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Tanzania's Fiscal Arrangements: Obstacles to Fiscal Decentralization or Structures of Union-Preserving Federalism?

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1. Introduction

Governments pursue fiscal decentralization for a variety of reasons: to make government more responsive and accountable to the people, to increase the efficiency of the public sector, and to promote national cohesion.[1] Generally speaking, public sector economists emphasize the accountability and efficiency benefits of decentralization and neglect the union preserving benefits. Consequently, decentralization policy-making often becomes a technical exercise in 'getting the incentives right' when designing a country's fiscal architecture. From this perspective, obstacles to fiscal decentralization consist of misaligned or perverse incentives created by ill-conceived or improperly implemented fiscal arrangements. The goal of policy-makers therefore is to develop a blueprint for a country's fiscal architecture in line with the principles derived from the normative theory of fiscal decentralization and international best practices.[2]

For example, advocates of decentralization generally agree that, after accounting for economies of scale and inter-jurisdictional spillovers, government services should be provided by the level of government closest to the people.[3] The contention is that, all else equal, the

[1] Rémy Prud'homme (1995), David O. Sewell (1996), and Vito Tanzi (2000) describe some of the potential dangers of fiscal decentralization, particularly macroeconomic instability that may result from undisciplined borrowing by sub-national governments. For an introduction to the consequences of 'soft budget constraints' in a federal system and a survey of the institutional measures used by a number of federal governments to harden sub-national budget constraints, see Yingyi Qian and Gérard Roland (1998) and Jonathan A. Rodden, Gunnar S. Eskeland, and Jennie Litvack (2003).

[2] The conventional view of the normative theory of fiscal decentralization is based on the classic article by Charles M. Tiebout (1956) in which mobile citizens sort themselves among jurisdictions providing the best tax-expenditure bundle. Wallace E. Oates (1972) elaborates on this model. While there are many excellent treatments of the normative theory of fiscal decentralization, Roy Bahl (1999, 2000) are accessible treatments. In addition, Jameson Boex and Jorge Martinez-Vazquez (2003) provide an excellent introduction to the topic in the context of developing countries, using the case of Tanzania to illustrate the concepts of fiscal decentralization.

[3] Wallace E. Oates (1972, page 35) provides perhaps the first and certainly one of the most elegant statements of the decentralization theorem: "For a public good – the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government – it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide *any* specified and uniform level of output across all jurisdictions."

government closest to the people knows best their tastes and preferences for local public services and will be more responsive and accountable to the demands of its constituents. The conventional wisdom regarding the assignment of expenditure functions in federal systems, although not precisely defined, recognizes of course that some government services are not effectively carried out at the local level. Income redistribution, for example, should be an exclusive competency of the central government. This view follows from the recognition that assigning redistributive expenditure programs to local governments may result in fiscal rent seeking in which low-income families move into jurisdictions offering more generous benefits. High-income families move out of these jurisdictions to escape the higher taxes required to finance these benefits. In the long-run, the tax bases of redistributive local jurisdictions are eroded, the quality of local services deteriorates, and low income families are left isolated in ghettos.

Moreover, according to the conventional wisdom, local government services should be financed at the margin from the local government's own source revenues. The rationale for this principle is that residents of a jurisdiction will not internalize the true marginal cost of providing local government services, if they do not face the tax price of providing them, and consequently the local government sector may grow too big. As a result, the promised benefits of greater allocative efficiency through decentralization may not be realized in practice. In short, the conventional wisdom generally calls for local governments to have a significant range of exclusive expenditure responsibilities along with sufficient revenue autonomy – at a minimum tax rate setting authority - to enable them to provide marginal financing of their expenditure responsibilities.[4]

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[4] See, for example, Charles E. McClure, Jr. (1983) for a more complete discussion of the rationale for requiring each level of government to finance expenditures from own source revenues at the margin.

Although the foregoing discussion does not provide a complete description of the normative theory of fiscal decentralization, it does describe two of its major concerns, namely the rational for expenditure decentralization and the importance of establishing a Wicksellian link between public tax prices and public services.[5] While recognizing the importance of 'getting the incentives right', the conventional wisdom of fiscal decentralization theory does not account for a major motivation for fiscal decentralization. The conventional wisdom neglects the importance of federalism as a set of institutional arrangements designed to preserve the union of a country. *Union preserving federalism* is a particularly important consideration in low income countries with weak national identities, like many of those in sub-Saharan Africa. We use the case of Tanzania to motivate our concept of union preserving federalism. Tanzania is a worthwhile example to study because it is actively engaged in fiscal decentralization reforms and shares many of the fundamental challenges to decentralization of many other sub-Saharan African countries.

The remainder of this chapter is organized as follows. Section 2 provides a brief description of the history, geography, and economy of the United Republic of Tanzania. Section 3 briefly describes Tanzania's current fiscal architecture. In doing so, we identify some of the weaknesses of the current fiscal arrangements in Tanzania from the perspective of the normative theory of fiscal decentralization. In section 4, we discuss five fundamental obstacles to fiscal decentralization in Tanzania and many other sub-Saharan African countries. More specifically, we examine ethnic fragmentation, widespread poverty, competition for natural resource rents, human resource capacity constraints, and weak and missing institutions that characterize many

[5] Generally speaking, the normative theory of fiscal decentralization concerns the so-called four pillars of fiscal decentralization: expenditure assignments, revenue assignments, intergovernmental transfers, and borrowing autonomy. To this edifice, we would add financial management and accountability mechanisms. For a more detailed description of the normative theory of fiscal decentralization, Wallace E. Oates (1972) is arguably the seminal work on this topic. Another excellent introduction to the normative theory of fiscal decentralization is Roy Bahl (1999).

sub-Saharan countries. Ironically, some of these obstacles represent, in our opinion, the very *raison d'être* for decentralization. The challenge facing Tanzania and other sub-Saharan countries is to develop institutions to cope with these challenges. Using the case of Tanzania, we try to show that a properly conceived and implemented framework for decentralized governance is an important strategy for doing so, but it may entail difficult trade-offs with some of the policy prescriptions derived from the normative theory of fiscal federalism. Section 5 provides a summary of our main conclusions.

2. The United Republic of Tanzania

The United Republic of Tanzania (GoT) is situated on the eastern coast of Africa and is bordered by Burundi, Kenya, Rwanda, and Uganda to the north, the Democratic Republic of Congo to the west, and Malawi, Mozambique, and Zambia to the south. Figure 1 provides a map of Tanzania showing the regional divisions of the GoT. Its land area, about 945,000 km^2, is almost one and a half times the size of France. The country's forty million people are about 95 percent ethnic Bantu but belong to as many as 130 different tribes. The population is surprisingly spread out across the geographical area of mainland Tanzania.[6] The most populated of the 21 mainland regions contains about 9 percent of the population, and the least populated contains about 2.5 percent. The average regional population is about 5 percent of the total population of mainland Tanzania. Although only about 8 percent of the population of the mainland resides in Dar es Salaam, it is the economic engine of the country. About 2.5 percent of the population lives on the Zanzibar archipelago which consists of two main islands, Pemba and Unguja, and some, mostly uninhabited, smaller islets. According to the CIA World Factbook, the population

[6] This may in part be a result of the significant intergovernmental transfers that have taken place over the past decades. These, along with other migration barriers, may have induced people to stay put and mitigated the kind of urban migration seen in other developing countries.

of Zanzibar is historically Arabic and 99 percent Muslim; thus making it culturally and ethnically distinct from the population of mainland Tanzania.

Tanzania is one of the poorest countries in the world. According to the United Nations' Human Development Report, Tanzania's per-capita Gross Domestic Product (GDP) was $744 in 2005 (measured at purchasing power parity), as compared to $42,000 for the United States, $10,700 for Mexico, and $2,800 for Bolivia. According to the 2006 Human Development Index, Tanzania ranks 152 out of 179 countries. More than 80 percent of the population works in the agricultural sector, which generates less than 30 percent of the country's GDP. The average life expectancy in Tanzania is about 52 years.

The GoT consists of 26 regional governments. Mainland Tanzania is divided into 21 political regions and 120 local government authorities (LGA), and the Zanzibar archipelago is divided into 5 additional regions. Tables 1 and 2 provide information on the geographic and socio-economic profiles of the regions of Tanzania. As table 1 shows, with the exception of Dar es Salaam, the population density of mainland Tanzania is fairly uniform, and the rate of urbanization is rather low at approximately 22.6 percent of the population residing in urban areas. Table 2 shows the gross domestic regional product in current prices for 2005, the adult literacy rate, infant mortality rate, and HIV-positive rate, by region. The adult literacy rate for mainland Tanzania is 71 percent, the poverty rate in terms of basic needs is 35.7 percent of the population, and the infant mortality is 99 per 1,000 live births. Except for the HIV-positive rate, the coefficient of variation for these socio-economic indicators is remarkably small for mainland Tanzania. The HIV infection rate is relatively high in Kilimanjaro at 14.7 percent; whereas, the average rate for Mainland Tanzania is slightly less than 6 percent.

Table 3 provides a profile of Tanzania's system of LGA's. The typical LGA employs 1,742 people and serves about 300,000 local residents. The employee compensation cost of these services was $434 million in 2007, which amounts to about 3 percent of the total value added of the economy. Another 1.2 percent of GDP is for other recurring expenditures by LGA's and about 2 percent of GDP is created through nonrecurring or development LGA spending, which can be considered to be some form of capital spending. In other words the LGA system creates about 6.2 percent of the country's GDP.

3. The architecture of GoT's fiscal decentralization system

To understand the fiscal arrangements of GoT, it is helpful to start with the political relationship between the central government and the local governments. Since a local government reform program was put in place in 1999, the stated policy of the central government has been 'decentralization by devolution'. The goal of these reforms is the devolution of specific government service responsibilities to the local level, along with the dismantling of the central and regional hierarchical government structure that previously managed these responsibilities. This includes turning over most budget allocation decisions and financial management responsibilities to the locally elected leaders of the local government authorities (LGA), of which there are about 133 across the 21 regions of the mainland.

To carry out this devolution of government responsibility the former Ministry of Regional Administration and Local Government (MRALG) became the Prime Minister's Office of Regional Administration and Local Government (PMO-RALG). According to the central government's website (http://www.pmoralg.go.tz), the mandate of this new office is to "facilitate the empowerment of Tanzanians through autonomous local government institutions geared to reducing poverty… [and to] champion decentralization by devolution and create the requisite conditions for Local Government Authorities to deliver quality services efficiently and equitably". The PMO-RALG has a Regional Secretariat in each of the twenty-one regions. The duties of the Regional Secretariat are as follows: 1) to ensure peace and tranquility in the regions, 2) to represent the central government in the regions, and 3) to assist and facilitate the local government authorities to discharge their responsibilities.

Notwithstanding the policy of decentralization by devolution, the PMO-RALG and the Ministry of Finance (MoF) continue to maintain considerable influence over the fiscal activities of local governments through the Regional Secretariat. The PMO-RALG provides budget guidelines and standards, and it audits local governments to ensure that they are adhering to these standards. It monitors local budgets, helps to create policy initiatives, provides technical capacity as needed, and does technical training. One of the more recent publications - the *Local Government Review 2007* - reports that 21.4 percent of total government spending was carried out by LGAs in fiscal year (FY) 2006-07, but local governments do not have much discretion over this spending because of restrictions on the central government's formula-based, sectoral block grants to local governments, which fund almost all of the spending by local governments. The elaborate governmental infrastructure of the PMO-RALG, depicted in Figure 2, further illustrates the high degree to which the PMO-RALG and the Regional Secretariat are involved in local government operations.

It is apparent that the promotion of decentralization by devolution is difficult. Even after a ten-year policy push, the central government continues to participate in almost every aspect of the LGAs fiscal activities. It is noteworthy that significant obstacles to *implementation* of decentralization policy seem to exist even for a government that 'buys into' the notion that the benefits of fiscal decentralization are worth pursuing. The extensive and persistent involvement of the central government in the fiscal activities of the LGA's in Tanzania must be borne in mind as we consider the extent to which the enabling legislation of fiscal decentralization describes actual practices and effective local autonomy.

The Zanzibar issue

A reader familiar with the relationship between the Revolutionary Government of Zanzibar (GoZ) and the GoT may reasonably assume that a discussion of the obstacles to decentralization in Tanzania would focus on the Zanzibar issue, but that is not the case here. The fiscal relationship between the GoZ and the GoT may ultimately need to be rationalized, but for the time being at least the Constitution grants the GoZ almost complete political and fiscal autonomy.[7]

The Constitution of the GoT provides for the establishment of the GoZ, the Zanzibar Revolutionary Council, and the House of Representatives of Zanzibar; none of which are required to report to the GoT. Moreover, Article 138 of the GoT's Constitution (http://www.tanzania.go.tz) states that the House of Representatives of Zanzibar may "… impose tax of any kind in accordance with the authority of that house." The Constitution of GoT also establishes a Joint Finance Commission (JFC) to determine Zanzibar's contribution to and allocation from the GoT's budget, but the JFC was only recently constituted and staffed with technical experts and to date has made little progress and exercised little influence on such matters.

[7] There appears to be considerable political tension between GoZ and GoT. For example, some of the key original historical documents that created the union between Zanzibar and the mainland government have been lost, and some scholars question the accuracy and authenticity of the alleged duplicates of the originals. This is just one prominent example of the suspicion that exists between these two governments and communities. See, for example, Greg Cameron (2002) for a description of Zanzibari's distrust of the 1964 union with mainland Tanzania, and Zanzibar's contemporary transition toward authoritarianism, which is in sharp contrast to the transition toward multi-party politics on the mainland.

Today, the finances of the two governments are effectively independent of one another. The only significant agreement between the two being the following: the GoZ should receive a 4.5 percent share of most (non-project-specific) international grant monies; the GoZ should receive 4.5 percent of the dividends of the Bank of Tanzania; and the GoZ should receive the excise taxes on goods manufactured on the mainland but consumed on Zanzibar.

The fiscal autonomy that the Constitution provides to the GoZ creates risks to the fiscal, economic, and political stability of the union. The GoZ could exercise its fiscal autonomy to adopt changes to its tax bases and rates *vis-á-vis* those of the GoT. This would increase the costs of tax compliance and tax administration, create opportunities for tax arbitrage, foster tax competition between the mainland and the island governments, create impediments to internal trade, and create difficulties in the East African Community with respect to custom duties. To date the GoZ has not exercised its fiscal autonomy to differentiate its tax system from that of the mainland. Rather it has chosen to act responsibly, in our view, by adopting conforming tax legislation.[8] That is, the tax bases and rates of GoZ's income tax, value-added tax, and customs duties are generally consistent with those of GoT.

The GoZ also exercises borrowing autonomy. The risk of allowing sub-national governments to borrow is that they do not take into account the impact of their borrowing on the credit worthiness of the nation as a whole. Furthermore, the central government may not be able to adopt a credible 'no bailout' policy. The combination of the GoZ's unfettered borrowing autonomy and the inability of the GoT to commit to a credible no bailout policy may give rise to

[8] Joint Finance Commission (2006) provides further details on the fiscal relations between the GoZ and GoT.

a soft budget constraint.[9] This could result in a lack of fiscal discipline by GoZ that could, at some future date, lead to macroeconomic instability.

The existing fiscal arrangements between the GoZ and the GoT create perverse incentives that put at risk the fiscal and economic stability of the union and thus, from the perspective of the normative theory of fiscal decentralization, call for reform of the intergovernmental fiscal system. Despite these risks, the current arrangements may be *union preserving*. GoZ's *de jure* autonomy in fiscal matters, though it does not exercise this autonomy in practice, may strengthen the hand of the GoZ in negotiations with GoT, or it may provide comfort to the GoZ that important institutions are in place to exit the union when and if it decided to do so. Although this political accommodation arguably violates the conventional wisdom regarding the appropriate arrangements for central government revenue assignments and regulation of sub-national borrowing authority, these arrangements may reflect a reasonable compromise with the prescriptions of the normative theory in order to preserve the union.

Tanzania's four pillars of fiscal decentralization

Putting aside the Zanzibar dilemma, we now turn to GoT's four pillars of fiscal decentralization, namely the assignment of expenditure functions, the assignment of taxing authorities, the design of the intergovernmental grant and transfer system, and the regulation of the borrowing authority of sub-national governments. We also examine the current fiscal arrangements from the perspective of the conventional view.[10] We then turn to a discussion of what we contend are the more fundamental challenges to fiscal decentralization in Tanzania, and in other countries of sub-Saharan Africa, specifically ethnic fractionalization, widespread

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[9] See, for example, Yingyi Qian and Gérard Rolland (1998) and Jonathan A. Rodden, Gunnar S. Eskeland, and Jennie Litvack (2003) for an introduction to the challenge of soft budget constraints in a federal system.

[10] Jameson Boex and Jorge Martinez-Vazquez (2006) provide a much more detailed treatment of these topics in their excellent work on the intergovernmental fiscal arrangements of mainland Tanzania.

poverty, competition for natural resource rents, human resource capacity constraints, and weak or missing institutions.

Expenditure assignments

The first pillar of the fiscal decentralization architecture is the assignment of expenditure responsibilities to the various tiers of government. As previously noted, the normative theory of fiscal decentralization suggests that, all other things equal, government functions should be assigned to the lowest level of government consistent with economies of scale and inter-jurisdictional spillovers. To enhance responsiveness and accountability, local governments should be given, as far as it is practical, exclusive assignments. Finally, to prevent fiscal rent seeking, income redistribution should be the exclusive responsibility of the central government.[11]

In Tanzania, the Local Government Acts of 1982, as amended, provide that local governments are responsible for the delivery of five basic sectors: primary education, basic healthcare, agricultural extension and livestock services, local water supply, and local public works. In addition, according to these laws local governments have responsibility for land use planning, sanitation, and local public markets. An important feature of Tanzania's expenditure assignments is that they have skipped over the intermediate level of government and assigned most of the responsibilities to local governments.

Although five specific functions are formally assigned to local government, this may not accord with actual practice in the field. First of all, most of these basic services are funded through formula-based, sectoral block grants from the central government, which come with specific conditions and spending restrictions. Second, the central government retains policy setting authority for grant funded sectors, which is the major reason for the spending restrictions associated with the transfers. Third, as mentioned above, the central government also plays a

[11] See, for example, Jorge Martinez-Vazquez (1998) for a more complete treatment of this subject.

significant role in personnel decisions for delivery of these services, even at the local level. Thus despite the seemingly genuine desire to decentralize along with the legal language of decentralization, a system has emerged in Tanzania that is *de facto* less decentralized than might appear by simply reading the enabling legislation.

This observation does not necessarily imply that the government is at fault or that some alternative approaches might be better suited to achieving the ultimate goal of fiscal decentralization in Tanzania. It might instead be the case, as we contend below, that the obstacles to decentralization in Tanzania arising from fundamental characteristics of the country's socio-economic conditions and its political economy preclude further decentralization at this time. In fact, these fundamental obstacles may well preclude following the prescriptions of the normative theory of fiscal decentralization in countries like Tanzania, at least at this stage of their development.[12]

Although assigning these five functions to sub-national governments generally follows the practice in many other decentralized countries, these assignments do not strictly accord with the principles of expenditure assignments derived from the normative theory and summarized above. For example, agricultural extension and livestock services are likely to create significant inter-jurisdictional spillovers due to externalities from research and development and vaccination and quarantine programs. To the extent that jurisdictions do not take into account these spillover effects, these services may be underprovided by local governments. Local water works and public works entail significant economies of scale and require engineering expertise that may not be available or may be unaffordable to local governments. Also, one would expect that

[12] Consider, for example, the government's strategy (*Local Government Fiscal Review 2007*, pages 5-6) to use the PMO-RALG to review the various ministerial budgets to "… ensure that functions carried out by the line ministries do not encroach on the functions that are assigned to local government authorities". This desire to give local government's some degree of autonomy conflicts with the government's "… significant concern…with respect to the capacity of local governments to deliver sectoral services".

organizing local markets should be within the competency of the private sector. It is difficult to justify local governments involving themselves in establishing local public markets on the basis of a market failure, unless it involves property right practices in Tanzania. However, market dues are a major source of revenue to local governments throughout East Africa, and this may provide sufficient justification for assigning this function to local governments, at least at this stage of Tanzania's economic development.

Finally, primary education and basic healthcare involve a significant element of redistribution, which, according to the principles of expenditure assignments, should be an exclusive responsibility of the central government. Moreover, since education and health care are often important parts of central government development policies, the central government will typically want to regulate and monitor local efforts in these areas. However, assigning control to the central level may not make sense within the broader context of the current socio-economic conditions of Tanzania. For example, in the case of education, particularly primary education, in an ethnically fragmented country like Tanzania, providing for instruction in the local tribal language may be an important element of a community's identity and communal aspirations. Central governments may impose excessive uniformity as cost savings measures, promote policies aimed at creating a *lingua franca* at the expense of local languages and cultures, and may promote instruction in the native language of the dominant ethno-linguistic group.

Similarly, primary healthcare involves an element of redistribution and, at least in the case of controlling contagious diseases, inter-jurisdictional spillover effects. These two characteristics of primary healthcare would suggest that this service should be assigned to a higher level of government. In an ethically fragmented country, however, there may be greater intra-group than inter-group altruism. Thus it may make sense to assign these redistributive functions to the local level, particularly when the main funding source for local governments is intergovernmental transfers. In short, assigning primary education and healthcare to the local level may be another union preserving feature of Tanzania's fiscal arrangements that, strictly speaking, cannot be rationalized by the principles of expenditure assignments derived from the conventional view of the normative theory of fiscal decentralization.

Revenue assignments

Public sector economists often say revenue assignments should follow expenditure assignments to ensure that sub-national governments have sufficient revenues to fund their expenditure responsibilities, at least at the margin. Generally speaking, sub-national governments should rely more heavily on relatively immobile tax bases, like a property tax; whereas, taxes with a redistributive or stabilization goal, like a progressive income tax, should be assigned to the central government. At a minimum, local governments should have rate setting authority over at least one broad-based tax in order to provide local governments with a source of marginal finance.[13]

Until 2003 Tanzania followed an 'open list' approach to local revenue sources, allowing local governments to design their own tax and fee structures with prohibitions only against the use of some major revenue sources reserved for the exclusive use of the central government. As Jameson Boex and Jorge Martinez-Vazquez (2006) point out, this is a higher degree of local fiscal autonomy than is typically observed in developing economies, particularly in sub-Saharan Africa.

A high degree of local fiscal autonomy is often advocated by economists, but the relatively autonomous local tax system in Tanzania was viewed by government officials there as

[13] For a fuller treatment of this topic see, for example, Richard A. Musgrave (1983) and Roy Bahl (2009) and the references provided therein.

cumbersome and inefficient. Local taxes were said to be difficult to administer; they were highly unpopular; compliance was low; and there was lack of coordination between the local and central government tax structures. In a budget speech in June 2003, the Minister of Finance began a major reform of local tax systems by proclaiming that a number of widely used local taxes and fees would no longer be allowed. Instead of those, he announced a ‘closed list’ of allowable local taxes and fees along with maximum allowable rates.

The closed list includes a building property tax, a land rent tax, sales taxes on crops, forest products and services, a guest-house (hotel) tax, and numerous administrative fees, fines, and penalties.[14] In addition, in 2004 most local business license fees were disallowed as part of a reform to stimulate economic growth. All of these changes have since been formally incorporated into law through amendments to the Local Government Finances Act of 1982.

These changes to the local government revenue structure caused a significant drop in local own source revenues, falling from about 19 percent of total local resources in FY 2002-03 to about 10 percent in FY 2004-05. To date, aggregate own source revenues continue to be about 10 percent of local resources, with the other 90 percent consisting of central government transfers and grants from international donors.

Clearly, these revenue assignments to local governments are not adequate to finance the expenditure functions assigned to them. In other words, there is a vertical fiscal imbalance. The central government is assigned the broad-based and high revenue yielding consumption and income tax bases; whereas, local governments are assigned the resource intensive expenditure functions, such as education, health, and public works. This arrangement is very common in

[14] The annual land tax is collected by the central government, 20 percent of which is remitted to the local government.

decentralized countries. According to the theory, local governments may overspend on public services when the Wicksellian link between public tax prices and public services is broken.

On the one hand, there are a number of sound reasons for concentrating taxing powers at the central level, including the need to conduct macroeconomic stabilization policy, to conduct the redistributive function, to provide for tax coordination, and to tax mobile tax bases. On the other hand, there is an old saying that he who pays the piper calls the tune, meaning that concentrating the taxing powers in the central government allows it to constrain the autonomy of local governments. In other words, making sub-national governments dependent on the central government for revenues and thereby constraining the autonomy of sub-national governments may be a another union preserving feature of Tanzania’s fiscal arrangements. A government unit that already enjoys substantial autonomy may feel more inclined to go it alone than a government that is dependent upon another.

To address this vertical imbalance, mainland Tanzania uses formula-based, sectoral block grants to finance local government services, which is the topic of the next section.

The system of intergovernmental transfers

In low-income countries, like Tanzania, most public sector economists recognize that local governments require predictable transfers from a higher level government to finance basic service delivery and infrastructure investment because of the vertical financing gap that is the consequence of the expenditure and tax assignments, as discussed in the preceding section. According to the conventional wisdom, there are several roles for intergovernmental grants and transfers. First, intergovernmental grants can be used to correct for inter-jurisdictional spillover benefits and costs. Second, they can be used by the national government to pursue national priorities in areas that are otherwise the exclusive competency of local governments, such as literacy or vaccination against contagious diseases. Finally, they can be used to fund central government mandates to sub-national governments. Central governments may mandate that local governments administer certain programs that are otherwise a central government competency because the local government may be able to do so more efficiently than the central government.[15]

In the conventional view, the intergovernmental transfer system also should provide for a generous unconditional transfer to give meaning to the fiscal autonomy of sub-national governments, to address vertical imbalances that often result from conventional tax and expenditure assignments in decentralized countries, and to address horizontal fiscal disparities among sub-national governments. The latter arise from differences in the costs of providing services or the size of local tax bases in some jurisdictions as a result of differences in local conditions, such as topography, climate, and so on. It is worth noting, however, that the advantages (disadvantages) possessed by some sub-national governments may reflect the historical practice of one ethnic group directing national resources to its benefit and to the disadvantage of other ethnic groups. A history of such practices often gives rise to a sense of ethnic grievance that is the fuel of civil wars and separatist movements in many parts of the world. In any event, we now turn to a description and assessment of Tanzania's formula-based, sectoral block grants.

Table 2 summarizes Tanzania's system of formula-based, recurrent, sectoral block grants and their respective allocation formulas. There is a single block grant for each of the five functions assigned to local governments. This system is formula-based which makes the allocations more predictable and less susceptible to political manipulation than *ad hoc* or

[15] For a more complete treatment of the theory and practice of intergovernmental grant design, see Anwar Shah and Zia Qureshi (1994), Ehtisham Ahmad (1997), Jun Ma (1997), Richard M. Bird and Michael Smart (2001), and Jameson Boex and Jorge Martinez-Vazquez (2003).

negotiated transfers. While an unconditional, equalization grant scheme, like that in Germany, India, Indonesia, Nigeria, South Africa, and the Russian Federation to name just a few, would give local governments greater expenditure autonomy, Tanzania decided to rely on a sectorally based transfer system. The advantage of this approach is that it gives the central government greater control over the use of funds by local governments. For example, it assures that funds are used for national priorities such as primary education and health care. Block grants also may make it easier for the central government to monitor the use of funds and to prevent waste, fraud, and abuse by local governments. The obvious disadvantage is that this arrangement decreases the autonomy of local governments to establish budget priorities.

Finally, transfers constitute nearly 90 percent of local government revenues, and the allocation formulas have equalizing features. Having transfer dependent local governments decreases the incentive for local governments to develop the administrative capacity to raise their own revenues and may inhibit the development of robust financial management systems. Absent these institutions, the ability of local governments to secede from the country is more difficult. Similarly, equalizing expenditures may help to mitigate ethnic competition that can lead to civil wars and secessionist movements.

Regulation of sub-national borrowing autonomy

Ideally, sub-national governments should have some perhaps limited autonomy to borrow in order to finance capital expenditures. This allows local governments to smooth expenditures over time when making 'lumpy' public investments and also increases intergenerational equity by financing long-lived assets over several generations. In addition, the ability to borrow from the market creates incentives for local governments to be fiscally disciplined in order to improve their credit rating and thereby lower the interest rate at which they can borrow. On the other hand, sub-national borrowing creates risks as well. As previously noted, providing sub-national governments with unfettered borrowing autonomy combined with the inability of a central government to make a credible commitment to a no bailout policy creates a soft budget constraint for sub-national governments. A soft budget constraint can give rise to a lack of fiscal discipline among sub-national governments which can eventually lead to fiscal instability and ultimately macroeconomic and political instability. Therefore, public sector economists generally advocate constraining in some way the borrowing autonomy of sub-national governments.

Regarding the borrowing autonomy of sub-national governments, there are two further issues facing the country. Tanzania currently lacks deep, private capital markets required to support market borrowing by sub-national governments. Second, as previously noted, local governments are heavily transfer dependent and thus lack a reliable and independent source of revenue that can be used to service their debt obligations.[16] Since local governments receive an overwhelming majority of their revenues from transfers, the central government could be seen as implicitly guaranteeing the debt of local governments. Perhaps for these reasons, the Local Government Finances Act of 1982 established the Local Government Loan Board (LGLB) which is a government-supported financial intermediary for LGAs. According to Jameson Boex and Jorge Martinez-Vazquez (2006), the weaknesses of the LGLB are the following: the Board's capitalization is inadequate; it exercises significant discretion in selecting local projects to be funded; and the current lending mechanism is substantially biased against wealthier urban areas.

4. Fundamental socio-economic challenges to fiscal decentralization in Tanzania

In the previous section, we described the main features of Tanzania's system of fiscal decentralization and identified some of the obstacles to decentralization from the perspective of

[16] Dana Weist (2004) discusses the importance of integrating capital financing systems (i.e., intergovernmental loans) with intergovernmental transfer systems.

principles derived from the normative theory of fiscal decentralization. We also pointed out that some of the seemingly ill-conceived features of Tanzania's intergovernmental fiscal framework may make sense from the perspective of union preserving federalism. We are now ready to turn to a discussion of the challenges to federalism posed by ethnic fractionalization, widespread poverty, competition for natural resource rents, human resource capacity constraints, and weak and missing institutions. We believe that these are the fundamental challenges to fiscal decentralization not only in Tanzania but in many other countries of sub-Saharan Africa, as well.

Paul Collier (2000, 2001, and 2007) makes the case that the combination of a dominant ethnic group, as opposed to simply ethnic fractionalization, weak institutions, particularly non-democratic or authoritarian rule, a high rate of poverty, and an abundance of natural resources are a toxic brew that significantly increases the probability that a country will experience civil war. Revenues from oil help finance guerillas and poverty reduces the opportunity cost of becoming a guerillas fighter. The challenge for the countries of sub-Saharan Africa is to develop indigenous institutions that allow them to moderate the civil strife that may result from these socio-economic conditions. We try to make the case that properly conceived and implemented union preserving federalism is a potentially important means of achieving the goal of greater national cohesion in Tanzania and elsewhere.[17] We begin with a discussion of the challenge of ethnic fractionalization.

Ethnic fractionalization

[17] According to Wallace E Oates (1972), political scientists recognize countries as being federal only in the limited number of cases in which different levels of government each possess an explicitly independent scope of responsibility and authority. Typically, these are constitutional provisions. We do not adopt this legalistic approach to the definition of federalism. For our purposes, we prefer the economic definition of federalism proposed by Wallace E. Oates (1972, page 17): a federal government is characterized by "[a] public sector with both centralized and decentralized levels of decision-making in which choices [are] made at each level concerning the provision of public services …."

In the popular mind, countries with a high degree of ethnic fractionalization seem to suffer from a proclivity for violence and government failure. In an influential article, James D. Fearon and David D. Laitin (2003) find that the countries at greatest risk for civil war are not those with a high degree of ethnic or religious fractionalization but rather the presence of conditions that favor insurgency. These include the rate of poverty and being an oil exporter. Alberto Alesina, Reza Baquir, and William Easterly (1999) provide evidence that racially diverse local jurisdictions in the United States spend less on local public services, everything else equal, than more homogeneous jurisdictions. Alberto Alesina and Elian La Ferrara (2000) find that there is less participation in social activities in racially diverse communities in the United States than in more homogeneous ones. These findings suggest that ethnically diverse countries or entities, combined with other factors such as the presence of natural resource rents, may make it difficult for the people to come together to pursue common goals.

As table 5 shows, Tanzania is the most ethnically fractionalized country in Africa. In fact, according to the authoritative study by James D. Fearon (2003), Papua New Guinea is the only country in the world that is more ethnically fractionalized than Tanzania.[18] Table 5 also provides a ranking based on an index of cultural diversity, which tries to capture the cultural 'distance' between ethnic groups. Although Tanzania is not the most culturally diverse country in Africa – it ranks 14th according to this index – it stills ranks quite high in Africa and in the world.

Based on this evidence, Tanzania would seem to be at risk of ethnic conflict, low provision of public goods, and potentially government failure. On a more hopeful note, Paul Collier (2000, 2001) reports evidence that democratic institutions can help moderate ethnic tensions in ethnically fragmented countries. He finds that diversity is damaging to economic

[18] We use the most commonly employed measure of aggregated ethnic fractionalization, defined as the probability that two individuals selected at random from a country will be from different ethnic groups. James Fearon (2003) provides further details on the properties of this measure and the data used to construct the ranking in table 5.

performance in the context of limited political rights. But, diversity has no effect on economic growth in the presence of democratic institutions. Thus, he provides some preliminary evidence that the challenge for Tanzania and other sub-Saharan countries is to develop democratic institutions that help to moderate ethnic competition. One of these democratic institutions in many cases may be some form of union preserving federalism that provides for cooperation to pursue common goals and autonomy to pursue communal or tribal goals.[19]

Widespread poverty

As table 2 shows the poverty rate in mainland Tanzania is 35.7 percent, and varies between 17.6 percent in Dar es Salaam at the low end and 55 percent in Singida at the high end. It perhaps goes without saying that widespread poverty is an impediment to fiscal decentralization, but it is worthwhile to take explicit account of how extreme poverty, of the type experienced in Tanzania and many other countries of sub-Saharan Africa, affects the capacity of local governments to provide services. At the same time, it is evident that widespread and extreme poverty is possibly the main reason for an urgent push to improve local government institutions and service delivery in many countries. Ironically, poverty may be both an obstacle to effective decentralization and its *raison d'être*.

As previously noted, Tanzania's per capita GDP was about $750 in purchasing power parity terms in 2005. The United Nations Human Development Index ranks Tanzania at 159 out of 177 countries. These data mean, for example, that about 30 percent of the adult population is not literate, that life expectancy is 51 years, that 80 percent of the labor force is employed in

[19] Tanzania has avoided the extreme consequences of the potentially combustible combination of fiscal fragmentation, widespread poverty, and weak or missing institutions, which the world has witnessed in Uganda and more recently in the Congo. According to Edward Miguel (2004, page 331), Tanzania avoided these extreme manifestations of ethnic fragmentation as a result of the wise leadership of Tanzania's first, post-colonial leader, President Julius Neyerere, who "… forcefully downplayed the role of ethnic affiliation in public life and instead emphasized a single Tanzanian national identity".

subsistence agriculture, and that almost 90 percent of the population is living on less than $2 per day.

Against this backdrop, it should be noted that annual compensation of the average LGA employee - $2,080 (measured at the official exchange rate) in year 2007 - is about five times the country's GDP per capita. This is an important fact that makes public service delivery in low income countries different from public service delivery in high income countries. The opportunity cost of a unit of local public services is significantly higher in terms of the amount of private sector services foregone in a low income country than in a developed country.[20] Thus perhaps one should be cautious in recommending increased service delivery through the public sector in such circumstances. This is especially important in Tanzania where donor funds are a significant share of the government's budget and may be luring productive resources out of the private sector with adverse consequences for economic and human development.

As previously discussed, one of the pillars of fiscal decentralization is local government revenue autonomy. A lack of revenue autonomy at the local level is, according to the conventional view, a sign of a poorly designed fiscal framework for decentralization. Table 6 shows the aggregate revenues raised by local governments by type of tax and the share of each tax in local government own revenues for FY 2006-07. Indeed, when one looks at the structure of Tanzania's tax system, it appears to provide for some level of local revenue autonomy, but there is in fact effectively very little revenue autonomy at the local level. As previously noted, in FY 2006-07 central government grants to local governments accounted for over 90 percent of local government revenues. Thus, the flow of revenues to local governments from central government grants overwhelms the amount collected by local governments from own sources.

[20] In contrast, the average weekly earnings in the goods producing industries in Canada was $998.61 in 2007 Canadian dollars; whereas, the average weekly earnings in local, municipal, and regional public administration is $856.34 or approximately 86 percent of the average weekly earnings in the private sector.

This evidence would seem to imply that more tax revenue needs to be generated by local governments; either by more effective use of current local tax instruments or by allowing the use of new taxes, but this conclusion would be mistaken.

The problem is that the rural areas, where most of the people live, are so poor that the tax base in most areas is inadequate to generate sufficient revenue for local governments to finance public services from own source revenues. High levels of poverty and underdevelopment usually imply that agriculture plays a large role in the economy. Table 7 shows the shares of GDP generated by agriculture, industry, and services in Tanzania. Agriculture makes up 45 percent of Tanzania's GDP and employs 80 percent of the work force. If one also imagines that 80 percent of the population is supported by agriculture, then some relatively simple calculations suggest that per capita GDP in the agricultural sector is about $202. This sum clearly leaves a large fraction of the population on the edge of subsistence.

Agriculture is notoriously difficult to tax, but even if it were not, there is little or nothing for the government to tax. The surplus from subsistence agriculture is too small for any government, local or central, to seek financing from this sector. If 40 percent of GDP is effectively untaxable, then government revenue must be generated from elsewhere. Figure 3 shows the sources of domestic revenue flowing to the central government for FY 2003-04. The central government's tax structure is fairly conventional, consisting of a number of taxes, including a value-added tax (VAT), an income taxes, a payroll tax (PAYE), import duties, and special excise taxes. Tanzania does not produce oil domestically; therefore, the excise tax and VAT on petroleum are basically equivalent to import duties. In fact, a large share of the general VAT itself is probably collected at the border, and the same is likely to be true for a large share of excise tax receipts. Adding the shares in figure 3 together suggests that about 60 percent of central government revenue is more than likely collected at the border.[21]

Looking at the revenue performance of the central government by region seems to confirm this view. Figure 4 provides the shares of central government tax revenue collections by region. It shows that the capital city, Dar es Salaam, generates 82 percent of the tax revenue; other regions contribute the remaining 18 percent of revenue to the central government, and the next largest revenue provider, aside from the capital city, generates only 3 percent.

These facts obviously help explain the transfer dependency of local governments in Tanzania. The lack of own source revenues is due to the lack of local tax bases in rural areas rather than a flaw in the assignment of taxing authority to the various tiers of government.[22] The crux of the matter is that widespread poverty increases expenditure needs and decreases the ability of local government to finance these needs. As a result, people's desires to meet their basic needs for merit goods, such as drinking water, healthcare, and education, may not be satisfied due to the lack of taxable economic activity. Unmet expectations among a large, impoverished, and ethnically fragmented population may boil over into political instability and civil conflict, particularly if there are significant amounts of wealth available to be plundered from natural resources.

Competition for natural resource rents

Although Tanzania is not 'burdened' with a bounty of natural resources, many sub-Saharan countries do have an abundance of natural resources, including natural gas, oil, precious

[21] A fundamental principle of optimal taxation, however, is that taxes should apply to as wide a tax base as possible in order to keep marginal tax rates as small as possible. Narrowing the tax base requires an increase in the tax rate for any given amount of revenue, and damage to the economy is known to increase with the square of the marginal tax rate. In poor countries like Tanzania, where large sectors of the economy are effectively untaxable, tax rates on the remaining sectors need to be relatively high in order to raise a given amount of revenue; thus increasing the deadweight loss of raising a given level of revenue.

[22] For a detailed discussion of the challenges posed by providing public services in remote areas, see Harry Kitchen and Enid Slack (2006).

metals, and gemstones. As previously noted, the combination of ethnic fractionalization, widespread poverty, and competition for natural resource rents in the context of weak and missing institutions can be a highly combustible mix.

According to the normative theory of fiscal decentralization, the authority to tax natural resources should be assigned to the central government. If the taxing authority is assigned to sub-national governments, the uneven distribution of resources throughout the country will lead to fiscal disparities among sub-national jurisdictions. Furthermore, such an assignment of taxing authority may enable resource-rich jurisdictions to finance government services with little or no taxes. This, in turn, may lead to inefficient migration from resource-poor jurisdictions which must use taxes to finance government services to resource-rich jurisdictions.[23] Thus, according to the conventional wisdom, the authority to tax the rents from exhaustible resources should be assigned to the central government for equity and efficiency reasons.

Charles E. McClure (1994, page 312) points out that the equity argument for centralized taxation of natural resources raises a fundamental concern of federalism. He says, "[t]he issue can be summarized simply: who are 'we' and who are 'they'?" In other words, if people's primary loyalties are to their country, rather than their ethnic group, then assignment of revenues from natural resources primarily to the central government presumably makes more sense. If, on the other hand, people's primary loyalties are to their ethnic group, then primary assignment to sub-national governments may be more appealing. As previously noted, the national identity of

[23] See, for example Kenneth J. McKenzie (2006) for a discussion of the issues surrounding the taxation of economic rents from exhaustible resources. He notes two exceptions or caveats to the conventional wisdom that the central government should be assigned the authority to tax the rents from exhaustible resources. First, there are externalities and infrastructure needs associated with resource extraction. These costs may call for a perhaps limited role for regional governments to tax exhaustible resources as compensation. Second, resource-rich regions may need to be permitted to maintain a significant share of the rents generated from natural resources within their boundaries in order to remain part of the federation. This observation is particularly pertinent in the context of countries with weak nation identities and weak or missing institutions. Despite the conventional wisdom, many, if not most, federal countries allow regional governments to take a sizable share of the economic rents from resources extracted from within their boundaries.

many sub-Saharan African countries is weak which may suggest that assigning a sizable share of the revenues from natural resources to the producing regions may be union preserving and thus desirable.[24]

In the context of an ethnically fragmented country, assigning the revenues from natural resources to a central government dominated by a rival ethnic group to the ones in the resource-rich regions may give rise to suspicions and tensions about the way in which these monies are being spent, whatever the reality of the situation. Moreover, environmental damage and infrastructure needs are associated with resource extraction. Again, a central government dominated by a rival ethnic group may be perceived, whatever the reality of the situation, as paying insufficient concern to the local environment that is the ancestral home of another tribe or group. Nigeria and Sudan are clear examples of countries in which these dynamics are at play: ethnic tensions are high and bordering on open revolt.

From the perspective of union preserving federalism, the simple prescription that the taxation of resources should be assigned to the central government may not be tenable. Some federal countries, Australia, Canada, and the United States being prominent examples, allow regional governments to tax natural resource extraction occurring within their territory. Another arrangement is to provide for asymmetric treatment of such regions in the federal system. This arrangement appears to be particularly attractive to countries with active separatist movements in regions with an abundance of natural resources. The Russian Federation in the case of Tartarstan

[24] As it may have been in Australia, Canada, and the United States. Interestingly, these three mature federal countries assign the revenues from natural resources to sub-national governments. This is particularly ironic because the conventional wisdom of fiscal decentralization is largely based on the work of students of federalism from these three countries. Charles E. McClure (1994) provides two possible explanations for this arrangement in these three countries. At the time that these federations were being formed the value of these resources could not be anticipated, and at that time the primary loyalty of the citizens of these countries may have been with their state or province rather than their country. So, these three successful federations may provide a precedent for idea that countries with weak national identities may prefer to assign primary responsibility for taxing natural resource to sub-national governments, despite the conventional wisdom.

and Indonesia in the case of Ache are examples of countries that provide for asymmetric treatment to resource-rich regions threatening secession. Clearly, this challenge to successful fiscal decentralization deserves greater attention from fiscal economists.

Human resource capacity constraints

Many low income countries have shortages of people with the training and professional skills to staff local government offices; this is particularly true in rural areas of low income countries. Human resource capacity constraints are exacerbated by the fact that the central government and often donors are competing for these same skill sets in a relatively shallow labor pool. This resource constraint is no doubt reflected in the high wages paid by the government sector, as previously noted. Human resource capacity constraints reflect widespread poverty which results in a lack of access to education. The lack of qualified individuals to staff local government offices also contributes to weak and missing institutions.

For example, the PMO-RALG claims to have serious concerns about the capacity of local governments to manage the delivery and financing of important local services. To underscore this concern, the government decided in June 2007 (*Local Government Fiscal Review 2007*, page 11) to require the Tanzanian Revenue Authority to assist the LGA's in the collection of local property taxes. The lack of true local government autonomy, however, is perhaps most clearly revealed by the following statement also in the *Local Government Fiscal Review 2007* (page 11):

> *Finally, it should be noted that despite the advances in fiscal decentralization made in Tanzania over time, local governments in reality have only limited expenditure autonomy. Most importantly, local governments continue to have only very limited control over local personnel decisions, as the approval of local government posts continues to be controlled centrally… .*

In Tanzania, the central government recruits and employs local government employees. While this may help address the lack of qualified people to staff local government offices in the short-run, this is clearly a serious constraint on the autonomy of local governments. In short, a decentralization strategy should include a plan to address the lack of qualified professionals to staff local government offices, particularly in rural areas. This is another issue that deserves greater attention from fiscal economists.

Weak and missing institutions

As one considers modern systems of decentralized governments, one cannot help but be impressed by their success and efficiencies. Nevertheless, even a casual glance across the political landscape of most modern economies will reveal that political corruption has a noteworthy presence. At any given moment in the United States, for example, one is likely to find one or more of the nation's former governors in jail, and every year dozens of mayors, council members, and other political figures are indicted, prosecuted, and convicted of public wrongdoing. Corruption is a worldwide phenomenon, and the scourge of government corruption is unlikely to have bypassed Tanzania. In fact, Transparency International ranks Tanzania 94 out of 179 countries, with a ranking of 1 being the least corrupt and a ranking of 179 being the most corrupt country.

We contend, however, that corruption is a symptom of weak and missing institutions rather than the cause of government failure. Undoubtedly, there is feedback between the two, where official corruption leads to government failure, and government failure breeds corruption. Be that as it may, honest, effective, and efficient governance requires robust and, we would argue, redundant accountability mechanisms. In democratic countries, accountability mechanisms include 'voice' or free and fair voting in competitive elections, civil society organizations, a free and independent press, an independent judiciary, and so on. Many of these institutions are missing in Tanzania and in many of the countries of sub-Saharan Africa.[25]

In a federal system, a mobile population willing and able to move among competing jurisdictions is an important accountability mechanism, as implied by Charles M. Tiebout's (1956) famous phrase 'voting with your feet'. In Tanzania, however, the population is relatively immobile due to local kinship ties and ethnic fragmentation of the population. In fact, Edward Miguel (2004) contends that land demarcation and individual land registration during the post-colonial period stopped the mobility of traditional African society. The resulting lack of mobility, rather than being a challenge to Tanzania's decentralization strategy, prevents one ethnic group from encroaching on the land of others and thus eliminates a principle source of inter-tribal wars.[26] The point being that the lack of mobility often observed in ethnically fragmented and traditional societies means that 'voting with your feet' is not an effective accountability mechanism for local governments in such countries.

When redundant accountability mechanisms are weak or missing, then fiscal decentralization, like a market economy, is likely to fail to deliver more responsive, accountable, and efficient government. Voting, important as it is for good governance, is not sufficient, and promoting greater mobility of the population among competing jurisdictions is likely to lead to greater ethnic tension rather than increased allocative efficiency. Therefore, fiscal decentralization experts should give greater attention to developing effective accountability mechanisms in environments in which there are sound reasons why accountability mechanisms

[25] For an excellent introduction to missing institutions in sub-Saharan Africa, see Marcel Fafchamps (2004).
[26] Another accountability mechanism in mature federal systems in the developed world, which are missing in Tanzania, is robust financial markets that efficiently price debt and punish irresponsible fiscal behavior by sub-national governments that borrow from the market.

that may work in the United States and other developed countries, like mobility, may not work in different socio-economic environments.

5. Conclusion

In this chapter, we have described the main features of Tanzania's fiscal system and assessed it from the perspective of the normative theory of fiscal decentralization. In addition, we have tried to point out instances in which we believe that seemingly ill conceived fiscal arrangements from the perspective of the conventional wisdom may be understandable from the perspective of what we are calling *union preserving federalism*. Examples include the fiscal autonomy of GoZ; the vertical imbalance created by the expenditure and tax assignments; and the assignment of some redistributive functions to local governments. We believe that these features of Tanzania's fiscal arrangements are examples of union preserving federalism in Tanzania.

We are not the first to point out that fiscal decentralization may play a constructive role in fragmented societies. On the contrary, Richard M. Bird and Thomas Stauffer (2001) and Richard M. Bird and Robert D. Ebel (2007) are two excellent collections of case studies on fiscal arrangements in fragmented countries. Our contribution to this discussion is to argue for making *union preserving federalism* an explicit and fundamental goal in designing fiscal arrangements rather than an afterthought.

While policy-makers and their technical advisors rightly pay attention to the incentives for allocative efficiency created by a country's fiscal arrangements, they should also be mindful of the incentives that the fiscal system creates for national cohesion. Richard M. Bird and Robert D. Ebel (2007, page 10), leading experts on fiscal decentralization, provide a succinct statement of the conventional wisdom derived from the normative theory:

> *" … providing clear expenditure assignments, giving responsibility for determining the rates for some major revenues to sub-national governments, and distributing transfers by means of a predetermined formula. …[A]n intergovernmental fiscal regime set up along these lines in effect imposes a hard budget constraint on subnational governments, and hence provides an appropriate incentive structure for ensuring economically efficient outcomes."*

Although this statement undoubtedly oversimplifies for dramatic effect, we believe that it reveals the approach that many take to the challenge of designing an intergovernmental fiscal system. It expresses the widely shared view, particularly among economists, that the goal of fiscal decentralization is to achieve allocative efficiency in the public sector, almost to the exclusion of recognizing any other legitimate goal for decentralization, such as national cohesion.[27]

Also implicit in this statement is the notion that by adhering to a few simple principles in the design of an intergovernmental fiscal system, a country can create "an appropriate incentive structure for *ensuring* economically efficient outcomes".[28] There are important goals for fiscal decentralization. In addition to creating incentives to increase the allocative efficiency of the public sector, one such goal is to create a fiscal framework that allows diverse peoples with diverse interests to cooperate to achieve common goals while simultaneously providing them with sufficient and effective local autonomy to pursue communal goals. We believe that decentralization policy-making will improve if the twin goals of allocative efficiency and national cohesion are made explicit, and the trade-offs between the two are thoughtfully investigated by theorists, empiricists, and practitioners.

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[27] Perhaps this focus on the goal of achieving allocative efficiency in the public sector reflects a division of labor in which economists opine on the necessary conditions for allocative efficiency, while others worry about developing institutions to achieve national cohesion. The problem with this arrangement is that there is no bright line between institutions promoting allocative efficiency and those promoting national cohesion. Indeed, there are likely to be trade-offs between the two.

[28] In a similar spirit, Paul Smoke (2003, page 7) makes the point that much of the promised benefits of fiscal decentralization is not based in careful empirical evidence but is all too often "… based on anecdotal instances of success or enthusiastic rhetoric about its benefits".

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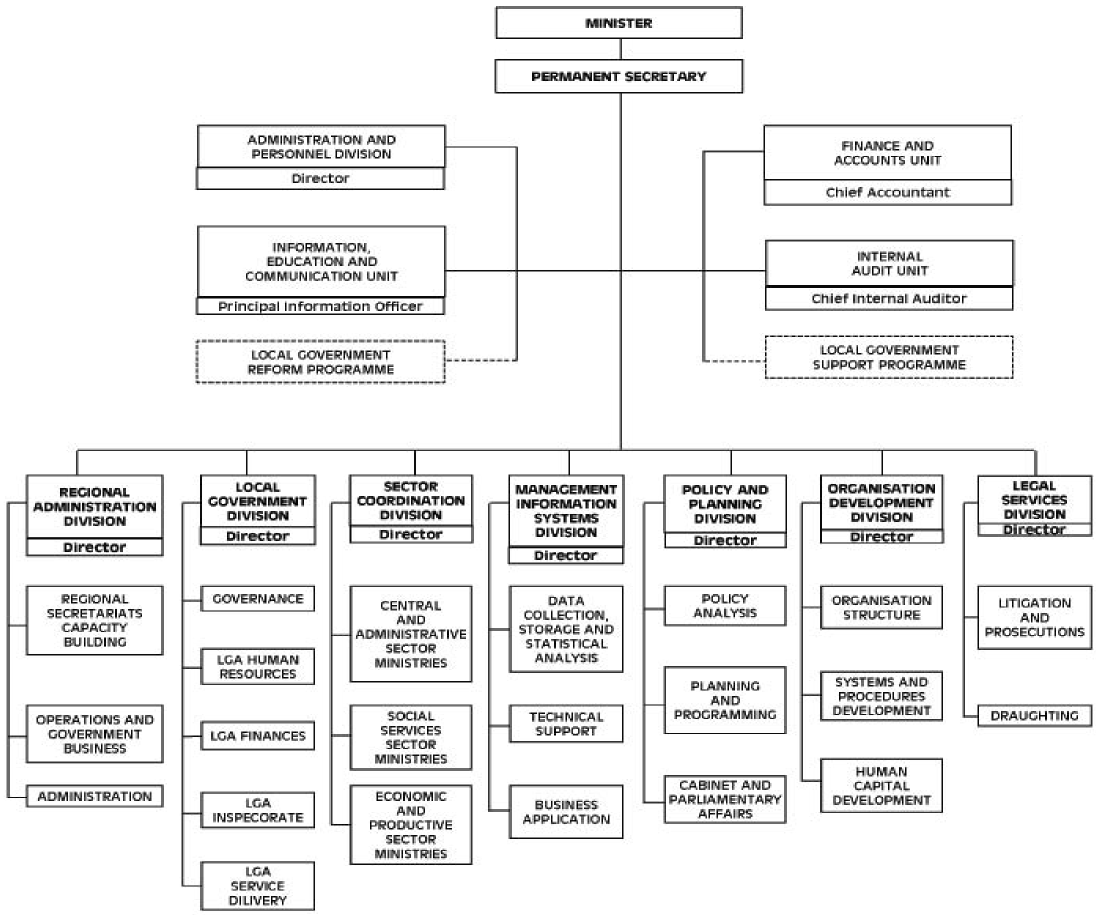
Figure 1: A map of the Republic of Tanzania

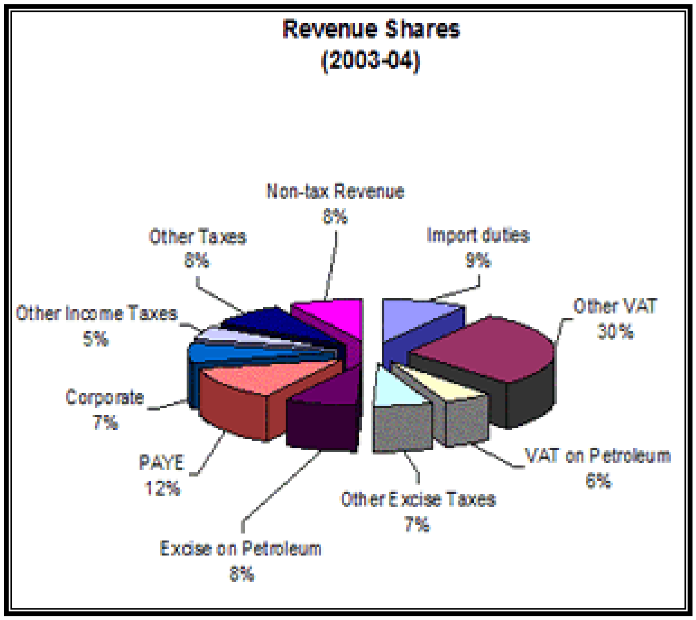
Source: MapsofWorld.com

Figure 2: Organizational chart of the Prime Minister's Office
of Regional Administration and Local Government



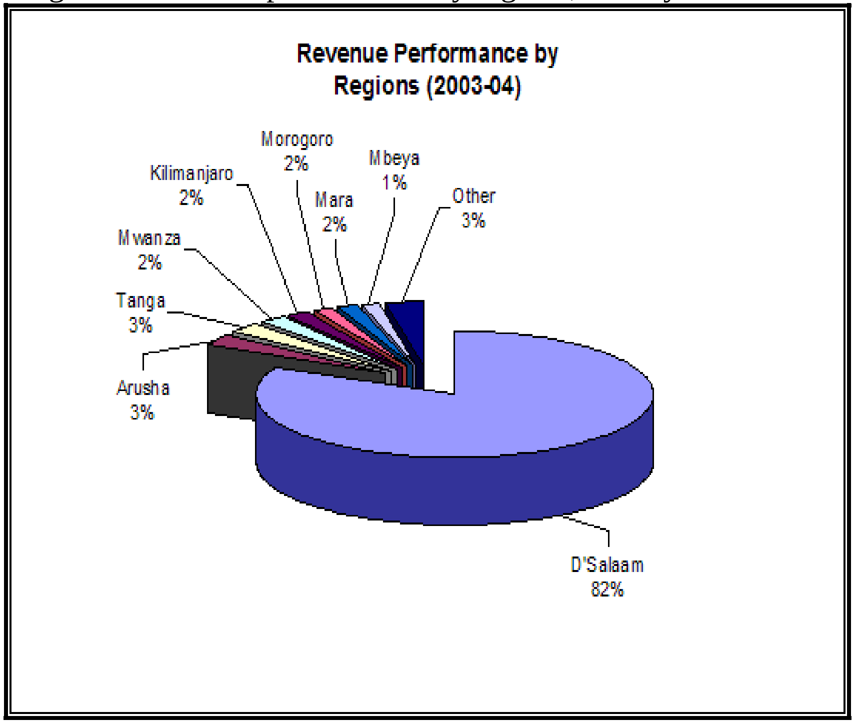
Source: http://www.pmoralg.go.tz/about_us/organizaton_structure.php

Figure 3: Revenues shares, fiscal year 2003-04



Source: Ministry of Finance (http://www.mof.go.tz)

Figure 4: Revenue performance by regions, fiscal year 2003-04



Source: Ministry of Finance (http://www.mof.go.tz)

Table 1: Demographic profile of the United Republic of Tanzania, by region

Mainland	Land area in sq. km. (‘000)	Population 2008 (‘000)	Population density per sq. km. (2008)	Rate of urbanization (percent)
Dodoma	41	2,005	49	12.6
Arusha	36	1,570	44	31.3
Kilimanjaro	13	1,569	121	20.9
Tanga	27	1,880	70	18.4
Morogoro	71	2,022	28	27.0
Pwani	33	1,015	31	21.1
Dar es Salaam	1	2,961	2,961	93.9
Lindi	66	887	13	16.0
Mtwara	17	1,272	75	20.3
Ruvuma	64	1,303	20	15.2
Iringa	57	1,680	29	17.2
Mbeya	60	2,502	42	20.4
Singida	49	1,295	26	13.7
Tabora	76	2,171	29	12.9
Rukwa	69	1,399	20	17.6
Kigoma	37	1,669	45	12.1
Shinyanga	51	3,549	70	9.2
Kagera	29	2,380	82	6.2
Mwanza	20	3,364	168	20.2
Mara	22	1,692	77	18.6
Manyara	46	1,288	28	13.6
Total-Tanzania	885	39,475	45	22.6
Coefficient of variation	50.5	38.7	331.4	
Zanzibar	(sq. km)	(’000)	(sq. km)	(percent)
Kaskazini Unguja	470	166	352	1.7
Kusini Unguja	854	108	125	5.2
Mjini Magharibi	230	460	1,998	81.9
Kaskazini Pemba	574	234	408	16.5
Kusini Pemba	332	226	681	17.9
Total-Zanzibar	2,460	1,193	485	39.6
Coefficient of variation	49.0	56.0	408.0	133.0
Total-Tanzania	887,460	40,668	46	na

Source: Tanzania in figures (http://www.nbs.go.tz/TZ_FIGURES/TZ_FIG_2008.pdf).
Note: Population figures do not include refugees.

Table 2: Socio-economic profile of the United Republic of Tanzania, by regions

Mainland Tanzania	GRDP per capita in 2005 at current prices (Shs. billion)[1]	Adult literacy rate (percent)[2]	Infant mortality rate (per 1,000 live births)[3]	Poverty rate (percent)[2]	Rate HIV-Positive (percent)[4]
Dodoma	219.9	66	114	34	1.4
Arusha	414.8	78	41	39	8.9
Kilimanjaro	445.8	85	46	31	3.3
Tanga	439.5	67	98	36	14.7
Morogoro	375.5	72	100	29	3.4
Pwani	269.0	61	101	46	0.9
Dar es Salaam	700.7	91	79	17.6	1.9
Lindi	315.3	58	129	53	3.9
Mtwara	278.0	68	126	38	1.7
Ruvuma	447.2	84	104	41	5.3
Iringa	456.9	81	102	29	7.9
Mbeya	422.1	79	101	21	4.2
Singida	208.2	71	82	55	5.0
Tabora	297.0	65	83	26	3.0
Rukwa	357.8	68	106	31	5.3
Kigoma	220.2	71	92	38	7.6
Shinyanga	243.4	55	92	42	2.6
Kagera	238.6	64	110	29	6.1
Mwanza	344.8	65	87	48	3.8
Mara	359.3	76	113	46	4.5
Manyara	384.2	na	na	na	5.4
Total-Tanzania	360.9	71	99	35.7	5.8
Coefficient of variation	32.5	13.3	23.3	27.6	64.9
Zanzibar Tanzania					
Kaskazini Unguja	na	na	103	na	na
Kusini Unguja	na	na	87	na	na
Mjini Magharibi	na	na	70	na	na
Kaskazini Pemba	na	na	101	na	na
Kusini Pemba	na	na	na	na	na
Total-Zanzibar	na	na	na	na	na
Coefficient of variation	na	na	na	na	na
Total -Tanzania	na	na	na	na	na

Source: [1]National Bureau of Statistics (http://www.nbs.go.tz/nationalaccount/index.htm).
[2]National Bureau of Statistics, Household Budget Survey, (http://www.tsed.org/home.aspx).
[3]National Bureau of Statistics, Population and Housing Census, 2002. (http://www.tsed.org/home.aspx).
[4] Tanzania in Figures 2008 (http://www.nbs.go.tz/TZ_FIGURES/TZ_FIG_2008.pdf).

Table 3: Profile of local government authorities

Number of local government authorities (in 2007)	120
Total number or local government authority workers (in 2007)	209,000
Total worker compensation (2007 exchange rate)	$434,093,000
Population of the most populous local government authority (2002 Census)	2,497,940
Average population of local government authorities (2002 Census)	300,000
Average number of workers per local government authority	1,742
Average annual pay per worker (in 2007)	$2,080

Sources: United Republic of Tanzania-Local Government Information (www.logintanzania.net), the Tanzania National Bureau of Statistics (http://www.nbs.go.tz/), and calculations by the authors.

Table 4: Sectoral block grant allocation formulas, FY 2005-06

Sectoral grant	Allocation formula	
Primary education	Number of school-aged children: (plus earmarked amount for special schools)	100 percent
Health services	Population: Number of poor residents: District medical vehicle route: Under-five mortality:	70 percent 10 percent 10 percent 10 percent
Agricultural and livestock	Number of villages: Rural population: Rainfall index:	60 percent 20 percent 20 percent
Water	Equal shares: Number of unserved rural residents:	10 percent 90 percent
Local roads	Road network length: 75 percent Land area (capped): 15 percent Number of poor residents: 10 percent	75 percent 15 percent 10 percent

Source: Table 8.1 in Jameson Boex and Jorge Martinez-Vazquez (2006). *Local Government Finance Reform in Developing Countries: The Case of Tanzania*. New York, NY: Palgrave MacMillan.

Table 5: Ethnic fractionalization and cultural diversity in sub-Saharan Africa

Country (descending order of ethnic fractionalization)	Ethnic fractionalization	Cultural fractionalization	Rank of cultural fractionalization
1. Tanzania	0.953	0.564	14
2. Democratic Republic of Congo	0.933	0.628	7
3. Uganda	0.930	0.647	5
4. Liberia	0.899	0.644	6
5. Cameroon	0.887	0.733	1
6. Togo	0.883	0.602	8
7. South Africa	0.880	0.530	20
8. Congo	0.878	0.562	15
9. Madagascar	0.861	0.192	36
10. Gabon	0.857	0.382	29
11. Kenya	0.852	0.601	9
12. Ghana	0.846	0.388	28
13. Malawi	0.829	0.294	31
14. Guinea Bissau	0.818	0.568	13
15. Somalia	0.812	0.290	32
16. Nigeria	0.805	0.660	4
17. Central African Republic	0.791	0.511	21
18. Ivory Coast	0.784	0.557	17
19. Chad	0.772	0.727	2
20. Mozambique	0.765	0.285	33
21. Gambia	0.764	0.548	18
22. Sierra Leone	0.764	0.534	19
23. Ethiopia	0.760	0.562	16
24. Angola	0.756	0.242	35
25. Mali	0.754	0.590	11
26. Senegal	0.727	0.402	25
27. Zambia	0.726	0.189	37
28. Namibia	0.724	0.589	12
29. Sudan	0.708	0.698	3
30. Burkina Faso	0.704	0.354	30
31. Guinea	0.669	0.490	22
32. Eritrea	0.647	0.398	27
33. Niger	0.637	0.600	10
34. Mauritius	0.632	0.448	23
35. Mauritania	0.625	0.272	34
36. Benin	0.622	0.400	26
37. Djibouti	0.606	0.404	24
38. Zibabwe	0.366	0.141	40
39. Botswana	0.351	0.161	38
40. Burundi	0.328	0.040	42
41. Swaziland	0.280	0.143	39
42. Lesotho	0.255	0.057	41
43. Rwanda	0.180	0.00	43

Source: Appendix of James D. Fearon (2003). "Ethnic and cultural diversity by country". *Journal of Economic Growth* 8: 195-222.

Table 6: Total local government own-source revenues, fiscal year 2006-07 (millions of Tanzanian shillings)

Type of tax	Revenue	Percent of total
Property taxes	5.476	9.0
Land rent	1.332	2.0
Produce cess	13.118	21.0
Service levy	15.138	25.0
Guest house levy	1.127	2.0
Licenses	1.470	2.0
Fees, permits and charges	14.631	24.0
Other own revenues	9.115	15.0
Total own revenues	61.411	100.0

Source: PMO-RALG, Local Government Fiscal Review 2007.

Table 7:
Shares of gross domestic product by sector, in 2007

Agriculture	45.3 percent
Industry	17.4 percent
Services	37.3 percent

Source: The World Bank