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Local Revenue Mobilization in Urban Settings in Africa

Odd-Helge Fjeldstad

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Introduction¹

The urbanization of poverty is one of the most dramatic developments on the African continent, yielding contrasting images of affluent residential and business districts and utter misery in sprawling shantytowns or slums. More than 50 per cent of Africa's population will soon live in towns and cities, and 50 per cent of Africa's poor will live in urban slums by 2025 (Tostensen *et al.* 2001). Southern Africa is the most urbanized region on the continent, with Angola currently having an urban population of more than 60 per cent and South Africa about 55 per cent. Urban migration does not seem to slow down, taking hundreds of thousands of women, men, and children to towns in search of a better life. Over the next ten years, some 50 million people in West Africa are expected to migrate to cities, and by 2030, it is projected that 63 per cent of the population will live in cities. The demographic change in East Africa is just as dramatic.

The growth of Africa's towns and cities has outpaced local authority capacity for service delivery in terms of management, infrastructure, and financing (McCluskey *et al.* 2003, p. 3). Firstly, the urban municipal authorities, many of which were originally instituted as colonial administrative institutions, have not been restructured to cope with the fast-growing population (Beall 2000). Secondly, a growing number of urban residents live in informal settlements characterized by deficient basic services such as housing, clean water, electricity, sanitation, refuse collection, roads, and transport (Devas 2003). Thirdly, many municipalities are financially weak and rely on financial transfers and assistance from the central government (Brosio 2000). Moreover, the revenue collection administrations are often inefficient and large amounts of revenues collected are inappropriately managed.

As a result, many African towns and cities are now faced with a governance crisis and poor service delivery capability. Consequently, the restructuring of governmental functions and finances between the national and municipal levels of government has entered the core of the development debate. In particular, fiscal decentralization – the devolution of revenue mobilization and spending powers to lower levels of government – has become a main theme of urban governance in recent years. The purpose of this paper is to explore the opportunities and constraints facing local revenue mobilization in urban settings. The study examines various revenue instruments available, their revenue potential, and how they affect economic efficiency and income distribution. Moreover, the paper discusses political and administrative constraints facing local revenue mobilization and factors impacting on citizens' compliance behaviour. The emphasis is on local government 'own revenues', but fiscal transfers from the central level and borrowing are also addressed. The paper argues that urban local governments need to be given access to adequate resources to do the job with which they are entrusted. However, own revenues mobilized in most urban local authorities in Africa are generally not sufficient to develop and supply adequate services for the fast-growing urban population. Hence, a general conclusion that emerges from this study is that local own revenues are a necessary but not a sufficient condition for fiscal decentralization.

¹ This paper is prepared for the volume *Local governance and poverty reduction in Africa*, edited by Karin Millett, Dele Olowu and Robert Cameron, and forthcoming in a publication by the Joint Africa Institute (www.afdb.org/jai). Preliminary versions of the paper were presented at the *Workshop on Local Governance and Poverty Alleviation in Africa*, African Development Bank, Tunis, 21-25 June 2005, and at *REPOA's 11th Annual Research Workshop*, Dar es Salaam, 4 April 2006. I would like to thank the workshop participants for valuable comments. Points of view and possible errors are entirely my responsibility.

The remaining part of the paper is organized as follows: The next section provides a brief review of the main components of current local government revenue systems, including ‘own revenues’ and transfers from the central level. Thereafter, challenges facing local government revenue reforms in Africa are assessed. The following section focuses on the strengths and weaknesses of major local ‘own revenues’ instruments. Measures to improving current property taxes, business licenses, and user fees are emphasized. The final section concludes by outlining some policy implications.

1. Revenue instruments for local governments

A sound revenue system for local governments is an essential pre-condition for the success of fiscal decentralization (Olowu & Wunsch 2003). In addition to raising revenues, local revenue mobilization has the potential to foster political and administrative accountability by empowering communities (Shah 1998; Oates 1998). However, prescriptions deriving from the theory and from good international practice impose huge constraints on the choice of revenue instruments for local governments.

In general, there are two main categories of current revenue for local authorities in Africa: (i) ‘own revenue’, which includes taxes, user fees, and various licences, and (ii) transfers from the central or regional levels, usually in the form of grants and revenue sharing (Bahl *et al.* 2003, p. 71). In some countries, municipalities are also allowed to borrow money for capital investments in infrastructure. This section briefly reviews some general principles for revenue assignment between different levels of government, and discusses challenges to securing fiscal responsibility at sub-national levels with respect to transfer systems and borrowing.

1.1. Who levies what taxes?

There is no ideal assignment of revenue sources between central and lower levels of government. Nevertheless, a set of ‘tax-assignment rules’ has been developed in the traditional fiscal federalism theory (Oates 1972; Musgrave 2000). These principles relate to the respective responsibilities of central and lower tiers of government in macroeconomic stabilisation, income redistribution, and resource allocation (Boadway *et al.* 2000). Furthermore, in developing countries the administrative capabilities of local governments in revenue design (that is, deciding on revenue bases and setting rates) must be taken into consideration (Bird 1990). Moreover, in large and diverse countries the issue of revenue harmonization between jurisdictions is important when assigning taxing powers.

The stabilization objective of the fiscal system calls for central control over the revenue instruments that may substantially influence central budget deficits or inflation. Thus, taxes on international transactions (customs duties) and a considerable share of income and general sales taxes (such as VAT) should be assigned to central government. If there are wide disparities in income and wealth across regions, as there are in many African countries, then local taxing powers may exacerbate these differences. Hence, the distributive function of government is an argument for centralized, progressive corporate income and wealth taxes. Since the central government can borrow money to make up for shortfalls, it can live with the more unstable revenue sources, such as customs duties and income taxes. Local governments, by contrast, require relatively stable sources of revenue. Thus, lower-level governments should tax revenue bases with low mobility between jurisdictions. Property tax is therefore often labelled as the ‘ideal’ local tax (see Section 3). Moreover, if properly designed, user charges on trading services such as electricity, water, sanitation, and solid waste collection may be attractive local revenue instruments. The same applies to benefit taxes such as road and port tolls, and to various licenses, which also may have regulatory functions.

There is no 'ideal' way of dividing revenue responsibility between central and lower tiers of government. While the general principles and theoretical discussions of revenue assignments are useful, in practice, country-specific factors play a large role (Tanzi 2000). The case for centralization is usually built around macroeconomic considerations and equalization, and the case for local government taxing powers on efficiency considerations. The 'optimal' way to do things, however, depends on how the government weighs these considerations (Bahl & Wallich 1992). Furthermore, the capacity to administer revenue instruments is always an important constraint to the assignment of 'taxing powers' to lower levels of government in developing countries. Finally, but not least important, local revenue sources must be politically acceptable (Bahl *et al.* 2003, p. 75). As a rule of thumb, less visible revenue instruments tend to be more acceptable to taxpayers.

1.2. Transfers and borrowing

Almost without exception, governments across the world assign more expenditure functions to local authorities than can be financed from their own revenue sources. The result of this mismatching of functions and finances – often referred to as 'vertical imbalances' – is that local governments are generally dependent on transfers from higher levels of government. There are a number of methods to close the fiscal imbalances of sub-national governments, some of which also reduce imbalances between jurisdictions (Ahmad 1997, p. 6). In practice, transfers may be in the form of surcharges or revenue sharing whereby a local government receives a share of the revenues from particular taxes collected by the central government within its jurisdiction (McLure 1999, p. 12). The main mechanism for intergovernmental transfers in Africa, however, is conditional and/or unconditional grants from central to local governments (see Box 4.1).² Moreover, in some countries, for instance in South Africa, municipalities are also given the right to borrow to finance investments in local capital infrastructure (Bahl & Smoke 2003, p. 8).

Box 4.1: Unconditional grants to local governments in Ghana, Uganda, and Ethiopia

Ghana uses a system where no less than 5 per cent of the total revenues collected by the central government are allocated to a 'Common Fund' for the disposal of sub-national governments.

In Uganda, unconditional grants are determined annually with reference to the reassignment of tasks between the national and sub-national governments. According to the Ugandan Constitution, the total amount is calculated using a formula that includes the unconditional grant of the previous year, corrected by the increase in the general price level, plus the net change in the budgeted costs of running newly devolved or subtracted services. Thus, the Ugandan formula takes into account the actual devolution of functions and its budgetary implications.

Ethiopia, in contrast, follows a less transparent system. When determining the size of the grant one starts with estimates of total resources available from tax and non-tax revenue and counterpart funds. However, direct foreign assistance, which is extensive in some jurisdictions, is not included. After negotiations with the regions, the national government allocates the total pool between itself and the regional governments. In 1995/96, a formula-based system was introduced in Ethiopia. However, the formula has changed every year since its introduction.

Source: Brosio (2000).

² See Ahmad (1997) for a more detailed discussion of intergovernmental fiscal transfers. Ajam (2001) provides a detailed presentation of intergovernmental fiscal relations in South Africa, and Boex (2003) discusses the formula-based grant system recently introduced in Tanzania.

Promoting fiscal responsibility at sub-national levels calls for implementation of a stable and transparent system of transfers, geared to filling any gap between the assigned spending and revenue-raising responsibilities of lower-level governments (Ter-Minassian 1999). The definition of such a system is far from easy, especially given the need to preserve adequate incentives for tax effort and cost effectiveness in spending by the sub-national governments. However, in the process of fiscal decentralization it is important to be aware of the risks for macroeconomic management and fiscal discipline. Mechanisms of fiscal transfers may impose considerably rigidity to the central government budget. Therefore, substantial devolution of revenues and spending responsibilities to sub-national jurisdictions can affect the central government's ability to carry out stabilization and macroeconomic adjustment through the budget.

The destabilizing potential of sub-national governments is greatest when they face no hard budget constraint (Ter-Minassian 1999; World Bank 2000). Expectations of bail out in case of financial trouble weaken the incentives to economise on costs, and may generate resource waste and rigidity within local authorities. These inefficiencies, in turn, may spill over into macroeconomic imbalances. In particular, concern for macroeconomic imbalance lies behind the common recommendation that strict limits should be imposed on the borrowing ability of sub-national jurisdictions (Bird & Vaillancourt 1998). It is feared that sub-national governments that are highly dependent on national transfers may increase their current expenditures above their capacity to fund them out of current revenues and then close the gap through borrowing. For instance, in the mid-1990s in Mexico, provincial borrowing contributed to a situation where some states were defined as 'bankrupt' (Tanzi 2000).

2. Reforming local government 'own revenue' systems

A widely found characteristic of local 'own' revenue systems in Africa is the huge number of revenue instruments in use by local authorities (Bahiigwa *et al.* 2004; Brosio 2000; Fjeldstad & Semboja 2000). In many countries, local governments seem to raise whatever taxes, fees, and charges they are capable of raising, often without worrying excessively about the economic distortions and distribution effects that these instruments may create.

A complicated and non-transparent local government revenue system is costly to administer and it facilitates corruption and mismanagement (Bardhan & Mookherjee 2002). Moreover, many local taxes have a distorting effect on resource allocation decisions, and, thus, an inhibiting effect on the start-up of new enterprises and the achievement of economic growth (Bahiigwa *et al.* 2004; Devas & Kelly 2001; Sander 2003). These effects occur when effective rates vary greatly between different goods that are traded, or when license fees are set too high for start-up small-scale enterprises to survive. In addition, the levels and types of local revenue instruments by themselves can result in the tax burden falling more on the poor than on the relatively better off in local communities (Fjeldstad & Semboja 2001). This is mainly due to the basic design of the local revenue system and the way revenues are collected (Fjeldstad & Semboja 2000; Fjeldstad 2001). Despite the many comprehensive central government tax reforms during the last decade, local government revenue systems in sub-Saharan Africa have remained largely unchanged until recently. Generally, a fundamental requirement when redesigning local revenue systems is greater emphasis on the cost-effectiveness of revenue collection, taking into account not only the direct costs of revenue administration, but also the overall costs to the economy, including the compliance costs to taxpayers. In addition, losses through corruption and evasion need to be reduced. Clearly, improved revenue administration cannot compensate for bad revenue design. Thus, reforming the revenue

structure should precede the reform of revenue administration since there is not much merit in making a bad revenue system work somewhat better.

Recently, Tanzania conducted a comprehensive reform of its local revenue system (see Box 4.2). The main elements of this reform were (i) abolition of unsatisfactory local revenue instruments, which were costly to collect from administrative and political perspectives (including the poll tax), and (ii) improvements to remaining revenue bases by simplifying rate structures and collection procedures. The Tanzanian reform demonstrates that radical changes of the local revenue system are possible, although it is too early to assess the longer-term impacts of this reform on local government revenues.

Box 4.2: Reforming the local government revenue system in Tanzania

Until mid-2003, it was not uncommon that local authorities in Tanzania had more than 70 different taxes, fees, and charges. In addition, there were many sub-groups of particular revenue instruments. There were also large variations on the rates imposed by councils on similar revenue bases, which led to smuggling of tradable goods across council borders within the country. The revenue system was costly to administer and it facilitated corruption and mismanagement. Moreover, many local revenue instruments, including the business licensing system, distorted market decisions and inhibited the start-up of new enterprises.

In June 2003, a comprehensive reform of the local government revenue system was carried out. A large number of so-called nuisance taxes, which were costly to administer and generated limited revenues, were rationalized. Thereafter, in June 2004, local business licenses were abolished based on the argument that they provided disincentives for the development of local enterprises. The Tanzanian reform demonstrates that radical changes of the local revenue system are possible. However, it is too early to assess the longer-term impacts of the reform. For instance, the rationalization implied that local governments have to be compensated for the resulting revenue shortfalls by the central government, at least in the short run.

Ongoing work initiated by the ministry responsible for local authorities focuses on reforming the current local revenue system and to identifying new revenue options. Among the proposals discussed are reforms of the property tax system, introduction of a unified business tax, and reintroduction and streamlining of the business license system. Moreover, many councils have started to explore methods to reduce the financial gap caused by the rationalisation by:

1. outsourcing revenue collection to private collectors to increase revenues from existing sources;
2. reducing costs (for example, by limiting the number of meetings and workshops and by retrenching surplus staff); and
3. imposing more cost-effective spending (for example, on electricity and stationery).

Current attempts for economic diversification may also help to expand the local revenue base in the longer term. Furthermore, co-production of services by councils and local communities is on the rise. For instance, an increasing number of primary schools are maintained and expanded via self-help schemes combined with technical support from the local government authorities.

Source: Fjeldstad *et al.* (2004).

3. Strengths and weaknesses of major local 'own revenue' instruments

As noted above, the local 'own revenue' systems across Africa are often characterized by a huge number of revenue instruments. However, the main sources of 'own revenues' in urban councils are usually property rates, business licenses, and various uses charges, often in the form of surcharges for services provided by or on behalf of the municipality. Nevertheless, experiences from a number of African countries show that these revenue instruments have serious shortfalls. For instance, property taxes can be very costly to administer (Brosio 2000, p. 20), and the enforcement of user fees has resulted in widespread resistance to pay from the poorer segments of the urban population in some countries (Fjeldstad 2004; Fjeldstad *et al* 2005). Moreover, complex business licensing systems have proved to be major impediments for the start up and expansion of especially micro and small enterprises (Devas & Kelly 2001; Sander 2003). However, international evidence shows that when well administered, these revenue instruments can provide substantial and reliable revenues for urban municipalities.

3.1. Property tax

Property tax is a major source of revenue in many urban councils (Mikesell 2002). In the 1990s, property taxes accounted for 40 per cent of all sub-national taxes in developing countries (Bird & Slack 2002, p. 6), but less in many African countries; for instance 10–30 per cent in urban councils in Tanzania (Fjeldstad *et al.* 2004), and around 20 per cent in South Africa (Bahl & Smoke 2003). It also has the potential to become an important revenue source in semi-urbanized centres in district councils. Textbooks on revenue assignments between various levels of government argue that few fiscally significant taxes are more appropriate to local administration than property tax. This is due to the fact that real property is visible, immobile, and a clear indicator of one form of wealth. Hence, in principle, property tax is difficult to avoid and if well administered it can represent a non-distortional and highly efficient fiscal tool.

Property tax can be administrated by both local and central governments (see Box 4.3). When local governments administer the tax, they are responsible for maintaining property and ownership records, determining taxable property values, calculating and distributing property tax bills, managing receipt payment, and applying tax enforcement against non-payers (Mikesell 2002, p. 22). In other cases, local governments have a say in the choice of the tax rate, while all parts of the administration of the tax are performed by the national revenue authority. In some countries, including Malawi, property valuation is done by the central government, while local authorities set rates and handle collection (Mikesell 2002, p. 28). West African French-speaking countries in general rely on the traditional French model, in which the property tax is administered and collected by the central government, whereas East and Southern African countries rely on local administration (Brosio 2000, p. 22). This is usually recommended in the literature that stresses that taxes should be administered by the government that is entitled to their revenue. However, mixed results prevail in both cases in Africa.

Box 4.3: Centralized property taxation in Indonesia

Indonesia offers an example of a near-total central control of property tax policy and administration. A flat tax rate of 0.5 per cent applies to the assessed capital value of land and improvements throughout the country. Revenue is divided according to nationally legislated shares: 64.2 per cent to local governments, 16.2 per cent to provincial governments, 10 per cent to the central government, and 9 per cent for administrative costs (also to the central government).

Property assessment operates through a mass valuation system that assesses land by a 'similar land value zone' approach (that is, land is divided into zones with an average sales price per square meter determined by the central government tax administration). Revaluations are done every three years, except in rapidly developing areas where revaluations are done each year. The system assigns tax liability to either the owner or the beneficiary of each parcel to avoid problems with unclear property titles. A payment point system works through designated banks, which receive pre-printed receipts for expected payments.

Source: Taliercio (2004).

Expert opinion diverges on how to improve property taxation in developing countries.³ Some experts blame the excessive centralization of property tax policy, which bars setting higher tax rates. Others blame what they consider the almost total anarchy deriving from local government freedom in this field. There is also dispute over tax administration. Certainly, property taxes have many attractions as local bases, but they also have some obvious weaknesses that need to be taken into consideration before heavy reliance is placed on them. Often the capability and capacity of the municipality are inadequate to administrate the property tax at a low cost (McCluskey *et al.* 2003, p. 23). These administrative weaknesses are manifested in problems of valuation and arbitrariness in tax assessment and enforcement.

In theory, assessment of property value and revenue collection are straightforward: conduct a cadastral survey that assesses the market or site value of each plot of land or property, and send a tax bill to each owner. In practice, however, cadastral surveys are expensive and time-consuming (Bahl *et al.* 2003, p. 79). The task is often beyond the financial and technical capability of many local governments (see Box 4.4). Tax offices in many sub-Saharan African countries are short on assessors, if they have any at all (Farvacque-Vitkovi & Godin 1998). In Uganda, for instance, there are eleven certified land and property valuers responsible for valuing three million parcels (McCluskey *et al.* 2003). The corresponding figures for Tanzania are approximately 100 certified valuers and five million parcels. Thus, it is difficult to conduct and maintain assessments, which are also often eroded by inflation. Particularly when property prices are changing rapidly, it is difficult to administer. Accordingly, the property tax base is inelastic, despite growth in the physical size or value of property, because old valuations are not updated and new properties not identified. In most cases, the system has been inherited from the colonial era and is poorly suited to present conditions.

³ Dillinger (1991) provides an insightful summary of these challenges.

Box 4.4: Deficient property tax administration in Kampala

The seriously deficient administration of the property tax in Uganda exemplifies the difficulties this tax has in providing substantial revenues to local governments in Africa. Although any local authority has the legal right to levy property taxes, in practice they are levied only by municipalities and town councils. Undeveloped land is not taxed, which inhibits the efficient use thereof.

The property tax is based on seriously outdated valuations, which are very low, although the law requires that valuations be carried out every five years. Many valuable properties are not taxed at all, and many newly refurbished buildings have not been re-valued. Systems of recording and valuing properties are seriously deficient. This is partly because the skilled technical staff needed to organize and supervise valuation work is in short supply.

The city of Kampala also shows a phenomenon that is taking place in many other metropolitan areas in Africa. Its urbanized area has expanded beyond its municipal boundaries, but neighbouring districts are either not allowed to levy property tax on residential properties, or abstain from doing so because they still have to provide the basic urban services to these areas. Low revenue is also attributable to poor collections, huge delays in payments, or simply to non-payments. Non-payments also derive from the high mobility of persons, frequent property sales/exchanges, and the inadequate registration of titles.

Source: McCluskey *et al.* (2003).

Cadastral systems may work in areas with regular street patterns, named streets, and numbered houses. In the absence of street addresses, tax bills are not deliverable, and penalties are unenforceable. The absence or scarcity of clear ownership titles is another challenge facing this form of taxation. Collection is often poor and many bills go unpaid because taxpayers are not identified or they resist payment because their housing conditions are too poor or urban basic services are not provided to their areas. However, revenue collection may also prove to be problematic in areas where the property matrix is in place. In principle, non-compliance of property tax can be enforced by confiscation and sale of the owner's personal effects in the building initially, and ultimately through the collateral of the real estate itself. However, experience shows that courts are often swamped by appeals from angry property owners and landowners (Skinner 1993, p. 364). Moreover, harsh enforcement mechanisms may result in intervention from politicians facing complaints from their constituents (Enemuo 2000, p. 193). Thus, high administrative and political costs are the crucial problems of property taxation.

Foreign donors have been involved in a number of cases focusing on capacity building, but with mixed results (see Box 4.5). However, if property tax is to play a greater role in municipal finances it is required that administrative and technical features of the system do not become obstacles. Hence, technical assistance should prioritize appropriate training of property valuers and to upgrading relevant skills of municipal staff. Moreover, current legislation is often a major obstacle in many countries (for example, in Tanzania and Uganda) and need to be revised (see McCluskey *et al.* 2003). The *Municipal Property Rates Act of 2004* in South Africa shows that it is feasible to address some of these problems by stipulating nationally uniform mechanisms of assessment and a monitoring process to ensure assessment quality. Clearly, property tax has to be simplified to adapt it to the reality of many African countries. Ambitious cadastral projects were undertaken in the 1980s, but many of them failed or were abandoned halfway (as in Cameroon, Mali, and Senegal). The use of very simple parametric methods for the evaluation of property values is advisable. Parameters could include the number of rooms, the quality of the building materials, and the area of

the city where the building is located. Such parameters are transparent and, in general, easy to apply. Such methods have been used in a number of countries (including Western countries) with satisfactory results. Administration could be left local, but the legal framework should be centrally provided.

Box 4.5: Good practices in property tax mapping in the Philippines

Naga City developed a pilot geographic information system (GIS) at the request of the Mayor with assistance from USAID. The project started out on a pilot basis with surveys of several central city blocks. The pilot data set was used to develop a building information database system (BIDS): Each building is assigned a unique property index number that all city information about that building, including whether or not the building has a permit, can easily be assessed.

In another city, Cabanatuan, the introduction of a GIS system based on aerial photography maps doubled the number of registered properties and thus improved revenues significantly. The city has also assigned each building a unique number and undertaken a door-to-door campaign to register taxpayers under the leadership of the mayor.

The municipality of San Fernando has set up a simple property tax mapping. The Treasurer's office, with the help of council officials, identified business establishments and determined whether they had paid property and business taxes or not. The list was organized into a database that is now regularly updated.

Source: Taliercio (2004, p. 36).

3.2. Business licenses

Local business taxes are generally levied in one of two ways (Devas & Kelly 2001, p. 384): either as a fixed amount, which usually varies by type, size, or location of the business, or as a percentage of turnover or profits. Assessing turnover or profitability, however, is difficult both in relation to small businesses, which often do not maintain proper records, and to large businesses with multiple premises across various jurisdictions. Thus, local business taxes often use proxies for turnover or profitability, such as the size of premises, type of business, number of employees, installed electricity power, etc.

In Francophone Africa, local governments levy a tax called the *Patente*, which was originally based on the French *Taxe Professionnelle* (Devas & Kelly 2001). In Cote D'Ivoire, the *Patente* was the largest single local revenue source in the 1990s, financing about 17 per cent of the local government budget, and more in the capital Abidjan. The calculation of this tax, however, is quite complex, involving the value of the premises, number of employees, turnover, machinery employed, installed energy capacity, and other size proxies. Moreover, within this formula, rental value of premises is by far the largest factor, so that the tax starts to resemble a property tax.

Interestingly, and atypical for Anglophone Africa, urban councils in Tanzania levy a local business tax named 'City Service Levy'. The City Service Levy (CSL) is levied as a fixed percentage on the firm's turnover (0.1 per cent of turnover for the bank/financial sector, and 0.3 per cent for the other sectors). In 2003, the CSL was the major local tax in urban councils. For instance, in Ilala Municipality, Dar es Salaam, the CSL generated in 2003 almost 34 per cent of the total revenues from the municipal's own sources. For the large VAT-registered taxpayers, CSL-billing is levied quarterly, while it is paid annually for the majority of small taxpayers who are not registered for VAT (URT, 2003:34). The amount billed is in essence a provisional tax based on 30 per cent of the firm's presumed annual turnover. Monitoring the turnover of large numbers of small businesses has

proved to be costly and time-consuming. This also applies to data collection and maintenance of tax registers. Information sharing and professional working relations between the municipalities and relevant central government bodies for the purposes of the CSL, are only utilised to a limited extent. Hence, on various occasions the issue has been raised whether CSL should rather be collected as part of VAT or Corporate Income Tax by the central government's tax agency, the Tanzania Revenue Authority (TRA). However, municipalities have expressed concern that if the City Service Levy is to be collected by the TRA, central government may too easily retain the revenue or merely seize taxing powers for this source of revenue (*ibid*, p. 35).

In Anglophone Africa, the standard mechanisms for mobilizing revenues from businesses have been through licensing. Although the original intent was regulatory, local business licensing has increasingly become simply a revenue source in most places. Typically, business licences generate between 5 per cent and 30 per cent of local government own revenues in urban councils. In many countries, however, the system has been quite unsatisfactory, often quite inequitable, and has imposed huge costs on business, while generating relatively little money. In Uganda, for instance, a common complaint from small and medium-sized enterprises has been that 'they do not know what to pay, where and to whom'. The regulatory aspects of the licence system have been largely abandoned. In addition, poor policy design and weak administration mean that licence coverage, assessment, collection, and enforcement rates are low, leading to poor revenue generation.

Obtaining a licence typically involve multiple visits to various offices, sometimes over several days, with associated travel costs. Failure to provide the correct licence receipts may result in closure of the premises. Consequently, the system is often riddled with rent seeking and corruption. Moreover, poor administration often means that many businesses are not included in the licence system due to lack of proper business registers (Aranjou-Bonjean & Chambas 2003). Furthermore, weak financial management will often imply that collection and enforcement provisions are rarely enforced. This erodes the tax base and introduces inequities into the system. Thus, many existing business licence systems across Africa contain serious defects. These include (Devas & Kelly 2001, p. 385):

- high compliance costs to businesses, due to multiple licensing and complex procedures;
- tariff structures that are complicated and do not reflect ability to pay;
- a process loaded with ineffective regulatory requirements, which provide opportunities for rent seeking;
- poor administration and evasion, which reduce the tax base and generate inequities; and
- a revenue source that generates relatively little income for local governments.

Recently, several African countries have reformed (Kenya and Uganda) or are in the process of reforming (Mozambique and Tanzania) their local business licence systems, to make them simpler, more transparent, and effective (Devas & Kelly 2001; Sander 2003; URT 2005). The main objectives of these reforms are to (a) enable local authorities to collect significantly more revenues, and (b) to reduce the compliance burden on the businesses. In the late 1990s, Kenya pioneered a single business permit (SBP) system, which has since become a model for other countries in the region (see Box 4.6).

The Kenyan SBP system was introduced on an optional basis in 1999, with all the local authorities being required to adopt it from January 2000. According to Devas and Kelly (2001, p. 387), the initial reports were positive. However, one major problem experienced was the lack of effective dialogue and communication with the local business community in the early stages, leading to misunderstandings and some initial resistance to the reform. Moreover, some local authorities chose inappropriate tariff sets – usually too high. This led to tax resistance from local traders. There were also cases of business misclassification (that is, over-assessment) leading to calls for improved administration, transparency, and accountability (Devas & Kelly 2001). On the positive side,

however, most local governments experienced substantial increases in revenues – some councils more than doubled their revenue from this source in one year. In some cases, this was due to improvements in coverage of the revenue base, but in most cases, the increase was due to choosing higher tariff sets (Devas & Kelly 2001, p. 388).

Box 4.6: The Single Business Permit (SBP) in Kenya

The Kenyan business license reform has the following components:

1. Local business licensing is decoupled from regulatory requirements, since these are usually ineffective and create opportunities for rent seeking.
2. All economic activities within the local jurisdiction are, in principle, included in the base. The law was amended to broaden the base to include all businesses and trades, including professionals such as lawyers, doctors, and private consultants. This aimed to widen the revenue base and to improve equity, while at the same time minimizing the economic distortions of the license system. To avoid double taxation, the central government abolished its registration fees on professionals.
3. Businesses are only required to have one business permit per premises regardless of the range of activities carried out there, hence the name Single Business Permit (SBP).
4. Local authorities are required to establish 'one-stop-shops', at which permits will be issued on the spot in exchange for the appropriate fee. The philosophy is a more customer-oriented approach to business licensing.
5. A standardized rate structure is established. Businesses are classified into eight sectors, which are subdivided into broad categories reflecting the scale of profitability of the business. These size categories are based on easily identifiable and objective criteria. The system is based on self-declaration, but with the opportunity for official checking.
6. The tariff structure is designed to be progressive, with smaller businesses paying less than larger ones. The system provides a standard tariff structure for all local authorities, but still allows local government discretion over the actual tariff rates.
7. Measures are taken to improve the local administration of the system. This includes the design of simplified SBP registration forms. Training is provided to encourage local authorities to work with the local business community in choosing the SBP tariff schedule.

Source: Devas & Kelly (2001).

In both Kenya and Uganda, the time required to obtain business permits has been substantially reduced due to the introduction of one-stop-kiosks (see Box 4.7). This has cut the compliance costs of the enterprises, though not necessarily the total costs since the tariffs have been raised. In general, however, collection performance remains a problem and there is a need for improved financial management. However, the early evidence is fairly positive. The new system seems to enable local authorities to enhance revenues. At the same time, compliance costs on businesses are lowered and the opportunities for rent seeking and corruption are reduced.

Box 4.7: Streamlining business registration in Entebbe municipality, Uganda

Until recently, the business registration and licensing system in Uganda was very complicated and time-consuming. On average, it took 36 days to register a business. Hence, many small and micro-enterprises avoided the registration process and remained informal.

A one-stop simplified business registration and licensing system was piloted in Entebbe in 2002-2003. The results of the pilot include:

- The licensing process became cheaper and shorter. Overall, the compliance costs for enterprises were reduced by 75 per cent (for example, registration time was reduced to 30 minutes).
- Compliance levels for registration improved by 43 per cent.
- Total revenue collection increased by 40 per cent.
- Administrative costs for the council were reduced. Administrative savings were 25 per cent in staff time and 10 per cent in financial resources.
- There were reduced opportunities for bribery.
- Relations between local authority staff and businesses were improved.

Source: Sander (2003).

3.3. User fees - linking payment and service delivery

Taxes are not the best mechanism for matching demand and supply of public services. Better links can be achieved through cost-recovery charging systems, which tie the amount paid directly to the amount consumed. Moreover, many African countries have a long tradition of providing basic public services through self-help activities and religious and other locally based organizations, as well as through institutionalized, long-term relationships between state agencies and organized groups of citizens (co-production). By providing a more direct link between citizens' contributions and service delivery, such mechanisms may become effective means to recover the costs of service provision, and to promote efficiency in the consumption of the service. Hence, most observers argue that user fees should play a prominent role in local government finance (Bahl *et al.* 2003, p. 76).

The main economic rationale for user charges is not to produce revenue, but to encourage the efficient use of resources within the public sector. When properly designed, user charges provide information to public sector suppliers on how much clients are willing to pay for particular services and by ensuring that what the public sector supplies are valued by citizens. Free or subsidized services may result in over-consumption of such services. Moreover, it may prove difficult to target the beneficiaries of free services (see Box 4.8). Yet, experiences from several countries, including Namibia and South Africa, show that user charges can impose a heavy burden on lower-income service users, and exclude the poorer segments of the urban population for the services (Fjeldstad *et al.* 2005; McDonald & Pape 2002). Adjustments can, however, be made to offset such effects. For instance, user charges can also reflect differences in ability to pay by incorporating sliding scales for the type of user or the amount of usage (Rondinelli *et al.* 1989, p. 71), although this will require adequate administrative capacity.

Box 4.8 Free services to the poor in South Africa

Improved service delivery to the poor is a priority for most African governments. In South Africa, for instance, the two pillars of this policy are to enable local governments to:

- make basic municipal services accessible to all citizens, and
- provide free basic services for poor citizens who cannot pay.

The challenge with respect to service delivery is foremost to ensure that poor households are the primary beneficiaries of the free services policy and associated resources. Since July 2001, every municipality in South Africa is supposed to provide at least the minimum free 'lifeline' supply to households of 6000 litres of water and 50kW of electricity per month.

Some observers have raised concerns with the manner in which this 'lifeline' policy has been designed and implemented. Firstly, it is argued that the quantity of the free services provided is too small. Secondly, since households are not means tested to see if they qualify for the free services, some middle- and upper-income households are benefiting more from the provision than poor households. Finally, there is the problem of delivering free services across the country, particularly in rural area. Therefore, many municipalities are now developing indigent registers to ensure that free basic services are provided to the poor.

Source: Fjeldstad (2004).

Box 4.9: Improving compliance through shared private water taps in Ondangwa, Northern Namibia

Residents in the poor informal settlements in Ondangwa Town Council generally prefer a pre-paid water system, since it offers the opportunity to economize water consumption and to control expenses, thus avoiding situations where bills cannot be paid and supplies are cut. However, communal taps frequently break down, often on account of misuse. Repair work is slow, often requiring spare parts that are not available in the country. In January 2004, for instance, Ondangwa Town Council ran twenty-five communal taps with pre-paid cards, of which ten did not work due to damages caused by vandalism. Residents relying on communal taps complained that vandals are usually non-residents.

In order to avoid heavy reliance on unreliable communal taps, residents of the informal settlements have been calling for private taps with the pre-paid system. At present, this service is only available in the formal settlements. Lacking this option, many residents of the informal settlements instead have chosen to pool resources and share a private tap connection, even though it is not pre-paid. In this system, three, four, or more households share one private tap connection, located in and ascribed to one of the participating household. Sharing the bill, that is paying equal shares of the connection fees and the expenses related to water usage, reduces the average costs for each household. More importantly, it decreases the risk of disconnection due to *non-payment, since all parties have an interest in keeping the supply running. Members in the arrangement who repeatedly fail to contribute to the water bills are eventually excluded. The concomitant loss of an assured water-source represents an effective regulatory and enforcing mechanism.

Source: Fjeldstad *et al* (2005).

User charges for 'trading services', including water, electricity, sewage, and solid waste removal, are major sources of revenue in urban municipalities in Southern Africa, especially in Namibia and South Africa (Fjeldstad *et al* 2005; Bahl & Smoke 2003). In particular, service charges on water and electricity supply are important. This revenue is generated by a surcharge added to the cost of the utilities that the local authorities typically buy from the utility companies, or, if the authority itself produces the utility, added to the cost of producing it.

According to Bahl *et al* (2003, p. 77), around a quarter of the electricity-distributing authorities in South Africa raise substantial revenues from the surpluses earned from their sales. A large share of these revenues is used to cover the cost of providing the service. However, in some municipalities a substantial surplus is left for general local government purposes. Hence, the tax component of the user fee is hidden for ratepayers, and the 'true level of local government taxation is not transparent' for citizens. The accountability capability of the local revenue system is therefore undermined. Moreover, since the consumer price of the service (for example, electricity) is overstated by the amount of the implicit tax, this may have negative impacts on economic efficiency (Bahl *et al*. 2003).

In Namibia, the majority of town councils are not determining their tariffs in accordance with an approved tariff policy of cost recovery (Fjeldstad *et al* 2005). Hence, several trading services, including water distribution, are operated with significant losses in a number of local authorities. This is also the situation for around a quarter of the municipalities in South Africa (Bahl & Smoke 2003). The situation is worsened by an increasing number of outstanding debtors in many local authorities, that is, consumers who do not pay for basic services due to various reasons, including affordability.

Experiences from South Africa and Namibia show that obviously there are a number of constraints on user charges and other means of cost recovery. These arise from equity considerations (that is, ability to pay), collection and billing methods (see Box 4.9), the quality of the services provided, and persistent resistance to pay. These lessons point to the fact that dealing with the policy problem of revenue enhancement requires some understanding of the factors underlying the individual's decision whether to pay or evade paying service charges (and taxes).

An increasing amount of evidence suggests that the rate of contribution to a public good is affected by factors such as citizens' trust in others and the trustworthiness of the government (Slemrod 2003). Without trust there is little basis for social co-operation and voluntary compliance with laws and regulations that could potentially benefit everyone. In particular, three dimensions of trust seem to affect citizens' compliance: (1) trust in the local government to use revenues to provide expected services, (2) trust in local governments to establish fair procedures for revenue collection, and (3) trust in other citizens to pay their share. The larger the fraction of the local population that is observed not paying is, the lower the perceived risk of being prosecuted is. This impacts on the individual ratepayer's perception of the credibility and trustworthiness of the revenue administration. Moreover, the attitude of local political leaders with respect to payment seems to be important, for example, by legitimizing non-payment through their own behaviour. This suggests that there are reasons and scope for innovation.

The problems of non-payment should therefore be attacked on several fronts, including service delivery, better administration and payment schemes, and community involvement. To achieve this, in-depth knowledge and data are required on payment levels for each ward, the proportion of municipal accounts delivered, the number and type of complaints received, living conditions for the poorest segments of the population, including the elderly and unemployed, etc. Moreover, customer care must show that complaining will bring results. Citizens should be encouraged to report defaults such as leaking taps or streetlights not functioning. The prompt redress of such complaints may help

convince people that the municipality means business. Furthermore, citizens' involvement in identifying problems and setting priorities may motivate a greater sense of community involvement. Initially, it might be advisable to link payment directly to visible improvements in services. Finally, the co-operation between local government officials, councillors, and community leaders in setting common goals might be a crucial trust-enhancing device.

4. Implications for policy

One major administrative problem today for many urban councils in Africa is their inability to collect fully the revenue due to them. In many municipalities, there are huge gaps between reported and projected revenues. This is due to: (1) poor administrative capacity to assess the revenue base, (2) poor administrative capacity to enforce the payment of taxes, (3) explicit and intentional tax evasion and resistance from taxpayers, (4) corruption, including embezzlement of revenues, (5) external pressure on the local finance department to provide optimistic projections, and (6) political pressure on the local tax administration to relax on revenue collection, especially during election periods. In this setting, fundamental issues to be addressed in the context of local government fiscal reforms are to redesign the current revenue structure and to strengthen financial management, as recent experiences from Tanzania show (see Box 4.2). Moreover, measures are required to enhance taxpayers' compliance and to improve the accountability of revenue collectors and elected councillors. This cannot be achieved without substantial and consistent political support from the central government.

Improved information supplied to the public on budgets and accounts may improve the opportunities for citizens to exercise their voice and demand accountability from local authorities. This is among the lessons we can draw from decentralization reform in Uganda (Reinikka & Svensson 2002). It is, however, important to stress that encouraging citizens and civil society to engage in fiscal and financial monitoring at the local level does not imply that such measures should replace formal auditing and accounting mechanisms. Nor does it imply that such measures will weaken the formal accountability mechanisms. On the contrary, it can strengthen the legitimacy and standing of local authorities in the communities by contributing with complementary measures to improved control of revenue collection and expenditures.

A fundamental requirement when further redesigning the local revenue system is greater emphasis on the cost-effectiveness of revenue collection, taking into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers. In addition, losses through corruption and tax evasion need to be reduced. To achieve these aims, there is a need to simplify the business license and fee structures further by reducing the number of rates and coverage (see Box 4.7). Moreover, local taxes and licences should be harmonized with central government tax bases, to avoid double taxation and conflicts with national development policies, such as job creation and private sector development. The experiences from Kenya with the one-stop-shop Single Business Permit systems are promising for future reforms (see Box 4.6).

More realism is also required when it comes to the implementation of a well-functioning property tax system. An important element of the fiscal decentralization process has been to give municipalities the power to value, assess, bill, collect, and enforce property taxes. Property tax has many attractions as a local revenue base since it is imposed on immobile assets and therefore is difficult to avoid – at least in principle. However, it has some obvious weaknesses that need to be taken into consideration before heavy reliance is placed on it (see Box 4.4). In particular, problems of valuation and tax enforcement often occur due to political interventions and administrative weaknesses. The

municipalities' capacity and capability to administer the property tax have in general proved to be inadequate. Hence, it has been difficult for many municipalities across Africa to maintain the current property valuation registers, let alone to continue the property valuation exercises. There is therefore a need to reassess the basis of the property tax in urban councils and to implement a more simple and coherent approach to the valuation provision, which takes into consideration administrative capacity and capability constraints facing the urban councils. A pragmatic policy approach is required, which may imply centralization of certain issues, such as management of property titles, valuation assessments, etc.

Local own revenues are a necessary but not a sufficient condition for fiscal decentralisation. In most urban local authorities in Africa, local sources are generally not sufficient to develop and supply adequate services for the fast-growing urban population. The reality is that most municipalities in Africa for a long time will continue to be heavily dependent on fiscal transfers from the central government. Only a few large urban governments located in rich areas are able to finance a substantial share of their total expenditure with their own revenue sources. Transfer systems based upon revenue sharing between the central and sub-national levels of government and grants from the central level should therefore be considered important components of the fiscal decentralization programmes.

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SUMMARY

The growth of Africa's towns and cities has outpaced local authority capacity in terms of management, infrastructure, and financing. Many African towns and cities are now facing a governance crisis. Accordingly, the capability and capacity of urban local government to provide basic services to a growing population have entered the core of the development debate. In particular, fiscal decentralization – the devolution of revenue mobilization and spending powers to lower levels of government – has become a main theme of urban governance in recent years. This paper explores the opportunities and constraints facing local revenue mobilization in urban settings in Africa. The study examines various revenue instruments available, including property taxes, business licences, and user fees, and their effect on economic efficiency and income distribution. Moreover, political and administrative constraints facing various revenue instruments and factors impacting on citizens' compliance behaviour are discussed. The analysis is exemplified by cases from across Africa and other regions. Local governments need to be given access to adequate resources to do the job with which they are entrusted. However, a general conclusion emerging from this study is that local revenues mobilized in most urban authorities in Africa are necessary but not sufficient to develop and supply adequate services for the fast-growing urban population.

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