EXECUTIVE SUMMARY

PROJECT DEFINITION

The Republic of Rwanda (RoR), through it's Human Resources and Institutional Development Agency (HIDA) and the Ministry of Finance (***HIDA/MINECOFIN***) under the Intergovernmental Fiscal Reform Unit (IGFRU) has contracted Dr. Ludovick Leon Shirima – as an International Consultant (IIC) to provide **'Technical Assistance to Support MINECOFIN IFGRU to Improve Reporting Systems from Districts and Elaboration of Transfer'** under Public Sector Capacity Building Project (PSCBP) initiative of the World Bank.

The objective of the consultancy is to support the IGFRU in various ways: Firstly, to give an elaboration of the fiscal reporting formats for transfers to districts for the Fiscal Year 2007, which is actually ending (I understand the ToR, was drafted mid of 2007). Secondly, to improve the elaboration of reporting formats for fiscal, physical activities and outputs for transfers to districts for the Fiscal Year 2008. Finally, to develop a simple standard guidelines for the earmarked transfer schemes regarding the intergovernmental fiscal transfers from the central to local governments.

PROJECT BACKGROUND AND RATIONALE

The Government of Rwanda (GoR) is cognizant of the importance of implementing budget reforms by implementing MTEF and introducing the Public Financial Management System (PFMS). This forms part of the government's initiative of pursuing the second generation of poverty reduction strategies in the name of Economic Development and Poverty Reduction Strategy (EDPRS). Overall, the approach underpins the strengthening of the Public Financial Management (PFM) as is extended to the government's effort of implementing the devolution of service delivery to the districts and fiscal decentralization.

METHODOLOGY DURING AND AFTER THE INCEPTION PHASE

I have adopted a phased strategy and task orientated approach to implement the study in accordance with the Terms of Reference (TOR). In total four phases have been identified each focusing on a distinct aspect of the study.
The approach and methodology of the study incorporates the following:

a. Firstly, literature and desk review on the existing reporting format and practices of formula based transfer allocations, fiscal and physical reporting and guidelines on implementing the same in the regional governments and international best practices.
b. Secondly, examine and analyse relevant information and data initially on the **central-districts** formula based and non-formula grants currently used or to be used. This kind of information will help us to define the challenges and needs in executing the transfer.
c. Thirdly, consultations and information gathering has been conducted for the selected stakeholders, donors and districts to assess the current practice of implementing the intergovernmental relations especially on fiscal and financial reporting.
d. Fourthly, propose plausible transfer reporting formats based on the findings of (a) to (c) above ready for adoption by the districts and Line Ministries.

In general the approach of the study has been participatory involving comprehensive consultations with stakeholders' mandated institutions specifically MINECOFIN/IGFRU, MINALOC and HIDA at the central level and others such as donors who are supporting the decentralization initiative. Primarily, a detailed review was carried out on the existing practices and international experience has been used to provide best practices. Differences will be pointed out and then alternative proposals will be forwarded for immediate and future actions by the government.

STUDY RECOMMENDATIONS

Several recommendations are advanced based on the findings of the current practices, literature review and stakeholders views from the consultations held to date. These recommendations are provided below.

Situational analysis carried out on fiscal transfers formulas implemented previously in RoR in part II of the current report revealed there are some problems with the proxy selection and formulas modelling therefore recommendations A to D are advanced:

- ***Recommendation A: There should be some modifications in the LABSF and CDF formulation for the 2008/09 budget transfers when the East African budget cycle will be adopted.***
- ***Recommendation B: Both in CDF and LABSF formulations weights are used, which are subjectively determined and not from the districts' data. This study recommends weights should be avoided as much as possible. Whenever, it becomes mandatory to use them; then they should be determined from the historical district data statistically or by regressions.***[1]
- ***Recommendation C: After examining the mathematical formulation for CDF I observed that the formulation requires some modifications especially in the construction of the two proxies namely transport infrastructure and access to water and electricity.***

It was noted that apart from the official grants going to the districts, some NGOs, donors and even the Line Ministries are transferring money to the districts which not all are known or documented, thus recommendation D.

- ***Recommendation D: It is useful districts report these types of transfers and IGFRU should conduct a survey to know exactly how many of these institutions are there in number and how much they contribute to the districts.***

Part III of the report dwells on elaborating the current fiscal year reporting format. Despite of the fact that the year is almost ending the following advices E and F are put forward:

- ***Recommendation E: The timing of the assignment signals that these proposals may not be applicable for 2007 as is approaching its end. We strongly suggest that the current proposals are still valid and relevant authorities must be informed to submit these by end of 1st quarter of the next financial year, especially for the EARGs.***

[1] For more insights on how this may be attained see my other study for Ethiopia where 'unit cost' equalization formula was deigned, June 2007.

- ***Recommendation F: The applicability of the proposed templates may be subject to minor modifications subject to discussions with the expected users. MINECOFIN under the Accountant General's office who are legally mandated to enforce good reporting should immediately run a capacity building programs to make sure users are capable of applying the proposed forms.***

The study in Part IV gives an elaboration on the transfer reporting formats for 2008 and the future periods. It builds on the 2007 proposals for the two proposed reporting on transfers expended on physical activities and output reporting. Aside, it presents amendments on the districts income statements to capture transfer revenues and expenditures programmatically. As such G and H recommendations are promulgated.

- ***Recommendation G: At outset we recommend form TRF 01 be used for this period and the future periods.***
- ***Recommendation H: Forms TRF – 01 & 02, are completely new forms. Users must be trained on what are the benefits of correctly declaring the contents of the form for their districts. That is, its use and relationship between its contents and the districts' CG transfers, expenditures, stock of assets and programme outputs.***
- ***On the other hand form – 03 is modifications of the current budget execution report intended to capture physical outputs; training also is mandatory for users.***

Part V of the current report forms the major section and interesting for the whole assignment. I attempted to expound the standard guidelines pertinent in the implementation of the largest transfer so far implemented by the GoR, dubbed earmarked grants (EARGs). Several points are notable and are reproduced underneath from I to Z:

- ***Recommendation I:***

The merits of the current allocation instalments were examined closely and two options are possible.

- ✓ ***Option 1: Maintain the current allocation instalment mechanism system.***

This requires four instalments one in each quarter. This implies that districts may access their four months transfer in the first two weeks of the first month in that quarter. If commitments are effected quickly the funds may be depleted fast leaving some of the remaining months in that quarter unfunded. Thus alternatively option 2 is given.

- ✓ ***Option 2: I recommend releases be made monthly from MINECOFIN to the budgeting agencies accounts. When this approach is adopted districts will be able to implement their programmes with continuity and this may be in tandem with the current monthly reporting requirements. (based on their budget allocation)***

- ***Recommendation J: Some earmarked grants implement programmes based on seasonality. For instance, in agricultural sector terracing, erosion protection, irrigation and the like, timing should be treated differently from recommendation I above. We propose a single instalment with respect to the season. For instance, one month before the season obtains. Thus districts under the supervision of the LMs should identify these kinds of programmes and submit their list to MINECOFIN for consideration and planning.***

Section 5.3 of Part V forms the main gist of the report recommendations. It gives viable and plausible issues need to be adopted to improve and simplify the transfer implementation and the required reporting. These are reproduced below.

- ***Recommendation K: Align the rest of the transfers to adopt the same calendar and sequential order as the EARGs.***
- ***Recommendation L: Gradually streamline LABSF and harmonize the other smaller grants into the mainstream grant which at this juncture seem to be EARGs since it accounts for a larger share of the districts budget from transfers.[2] In reality merge LABSF and all the smaller grants into EARGs.***
- ***Recommendation M: Simultaneously, start to relax the conditionalities attached to the EARGs and incrementally add the districts' discretionary powers in using grants according to their local needs and priorities based on the EDPRS and the MDGs objectives.***
- ***Recommendation N: CDF should cease receiving grants from MINECOFIN as now EARG is rapidly expanding. At the same time as the conditionalities are relaxed, districts shall now be able to allocate their resources between current and recurrent budgets themselves. They should be required by the law to have discretionary powers to allocate their funds within 70:30 to 60:40 proportions with respect to recurrent and current activities. This autonomy is required for accountability and giving districts ownership of their budget process, prioritization as well as execution.***
- ***Recommendation O: CDF will be donor conduit for development project support only, until such a time when donors are convinced that MINECOFIN has the ability and trust of handling CDF matters and finances.[3] (This may take 3 to 12 months)***
- ***Recommendation P: When recommendation N obtains CDF should be transformed into say Grant Commission or something similar under MINECOFIN due to its immense and undisputable experience in operating grants and allocation formula design.***
- ***Recommendation Q: With the above recommendation it means that CDF will at this time be responsible of designing allocation formula, advice MINECOFIN and districts on formula application issues including data preparation.[4]***
- ***Recommendation R: As recommendations I thro' Q obtains IGFRU role remains more clear and visible. It shall be a policy hub on the fiscal relations between the various levels of government. Specifically it will focus on:***
    - ✓ Local government revenue sources such as transfers from the centre, own source revenues, loans and etc;
    - ✓ Expenditure responsibility and revenue assignment;

[2] It accounts for about 84 percentage points of the total grants and makes conditional transfers in total to account for about 90%.

[3] This is misconceived and unfounded doubt on the part of the donors since CDF is controlled by MINALOC/MINECOFIN right from its inception and now fully answerable to the later, with the enactment of the new organic budget law (OBL).

[4] For more informed roles of transfer commission see the Australian Model, it is independent and autonomous body from both the central and local governments.

- ✓ Revenue sharing mechanism;
- ✓ Track, monitor and evaluate with an aim to advice on central revenue sources;
- ✓ Inter-jurisdictional spill over effects, vertical and horizontal fiscal imbalances.

- ***Recommendations S: It is therefore to the interest of this study to see that these guidelines are adopted after a careful capacity building initiative is pursued specifically in the area of M&E, which currently is missing.***

Therefore, following the above discussion we recommend that:

- ***Recommendation T: There should be a transparent and legal way of determining the transfer pool due to the lower levels of government. The main Earmarked Grants (EARGs) total transfer pool should be determined based on known criteria. I propose it to be a fixed proportion of the total central government resources from domestic mobilization[5] and the committed external financing. These sources are known and predictable.***
- ***Recommendation U: MINECOFIN should design and apply equalization formula in allocating EARGs to the lower levels of government. The formulation should select indicators based on the elaboration given on Part V of this report. Nevertheless, this recommendation should be read together with recommendation M above. The equalization formula must consider proxies that are the main 'cost drivers' within their programs.***
- ***Recommendation V: MINECOFIN should now transfer funds directly to the districts' accounts and avoid routing grants to the Line Ministries or any other agencies.***
- ***Recommendation W: IGFRU should now assist districts and implementing agencies to understand the distribution formula through capacity building programmes within the programmatic sectors using very few proxies as suggested above until when recommendation M becomes operational, where districts will be able allocate funds and swap them based on priority.***
- ***Recommendation X: Avoid as much as possible using subjective weighting parameters, e.g. population 20% and area 80%. If these are to be used they should be derived from historical data or by regression analysis.***
- ***Recommendation Y: With rec. V above this study emphasizes the use of 'unit cost' approach, which is finally translated into 'expenditure needs' to be introduced to both central and district formula to be designed. This will also be a useful tool in making budgeting projections and estimations. The unit cost approach does not permit the use of subjective weights.***
- ***Recommendation Z: MINECOFIN and especially Line Ministries should build capacity for the districts on distribution formula design, data collection and possibly establish a unit in each district responsible for both (i.e. formula design and data collection)[6].***

The issue of grant formula design as a criterion in Rwanda for implementing transfers needs more attention and thus two options are proposed:

- **Option 1:**

---

[5] Especially revenues collected by the Rwanda Revenue Authority (RRA).

[6] Recently I had established the same framework in Ethiopia for all regional governments and works fairly.

Assume now all grants are successfully merged into the EARGs with an exception of CDF. Assume further most of the programmatic ties are relaxed, which implies districts have more discretionary powers to swap funds between programs according to their DDPs and EDPRS priority areas. Then MINECOFIN can do the following simultaneously:

(i) Reform earmarked grants to reflect the 'needs' of the districts into 'block grants', which is completely *'untied'* or partly *'tied'*.

(ii) Then if completely **untied;** design a grant formula based on the **'unit cost'** approach to be used by MINECOFIN to allocate funds to the districts. In this case districts shall be allowed to allocate funds among the current and recurrent budgets according to their local priorities.

(iii) If **partly tied;** design a formula same as in (ii) above but add a condition that 30% to 40% of their expenditure from the transfers or total budget should be committed into capital budgets.

- **Option 2:**

Design a formula with two components in a single equation capturing both current and recurrent shares of the budget. MINECOFIN can use this formulation to distribute grants and advice districts of what proportion of the transfers is for the two components.

Important!! ***As such no formula needed at Line Ministry level as it has been directed recently.***

- ***Recommendation AA: Reverse the current budgeting process to reflect more of 'bottom-up' approach using the concept of 'unit cost' as a budgeting tool. This will give the budgeting agencies a more ownership of their budget process and execution.***

Finally, various levels of government must play their roles to consolidate the attainment of the objectives of the transfers from higher to lower levels of governments. The various levels of government should work together to speed up the attainment of the objectives of the EARGs. The CG and LMs should focus mainly on policy issues, coordination and transfer regulations. They should continue releasing the funds to the districts and avoid channelling them to the non-intended beneficiaries. Issue regularly and update the reporting formats as needed to accommodate any changes in the nature of transfers. The central government should make use of the presence of the provincial office in relaying the directives and policies to the districts.

In turn, the districts are recommended to account for every transfer received and show clearly what expenditures were financed out of that. Districts and the other lower levels of government should furnish the CG with correct data to be used as an input in the allocation formula. At the time of budget execution they should respect the commitments made against programmes. In short they must abide to the provisions of the OBL and FIRs.

REPORT STRUCTURE

This report is divided into seven main Parts. Part II provides situational analysis for fiscal transfers for districts for 2007/2008. Part III builds on the findings presented in Part II, outlining fiscal reporting format for transfers to districts for the fiscal year 2007. Part IV gives an account of the proposed reporting format for fiscal and physical activities/outputs for transfers to districts for the fiscal year 2008. In Part V, we present standard guidelines for the

EARGs from the central government to the districts. At penultimate referenced materials are provided and finally, appendices are given.