable multi-year planning horizon, local governments are essentially forced to develop two separate budgets: one for own-source funding and one for expenditures funded with central government resources. This inconsistency hinders budget planning, stands in the way of an integrated budget approach, and is a major impediment to a sound local budget process.
- International experience shows that assuring adequate funding for local governments can become an important concern during decentralization reforms. As local governments become increasingly autonomous over time, the central government may consider local government activities as an increasingly convenient opportunity to “off-load” its budgetary problems on the local government level when it faces fiscal imbalances.

In response to the current vertical allocation of resources, what are the policy issues that can be addressed through the development of a system of intergovernmental grants? First, there is a need to formally move the vertical resource allocation process away from the National Minimum Standards approach (Section 2.2). Second, what mechanism should be used to come up with funding levels for local government activities? Are *ad hoc* funding decisions an acceptable way or should some type of multi-year funding rule be used to determine the pool of resources used for local government activities (Section 2.3). Third, we consider to what degree certain local government activities and funding decisions are still lodged within the sectoral budgets as opposed to being truly devolved to the local government level (Section 2.4).

2.2 Formally abandoning National Minimum Standards as a guide to vertical resource allocations

A key challenge of fiscal decentralization reforms in Tanzania is that local governments should be adequately funded. This is particularly true given the importance of the government services which local governments provide, including basic education, health care, water supply and infrastructure. In fact, the regulations accompanying the Local Government Finance Act (Government Notice 282, Published 4 August 2000) require the central government “to ensure that there is availability of the required level of funding in line with determined affordable minimum national minimum standards of services” (Section 6a of the Regulations).

Unfortunately, the regulations shy away from adequately defining the terms “minimum standards” or “affordable minimum standards” in any way other than that are to be determined by the sector ministry “after consultant with the minister ... upon which funds will be made available...”

Ultimately, in practice, whatever constitutes affordable minimum standards is determined as a negotiated solution by Ministry of Finance, the President’s Officer – Regional Administration and Local Government (PO-RALG), and the line ministries within a range that has on one extreme, the amount necessary to implement the desired “wish-list” standards that line ministries would like to achieve, and on the other extreme, the all-to-real resource constraint faced by the central government. Thus, in reality, the budget process is failing to fund the sectoral “minimum standards of service delivery” that are established by the sector ministries. For instance, based on a full costing of the official NMS standards in primary education, local governments might only be receiving, say, 60 percent of the minimum education standard – defying the purpose of defining the unachievable “minimum” standard in the first place.

While the use of budget norms or minimum standards is not uncommon, the practice has a number of undesirable effects. Perhaps most importantly, the reliance on “minimum standards” (which fail to take into account resource availability) limits the accountability of local government authorities. The minimum standards falsely raise the expectation by the population that such standards of service delivery are actually met, allowing local governments to indiscriminately pass the blame for inadequate local service delivery to the central government’s inability to pass down adequate resources.⁴

2.3 Choice between funding rules and ad hoc allocations

If insufficient resources are available in order to ensure that an “adequate” level of resources is provided to local government activities based on certain minimum standards, then how should local government funding levels be determined? As visualized in Figure 1, there are two basic ways in which the actual determination of transfer funds can be approached. First, the determination of the overall size of the funding pool(s) can be done annually on an *ad hoc* basis, so that the level of funding of local government activities is determined annual as part of the annual budget formulation process. Second, the overall level of local government funding can be determined on a more objective and stable basis, for example, as a percentage of total central government revenues, with this percentage fixed for a number of years.

⁴ In fact, resources are seldom “adequate” for the provision of public services, especially since service delivery targets tend to rise in response to the greater availability of resources. For instance, even school districts in the United States habitually complain of inadequate resources, and have annual fundraisers to support the purchase of certain school materials.

There are advantages and disadvantages to these two different approaches. The ability to change the overall level of funding annually on an *ad hoc* basis provides central governments with more flexibility to pursue macroeconomic stabilization policies. On the other hand, the use of an *ad hoc* rule causes uncertainty for local government budgets. The desirability of making revenue flows for local governments more predictable suggests that the introduction of a funding rule for the equalization pool may be a superior alternative. A common version of this rule is to fund the transfer pool with a percentage of central government revenues and to fix this percentage for a number of years, for example, three to five years. The percentage may be applied to only some central government taxes rather than all revenues. But, even though the adoption of this type of rule contributes significantly to the revenue certainty of local budgets, it stops short of providing local governments with fully predictable revenues, since the actual future revenue streams produced by central government taxes are themselves uncertain.

Given the current policy context, it would not be practical to fix the resource envelope for local governments as a percent of budget resources in the short run. First of all, the pool of local resources has been increasing in recent years, making it counter-productive to fix the level of local government funding as a share of national budgetary resources. Additionally, the central government does not have full control over the resource envelope for local government activities, as a considerable part of the local government budget is donor-funded and specifically targeted at the services that are delivered at the local government level. However, since in the medium- to long term, a vertical funding rule would be desirable in order to assure a stable and predictable funding source for local governments in Tanzania, the government should consider the introduction of a vertical funding rule as a policy objective in the medium term. Such a funding rule would specify the size of the various transfer pools (e.g., the Local Education Fund, the Local Health Fund, and so on) as shares of a broad-based national revenue base.

2.4 Vertical allocation and expenditure responsibilities

In accordance with the mantra that “finance should follow function,” a final concern with regard to the vertical allocation of resources in Tanzania is whether funding for local government activities has indeed been fully decentralized. While some sector activities are highly devolved, other sector ministries are much more centralist in their approach to decentralization.

Primary education is an example of a sector in which fiscal devolution has been very systematically pursued. District Education Officers (DEOs) essentially bear the full responsibility for the delivery of primary education in each district, and the associated funding is provided through the regular conditional recurrent grant system. Whatever control is exercised by the central government over the local provision of primary education is done through the grant system, as the transfer mechanism gives central government agencies (including RALG, the Ministry of Finance, and the Ministry of

Education) a large degree of control over the number of teachers and staff, educational resources, and resources made available to local governments through the budget guidelines and the budget formulation process. However, there is a substantial amount of local control over the actual delivery of services, including the hiring of teachers, the location of new school buildings, and the procurement of non-labor inputs, such as textbooks and school materials.

On the other extreme, an example of a much more centralized sectoral approach is the provision of basic health care, which according to the Local Government Act is also a local government responsibility. However the Ministry of Health continues to play a much more active role in the local provision and funding of local health care.

While part of the resources needed to provide local health care services are provided through the conditional grant system, additional funding for the provision of basic health care services is provided through the ministerial budget. For instance, the provision of medical stores (drugs; medicines) to local governments is structured and funded through the Ministry of Health rather than through the regular (recurrent, conditional) local government allocations.⁵ While an internal formula is used to divide these resources between the various local government units, the entire process is internal to the Ministry and lacks outside scrutiny. The Ministry of Health argues that the purchasing of drugs was not devolved to the local government level in order to force local governments to acquire their medical supplies through the centrally controlled Medical Stores Department so as to assure the quality of medical stores.

However, regardless whether these resources are devolved or continue to flow from within the ministerial budget, there is a need for more clarity in each sector as to local governments' roles, rights and responsibilities in the provision of local government services. This clarity should come in the form of sectoral manuals, which should clearly specify the mutual rights and responsibilities of the local governments versus the central government line agencies in providing local government services (see Section 7.3).

3. The proposed horizontal allocation of resources among LGAs in Tanzania

The horizontal allocation of resources signifies the part of the intergovernmental grant mechanism that distributes the available pool(s) of resources between the different eligible local government units. As noted, this is an area of the transfer mechanism in

⁵ Each local government authority receives an internal allocation for drugs and vaccines from the Ministry of Health and is able to “charge” drugs from the Medical Stores Department against that internal account. Similarly, the Ministry of Health continues to control the allocation of transportation resources (vehicles) and administrative resources (computers).

which substantial improvements can be made fairly quickly in Tanzania through the introduction of formula-based funding schemes. The current section presents a suggested formula-based mechanism for the horizontal allocation of resources among LGAs in Tanzania. Sections 4 through 6 discuss specific considerations for each of the six sectoral allocation formulas.

There is a clear consensus among stakeholders that in the horizontal allocation of resources, Tanzania needs to move away from the current needs-based system of National Minimum Standards towards a formula-driven horizontal allocation mechanism. Sound principles of transfer design suggest that such formulas should be based on the number of clients or the size of the local population (as proxies of local demand) rather than the input-based focus of the current system (such as current service levels or the presence of infrastructure), which is driven by the current level of supply.

In this section, we first review the policy objectives of the transfer system in Tanzania and consider the current policy environment (Section 3.1). Next, we revisit the universal principles of transfer design and the need to move towards a resource-allocation formula that is driven by client-focused, financial norms rather than by input-based physical norms (Section 3.2). Section 3.3 outlines the basic transfer mechanism that should be used for the various sectoral funds. Section 3.4 discusses the phasing in of the new formula-based allocation mechanism. Finally, Section 3.5 considers whether sectoral formulas should be applied separately to PE, OC, and capital funding.

3.1 General issues

The government's basic policy objectives with regards to the system of intergovernmental grants, as specified in the Regulations to the LGFA with regard to local government financing (Article 4), are:

- to recognize that funds received by LGAs ... are public resources that should be used economically, diligently, efficiently, and effectively ...
- to recognize that the transfer of recurrent block grant funds from central government to LGAs is carried out in a manner that increases council responsiveness to local priorities and promotes efficient mobilization and use of resources by LGAs;
- to ensure that the allocation of block grants and other form of grants guarantees equitable access by the population to basic services within the affordable funding levels;
- to ensure that there is objectivity, transparency, and accountability in the system of managing public finances.

In contrast to the stated objectives of the current grant approach in Tanzania, the current system of local government allocations achieves none of these objectives. Problems with the current system of local government allocations include:

- Non-affordability of national minimum standards.
- Non-transparency.
- Supply-focused, rather than demand or client-focused.
- Lack of incentives for efficiency in local service delivery.
- Inequitable allocation of resources.
- Complexity and transparency result in lack of accountability.
- Lack of local government ownership.

3.2 Horizontal Resource Allocation: Moving from the Supply-Focus of Minimum Standards to the focus on the Demand for Public Services

Any newly-developed system of intergovernmental grants in Tanzania should attempt to adhere to the universally acceptable principles in the design of a system of intergovernmental transfers (Box 1). These principles and rules provide substantial guidance on the proposed system for intergovernmental grants in Tanzania. For instance, throughout the current document, we note that the use of minimum standards in order to determine both the vertical as well as the horizontal allocation of resources has been a significant concern). In fact, the NMS approach violates one of the key tenants of grant design as laid out in the universal principles of transfer design, that the grant allocation mechanism should focus on the demand (clients or outputs) rather than the supply (inputs and infrastructure) of local government services.

Box 1
Principles in the Design of a Formula-Based Allocation Mechanism

Universally accepted principles of transfer design

- Provide revenue adequacy: A transfer formula should provide a source of adequate resources to local governments to achieve its policy objectives.
- Preserving budget autonomy: A transfer system should preserve budget autonomy at the subnational level within the constraints provided by national priorities
- Enhancing equity and fairness: The transfer mechanism should support a fair allocation of resources.
- Stability: Transfers should be provided in a predictable manner in a dynamic sense.
- Simplicity and transparency: Transfer formulas should be simple and transparent, and should pursue one objective at a time.
- Incentive compatibility: The transfer system should not create negative incentives for local revenue mobilization, and should not induce inefficient expenditure choices.
- Focus on service delivery: Transfer formulas should focus on the demand (clients or outputs) rather than the supply (inputs and infrastructure) of local government services.
- Avoid equal shares: Reliance on the “equal shares” principle as a major allocation factor should be avoided in the design of an allocation formula.
- Avoid sudden large changes: The transfer system should avoid sudden large changes in funding for local governments during the introduction of the new transfer mechanism.

Desirable characteristics of allocation factors.

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

Source: Martinez-Vazquez and Boex (2001).

3.3 Basic approach to formula-based sectoral allocations

Introducing a client-based philosophy in the grant mechanism.

The introduction of a formula-based system of local government grants in Tanzania provides an opportunity to move away from the supply paradigm inherent to NMS. Instead, the level of grants that each local government receives could be based on demand-driven criteria. The two different approaches are compared and contrasted in Figure 2 and 3.

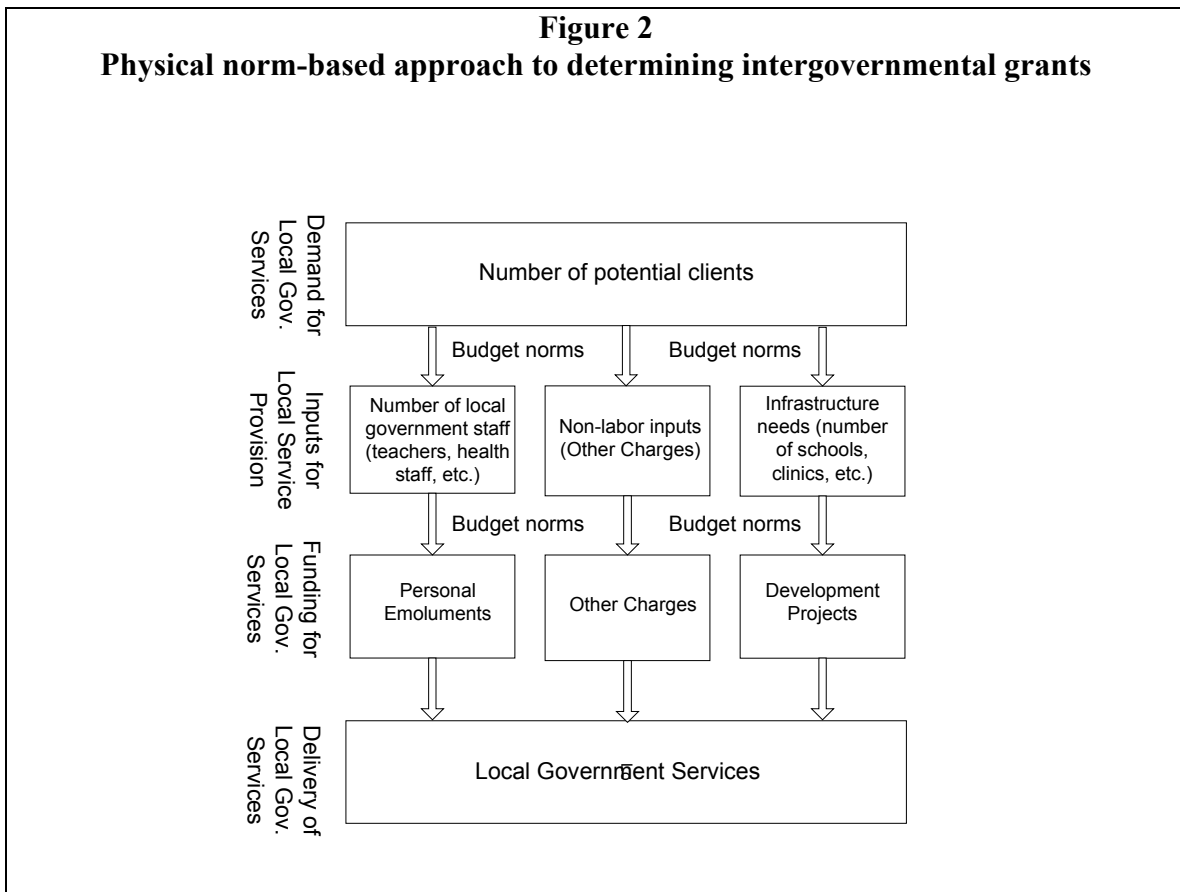
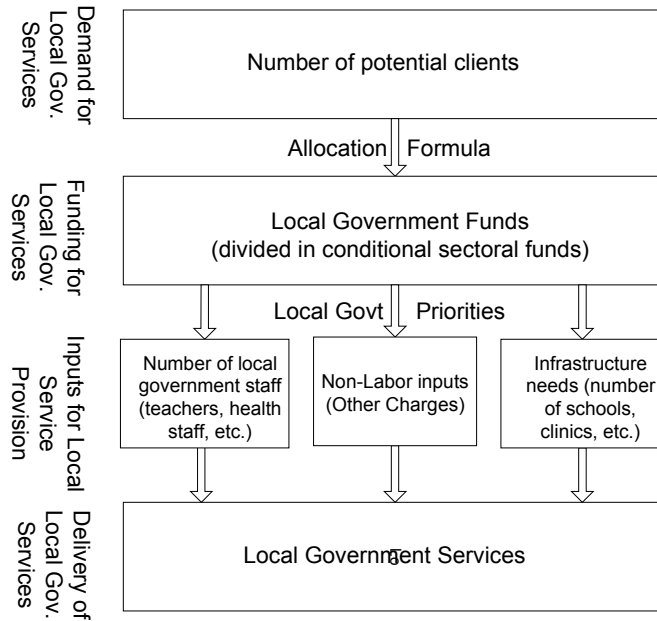


Figure 2 outlines the current approach to allocating local government resources. Under the current system, the demand for local government services (for instance, the number of children in need of schooling) determines the level of inputs (such as the number of schools and the number of teachers) based on the NMS, which in turn determine funding levels.

Figure 3
Demand-based approach to determining intergovernmental grants



In contrast, the demand-oriented approach follows a different sequence of steps, as highlighted in Figure 3. Most importantly, rather than the level of inputs determining the level of funding as under the current system, under the proposed approach the level of demand would determine the level of funding, and in turn the level of funding would determine how many inputs (staff and OC) each local government would be able to afford. In practice, the difference would most likely be felt most strongly in the determination of PE, since under the current approach, the determination of PE is most clearly driven by the number of local government staff approved by the CSD.

Assuring that funding is driven directly by the level of demand for government services rather than indirectly through the cost of inputs may seem a trivial difference, but it reflects a major shift in the philosophy of local government service delivery. The current grant approach treats local governments largely as passive agents of the central government, in which success is not defined by the efficient and successful delivery of government services but rather by the degree of conformity that local governments achieve to the national norms. As such, the current approach is dogmatic and inflexible.

In contrast, a demand-driven grant system provides an incentive for local governments to respond to local communities' needs in a creative and flexible manner in a way that a more centralized system is generally not able to do (and which the current system discourages). For instance, a local government facing low primary school enrolment rates due to high levels of local illiteracy and poverty might respond very differently (for instance, by emphasizing adult education and "food-for-school" type programs) compared to a district which is facing low enrolment due to low population density and transportation problems (which, for instance, might provide support the cost of bicycle taxis for students that live furthest from school). Providing local governments with such flexibility in delivering local government services in order to meet the needs of local communities lies at the core of achieving the benefits of decentralization. However, by over-emphasizing the way in which local government services should be supplied rather than looking at the need that should be addressed, the current system of intergovernmental grants stands in the way of a renewed focus on improved local service delivery.

Defining the basic allocation mechanism.

A basic transfer mechanism could be adopted in Tanzania that allocates resources among local governments in proportion to a limited number of allocation factors, where the importance of each allocation factor would be determined by its relative weight.

The formula may be included in the relevant legislative framework as a verbal description, such as "*Central government funding to local governments is divided in the following fashion: x percent of resources are allocated among local government authorities in proportion to their population, while y percent of resources are allocated among local government authorities in proportion to their land area.*" Alternatively, the formula may be expressed mathematically as:

$$\begin{aligned}
 \text{Transfer for Local Government} &= (x_1 / X_1) * a_1 F \\
 &+ (x_2 / X_2) * a_2 F \\
 &+ \dots \\
 &+ (x_n / X_n) * a_n F
 \end{aligned}$$

where:

- F is the pool of funds to be allocated among all local governments;
- a_i signifies the relative weight of each factor so that a₁ + a₂ + ... + a_n = 1; and
- x / X represents the share of each factor that is present in the local government area.

This basic allocation mechanism proposed is commonly used in countries across the world.

On the types of allocation factors to be used.

Most fiscal policy experts would agree that the Government of Tanzania should introduce a formula-based grant system that relies on a series of simple, straightforward sectoral allocation formulas. Each of these formula would be based on a few factors that are crucial in determining the demand and cost of service provision in each respective sector. This leaves a wide range of possible allocation factors to be considered for each sector, to be determined in discussion with sectoral experts and local government officials. Our considerations address a number of specific issues regarding possible allocation factors in Tanzania. Specific options and considerations for each of the six sectoral formula are discussed in the subsequent sections.

Population. Population is an important (if not the most important) factor in most allocation formulas around the world. The importance of the population-based component in transfer formulas reflects the assumption that local governments' expenditure needs generally grow proportionally or largely proportionally with the size of their constituencies. Similarly, other demographic measures (such as the size of the population under age five, or the size of the school-aged population) may be used as allocation factors as well.

Land area. In order to assure equitable access to local government services, the necessity of financial resources generally increases as a district's land area increases. Less densely populated areas typically require higher levels of government service and create higher costs because it is more costly to serve a population that is more spread out. In order to assure reasonable access to public facilities such as schools and health clinics, a larger number of facilities need to be constructed, and the cost of operating these facilities tends to be higher per client since student-teacher ratios and similar measures of usage of tend to be lower in less densely populated areas. In addition, construction costs and transportation costs are higher in less densely populated areas, and professional public servants may need to be awarded bonuses to serve in more remote parts of a country.

The "equality" principle. One of the most common and troublesome elements in designing allocation formulas is the common use of the "equality principle" or "equal shares" as an allocation factor, in which each local government gets the same amount of funding, regardless of its population. In fact, equality is an important component in the Road Levy Fund in Tanzania, and fixed costs are an important component of the recommendations provided in the (PWC 2000). Likewise, Boex (2003) finds that "equal shares" indeed forms a part (albeit of relative small component) in the incidence patterns of sectoral allocations in Tanzania.

The use of "equality" or "equal shares" as a factor in a distribution formula raises concerns about incentives, efficiency and basic fairness, especially if the component is a

dominant factor in the allocation formula.⁶ Proponents of inclusion of an “equal shares” component in an allocation formula argue that scale economies exist in the provision of public services, so that smaller jurisdictions will need more funds in order to provide the same level of public services. It is a matter of debate whether this argument is in fact valid, as the “minimum efficient scale” for most government services provided by local governments is typically quite low (see Box 3). To the extent that there are districts in Tanzania that are so small that they fall below the minimum efficient scale, it is questionable whether such outliers should be compensated through a fixed grant amount, or whether a more appropriate policy response would be to (encourage them to) merge with a neighboring district.⁷

Poverty. Local government resources in Tanzania are generally allocated in a slightly pro-poor manner (Boex 2003). Indeed, inclusion of poverty levels as an allocation factor would be appropriate because poor households typically rely more on publicly provided services (such as public health care), while at the same time the provision of local government services to poor residents can also be more costly (for instance, assuring school attendance of children from poor households is more costly). A major problem in this regard in Tanzania is the absence of good district-level poverty data. The most recent source of poverty data is the Household Expenditure Survey (2002), but the survey only reports poverty incidence at the regional level, and not at the district level.

Fiscal capacity equalization and stimulation of fiscal effort. While the current legislative and regulatory framework authorizes the introduction of an equalization grant, there are many obstacles to actually introducing such a grant scheme. Most importantly, the current local government allocation mechanism is highly oriented towards conditional grants for national priorities, and in fact even lacks a window for the allocation of unconditional grants. As such, these factors only become relevant in the medium term with the possible introduction of a general purpose (unconditional) local government fund.

Regional cost variations. It is widely recognized that there are cost variation across Tanzania that make it more costly to provide local public services in different parts of the country. These variations particularly effect non-labor items which have to be shipped from major cities, such as school books, medicines, or certain construction materials.

⁶ The equity concern in Tanzania is illustrated by the following comparison: Every one million Shillings that is allocated to each local government as a fixed amount (or equal share), Kinondoni Municipality will have to share among 1.2 million residents, allowing it to provide only TSh 0.80 of services per resident. At the same time, a fixed amount of TSh 1,000,000 amount translate in TSh 22 per resident for Pangani District with it population of roughly 44,000 (which is a 25-fold increase over Kinondoni).

⁷ Inclusion of a large lump sum (fixed amount) or equal shares factor in an allocation formula would also result in a very dogmatic approach to local government administration, with local governments hiring certain officials simply because “local governments should have a ...” (a bee-keeping official, for instance), rather than from a prioritization of local needs. In addition, the fixed amount’s nature as an “endowment” fails to provide smaller local government’s with an incentive to find creative ways around scale economies through out-sourcing or other techniques.

One proxy for such regional cost variations which is commonly suggested is the distance from the capital city (or in the case of Tanzania, the distance from Dar es Salaam). However, the distance from Dar es Salaam would actually not be a very good measure of regional cost variations, as this measure fails to take into account the fact that what matters is not just sheer distance but accessibility; there are in fact rural districts which may be geographically located relatively close to Dar es Salaam but which have poor access to Dar es Salaam due to poor transportation infrastructure. A better measure of the cost variations faced by local governments across the national territory would more directly rely on the actual variations in the cost of local government service provision. Although no such measure is available at the local level in Tanzania, PWC (2000) proposes to use regional diesel fuel prices as an indicator for regional price fluctuations. Given the fact that regional variations in the price of diesel fuel are caused by higher shipping costs in less accessible locations (which also causes increases in the cost of local service delivery), inclusion of a regional price index based on diesel fuel prices would be an appropriate mechanism to compensate local governments for the fact that they face a higher cost structure.⁸

The cost of maintaining current service levels. One common concern in the transition towards a formula-based system of intergovernmental grants is whether the formula-based allocation will suffice to operate existing infrastructure and maintain existing service levels. Policy makers may seek to assure the continued operation of local government at current service levels by supporting an input-based formula approach which allocates resources based on the level of existing infrastructure and existing levels of public local employees. We noted earlier that such a supply-focused approach to intergovernmental grants should be considered a “bad” practice for a number of reasons. This concern is better addressed by phasing in the introduction of a new formula-based approach over time, or by holding local governments (partially) harmless for potential declines in resource availability.

3.4 Phasing in of the horizontal allocation formula

Even though the benefits of introducing a formula-based allocation mechanism are unmistakable, it would be a mistake to introduce a new formulaic approach overnight. There are two reasons why the proposed formula-approach should be introduced over a multi-year period in Tanzania. General approaches to introducing a new transfer formula are discussed in Section 3.2.6 of this report.

First, a phasing-in of the new approach will prevent large sudden increases in resource allocations to under-resourced districts. Second, we propose that the government consider

⁸ This approach would not be sound if regional variations in the price of diesel fuel would be determined by government regulation or if the price of diesel fuel would be set by a (government) monopoly, as is the case in some African countries.

holding local governments fully or partially harmless against decreases in their resource allocations.

We consider it important to gradually phase in the new allocation formula because sudden large increases in resource allocations could potentially result in inefficient allocation or even misappropriation of public resources by local governments, which in turn could trigger a back-lash against the entire decentralization process. A more gradual introduction of the formula-based approach would further buy some time to address ancillary issues of administrative nature, such as how local governments should move to hire new local staff through CSD once local government grants are driven by the formula as opposed to having PE determined as a function of centrally-approved staff levels. An additional benefit of phasing in a formula is that the technique is resource neutral (it does not cost anything extra).

In addition to phasing-in, the central government might hold all LGAs are fully or partially “harmless” against possible decreases in resource allocations. This means that no local government would receive fewer resources (in nominal terms) than in the previous year. Assuring that the reform process has no “losers” would make any reform more politically acceptable, as the holding harmless clause would prevent significant social consequences: no local government would have to reduce any of its services and no local government staff would have to be moved. Not holding harmless would be of questionable economic and social merit in the context of a developing country such as Tanzania, as it would potentially result in capital resources being idled unnecessarily.

Unfortunately, holding harmless does not necessarily eliminate all opposition to reforms. Those districts that have been historically successful in attracting central government resources may still oppose the introduction of a formula-based approach, as they will no longer be able to receive disproportionate increases in funding over time. Under the formula-based approach, despite the holding-harmless clause, these local governments will still lose in relative terms as their resources are held constant while other districts receive larger allocations over time, until all districts receive their “fair” formula-based share of the local government resource pool.

It further needs to be noted that holding harmless is not free of costs, and it is not always feasible in all circumstances. After all, resources that are used for holding harmless cannot be used for formula-based distribution, unless additional sources are specifically set aside for this purpose.

3.5 Should an allocation formula be applied to PE, OC and capital development?

Under the current system, local government grants for each sector are separated into three types: personal emoluments, other charges, and funding for capital development

projects.⁹ Some stakeholders in Tanzania have suggested that it might be more straightforward to maintain the current approach for PE resources while introducing an allocation formula exclusively for OC resources.

There are three reasons why such a separation between PE and OC would not be desirable. First, introducing a formula-based approach exclusively for OC would result in a system that would continue to exclude more than three-quarters of local government resources from an objective, formula-based allocation approach. Secondly, sound budget practices recognize that budgetary decisions should be made by the policy maker with the best information to do so. It is widely recognized that central government officials are not in the best position to determine the balance between PE and OC at the local level. Third, the creation of an artificial separation between PE and OC in the budget process would run counter the trend at the national level towards integration of budget processes for PE, OC and capital budget resources.

3.6 Allocation of Donor Resources

There exists a substantial amount of donor support to local governments in Tanzania. While an increasing amount of this support flows to local government authorities through central government accounts as part of sector-wide approaches (SWAPs) –for instance, the Common Health Basket Fund or the Primary Education Development Program (PEDP)- substantial sums of funding from bilateral donors, multi-lateral agencies and non-governmental organizations continue to circumvent the national budget accounts in supporting the delivery of local government services and the development of local capital infrastructure.

Concentration of donor development funds in a few districts, which results from the areas-based approaches followed by a number of bilateral donors, results in an inequitable allocation of resources and reduces the transparency and accountability of the decentralized system, as it becomes unclear for citizens whether they should attribute progress in their district to their local assembly or to donor contributions when compared to other districts. Additionally, one would want to prevent a situation where individual local governments essentially compete for the favor of donor agencies.

Reform of donor-funded local development activities is needed to address a number of shortcomings of a parallel structure of capital development funds and intergovernmental transfers. We view that the long term policy objective of the Government of Tanzania

⁹ In reality the distinctions between the categories are much less clear. For instance, it would not be unusual for local governments in developing countries to reallocate OC resources for capital development purposes or vice-versa by re-classifying certain activities. Local government reallocation of resources from their PE allocation towards other purposes (for instance, OC) has been reported as a problem as well (Dehn et al. 2002; Semboja 1999). Also DPED disburses both its recurrent and investment resources through the recurrent transfer mechanism.

and the donor community should be to integrate the various donor-funded local development schemes into the government's overall system of intergovernmental transfers. Although the scope of the problem may decline over time as more donors join basket funding arrangements, it is important to recognize that full integration of the donor resources into the government's system of intergovernmental fiscal transfers through basket funds will never be universally acceptable to all donors, simply due to the fact that donor agencies pursue their own policy priorities and adhere to their own national regulations.

One specific case where greater coordination between intergovernmental grant system and donor-funded local development funding instruments would likely be feasible (and greatly contribute to the more equitable allocation of development resources across districts) is in the implementation of the Local Government Support Program (LGSP) facility currently under preparation (World Bank 2001). The local government funding mechanism for the LGSP can be defined so as to take into account the development funding currently already provided by bilaterally-funded area-based programs. Reducing LGSP allocations for areas that are receiving substantially equivalent area-based bilateral donor support for development projects would have two effects. First, it would restore some degree of inter-district equity in external local development funding in Tanzania, by assuring that donor-supported districts do not receive funding twice (once from a bilateral donor, and second, additional funds from LGSP). Second, such a funding mechanism would remove the incentive for local governments (and donors) to further pursue area-based development projects and encourage integration of development funding into basket funds or LGSP.

4. Funding the local provision of primary education: local education grants

The most important responsibility of local governments in Tanzania is the provision of primary education and adult education. For this purpose, each local government authority currently receives a conditional grant from the central government notionally based on national minimum standards for education. As noted earlier, the responsibility for the delivery of primary education in Tanzania is highly devolved; other than the determination of how many teachers and educational staff each LGA can hire with central government funds (which is determined by CSD), all key decisions and purchases are essentially made at the level of the District Education Officer.

While until recently parents whose children were enrollment in primary schools were required to pay school fees, in 2001 President Mkapa announced the re-introduction of universal primary education in Tanzania. As such, the purpose of the Local Education Fund is well defined: the Local Education Fund should distribute its resources among local governments in order to provide core funding for the delivery of primary education of school-aged children in each local government area. In addition, local governments are

responsible for providing community-based adult education programs, although this is a significantly smaller component of the local government education portfolio.

As stressed earlier, there is a need to formalize the roles, rights and responsibilities of local governments in the provision of local government services, including education. This clarity should come in the form of local education service delivery manual, which should clearly specify the mutual rights and responsibilities of the local governments versus the Ministry of Education and other central government agencies in providing local education, hiring and firing decisions, reporting requirements, inspections, and so on. Such a document is currently lacking.

4.1 The current horizontal allocation of education resources

The current horizontal allocation of primary education is supposed to be based on minimum standard for education, largely driven by a target student-teacher ratio of 45 pupils per teacher and certain other budgetary norms. However, in reality, funding for primary education is allocated in a highly discretionary manner: funding for primary education (as well as inputs into the delivery of education such as teachers or classrooms) varies greatly between local governments, both when expressed on a per-pupil basis or when expressed per school-aged child. Incidence analysis uncovered that educational resources are allocated in a mildly pro-poor and pro-rural manner, but that at the same time wealthier (developed; urban) districts receive proportionally more resources (Boex 2003). Evidence was also found that fixed costs or “equal shares” are considered in the allocation of education grants.

A separate allocation approach is used for the Primary Education Development Program (PEDP), which is a donor-funded program which provides additional funding to local governments for primary education through the regular budget channels (i.e., as conditional recurrent education grants). As part of PEDP, local governments receive pooled grants from the PEDP Fund both for the purpose of recurrent expenditures as well as for infrastructure development projects. The grants are split into two parts: (1) capitation grants to fund operational costs (essentially replacing the resources lost by primary schools as a result of the abolition of school fees), and (2) investment grants for the maintenance and construction of educational facilities, such as classrooms and school furniture.

Correspondingly, two allocation factors are used to distribute PEDP funds. First, the level of capitation grants that each local government receives (and should pass on to primary schools) is based on the number of students attending in a school. Attendance for purposes of preparing the budget will depend on the average attendance in the previous year adjusted for expected changes. Second, primary schools receive an investment grant to meet costs for furniture and equipment (chairs, desks, black boards and tables), civil works, and construction (new construction or rehabilitation of classrooms or teacher

houses). According to the PEDP Financial Management and Accounting Manual (2001), this grant is distributed among local governments on the basis of the development (investment) budget prepared in line with the school plan of action and approved by the council. Over the period of PEDP program all schools will be covered by the investment grant, but in any one year not all schools will receive funds from this source. The grant made available to qualifying schools will be based on the quarterly cash flow indicated in the action plan and the construction plan approved by the local government council.

4.2 Discussion of possible allocation factors

In line with the vision of a demand-oriented system of intergovernmental grants discussed on Section 3, a number of potential allocation factors should be considered in the development of an allocation formula for the disbursement of grants from a Local Education Fund:

- Number of potential clients for education services.
- Land area.
- Local / regional cost differences.
- Disadvantaged students and special needs students.
- Stimulation of school performance.

Rather than recommending a specific allocation formula for education grants, this background paper discusses various considerations that should be taken into account in the development of such a formula.

Number of potential clients for education services.

The momentum pushing the “second wave” of decentralization reform in Tanzania has been the need to improve the efficiency and quality with which local government services –including local primary education- are provided. In order to assure an equitable and efficient distribution of resources, the focus of any formula-based allocation mechanism for educational funding should clearly target the potential clients who would benefit from these services. This begs an important question: which variable should be used to measure the number of clients of primary education in a local government district: actual enrollment in a district or the number of school-aged children? Actual enrollment figures would have to be reported by the local school district officials themselves, while the size of the school-aged population could be based on census figures. While there are a number of arguments both in favor and against using each of these measures, we consider that the number of school-aged children is the better measure in an allocation formula for education funding.

One important reason why the school-aged population count in a district (based on census data) is a preferred measure of the local demand for primary education is because local governments are able to manipulate school enrollment figures. If enrollment were used in

order to distribute local education grants, school officials and local governments would be able to misreport and inflate reported enrollment figures in order to secure more central government funding. The ability of the central government to monitor and verify locally reported enrollment data in Tanzania should be deemed insufficient to ensure that self-reported enrollment figures are not subject to such reporting bias.

Another important reason why the school-aged population count in a district should be considered a better measure of local education needs is that enrollment figures are not only a reflection of the demand for education, but also reflect the quantity of education supplied. As an example, one might consider a district where there is not a single school, and as a result, there is no enrollment to report despite the fact that there are children in the district that would attend school if there were one. This example makes clear that the reliance on school enrollment figures versus the number of school-aged children would perpetuate the bias against under-resourced local government districts, and that the use of the potential number of clients would result in a more equitable allocation of resources.

At the same time, we should acknowledge that enrollment figures provide a more up-to-date measure of district primary education needs, as the size of the school-aged population based on census data would only be available every ten years (although inter-census estimates could be produced by the statistics bureau). To be fair, it should be noted that enrollment data is likely not available instantaneously either; a lag of one, two or even more years in the reporting of enrollment data is not uncommon in developing countries. Another potential concern that should play a role in the selection is the possible presence of significant inter-district migration. If such population movements are present, census-based estimates are likely to be less accurate than enrollment counts.

Another disadvantage of basing education allocations on the number of school-aged children as opposed to enrollment figures is that it fails to compensate local governments for students who are enrolled out-of-district.

Finally, we should recognize that the inclusion of actual enrollment figures might give districts an incentive to reduce drop-out rates and encourage recruitment and enrollment drives, particularly the enrollment of girls. At the same time, the use of enrollment figures (vis-a-vis the size of school-aged population) would penalize districts with high dropout rates, who might have high drop-out rates due to factors unrelated to educational performance; in particular, there appears to be a strong correlation in Tanzania between attendance rates and the need for impoverished households to rely on child labor.

Land area.

As noted already in Section 3, local governments that cover a greater geographical area (i.e., rural local governments) generally incur higher costs because it is more costly to serve a population that is more spread out. In the case of primary education, in order to assure equitable access to government services, a larger number of smaller schools is needed and the cost of operating these facilities tends to be higher since student-teacher

ratios in rural areas are generally lower. Compared to other government services, the positive relationship between the cost of providing local government services and land area is particularly strong for primary education, where physical proximity to a primary school is crucial in assuring reasonable access to public education.

Regional cost differences.

Differences in the access to major economic centers (particularly Dar es Salaam) result in cost differences faced by local governments in the delivery of local government services. It is possible to compensate local governments for such cost variations, for instance by introducing a regional price index based on diesel fuel prices.

However, the impact of such cost differences on the provision of primary education is relatively limited for two reasons. First, regional cost variations in Tanzania appear to be relatively limited, ranging roughly only 20 percent above and below the average price level. Second, the cost of primary schooling is largely driven by personnel expenditures: non-labor expenses (other charges) only account for 15 percent of total local educational spending. As such, the overall impact of regional price variations on the cost of providing primary education is likely to be relatively minor.

Disadvantaged students and special needs students.

There are several categories of special needs students in Tanzania which might be taken into account as part of the resource allocation process.

First, there is the concern posed by the presence of nomadic and other traditional peoples within Tanzania, among them the Masaai. Due to the nomadic and traditional lifestyles of these groups, allocating resources for their education to local governments in proportion to census-counts makes little sense. Instead, the Ministry of Education currently licenses a number of boarding schools for the purpose of educating Masaai children. Since these schools do not serve a regular local student base, additional funding sources could be allocated to fund these schools.

Second, the Ministry of Education currently licenses a number of schools for deaf and blind students. These schools are typically located in urban local governments but serve a student population which draws special needs students from a number of different districts, and as such, one cannot simply expect the local government in which these schools are located to fund these schools from regular resources.

There are essentially two budgetary responses to provide additional funding in support of these two groups of special needs students.¹⁰ The first response would be for the Ministry of Education to simply funnel a small conditional grant from the Ministry of Education budget to the local government authorities in which these schools are located for the

¹⁰ A third category of special needs students that could be addressed in a similar fashion would be refugee children.

purpose of maintaining these facilities. This approach would have the benefit of removing a complicating factor from the funding formula.

A second response would be to include the number of special needs students as a separate factor in the allocation formula of the Local Education Fund, whereby additional funding would be allocated to local governments in proportion to the number of special-needs or nomadic students registered at these schools. Since these schools are licensed by the Ministry of Education and the number of these schools is limited, the Ministry of Education should be able to verify the actual attendance levels at these schools through a combination of self-reporting and inspections.

A final category of special-needs students that might be considered as part of the allocation formula for the education fund are children from poor households, recognizing the impact of poverty on the cost of education. It is a well-established fact –both in developed as well as in developing countries- that it is harder and more costly to reach a similar level of educational achievement with children from poor households. This is true for a number of reasons, including the fact that poverty-stricken parents may not understand the need for an education in the first place; students from poor households may have greater pressure to work in order to contribute to the household’s livelihood or may need to take care of siblings or sick relatives; students from poor households often learn less in the home environment and receive less reinforcement from their parents and community; and students from poor households potentially face the detrimental effects of malnutrition and disease. In response, a pro-poor allocation of resources might assign a higher level of resources to districts that face a higher incidence of poverty.

School performance

One final factor that ought to be considered in the context of a Local Education Fund is the role of school performance, and whether a measure of school performance should be included in the allocation formula. Ministry of Education officials may feel it might be desirable or even necessary to reward local government districts that perform well with additional funds, in order to provide an incentive to improve local school performance. While this is an understandable desire, we would caution against the use of such performance measures in the formula. First, in a decentralized system, the main source of pressure to perform well should come from the community and the local council. Second, it is very hard to come up with a good performance measure. For instance, completion rates fail to discriminate between a district where many pupils drop out in the first grade level (or never attend school in the first place) versus a district where many students nearly complete their entire primary education but drop out right before the completion exam. It would also be relatively easy for schools or districts to manipulate performance measures. Even in developed countries such as the United States, schools are occasionally caught cheating with school records or student test scores in order to

artificially increase the school's performance record.¹¹ Third, inclusion of performance measures in the allocation formula might give the wrong incentives. For instance, providing an incentive to reduce the teacher-pupil ratio might result in a district hiring a large number of unqualified teachers or having an excessively large number of poorly qualified teachers at the lower grade levels. Fourth, it is likely that such performance incentives would be counter-equalizing, as wealthier urban districts are better positioned to achieve better school performance. A fifth and final concern would be that the use of (especially vaguely specified) performance measures would give the Ministry of Education excessive control over how local governments provide schooling.

There are a variety of fiscal and especially non-fiscal incentives that may be more promising in improving the quality of public primary education. For instance, the Ministry of Education might offer limited matching grants (from the ministerial budget, not from the Local Education Fund) to local governments or schools where school committees voluntarily collect local school contributions. The Government may further designate individual schools or local districts as "School of Excellence" or recognize "Excellence in Local Education" and accord the honor and prestige that would come along with such an award to a handful of local government districts that have demonstrated the biggest improvements in educational quality based on a number of predetermined measures. Such an arrangement would maintain a clear separation between the core responsibility of local governments (provision of primary education, for which it should receive sectoral grants) and the stimulation of national policy objective, which falls within the purview of the central government (through the Ministry of Education). Regardless of the mechanism chosen, performance stimulation should be done in such a manner that limits the discretion of the Ministry of Education to exert undue control over local governments, avoids providing local governments with unwarranted incentives, while at the same time preventing local governments from being able to manipulate the formula or the performance measures.

5. Funding the local provision of basic health care: local health grants

The second-most important functional responsibility of local governments in Tanzania is the delivery of primary health care services. About one-third of all health care services in Tanzania are directly provided through local governments. In addition, more funding for the provision of local health care services is internally provided to local governments through the Ministry of Health. Direct conditional allocations for local health care account for approximately one sixth of the local government level's grant resources.

¹¹ This "cheating" can take in a variety of ways. Schools may outright falsify administrative records. More creative approaches are probably more common. For example, schools could encourage poorly performing students to report sick or be absent during the completion certificate examination, thereby boosting the passing rate.

Before proceeding with a discussion on the horizontal allocation of resources for the provision of local health care services, it is important to note that compared to other local government services such as local primary education, the decentralized funding of health care services presents a number of complicating factors. These complications include:

- First, not all health care falls within the realm of the local government level, making it harder to separate the vertical allocation of responsibilities (and thus, making it harder for “finance to follow function”). Unlike rural areas, many urban centers have referral hospitals that serve a regional (not just local) function. As a result of their supra-district function, these referral hospitals receive their funding from within the central ministerial health care budget. Despite guidelines about hospital admission and referrals, urban households might be able to circumvent the referral system and disproportionately rely on centrally funded health care facilities, even for the delivery of primary health care services.
- Second, there are substantial concerns about inter-district spillovers in the delivery of health care services. In particular, households may receive health care services outside their own local government district if they believe that the health care that they can receive elsewhere is superior in quality. While this concern is not an excessive problem for routine and preventative health care services (since proximity to the health care facility is an important determinant, and the quality of services is likely to vary less geographically), inter-district spillovers are likely to be an important concern in the case of the range of curative services that fall within the realm of local governments.
- Third, by its very nature, the cost structure of health care service provision is much more complex than other local government services. Health care provision results from a multifaceted mix of professional medical services, support services, medical stores, capital infrastructure and medical equipment. As a result, funding arrangements will necessarily be more complex and less transparent.
- Fourth, in addition to public sector health care facilities, many health care services are provided through private (particularly, NGO) clinics and hospitals, which receive either full or partial public funding. Careful consideration should be given to how such non-governmental health care facilities should be integrated into the funding arrangements for local health care provision.

Finally, one health issue in Tanzania that requires our attention is the impact of HIV/AIDS. HIV/AIDS is a major health concern and continues to be a matter of national priority. Naturally, one would expect that health care needs to be higher in districts with higher levels of HIV infection than other districts. The absence of accurate, systematic district-level data on HIV/AIDS makes it particularly hard to allocate increased funding for AIDS prevention and other health care costs to districts with a higher incidence of HIV/AIDS. However, as AIDS policy remains a national policy issue, the Ministry of Health will be able to focus greater energies and resources on those areas of the country in their efforts to reduce the spread of the virus.

5.1 The current horizontal allocation of health resources

As with other local government resources, the current allocation of conditional grants for health care is done in a highly discretionary fashion. Notionally at least, the allocation of health care resources across local governments is based on the national minimum standards of health care service delivery, which takes into account the cost of operating existing facilities, the number of patients and hospital beds, and the size of the local population. In addition to these NMS norms, a clear policy objective of the government is to assure accessibility to health care services. The Minister of Health wishes to assure general access to health care by ensuring that a health care center or clinic is located within six kilometers of every household in Tanzania.

In addition to direct conditional grants, as we noted earlier in this section, the Ministry of Health continues to play a much more active role in the local provision and funding of local health care than other sectoral ministries. As noted, the provision of medical stores (drugs; medicines), transportation resources and administrative equipment to local governments is controlled and funded through the Ministry of Health rather than through the regular (recurrent, conditional) local government allocations.¹² However, it is unclear to what degree the Ministry actually adheres to these internal formulas; these internal allocation mechanisms should be subjected to external verification and monitoring, as the current system lacks substantial transparency. During meetings with local government officials, questions were raised about the internal allocation of such health resources. Paraphrasing a comment made by a local government official which is indicative of this lack of transparency and lack of trust regarding central government allocations was: “a nearby district recently received three new vehicles from the Ministry of Health; we got none. We don’t understand how this was decided. This is not fair.” As noted earlier, the study team finds the rationale for maintaining centralized funding for medical stores, transportation and administration extremely weak, and believes this arrangement should be reconsidered.¹³

Finally, local governments receive additional allocations from the donor-funded health care basket fund. The current allocation of Common Health Basket Funds is an extremely transparent one-factor formula that exclusively relies on population: each district receives

¹² According to Ministry of Health officials, these resources are allocated based on internal formulas. For instance, the internal allocation for medical stores is based on current usage of infrastructure and the size of a local government’s population (for instance, for the allocation of vaccines). Vehicles are centrally purchased and distributed based on the exact mileage that district health care staff needs to travel in order to visit each health care facility once per month.

¹³ This is consistent with the government’s policy findings in the PRSP, which seeks to place greater emphasis on primary health. According to the PRSP, the government will develop initiatives to “strengthen and reorient the delivery of secondary and tertiary health services, to ensure more effective support of primary health care.”

US\$ 0.50 per person. At the request of the Common Basket Fund Steering Committee (CBFSC), the Ministry of Health is currently developing recommendations for a new formula for the basket fund. A preliminary formula which is currently under discussion relies on four allocation factors:

- Population: 50 percent
- Poverty welfare index: 15 percent
- Mileage driven: 5 percent
- Burden of disease: 30 percent

The commitment of the Ministry of Health to develop an improved formula-based approach to allocating local health care grants should be considered a strong positive signal. As further discussed below, the preliminary formula prepared by the Ministry of Health's team forms a solid starting point for a recurrent health funding formula, and the team itself offers a well-informed counterpart for discussion and dialogue in the development of an improved formula-based approach for financing health care services.

5.2 Discussion of possible allocation factors

Again, the background paper does not seek to recommend a specific formula-based scheme for local health care grants. However, this paper does highlight a number of potential allocation factors should be considered in the development of an allocation formula for the disbursement of grants from a Local Health Fund, including:

- Number of potential health care recipients.
- Local health care conditions.
- Access to health care facilities.

Number of potential health care recipients

As the discussion for the education formula reveals, there are two basic ways to approximate the number of potential recipients of local public health services in a local government area. The first approach relies on the actual usage rates, such as the number of out-patients at a clinic or dispensary, and the hospital bed occupancy rate for district hospitals. The second approach approximates the potential demand for health care services in an area based on demographic characteristics, such as the size of the population in the area, and the number of residents under the age of five. Although there are pros and cons to either approach, there are a number of reasons why we propose relying on demographic variables to approximate the demand for health care services:

- Actual usage of health care facilities can easily be misreported, both by facility staff and by the District Health Officer, in order to secure greater funding. The central government is unable to properly monitor reported figures.

- Actual usage of health care facilities is not only an indicator of health care needs, but is also greatly affected by the current supply of health care. A politically weak, under-developed local government may not have any health care facility, and therefore would lack any patient count. This obviously does not mean that there is no demand for health care services.
- Allocating resources in proportion to actual usage would thus inefficiently perpetuate current spending patterns. Rather than resourcing rural health care facilities, a formula relying on usage rates would over-fund urban health care facilities, continuing to force rural households to travel further in order to access quality health care facilities.

It is important to note that health care needs vary greatly between different groups of the population. In particular, children younger than five tend to have a substantially higher demand for health care services, as this population group has a high demand for acute and episodic health care. This category includes treatment for such ailments as malaria, diarrhea, and birth-related health problems.¹⁴ In contrast, the general population has a higher demand for the treatment of chronic long-term conditions, two-thirds of which is accounted for by tuberculosis and HIV/AIDS. As such, if the demographic structure of local governments varies substantially between districts, it would be proper to include the population under age five as a separate factor in the apportionment formula. Inclusion of this factor would allocate greater funding for regions with higher birth rates, thus supporting a reduction in infant mortality rates, maternal mortality rates, and under-five mortality rates.

Local health conditions

In addition to different demographic structures, local governments face different local health care conditions. For instance, it is generally agreed in the health care community that poverty-stricken households have higher health care needs. However, the correlation between poverty and illness is not universal, as there are numerous specific factors that result in poor health and increase the need for health care. Specific reasons for poor health status include suboptimal nutritional intake, lack of access to clean water, exposure to unhealthier (less hygienic) living environments, and unhealthier lifestyles and engagement in riskier activities.

There are two general approaches to measure the local health care conditions. Under the first approach, the allocation formula would consider factors that are known to contribute to poor local health conditions, such as poverty or illiteracy. This is the likely rationale behind the proposed inclusion of a poverty welfare index in the formula for the Common Health Basket Fund. In this regard, it should be reiterated that little socio-economic data is available at the district-level in Tanzania. As a result, Ministry of Health officials suggest applying regional poverty rates to approximate local poverty conditions. In the

¹⁴ Malaria and other fever-related illnesses alone account for almost half of acute health care needs.

absence of a local-level poverty variable, this approach should be considered a reasonable second-best solution.

The second approach to proxy local health conditions in the allocation formula is by considering the result of local health conditions. For instance, poor local health conditions result in higher infant mortality or under-five mortality rates. As such, these variables –if measured properly- could be considered reasonable indicators of local health conditions. As part of its formulaic approach, the Ministry of Health is considering to compute a more complex measure for the “burden of disease” which would be a broader measure of the incidence of disease across different districts. The concern about such measures that are based on reported health care data is that they tend to be biased: districts where access to health care is better will record a higher burden of disease, whereas districts with more limited health care facilities will underreport their relative health care burden. Given the current state of data gathering and reporting, the Ministry of Health would have to rely excessively on extrapolation in order to arrive at local-level data for all local government districts in Tanzania. While the Ministry of Health is focusing its attention on improving the sector’s health-care reporting mechanism, we do not believe that it is currently in a position to provide statistically unbiased reports of the burden of disease at the local government level.

Access to health care facilities

Two factors could be potentially included in the health care formula to account for the impact of geography on the provision of health care services: the mileage of health care routes and land area.

Recurrent transportation costs (gasoline and vehicle maintenance) account for a non-trivial portion of the local health care budget, particularly in inaccessible rural areas. In response, the Ministry of Health team would be inclined to include the exact mileage that district health care staff needs to travel (in order to visit each health care facility once per month) as an allocation factor in the local health care formula.

A second and potentially more comprehensive measure of access to health care would be a local government’s land area. Obviously, this measure would likely be highly correlated to the mileage of health care service routes, and there are pros and cons to relying on land areas instead of mileage. On the negative side, land area may overstate the need for health care resources of districts that contain large unpopulated swathes of land. On the positive side, land area is arguably a more objective, transparent measure of access and is more directly related to the government’s policy objective of assuring the provision of health care services in close geographical proximity to the population. In addition, land area may in fact be a better measure of the challenges faced by rural districts in providing health care services, which not only includes the logistical issues of access, but also the challenges of hiring quality medical personnel in rural areas, and the social, economic, and cultural differences found in rural environments.

6. The horizontal allocation of other sectoral funds: road maintenance, water, agricultural extension and local administration

6.1 The horizontal allocation of roads resources

The budget formulation process in Tanzania has two parallel structures to provide local governments with funding for the maintenance of local roads: in addition to the regular recurrent conditional grants for road maintenance, local governments also receive grants directly from the Fuel Levy Road Fund.

Conditional grants for road maintenance represent a very small share of local government budget allocations, accounting for less than 2 percent of local government grants, making it the smallest sectoral grant in Tanzania's local government finance scheme. According to the road maintenance norms established in the National Minimum Standards (PWC 2000), resources should be allocated depending on the length of earth roads in each local government authority (for annual grading), the length of gravel roads, and annual pothole repair for paved roads (plus resealing every eight years). In reality, the grants appear to be allocated in a much more discretionary manner, with larger per capita variations than either education or health care expenditures.

At the same time, 30 percent of Fuel Levy collections (a tax on all petroleum sales) is set aside for local authorities for maintenance of district and local roads. The funds are divided horizontally between local authorities according to a formula which incorporates "equal shares" as the main factor; in practice, 85 percent of the Fuel Levy funds is divided among local governments based on equal shares, with the remaining 15 percent allocated in proportion to existing road lengths and population (World Bank 2001).

Obviously, the existence of two parallel mechanisms to provide funding for road maintenance is unnecessary and redundant. As a result, it makes sense for the two mechanisms to be integrated in the medium term. This could be achieved by funneling the 30 percent of the resources raised by the Fuel Levy to local governments as part of the regular recurrent local government allocations. Alternatively, since the size of road maintenance grants is extremely small to begin with, it might be politically more feasible to terminate the conditional road maintenance grants and instead maintain the Fuel Levy fund for road maintenance somewhat outside the regular conditional recurrent grant mechanism.

Regardless of the form chosen, a clearly expressed and consistently applied formula would be needed to distribute road maintenance funding among the different local governments. Possible allocation factors include:

- Equal shares
- Length of roads (by road type)
- The demand for road maintenance

Equal shares

The premise on which the equality principle might be invoked in the allocation of road maintenance resources is that each district, no matter how few people live there and no matter how large or small the district, has a need to maintain roads. An additional argument in favor of the reliance on equal shares might be the large fixed cost involved in road maintenance. While both points might be true, the equality principle or “equal shares” approach is not an appropriate way to distribute (the majority of) resources for road maintenance among local governments since major equity, efficiency and incentive concerns surround the use of equality as an allocation factor. More importantly, beyond the political expediency of the factor, the equal shares approach fails to provide a tangible link between a district’s characteristics and the quantity of road maintenance that is needed.

Length of roads (by type)

One measure of the “need” for road maintenance is the physical presence of roads, so that one might provide local road maintenance grants in proportion to the length of road (by type of road) in each local government district. This was, on paper at least, the approach pursued by the National Minimum Standards scheme.

The main shortcoming of this approach is that the potential inequity of the approach: it tends to provide resources where roads are more abundant, and not necessarily where they are needed. However, this is not a very persuasive argument given the fact that these resources are targeted for road maintenance: the problem with equity should be addressed through the allocation of development grants for road construction. Moreover, unlike in the case of education or health where the reliance on existing infrastructure also gave rise to potential inefficiencies, it is unlikely that the use of road length as an allocation factor will result in serious efficiency concerns. After all, given the relative proportions of capital and recurrent costs, it is unlikely that local governments will construct additional roads just in order to receive minor additional recurrent funding for road maintenance.

One more serious concern in potential using road mileage as an allocation factor, however, is the potential unavailability of accurate and reliable data regarding the presence of different types of roads (earth, gravel, and paved) in each local government area.

The demand for roads: population and land area

An alternative, perhaps more proper way to quantify the public demand for roads and road maintenance is to consider the potential need for roads, as measured by the number of potential road users and by the locality's transportation needs given the land area of the local government. This would suggest that road funding might be distributed among local governments based on two simple factors: population and land area.

In addition, there exist a number of alternative measures of potential road usage that might be used as allocation factors. For instance, the number of registered vehicles in a district might be indicative of the potential level of road usage in a local government area. One shortcoming of this measure is that there are several local government authorities in Tanzania which are not authorized to register vehicles. A second alternative measure of potential road usage would be the level of gasoline sales in a district. This measure is commonly used in other countries (including developed and developing countries) in the allocation of Roads Funds. However, again, this proxy might fall short in that there are districts in Tanzania so isolated that they do not have any gasoline stations.

6.2 The horizontal allocation of water resources

Total central government allocations for the local water sector are quite small. Conditional transfer for local water services account for approximately TSh 7 billion, which is slight more than 3 percent of total recurrent grants. Although water is claimed to be one of the government's priority sectors, the limited amount of resources allocated for this purpose raises the question whether the local water sector is in fact viable as a stand-alone sector, both from an administrative viewpoint, as well as for the purpose of targeting intergovernmental grants.

Local water allocations are distributed across local governments with a high level of variation, reflecting the central government's discretionary approach to allocating local government resources typical of the current system of intergovernmental fiscal relations. While urban local governments historically did not receive funding for local water operations, some urban governments have more recently received allocations for OC, while municipalities in Dar es Salaam region now receive both PE and OC for water operations. In fact, per capita variations in water allocation show the largest level of variation among all conditional sectoral recurrent grants.

A fair policy question in Tanzania is whether local water operations warrant a separate sectoral allocation. The relatively small amount of overall grant funding for this purpose indicates either that this sector is not truly a priority, or that funding is allocated to the water sector through alternative mechanisms. In addition to discretionary central government allocation decisions, the apparently erratic incidence of water spending across local governments is also caused by variations in the challenges faced by local governments in providing communities with safe water sources. Because local conditions

vary so greatly in ways that may be hard to measure, the current highly discretionary pattern of water allocations makes it difficult to capture the current incidence with an allocation formula.

Frankly, given the fact that the policy objective of the water sector is to provide access to safe drinking water in order to assure healthy living conditions for all households, establishing a conditional allocation formula for the water sector –which would dictate local governments exactly how much to spend on water engineering- might not be the most effective policy approach. Instead, in the medium term, it might make more sense to allow local governments more flexibility in spending the resources that are currently targeted for water operations. For instance, local water resources might eventually be integrated into the health sector grant or be integrated into a future unconditional general purpose grant. This would allow local governments the flexibility to choose among alternative ways of improving the public health at the local level: for instance, through the delivery of preventive health services, or through the improvement and maintenance of safe public water access.

The “usual suspects” in developing an allocation formula for the maintenance of local water systems are in many ways similar to the allocation factors identified for health care, especially the second formula option proposed for the Local Health Fund. Obviously, an important indicator for the need for maintenance of public water supplies is the size of the general population. In addition, it could be argued that poor households rely disproportionately more on public water sources. Further, rural districts (local governments with greater land areas) have a disproportionately greater need for maintaining their water systems: as land area increases, the total number of water access points needed also increases. A larger land area also makes maintaining water supply equipment more costly in terms of transportation costs.

6.3 The horizontal allocation of resources for agricultural extension

Agriculture is a relative newcomer to fiscal decentralization in Tanzania. While the financial resources for key local sectors such as primary education and health care were devolved following passage of the Local Government Act of 1982, a conditional grant for agricultural extension was not separately established until the 2000-2001 fiscal year. In addition, agricultural extension is one of the smaller sectoral funds. Only around three percent of local government allocations is earmarked for agricultural extension. In the medium term, as the government is seeking avenues to provide local governments with greater fiscal discretion, one possibility would be for the agricultural grant resources to be integrated into an unconditional local government fund.

Resources for agricultural extension are allocated to local governments in order to provide basic training and support to local farmers and for assistance in livestock development, including vaccinations. The horizontal allocation of resources is

determined in a highly discretionary manner as part of the budget formulation process, with the relevant line ministries with oversight over agriculture and livestock, as well as the Ministry of Finance vetting the budget requests from local governments.

As a late-comer to the decentralization process, the Ministry of Agriculture and Cooperatives (and the other involved ministries) may have been exposed less extensively to the need to introduce a formula-based approach to funding local extension services. However, conceptually it should be relatively easy to identify the need for agricultural extension, as the general goal of Tanzania's agricultural policy is the improvement of the well-being of agricultural producers. Since most individuals involved with agriculture are small land holders or small livestock keepers, the focus of the policy is to improve the income levels of the smaller producers by commercializing their production.

There are two basic ways to measure the need for extension services: by focusing on the amounts of agricultural production and the number of livestock in a local government area, or by focusing on the number of agricultural producers that reside in each local government.

The level of agricultural production

If the allocation of resources for agricultural extension services were to be driven by the amounts of agricultural production and livestock in each local government area, then logical factors to enter into an apportionment formula would include the number of hectares of land being cultivated (potentially differentiated by type of crop) and the number of cattle or livestock present in each local government area.

There are two potential difficulties with this approach. First, it is extremely unlikely that accurate data is available for the levels of crop cultivation and the number of livestock in each local government area. Second, reliance on the level of agriculture production would bias resource allocations for agricultural extension services in favor of districts with large commercial agricultural producers, which would run contrary to the government's policy objective of specifically targeting subsistence-type agricultural producers.

The number of agricultural producers

The second option in distributing resources for agricultural extension is to do so in accordance with the number of farmers and livestock holders in a local government area. This approach would target the resources to the local level in proportion to the potential clients of agricultural extension services. However, as we have seen consistently throughout this study, the availability of accurate district-level data is a common problem: indeed, no systematic data is available for the number of agriculture producers at the local level in Tanzania.

6.4 The horizontal allocation of local administration resources

The final earmarked “sectoral” allocations in Tanzania represent targeted funding for the administration of local governments. While considering the formula-based approach for these administrative grants, it is important to keep in mind our longer term vision for the system of intergovernmental grants in Tanzania.

As highlighted in Section 1.3, the stated government objective is to accord local governments greater discretion to move resources between sectors over time. As such, a longer term view for the system of intergovernmental grants could possibly include three main recurrent transfer windows. The delivery of key public services could be safeguarded by sectoral funds for local education and health. However, one possibility is that the resources currently allocated through the smaller sectoral funds (those for water, roads, agriculture and administration) could be combined into a single unconditional “general purpose” unconditional local government fund. This general purpose fund would serve the purpose of funding the general operation of the local government, minor expenditure responsibilities, and could possibly be allocated in an equalizing manner.

Local government allocations for administrative purposes are possibly the most discretionary and supply-driven component of the recurrent grant system currently in place in Tanzania. These administrative grants are almost exclusively driven by the number of local government staff that is approved by CSD-LGB for administrative positions outside the priority sectors. Local government staff functions covered under this grant include cooperatives officers, forest officers, beekeeping officers, lands surveyors, town planners, community development officers, district trade officers, and local culture officers.

When moving away from the input-focus of the current system of local government allocations, a number of possible allocation factors should naturally be considerations in the development of a formula-based allocation mechanism for the general operation and administration of local governments, including:

- Equal shares
- Population and measures of fiscal need
- Fiscal capacity equalization
- Stimulation of fiscal effort

Equal shares

The supply-driven National Minimum Standards approach advocated that a large share of administrative funding should be allocated between local governments based on a fixed cost, or equal shares principle. This argument was rooted in the notion that the operation of each local government requires a standard set of local staff, irrespective of the size of the local government district.

As one of the universal principles of transfer design, “equal shares” should be avoided as a major allocation factor in the design of transfer formulas, because the practice gives rise to major equity, incentive, and efficiency concerns. Nonetheless, the equal shares principle is an extremely popular and widely practiced technique in transfer design. One major reason for its popular appeal is its extreme simplicity: no data is needed and this approach treats every local government “equally.” A second (more pragmatic reason) for including equal shares (or a fixed amount) as at least a small part in the allocation formula is that it indemnifies very small local governments, for which scale economies might truly be an obstacle. For instance, in Tanzania there are seven districts which have a population of less than 100,000, compared to the average district population of 300,000.

Ultimately, if it is decided that an equal shares component or lump sum amount ought to be included in the allocation formula, this amount should be a small proportion of the overall General Purpose Fund. Practically, this could be done in two (financially equivalent) ways. First, each local government could be given a fixed lump sum, say TSh 10,000,000, while distributing the remainder of the funds using the regular formula approach. Alternatively, “equal shares” could simply be included as an allocation factor in the formula with a relative weight of approximately 0.10.

Population and measures of local fiscal needs.

The expenditure needs of a local government may be defined as the funding necessary to cover all expenditure responsibilities assigned to the region at a standard level of service provision. A general purpose funding formula may take into account not only population as the primary indicator of a local government’s fiscal needs, but unconditional or general purpose funding formulas often also include other measures of local governments’ fiscal needs, such as the size of the presence of “needier” population groups such as children or elderly, local government’s land area and terrain, climatic factors, and other social development factors. As such, general purpose funds can be used to equalize the fiscal needs between different subnational governments, allowing all local governments to fund a standardized basket of local government services. In addition to population, probably the second-most common needs factor used in unconditional grants is land area, which is used, among others, in Uganda’s unconditional grant and Nigeria’s General Allocations Fund.

Fiscal capacity equalization

In addition to allocating local government funds in a needs-equalizing manner, the Local Government Finance Act authorizes the Minister of RALG to prescribe criteria for the introduction of an equalization grant for local governments that have a “weak revenue base” in order to “maintain and develop other necessary services within its area.”

While this clause authorizes the introduction of an equalization grant that equalizes fiscal capacity, there are many obstacles to actually introducing such a grant scheme. First and foremost, the current local government allocation mechanism is highly oriented towards

conditional grants for national priorities, and in fact even lacks a window for the allocation of unconditional grants. In fact, there appears to be limited support at the center for an unconditional local government grant in the short run in the absence of a framework of minimum conditions or tight controls. Second, there appears to be a limited understanding about what introduction of an equalization grant would entail, and how fiscal capacity would be measured. Certainly, in the short run, the data that would be needed to properly measure fiscal capacity is simply not available. Third, the introduction of an equalization grant would mean a radical departure from the current pattern of local government allocations: Boex (2003) finds that currently local government resources are allocated in a un-equalizing manner as far as fiscal capacity: wealthier districts (in other words, district with potentially greater fiscal capacity) are currently receiving larger per capita grants from the central government.

As such, the introduction of an equalization grant seems to be more appropriate in the medium term. However, even in the short run, it should be noted there is an alternative way to assure that resource-constrained local governments generally receive greater funding. After all, the analysis of local economic conditions revealed a high degree of correlation between local governments' resource bases (as proxied by household expenditures) and population density and poverty. This suggests that if a general purpose (unconditional) fund is allocated in proportion to land area and poverty, that this would generally provide greater resources to local governments with smaller own resource bases.

Stimulation of fiscal effort

Although there is no specific provision in the Local Government Finance Act for the stimulation of local fiscal effort, the regulations that guide the LGFA suggest that the recurrent block grant system should promote the efficient mobilization of resources by LGAs. However, our proposals do not include any directly stimulation of local fiscal performance through the suggested allocation formulas. Although there is no economic argument to stimulate local expenditure levels in the long run, the stimulation of fiscal performance may be justified in the short run, for instance in order to overcome temporary problems with tax administration. As such, it will be important for the central government to provide a signal or stimulus to local governments to maintain a steady (or even increasing) level of tax effort, particularly as increased local fiscal autonomy might potentially "crowd out" local funding of expenditure programs. However, we believe that, like in the case of fiscal capacity equalization, the data needed to properly measure the actual level of fiscal performance or fiscal effort in Tanzania is currently simply not available. In addition, there are more appropriate ways to stimulate fiscal effort other than through the level of recurrent grants. Both the introduction of a set of "minimum conditions" (which might include conditions on own source revenue collections in order for districts to be granted a greater level of fiscal autonomy) as well as the local capital development grant scheme (which could allocate more funding in response to greater local fiscal effort) are better policy tools for stimulating local fiscal effort than the recurrent grant scheme.

7. Considerations for the implementation of a new system of intergovernmental grants

A number of decentralization issues should be carefully considered as they relate to the implementation of a formula-based system of intergovernmental transfers in Tanzania.

7.1 How should formula-driven grants be incorporated into the national budget formulation process?

We noted earlier in this report that grants to local government authorities are treated almost as regular central budget items in the national budget formulation process: they are negotiated by the Budget Commissioner in the budget formulation process and included in the national budget document at a very high level of detail. This raises the question how a new formula-based system of intergovernmental grants would change the way in which local government allocations are included in the national budget? There are essentially two possible options.

It should be recognized that the most radical departure from current practice is not going to be the change in the budget presentation. Rather, the nature of the local government votes in the national budget would drastically change from one in which the national parliament exercises its budget authority over individual local government budget line items to a system in which parliament limits its budget authority to dividing grant resources among local governments in the context of the central government's formula-based intergovernmental grant mechanism, while allowing each local government the discretion to allocate their resources within their respective budget envelopes determined by the grant formulas.

7.2 How should formula-driven grants be incorporated into the local budget formulation process?

The introduction of a formula-based grant system leads to a second related implementation issue: how should the introduction of a formula-based approach be integrated in the current local government budget formulation process? As a practical matter, the nature of these budget guidelines would likely change substantially in response to the introduction of formula-based allocations.

As was the case for the national budget formulation process, the biggest change would result from the fact that the resource envelopes for each local government authority would no longer be subject to negotiation at any point in the budget process; the resource envelope for each local government would solely be determined by the allocation formula. Central government officials are no longer able to control or manipulate the size of local

government allocations beyond what is computed by the formulas, but it also means that local governments will no longer be able to ask for ex-post grants or gap-filling grants in case they fail to manage their resources wisely.

Budget guidelines would continue to provide local governments with specific guidance in the formulation of their budgets, providing local governments with guidelines on the format of the local budget, specifying grant conditions which local governments are required to follow, and specifying performance measures which will be used to evaluate and promote local government accountability. Whereas under the current system the central government inconsistently applies the national minimum standards (for instance, the student teacher ratio), under the new system the central government would consistently enforce the new demand-oriented financial norms and monitor local government performance measures such as the student-teacher ratio, but the local governments would ultimately be accountable to their electorate for their performance.

The proposed inclusion of grant conditions in the local budget guidelines will give PO-RALG and the Ministry of Finance continued control over the budget formulation of local governments to assure, for instance, that local staff salaries are paid and that resources are not misappropriated.

At the same time, the new approach would allow PO-RALG to yield greater budget flexibility to “good” local governments (those LGAs that meet certain minimum conditions), by imposing fewer grant conditions.¹⁵ In addition, local governments that face a shortage of capital infrastructure or those LGAs that are unable to attract additional local government staff such as teachers or health care personnel due to labor market conditions could be allowed by PO-RALG to more freely shift resources within their overall budget envelope. Allowing local governments this discretion would reverse the current vicious cycle where under-resourced local governments are unable to hire additional teachers due to a result of a shortage of classroom in the districts.

7.3 Clarifying the roles and responsibilities of local governments: Harmonizing regulations and grant conditions in Local Government Service Delivery Manuals

The excessively conditional nature of the National Minimum Standards approach in funding Tanzania’s local government has tied the hands of local governments, and has distracted them from focusing on the quality of local government service delivery.

¹⁵ A system of “minimum conditions” for increased local fiscal discretion is currently under development by LGRP, which would allow local government authorities that meet certain minimum conditions greater flexibility to allocate their grant funding. In recognition of these developments, the recommended grant mechanism is set up in a flexible way that accommodates different levels of fiscal discretion, and allows for a gradual reduction of central government conditionalities over time as the general ability of local government to administer these services in a transparent and accountable manner grows over time.

Increased local government ownership over locally delivered government services will be an important factor in achieving the benefits of decentralization. Even though we advocate that the NMS should be eliminated in guiding local government finances, we note that there will be a continued need for budget guidelines, the imposition of sectoral grant conditions, reporting requirements, and performance targets.¹⁶ However, current regulations and guidelines that impact local government budget practices at a sectoral level are extremely fragmented; they are contained in a large number of policy documents, including the annual budget guidelines, the local government financial management manual, sectoral policy documents, ministerial circulars, basket fund regulations, and so on.

The absence of a clear and consistent local service delivery framework deprives local government from the necessary information to autonomously deliver local government services, and allows sector ministries to have excessive control over local governments. A more consistent policy approach would harmonize all sectoral regulations, conditions and guidelines on a sectoral level into a single sectoral document to establish a clearer operational framework for local governments, clarifying local governments' roles, rights, and responsibilities in the delivery of local government services.

Clarification could come in the form of sectoral local government service delivery manuals" which could specify:

- the functional responsibilities of the local governments in delivering sectoral services;
- the sectoral objectives, targets, regulatory guidelines, and norms to be followed by local governments in delivering sectoral services;
- the reporting requirements imposed on local governments, not only the reporting requirements needed for central government to monitor local government performance, but also local reporting requirements toward the local community, which would allow local stakeholders to hold local government officials accountable.
- the rights and degree of discretion of the local governments in delivering sectoral services.
- appropriate grant conditions and budget norms imposed on local governments. For instance, central government conditions could limit local governments from using grant funding to increase the administrative overhead of district administrative offices.
- the procedures for communications between local governments and the line ministry (including how the line ministry will communicate policy changes or new regulations to local governments, and who local governments need to contact for clarifications, questions, and so on).

¹⁶ We note that NMS could still provide useful guidance on defining local government performance measures and targets, but should not be used as highly detailed grant conditions.

- the delineation of the activities which local governments are expected to fund from the recurrent grants (thereby preventing central government agencies from potentially off-loading these responsibilities onto local governments in the future as unfunded mandates);
- the funding formula used for the distribution of block grants among local government authorities;
- the level and distribution of any (supplemental) resources that are provided through sector ministry budgets for the delivery of local government services.
- remedial action taken when LGAs fail to abide by the conditionalities imposed.

In order to assure that the local government service delivery manuals reflect a mutually acceptable determination of rights, responsibilities and procedures, the sectoral service delivery manuals should be drafted with involvement from representatives of President's Office – Regional Administration and Local Government, the Ministry of Finance, the respective sectoral line ministry, and local government representatives.

7.4 Local Personnel Hiring and Firing

Whereas under the current system PE expenditures are driven by actual local government staff levels (as approved by CSD), under a formula-based grant system the resources that local government would have available for personal emoluments would likely be determined by formula as part of their overall resource envelope.

In order to properly implement this provision, local governments should be given clear direction on how they can hire and fire local government staff, and how the personnel decision should be structured as part of the local budget formulation process. This operational detail could either be included in the Local Government Financial Management Manual, or possibly be made integrated into the local government service delivery manuals proposed in Section 7.3.

As a result, the introduction of a formula-based approach requires the government to move forward with all deliberate speed with the reform of the manner in which the Civil Service Department (CSD) approves local government staff positions. Under the new approach, CSD could have an important administrative and oversight role, assuring that local government staff positions and PE commitments do not exceed the funding that local government authorities have available for this purpose as determined by the formula.

In the absence of the needed civil service reform / local government hiring and firing discretion, local governments would be unable to initiate the hiring of additional local government staff (or firing of excess staff) and thereby exert discretion over their grant resources despite the introduction of a formula-based grant system.

7.5 Data issues and enhancing transparency in local government finance

An orderly decentralization process requires a strong central government which can guide and monitor the decentralization process (Bahl 1999). Problems often arise because most developing and transition countries do not have a strong ability to monitor the local government finances. Since the availability of district-level data has been a constraining factor in the analysis of local government finances and the design of a formula-based intergovernmental grant system, an important priority of the central government should be prioritization of the development of a local government data base.

Additional steps could be taken to enhance the transparency in local government finances, which would in turn stimulate improvement in local service delivery. At the current time, local governments and local citizens (and central governments and donor agencies, for that matter) do not have access to the most basic financial comparisons between districts. For instance, local governments are generally unaware how much they receive for local education per pupil compared to neighboring districts or compared to the national average. The availability of such basic information is crucial to ensure local accountability, stimulate local policy debates and advocacy, and assure overall transparency of the system of local government finance. Although individual local governments and local community groups can be intelligent consumers of basic analytical reports, local governments are generally not in the best position to produce such studies. Instead, due to the scale economies associated with such research, such analyses could best be produced centrally, either within the central government, by the Associations of Local Authorities in Tanzania (ALAT), or by an independent research center or academic institution.

7.6 Strengthening Local Government Financial Management and Accountability

Although it is not the focus of the current study, the development of a system of intergovernmental grants Tanzania holds important implications for the need to strengthen local government financial management and accountability. A controlled and gradual process of fiscal decentralization will require central government leadership on matters such as the imposition of a uniform system of financial accounts, audit rules, disclosure requirements for borrowing, determining when to relax spending mandates, how to adjust grant distribution formulae, and how to impose proper limits on borrowing. There is also the need for technical assistance to local governments, in several areas. Especially the smaller local governments require assistance in areas such as accounting, treasury, tax administration, data processing and project evaluation.

Strengthening local government capacity in financial management is already a main component of the LGRP medium term work plan (LGRP 2002). In addition to the more

traditional emphasis on strictly improving local government accounting procedures and capabilities at the local level, the strengthening of local government financial management should focus on compliance with reporting requirements and accountability issues as well.

7.7 Need for a Local Government Finance Commission and a Local Government Fiscal Analysis Unit

A final implementation consideration that follows from the introduction of a formula-based approach is the determination who should be the “steward” of the intergovernmental grants process. Given the number of stakeholders involved in the disbursement of local government finance, it is felt in many countries that guardianship over the system of intergovernmental transfers cannot be entrusted to a single ministry or government organization. Obviously, the ultimate determination which allocation formula is used, and, to a lesser extent, which local governments have met the “minimum conditions” to achieve greater fiscal discretion, are monumental decisions that should be made by an impartial, widely respected inter-ministerial (and potentially inter-governmental) supervisory body.

As a result, many countries entrust supervision over the grant process to a Local Government Finance Commission, comprising of representatives from key central government ministries and agencies (including Ministry of Finance, Ministry of Local Government, CSD, and possibly the main sector ministries) as well as representatives from the local government sector.

While grants commissions have different functions in different countries, grants commissions are generally semi-autonomous institution that report to either the Ministry of Local Government or, more typically, the Ministry of Finance. The responsibilities of the LGFC would include collecting and updating the required data, overseeing the implementation of the transfer mechanism, introducing changes in the mechanism to keep it within its objectives, and maintaining an open dialog with the stakeholders both with the central government as well as at the local government level. A LGFC would assure high-level coordination between the key stakeholders and would exert impartiality and objectivity in administering the grant system.

We further believe that a local government fiscal analysis unit is a necessary ingredient in order to achieve an orderly system of decentralized local government finances. Such a unit, probably located in the Ministry of Finance, should have staff adequate to continuously monitor local government finances (Bahl 1998). Many of the talented analysts are typically assigned to other “more important issues” with the result that many countries do not have such a fiscal analysis unit. Such a unit would be able to redress some of the problems with the availability of a comprehensive local government data system; the analysis unit would further be able to engage in local revenue forecasting and

modeling local government fiscal issues needed to track the performance of local government finances.

8. Concluding remarks

The local government reform process that started in 1999 has come to a critical juncture. Replacing centrally-determined local government allocations with a formula-based mechanism would have both important economic and political impacts. Ultimately, the introduction of a formula-based grant system would make Tanzania's public sector more efficient, more responsive and more pro-poor. If Tanzania chooses to continue down the path of decentralization reforms, the country is well-positioned to become the next success story in local government finance reform in Africa.

At the same time, the introduction of a formula-based system would also result in an important shift in the vertical power balance between the central government and local governments. The introduction of a formula-based system would reduce the ability of the central government officials to influence local affairs and use local government allocations as a political tool. As a result, the design of a system of intergovernmental grants is the "easy" part of the reform; the main challenges to the introduction of a system of formula-based grants should be expected to arise during the implementation phase.

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