April 2022

Intergovernmental Fiscal Transfers for Improved Local Governance and Service Delivery

Reform discussion note

Introduction – Key Issues for Reform

- **Intergovernmental Fiscal Transfers (IGFTs) currently constitute the most important part of LGA revenues.**
- **The IGFT system is, in addition to the reimbursement of salaries of staff (discussed in separate note on reform of PE IGFT), constituted by**
  - 18 sector specific ORT transfers (of which health, education and agriculture constitute 38%, 34% and 5% respectively – and other sector grants each less than 1%), and the General Resource Fund (GRF – 9.6% of all ORT transfers[1]).
  - 5 different development transfers: the non-earmarked District Development Fund (DDF) (for rural LGAs) and Infrastructure Development Fund (IDF) (for urban LGAs), earmarked funding for City Roads and water sector – in additional LGAs also receive Constituency Development Funds (CDF) that are subjected to MP's planning priorities.
- **IGFTs are intended to fill the gap between the own revenue sources assigned to LGAs and the costs of provision of devolved services – however, the size of fiscal transfers is inadequate:**
  - The real value of IGFT has declined over the last decade. In particular ORT transfers have declined in real value: adjusted for population growth and inflation LGAs receive today approximately 25% less of what they received four years ago.
- There are significant local infrastructure and service delivery gaps within the LGAs, and it is beyond the fiscal capacity of LGAs to substantially address all of these. The purposes of the specific grants are vaguely formulated, and, in this manner, it is difficult to hold the LGAs accountable for delivery of the related services and impossible to determine the exact funding needs.
- The GRF for instance should allow LGAs to perform basic administrative and policy functions – but the low level of funding has led some LGAs to accumulate debt as they cannot finance all the required expenses.
- The National Decentralization Policy stipulated that no less than 5% of National Net Revenue should be set aside for LGAs development. While the precise approach for monitoring this policy has been debated2, then, using conservative estimates, GRF only constitutes about 0.5% of NNR and the combined value of all development funds to LGAs only once in recent years have been above 3% of NNR.

1 Figures for actual transfers 2020/21. For details and for other years please see the Situational Analysis Report.

2 For instance: what elements of LGA transfers should be included in the calculation (only GRF? Or all development funds? Or all transfers including also PE transfers?). The definition of national Net revenue is also debatable: should debt payments, pension payments and all other statutory payments be deducted from gross national revenue before the % share is determined? For detailed analysis see the Situational Report.

- **The devolved functions of LGAs are to a significant degree financed outside of the IGFT system** as (i) some GoM funding for devolved functions (both capital and ORT) are managed by various MDAs rather than the LGAs and (ii) several DP supported projects for LGA service delivery are classified as MDA votes.

- **The majority of IGFTs are in the form of conditional / earmarked grants to LGAs,** only the GRF and DDF/IDF transfers are to a degree unconditional / non earmarked. If all transfers are highly earmarked, it is difficult for LGAs to respond to local needs and priorities and LGA budgets will reflect only national budget priorities. The CDF is unconditional but subject to the planning priorities of the MPs. Unless addressed, this will undermine the overall rationale of the entire decentralisation process: that LGAs should be accountable to their local citizens and ensure that budget allocations are made in response to local needs and priorities. Currently, the GRF is effectively spent mainly for ORT of administrative functions and councillors' allowances, leaving only the DDF/IDF (and CDF) as a discretionary source of finance subject to local planning and budget prioritisation.

- **The allocations of fiscal transfers across LGAs are highly inequitable.** Some LGAs in spite of similar profiles receive less than 50% than others[3]: for ORT mainly for historical reasons as many transfers are based on the number of facilities and staff within the LGA, whereas inequities in development is more ad-hoc. The degree of per capita inequities varies across the various fiscal transfers: typically, the smallest transfers are distributed with the highest degree of per capita inequities. In general, the allocations of transfers are not made in accordance with objective formulas (as otherwise indicated in the Decentralisation Policy). Both NLGFC and several sectors have developed proposals for allocation of fiscal transfers according to various formula, but most of these initiatives have not been implemented in practice.

3 For detailed discussion of each of the IGFT components please see the Situational Analysis.

Proposed Main Strategies and Options for Reform

The current challenges of the IGFT system must be addressed in a coordinated manner, but also with due recognition of the many sector-specific challenges and opportunities for reform.

Issues of adequacy and equity must be addressed simultaneously: it is not practically possible to introduce a new formula for sharing transfers across LGAs without provision of additional funding – otherwise some LGAs would face reduced annual IGFT allocations. As a matter of principle, LGAs should be "held harmless" during the transitional period of phasing in new formulas for allocations of transfers.

Adequacy of fiscal transfers can be addressed in several ways (in combination or as separate strategies), discussed further below:

- Determining the size of fiscal transfers based on costing of devolved functions,
- Establishing share of national revenue for LGAs,
- Gradual restoration of previous levels of funding for elements of IGFT where funds have been effectively reduced in the past,
- Devolution of existing GoM funding for local service delivery (MDA capital and recurrent budgets) where feasible,
- Integration of current and planned DP funding into the IGFT system.

Equity of IGFT is widely acknowledged best to be achieved through the application of transparent and need based formulas for fiscal allocation. Reforms need to consider:

- Formulas that are practically implementable, with plans for gradual application,
- Where possible include both GoM and DP funding for local services to ensure comprehensive equity,
- Effective use of formulae through national budget process.

LGA autonomy: can be addressed through IGFT reforms by balancing conditional versus unconditional funding in a manner that optimise balance between national policy objectives and local needs and priorities.

Sector specific challenges and opportunities for reform must be recognised and the reform of IGFT systems will in part be based on sector specific reforms as elaborated below.

Adequacy of Fiscal Transfers

To enable LGAs to deliver quality services, then they must be provided with adequate funding. **Five mutually supportive reform strategies/actives are recommended** to ensure this in a manner that is most relevant and feasible.

1. **Determining the size of fiscal transfers based on costing of devolved functions.**

    a. This is mainly feasible to establish for conditional fiscal transfers where the objectives of financing (at least for a subset of activities) are very clear and where an agreed and affordable minimum service delivery target can be agreed upon.

    b. It is recommended for each sector to establish agreed minimum service delivery targets to be delivered in relation to each of the conditional grants[4].

2. **Establishing share of national revenue for LGAs**

    a. Providing LGAs with a fixed share of national revenue would ensure that LGA fiscal resources increase corresponding to national budget increases. Such rules would also provide LGAs with more certainty and strengthen long term planning and local citizens capabilities for holding their LGAs to account. The disadvantages of such rules include foremost the limitations it imposes on national policy and priority setting.

    b. Past policy rules have been articulated too vaguely and have not been informed by LGA resource needs. Within Government there is no consensus for the establishment of a general fixed share for LGAs. However, it is recommended to agree on how to monitor LGA share of budget generally (monitoring e.g., LGAs share of ORT and development by specific sectors and generally in order to monitor broad sector compliance to devolution), but more importantly also to explore the possibilities for the establishment of specific revenue sharing elements that are realistic and enforceable. Two areas are proposed:

        i. Setting a minimum for discretionary development funding in LGAs – if a target of approximately 1 USD/capita is set, this would amount to approximately 1% of domestic revenue which is deemed a realistic target5: subject to further detailed analysis and dialogue.

        ii. Setting a fixed share of road fund financing for the maintenance and development of LGA roads - tentatively 35%6 - subject to further detailed analysis and dialogue.

3. **Gradual restoration of previous levels of funding for elements of IGFT where funds have been effectively reduced in the past.**

    a. Several fiscal transfers – in particular the various ORT transfers - have effectively declined in value, yet the objective of the fiscal transfers remains the same which is unrealistic.

    b. Restore the value of all ORT transfers to previous levels (adjusted for population growth and inflation), starting initially with the smaller ORT transfers, or transfers where none of the other proposed strategies are immediately implemented.

4 See the separate reform discussion note on Expenditure Assignments – see also further discussion in this note on sector specific reform initiatives.

5 The 1% is deemed affordable. If the funds are earmarked solely the DDF/IDP it will be easy to monitor. From a local perspective it will be experienced as very important as it will double the amount of funds current available (from DDF and World Bank support to GESD combined).

6 The Road Fund Administration Strategic Plan (2019-2024) considers devolution of funds to LGAs as a policy priority. In its current budget projections approximately 20% of the revenue from the Fuel Levy is set aside for City roads alone. The Decentralization Policy foresaw fuel levy as a source of ceded revenue. Once agreement has been reached on the percentage of fuel levy to be shared with LGAs, then the funds should be distributed across LGAs according to a formula (based on e.g. road network and population).

c. A detailed plan for restoration of the value of transfers need to be prepared – it will approximately require an increase of 25% of the nominal value.

4. Devolution of existing GoM funding for local service delivery (MDA capital and recurrent budgets) where feasible.

a. A tentative overview of GoM central government managed funding for local service delivery is found in the Analytical Report, this includes inter alia the centrally managed drug budget under NLGFC and various capital investments managed by ministries responsible for health, education and local government.

b. Dialogue with MDAs on devolution of these budget lines – as part of the sector service delivery plans[7].

5. Integration of current and planned DP funding into the IGFT system.

a. Several DP funded programs for local service delivery are not fully integrated into the IGFT system; in this way LGAs appear to be even more underfunded.

b. Some of these DP funds are targeting only selected LGAs and if not included in IGFT records then very difficult to have a fair system for formula-based allocation of resources.

c. Particular attention to be provided to DP funding for ORT type of expenditures like operational costs for schools, health facilities and the operations of LGA departments.

d. Sector devolution plans to identify the opportunities for integration of DP funding into the IGFT system:

   i. At a minimum, ensure that DP funding are reflected in statistics of fiscal transfers to LGAs for a proper mapping of resource flows,

   ii. Where possible, ensure that DP funding to LGAs is fully integrated into IGFT and apply GoM modalities for funds transfer and local PFM procedures for accounting and reporting.

   iii. An initial step for the above will be a complete mapping of DP funding in support of financing devolved services by sector.

7 See Reform Discussion Note on Expenditure Assignments.

Equity of Fiscal Transfers

The allocations of fiscal transfers across LGAs are highly inequitable. The allocations of transfers are not made in accordance with objective formulas (as otherwise indicated in Decentralisation Policy). Both NLGFC and several sectors have developed proposals for allocation of fiscal transfers according to various formula, but most of these initiatives have not been implemented in practice.

To ensure a practical and implementable application of formula-based allocation of LGA transfer it is recommended to:

1. **Develop formulas for horizontal allocation of LGA transfers:**
    a. Coordinated by NLGFC to develop the formulae in a collaborative manner with relevant MDAs, MoF and LGAs
    b. Ensure that formulas are based on objective criteria of relevance for the purpose of the fiscal transfer – based on National Statistical Office data,
    c. Introduce use of equal share by LGA as part of the formulas where relevant to ensure that all LGAs get a minimum level of funding[8].
2. **Ensure that the formulae – where feasible – are applied to the combined pool of GoM and DP funding for local services (e.g., both the GoM and DP funded education grants).**
3. **Ensure that the practical implementation of formulae does not lead to decrease of any LGA allocations ("hold LGAs harmless" at least in nominal terms) – thus have a practical phase-in plan in place in line with MTEF outlook.**
4. **For practical implication of the formula: ensure that the use of formulae is applied as part of the national budget process – with parliamentary approval of actual budget allocations (not stand-alone approval by Parliament of the formulas per se[9]).**
5. **Monitor the effective application of formula-based allocations by**
    a. Transparent publication of budget allocations and the corresponding formula and factors.
    b. Application of formula-based allocation through automated and public accessible database.

8 Past efforts for allocation of transfers across LGAs have mainly used population-based statistics. This is a good practice that also is widely used internationally; however, it is difficult to apply in situations where the total grant pool is very small and where the purpose of the transfer largely is to maintain a basic LGA office (as in the case of most of the small ORT transfers). At the same time it should be ensured that the use of equal share in formulas does not provide incentives for fragmentation of the LGA system.

9 For details on institutional arrangements and procedures for the management of the fiscal decentralisation reforms see the separate reform discussion note on that topic.

Balancing LGA Autonomy and National Priorities

The majority of IGFTs are in the form of conditional/earmarked grants to LGAs, only the GRF and DDF/IDP and CDF transfers are to a degree unconditional/non earmarked. If all transfers are highly earmarked, it is difficult for LGAs to respond to local needs and priorities.

A most radical reform option would be to let all fiscal transfers be completely unearmarked, but that would constitute a complete overhaul of the IGFT system and nature of decentralisation in Malawi. In lieu of such a radical change, there are three major reform options:

1. **The GRF can be expanded in size.** The GRF is an unconditional grant that can be used by LGAs for any local priority: recurrent or capital expenses. However, in practice the GRF is spent primarily on the local administration including local administrative staff, and councillor allowances. While it is important to ensure that the GRF is sufficient to cover these functions, a broad general increase of the GRF may also lead to expansion of LGA administrative costs without significant improvements of local service delivery. The size of GRF should at a minimum be adjusted to ensure that these core administrative services can be undertaken[10]. A more radical proposal would be to expand the purpose of the GRF also to include the provision of services currently financed through the 15 smallest sector specific ORT transfers. While LGA discretion in this manner would be enhanced it may also lead to the risk of LGA negligence of some of the smaller sectors unless some national oversight mechanism is established to avoid that.

2. **The discretionary development grant (in rural LGAs the DDF, in urban LGAs the IDF) can be expanded and also function as a pooled fund** for the various existing sources of development funding in support of LGAs. The GoM has initiated reform to substantially supplement the DDF with World Bank funding (through the GESD project). This enables LGAs to implement local projects according to their own local budget priorities, within areas such as classroom construction, health facilities, water supplies and other local capital investments to enhance local service delivery within their mandates. If combined with continued emphasis on the corresponding LGA performance assessment system it will further guarantee value for money, local accountability, and local service delivery. The expansion of this form of finance can be undertaken through

   a. Increased GoM funding ref. section 3 above, in addition it can also be explored if CDF could be consolidated within such one general development grant for LGAs.

   b. Prioritisation of future capital investment funding for LGAs through this modality rather than solely future sector specific capital grants,

   c. Exploration of additional DP funding for both urban and rural discretionary transfers,

4. **Finally, the internal earmarking of existing sector grants can be relaxed.** The scope for additional LGA budget decisions within sector grants can be explored. Given the current limited size of sector transfers, this is not currently a major reform option. However, the degree of internal earmarking of sector grants is an issue that requires attention if/when sector grants are expanding.

10 Ref. NLGFC letter to Secretary to the Treasury 20th October 2021.

Sector Specific Reform Plans

Each sector face unique challenges as well as opportunism for reform[11]. Sectors should in their respective local Service Delivery Plans consider issues for IGFT reforms in particular:

1. How service delivery can be financed through a mix of financing arrangements including:

   a. Sector specific fiscal transfers

   b. Non-earmarked transfers – including DDF/IDF/PBG

   c. Own Source revenues

4. With regards to the sector specific transfers:

   a. **Adequacy:** provide guidance on the purpose of each of the sector grants and establish costed minimum service targets as basis for costing of the transfers.

   b. **Integration of DP support into IGFT system** where possible to ensure transparency in resource allocation and harmonisation of management procedures. Where relevant and feasible, ensure that DP funding for financing of LGA service delivery is established as fiscal transfers and reflected in national and LGA level budgets.

   c. **Equity:** provide inputs to the sector specific formula.

   d. **Facility grants:** ensure harmonisation and integration of the (GoM and DF funded) facility grants into IGFT system to the extent possible.

11 The education sector for instance is initiating a new program that seeks to address education specific issues of the adequacy and equity of resource allocation to the LGAs. See details in analytical report. Note that the sectors include in addition to the existing 18 sectors also general administration (currently mainly financed through GRF).

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