Diagnostic of Intergovernmental Fiscal System – Urban Authorities in Uganda

Final Report

Jesper Steffensen &

Emmanuel Ssewankambo

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Submitted by:

Jesper Steffensen

DEGE Consult Aps
Klosterstræde 23, 1st floor,
1157 Copenhagen City, Denmark
Phone: +45 23 44 12 07
Tax Identification (CVR): 28487207
Email : js@dege.biz

In association with:

Emmanuel Ssewankambo

MENTOR CONSULT Ltd
Mugalaasi Place, Plot 90/91
Sir Albert Cook Rd, Rubaga Wakaliga
PO Box 54, Kyambogo, Uganda
phone: +256 (0)41 345739
email : mentor@africaonline.co.ug

List of Content

List of Abbreviations

APIR	Annual PEAP Implementation Review
B	Billion
BFP	Budget Framework Paper
CAO	Chief Administrative Officer
CB	Capacity Building
CBOs	Community Based Organisations
CD	Capacity Development
CDD	Community Driven Development
CG	Central Government
CRM	Common Results Matrix
CSO	Civil Society Organisation
D/LGAI	Director/Local Government Administration & Inspection
Danida	Danish International Development Agency
DDP	District Development Project
DDPG	Donor Development Partners' Group
DPPG	Donor Decentralisation Partners Group
DPs	Development Partners
DPSF	Decentralisation Policy Strategic Framework
DM	Decentralisation Management
DMSWG	Decentralisation Management Sector Working Group
DSCs	District Service Commissions
DSWG	Decentralisation Sector Working Group
EG	Equalisation Grant
FDS	Fiscal Decentralisation Strategy
FM	Financial Management
FY	Financial Year
GT	Graduated Tax
GoU	Government of Uganda
HIV	Human Immunodeficiency Syndrome
HLG	Higher level of Local Government
HRD	Human Resource Development
HRM	Human Resource Management
ICSC	Implementation Coordination Steering Committee
IGFT	Intergovernmental Fiscal Transfers
IGFS	Intergovernmental Fiscal System
IGFTS	Intergovernmental Fiscal Transfer System
JAF	Joint Assessment Framework
JARD	Joint Annual Review of Decentralisation
JBSF	Joint Budget Support Framework
JBSO	Joint Budget Support Operations
JFA	Joint Financing Agreement

JOC	JARD Organisation Committee
LDG	Local Development Grant
LED	Local Economic Development
LG	Local Government
LGA	Local Government Act
LGBCC	Local Government Budget Coordination Committee
LGBFP	Local Government Budget Framework Paper
LGDP	Local Government Development Programme
LGFC	Local Government Finance Commission
LGPAC	Local Government Public Accounts Committee
LGROC	Local Government Releaeses and Operations Committee
LGs	Local Governments
LGMSDP	Local Government Management and Service Delivery Project
LGSIP	Local Government Sector Investment Plan
LST	Local Service Tax
LLG	Lower Local Government
MC	Municipal Council
M&E	Monitoring and Evaluation
MDAs	Ministries, Departments and Agencies
MoFPED	Ministry of Finance, Planning & Economic Development
MoGLSD	Ministry of Gender, Labour & Social Development
MoLG	Ministry of Local Government
MoLHUD	Ministry of Lands, Housing and Urban Development
MOPS	Ministry of Public Service
MOU	Memorandum of Understanding
NAT	National Assessment Team
NCG	Nordic Consulting Group
NDP	National Development Plan
NGOs	Non-Governmental Organisations
NPA	National Planning Authority
OAG	Office of the Auditor General
OBT	Output-Based Tool
OPM	Office of the Prime Minister
PBGS	Performance-Based Grant System
PCC	Policy Coordination Committee
PCU	Programme Coordination Unit
PD	Programme Document
PEAP	Poverty Eradication Action Plan
PFM	Public Financial Management
PIC	Policy Implementation and Coordination
PPDA	Public Procurement and Disposal of Assets Act
PM	Programme Management
PMA	Plan for Modernization of Agriculture
PRDP	Peace Recovery and Development Plan
PS	Permanent Secretary
PSC	Public Service Commission

PSM	Public Sector Management
PSR	Public Sector Reform
PSRP	Public Service Reform Programme
PSMWG	Public Sector Management Working Group
MTR	Midterm Review
RDE	Royal Danish Embassy
ROM	Results Oriented Management
RT	Review Team
SWAP	Sector Wide Approach
SWG	Sector Working Group
TC	Town Clerk
TOR	Terms of Reference
UAAU	Urban Authorities Association of Uganda
UCG	Unconditional Grants
UGSH	Ugandan Shillings
ULGA	Uganda Local Government Association
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
USMID	Uganda Support to the Municipal Infrastructure Development

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Jesper Steffensen and
Emmanuel Ssewankambo,
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Preamble

Intergovernmental Fiscal Transfers (IGFTs) are the most dominant feature of local government finance in most developing countries, and Uganda is no exemption from this. This Report provides a diagnostic overview of the IGFTs in Uganda with specific focus on the municipalities. The Report is the first of four studies, which will provide valuable input for the coming design of the planned Uganda Support to Municipal Infrastructure Development (USMID) Project, which will be piloting intensive support to municipal infrastructure development, and to other initiatives supporting local service delivery and governance. Other related studies in the pipeline will deal with financial management issues/own source revenue mobilisation, institutional and capacity issues and assets management. The study is commissioned by the World Bank in cooperation with the Ministry of Land, Housing and Urban Development (MLHUD); and is funded by Danida, which is planning its support to local service delivery and governance as well.

The Report provides a brief overview of the fiscal and administrative relationship between central and local government with specific focus on the evolution of and trends in the system of urban governments, paying attention to the drivers and constraints in the development against the stated objectives of decentralisation (Section 2). It also provides a brief snapshot of the major institutional and legal frameworks for local governments in Uganda. Amongst the major challenges identified are: the continued fragmentation of the LG system with the introduction of new local governments which have among others put pressure on the administrative capacity and the entire funding system; inadequate funding of the new staffing structures that were introduced in 2005; policy initiatives which have decreased the LGs' options for revenue mobilisation and some specific initiatives towards re-centralisation within the administrative, fiscal and policy frameworks. However, there is room for technical improvement in the existing system, and new programmes have to be shaped in a manner to account for and mitigate these challenges. In addition, it should not be forgotten that piloting and technical improvements may inform the policy development and the overall intergovernmental relationship.

Furthermore, the Study provides in Section 3 an overview of trends and challenges to the overall IGFTS in Uganda, with further details on the grants to municipalities. This is done with the point of departure in a review of the legal and policy objectives of fiscal decentralisation in Uganda, and the international good practices in this area. It also provides a status of the implementation of the Fiscal Decentralisation Strategy (FDS, 2002). The detailed review of the IGFTS in Section 3 is supported by a number of annexes with further details (annexes 3.1-3.3) as well as simulations of the expected grant support from the coming USMID project (annexes 3.4-3.5). The Report outlines the major structural and technical challenges in the existing IGFTS. Some of the core challenges are: i) the decline in the real value in the grants – particularly when the size of grants is adjusted for price/cost increases -, trends in the size of the population and new functions/cost drivers; ii) the increased level of conditionalities and fragmentation in the grant system and iii) the decline in the relative size of the performance-based non-sectoral development grants. The municipalities have a significant funding gap in core infrastructure areas, which cannot be bridged by the existing size and composition of the grants. The overall conclusion of this Section is that that the USMID project will be highly relevant to address some of the municipal funding challenges, and will be positioned to address some of the weaknesses in the implementation of the FDS (2002) as far as the targeted municipalities are concerned. However, there will be need to combine strong support to the enhancement of the municipal capacity in areas such as planning and revenue mobilisation with improvements in the overall incentive framework around the annual assessments of LG performance and with closer targeting of the grants towards core municipal functions.

The performance-based grant system (PBGS) – including the process and indicators – is the subject for diagnostic review in Section 4. The main conclusions are that the system is still highly relevant for the local (municipal) governments, that it has impacted positively on the performance and capacity of LGs and is still addressing its objectives. However, there are a number of areas in terms of the processes and specific indicators, which need to be reformed, moving towards a "third generation" of the PBGS. The procedures around the assessments need to be strengthened to make it more credible, neutral, timely and transparent, with a sufficient level of quality assurance and buy in from other stakeholders. In terms of the indicators it is recommended to focus on the core areas of public financial management in the broad sense, indicators targeting physical planning, project implementation capacity and performance as well as governance/transparency all customised to municipal peculiarities. The grants are multi-sectoral and should target multi-sectoral performance areas. In the same vain, it is important that the system is simplified in the light of ensuring sufficient objectivity and cost caution models, which ensure future sustainability of the system in a resource constraint environment.

In the final concluding section, the Report provides a framework for comparison of the IGFTS in Uganda against the internationally recognized practices and identifies areas where the coming USMID may contribute moving the reform process forward. The conclusion is that the system will provide a good opportunity to test bridging of the fiscal gaps. It also recommends a few additional preparatory studies and tasks, which should be initiated in the short term.

It is the hope of the authors that this study will provide an appetite for further reviews of other studies and materials listed in Annex 6, as well as be of importance for the coming planned study of the overall system of LG Finance – the update of the Fiscal Decentralisation Study (2001) and the GoU's Fiscal Decentralisation Strategy (2002). The Report also contains a number of important annexes, which should not be overlooked in the internalization of the Report.

1. Introduction

1.1 Background and Objectives of the Diagnostic of the IGFTS

This Report provides a diagnostic review of the overall grant system in Uganda, with a particular focus on municipal grants[1]. The Report is intended to contribute to the analytical work for the ongoing planning of the World Bank supported Uganda Support to Municipal Infrastructure Development (USMID) Project.[2] The first phase of the support is planned to address the infrastructure gaps and institutional strengthening of fourteen municipalities in Uganda, hence the diagnostics pay special attention to the issues and challenges for these municipalities.

The background for the study is a strongly perceived need to address the special urban infrastructure needs and funding gaps, seen in the light of the increasing level of urbanization and urban challenges. Government of Uganda (GoU) has approached the International Development Association (IDA) of the World Bank to support the urban development agenda in its National Development Plan (NDP). Since the Bank already has on-going support for Kampala City, it is considering providing support to secondary cities (municipalities). This will be a long-term engagement and the Bank intends to provide support for institutional strengthening at both centre for ministries responsible for urban development and management (Ministry of Lands, Housing and Urban Development and Ministry of Local Government) as well as at the municipalities. The first phase of the support is planned to focus on addressing infrastructure gaps and institutional strengthening of fourteen municipalities[3].

The initiative is planned to address the urban funding challenges and to begin a process for both addressing the infrastructure backlog funding requirements, and keeping pace with the investments the rapidly growing cities are going to need. Therefore, a key challenge will be to use any future urban project to either pilot or establish, over a relatively short timeframe, a fiscal support system that can be expected to meet urban investment requirements in the long term, and which is integrated with the government's fiscal architecture and falls within its resource constraints. The supportis envisaged to be closely linked with the ongoing nation-wide systems and procedures for allocation of funds under the performance-based local government (LG) and capacity building grant schemes.

Part of the fiscal gap can be addressed by improving own source revenue generation, but it is well acknowledged that a significant portion of the funds will have to come from central transfers. Recent oil discoveries in Uganda are seen by the government as an opportunity to open a window focused on addressing infrastructure development requirements in the country generally, and urban investment demands specifically. Government has indicated

[1] The study has been funded by Danida, which is also planning its future support to local service delivery.
[2] More detailed studies, if required, will be carried out as part of the project itself.
[3] (i) Arua MC, (ii) Gulu MC, (iii) Lira MC, (iv) Moroto MC, (v) Soroti MC, (vi) Tororo MC, (vii) Mbale MC, (viii) Jinja MC, (ix) Entebbe MC, (x) Masaka MC, (xi) Mbarara MC, (xii) Kabale (xiii) Fort Portal and (xiv) Hoima MC.

concern regarding both funding constraints that set limits on the current transfer system as well as urban LG capacities that raise risks to the efficient use of these resources if they were to become available in the relatively near future. Government has therefore indicated that they would like to see support to the urban sector designed as a *transitional* (and additional) vehicle for establishing and testing suitable transfer mechanisms that create the right incentives for capacitated and effective performance by the urban LGs. The diagnostic work is developed in this light.

1.2 Methodology and Outline of the Report

As part of conceptualization and preparation of support to the urban agenda, consistent with the Government National Development Plan (NDP), a number of background diagnostic assessments will be conducted. The intention of the diagnostic approach versus more detailed studies is to: (i) establish the primary issues that would determine/influence future support for the urban sector and the linkage between this support and the ongoing support to the existing local development grants and capacity building support for local governments; and (ii) provide sufficient information to design the key parameters of the support and linkages between the various initiatives to support local service delivery.

This diagnostic study is the first of the four studies, which include the following:

i. **Assessment of the evolution of the Intergovernmental Fiscal System (IFGS), with particular reference to urban (municipal) requirements (this Report);**
ii. Assessment of municipal financial management;
iii. Assessment of the supporting/oversight institutional framework, systems and capacity building needs of municipalities; and
iv. Assessment of baseline municipal asset inventories and preparation of asset registers.

The work has been carried out by an international consultant Jesper Steffensen (team leader), Dege Consult, and a national consultant Emmanuel Ssewankambo[4], Mentor Consult, from November 2010 – January 2011 with field-work in January 2011.Comments from the World Bank, received in May 2011, have been addressed in this Final Report.

In keeping with the diagnostic approach, existing data has been used to the maximum extent possible. To supplement this data, questionnaires have been developed and submitted to each of the 14 municipalities envisaged to be covered by the support, see Annex 2. Secondly, the team has been on field-missions to Mbale, Gulu and Masaka municipalities to get first hand input on qualitative as well as quantitative data. Thirdly, interviews have been conducted with key informants in MoLG, MoFPED, LGFC, MoLHUD, NPA and DPs and questionnaires have been submitted to MoLG, MoFPED and LGFC with specific focus on the quantitative data. The team has received written feedback from 9 of the 14 municipalities.

[4] As mentioned in the acknowledgement, a larger number of people have contributed significantly to the work of the consultants.

The Report includes an assessment of the Uganda IGFTS, documenting policy and operating practices including the evolvement in the legal and regulatory framework of decentralization in Uganda, itsimplications for the effective functioning of a devolved local government system, how they affect the intergovernmental fiscal transfer system (IGFTS), and includes discussions of options for strengthening urban local government performance from the perspective of a more effective, capacitated and incentivizing fiscal structure. The major part of the study is the diagnostic of the existing IGFTS and its performance-based transfer features.

The Report encompasses a rapid diagnostic of the following three areas:

i. A synopsis of the **administrative and fiscal relationships** between the central and LGs, (with focus on municipalities) within the decentralization policy framework adopted by Government and a brief summary of the practice vis-à-vis the policy and how it has evolved over the years. Taking into consideration the political economy and other factors, a brief analysis on the drivers and constraints for effective intergovernmental fiscal reforms concludes this section (Section 2).

ii. A **review of the current Intergovernmental fiscal transfer system (IGFTS) for urban local governments** and an assessment of how the proposed future municipal support programme could contribute to strengthening and improving the current system. Specifically, the assessment describes the framework (policy and procedural) and practice for the vertical allocation of resources (i.e. between the central government and municipalities) and the horizontal allocation of resources (among municipalities), a brief analysis on the typical gaps[5] (if any) between the existing transfers and development requirements of municipalities in infrastructure provision, measured as type and costs of investments in the urban areas compared with the existing level of grants, and weaknesses in the design and practice of the IGFS as compared to international good practices.

   As part of this exercise, the Report includes a compilation of data relating to the **actual fiscal transfers** – **focusing on particularly the development grants -** from central government to the 14 municipalities for the past five to seven years and the difference, if any, between actual transfers and entitlements during this period on various components of the transfer system.

   Finally, this part of the assessment also encompasses a quick assessment of the possibilities and constraints for increasing the quantum of intergovernmental transfers to address the increasing infrastructure backlogs at the municipal level and recommend potential cost effective mechanisms for implementing these and for improved municipal service delivery as per municipal mandates provided for under the LG Act CAP 243 (Section 3).

iii. Section 4 provides a review of how the current LG Assessment process under the LGMSD works (with specific focus on municipalities) and its suitability and adoption

[5] This part does not encompass a full fiscal needs/gap study, which is largely outside the scope of the analysis, but will review the type of investments required, the typical unit costs, compared with the available funding from existing development grants to urban authorities.

for the proposed future municipal support programme, including the links between the ongoing assessments and the future support to urban authorities.

Detailed recommendations are included in each of the Sections. Finally, the Report encompasses a concluding Section (5) with the main findings and conclusions compared with international principles, and a review of how the USMID project will support the reform process, and a number of supporting annexes with further data and resource materials (Section 6).

2. Fiscal and Administrative Relationships between Central and Local Governments

This section gives a synopsis of: the evolution of the decentralization system in Uganda; the fiscal and administrative relationships between the central and LGs (with focus on municipalities) within the decentralization policy framework adopted by Government whilst discussing the practice vis-à-vis the policy and how it has evolved over the years.It is concluded with a brief analysis on the drivers and constraints for effective intergovernmental fiscal reforms taking into consideration the political economy and other factors.

2.1 The Evolution of the Overall System of Decentralization in Uganda[6]

This sub-section gives a summary of the evolution of the system of decentralization in Uganda[7]. During the colonial period, Uganda had chiefs at village, parish, sub-county and county levels. From the 1920s onwards, these chiefs were selected on merit and were subsequently turned into salaried workers. The chiefs were responsible for collection of taxes, maintenance of law and order as well as the administration of local justice. The Local Government Ordinance of 1949 established districts as local government administrative units. Elections were introduced in the 1950s, but considerable central control continued to be exercised right up through independence.

Since independence in 1962, Uganda has experienced both decentralised and extremely centralised forms of governance. The 1962 Constitution promulgated at independence provided, under a federal arrangement, for devolution of significant powers and functions to Kingdoms, Urban and District Councils. Regarding urban areas, the British colonial government regulated the planning and administration of almost all the urban areas in Uganda under the Urban Authorities Act 1958, which was later amended to the Urban Authorities Act, 1964[8].

The 1967 Constitution and the Local Administration Act of 1967 re-centralised all the decision-making powers. The Military Government abolished Local Councils altogether in 1970's. The re-centralisation process, but also the general decline in the economy, led to significant collapse of the services provided by the district administrations.

In 1986, Government commissioned a commission of enquiry into Local Government (Mamdani Report) on which basis a white paper was prepared and submitted to Cabinet. Based on the desire to re-introduce political participation and democratisation, in 1987, the National Resistance Movement (NRM) Government enacted the Resistance Councils and Committees Statute, which repealed Part 1 of the Local Administration Act of 1967 and the Urban Authorities Act 1964. The Statute introduced the Resistance Council system, which

[6] For a detailed evolution of the IGFTS, may you refer to section 3.1.3.
[7] This section has largely been extracted from the Joint Annual Review of Decentralization 2004, *Status Report:* Overview of the Status of Decentralization in Uganda 1993 – 2004. See also Steffensen, Tidemand and Ssewankambo, 2004.
[8] MoLG, National Urban Policy Development Support, Draft Urban Situation Analysis Report, April 2010.

in effect transferred authority to plan, make decisions, administer local justice and provide services to the communities.

The current dispensation or system of democratic decentralisation introduced under the 1993 Resistance Council Statute was the outcome of a review of the resistance council system and related statutory instruments. The Statue was reviewed between 1993 and 1995 and led to the development of the existing decentralisation policy framework, borne out of the desire to make local governments effective centres of local and democratic decision making for planning, implementation and management of development services and ensure support from the local level. The 1995 Constitution further consolidated the decentralisation policy, ensuring its application at all Local Government levels. Following the promulgation of the Constitution, the Local Governments Act, 1997,[9] was accordingly enacted, further elaborating the LG set-up and structures, LG responsibilities for service delivery, LG revenue sharing arrangements and election procedures for local leaders, as well as arrangements for execution and coordination of LG monitoring and inspection.

The LG-Act, 1997, has been amended several times and further amendments are underway[10]. The amendments in the LGs Act reflect the need to take stock of lessons and experiences during implementation, changes in the political environment, some affected by the introduction of the multiparty system at both central and local levels, and the need to review the decentralisation framework to reflect the changing contexts. The amendments are also testimony to Government's realisation of the dynamic nature of implementation of the policy where the process of implementation involves learning, conflict testing, attitudinal and behavioural change and attainment of requisite new skills, among others, and the changes in the political environment.

Hence, the practice notwithstanding, the main decentralization policy thrust in Uganda is inclined towards devolution where the policy intentions are to transfer responsibilities for decision making and delivery of services to local governments which elect their own chairpersons and councils, raise their own revenues and have independent authority to make investment decisions. These objectives have also been generally re-instated in the recently adopted National Development Plan (NDP), Section 8.14.

2.2 Relationships between Central and LGs – Focus on Municipalities

This section provides an overview of the fiscal and administrative relationships between the central and LGs, (with focus on municipalities) within the decentralization policy framework adopted by Government whilst discussing the practice vis-à-vis the policy and how it has evolved over the years.

[9] In this report, the LG Act 1997 is quoted synonymous to LG Act Cap 243.
[10] The Local Governments (Amendment) Act, 2001; The Local Governments (Amendment) (No. 2) Act, 2001; The Local Governments (Amendment) Act 2005; The Local Governments (Amendment) Act, 2006; The Local Governments (Amendment) (No. 2) Act, 2006; The Local Governments (Amendment) Act, 2008; and The Local Governments (Amendment) (No. 2) Act, 2008.

2.2.1 Fiscal Relationships Between Central and LGs

Under the fiscal relationships between Central and LGs, two broad issues that impact on the overall functioning are discussed: Central Government (CG) transfers and Own Source Revenues (OSR).

a) Central Government Transfers[11]

The fiscal framework in Uganda is entrenched in the Constitution as well as in the LG Act. Section 83 (1) of the LG Act Cap 243 stipulates that the President shall, for each financial year, cause to be presented to Parliament proposals of monies to be paid out of the Consolidated Fund as (a) unconditional grant (b) conditional grant and (c) equalization grant. Section 83 (6) specifies that the Government shall remit conditional, unconditional and equalization grants direct to district, city, municipal and town councils. In turn, section 77 (1) states that the local governments shall have the right and obligations to formulate, approve and execute their budgets and plans provided the budgets are balanced.

Based on the above policy provisions, the Central Government transfers to LGs increased tremendously from 1995/96 to FY 2000/01. In the first years, the increase was also reflected as an increase in share of the total public budget from about 19.8 % of the total public budget (excl. donor projects) to 38.3 % (excl. donor projects)[12]. From 2002/03 where the donor projects are included in the budgets, the grants as share of total public budget has declined from about 27.3 % to about 21-23% in FY 2009/10 and FY 2010/11 respectively(see Section 3.2). In terms of the size of the total grants, although there has been a nominal increase in the transfers, the per capita real transfers have declined significantly from 2003/04 to FY 2010/11, even before adjustments of extra costs of new functions, staffing structures and new LGs. Despite the nominal increase in the amounts of monies transferred to LGs, the volumes are still not commensurate with the service delivery requirements in LGs as manifested by a long list of un-funded priorities in LGs, especially the urban councils.

Contrary to the policy intentions, the Unconditional Grant is a decreasing proportion of the total central government transfers from approximately 34.5 % in 1995/96, 23% in 1998/99, 11% in 2004/05 and down to 10.5% in 20010/11[13]. Moreover, it is mainly used to meet the wage bill and as such highly conditional/with limited LG discretion. Hence, the conditional grants constitute the majority of the central government transfers to LGs at approximately 90%. These conditional grants are largely for recurrent expenditure and are earmarked for specific sector activities. The equalization grant (only constituting less than 0.5 % of the transfers) is meager, spread too thinly across many LGs, and often not used for the intended purposes of reducing the disparities in service delivery between LGs. Moreover, the equalization grant allocated to municipal councils has been very low (less than 0.04 % of the total grants) over the years.

Overall and over time, the resources allocated to LGs have not only been insufficient but are also highly conditional, limiting LGs flexibility/discretion and hence the overall objectives of the LG system. The sector earmarked conditional grants imply that the LGs

[11] For a detailed discussion of fiscal issues, may you refer to section 3.
[12] See also JICA, Tidemand, Steffensen and Ssewankambo (2008) for review of the historical trends.
[13] See Annex 3.1 Trends in LG Finance.

gives precedence during planning and implementation to national sector policy as identified by the Central Government as opposed to the LG specific investment priority needs. This delays the pace of eliciting bottom-up, participatory and integrated planning as well as people's empowerment, which is likely to result into services that can be accessed, well managed and sustained. This cements the need for the introduction of a stronger element of discretional grants to address the locally planned infrastructure investment needs especially in urban areas. Measures should be put in place to ensure that such discretional transfers are released on time, in full and in a transparent and predictable manner.

b) Own Source Revenue (OSR)

The overall trend in OSR has been from a system where LGs had a relatively high level of OSR and therefore relative autonomy to make decisions,to a highly restricted system with fewer local revenue assignments that have less potential. However, there is still significant room for improvements in the LG OSR generated through technical means and support[14].

The LGA Cap 243 section 80 (1) empowers the local governments to levy, charge and collect fees and taxes, including rates, rents, royalties, stamp duties and registration and licensing fees and the fees and taxes that are specified in the Fifth Schedule to the LGA. There are a number of potential local revenue sources especially in urban areas. These include: taxi and bus parks, market dues, trading licenses, property tax, etc. In the 1990s LGs and Urban Councils in particular used to collect reasonable amounts of revenue[15]. However starting in early 2000s, local revenue generation was interrupted and the realizations started to decline, see Annex 3.2.

Whereas in 1997, the LGA Cap 243 provided for the collection of graduated tax, including the level of taxation, in 2001, it was amended that 'notwithstanding anything contained in the provisions of this Act, the Minister may, by statutory instrument, and in consultation with the Minister responsible for finance, declare the scale or rate of Graduated Tax to be levied by Local Governments throughout the country. This led to the establishment of low rates leading to the decline in the local revenues collected. With even greater impact on the LG fiscal stands, in 2005, section 80 of the principal Act was amended and graduated tax was suspended starting FY 2005/06. Instead the central government started to transfer GT compensation grants to LGs, although not fully commensurate with the previously collected level.

In 2008, section 80 of the LGA was amended and it was provided that local governments may levy, charge and collect (a) local government hotel tax to be charged on all hotel and lodge room occupants and to be collected and paid by hotel owners; and (b) local service tax to be levied on all persons in gainful employment or which are practicing any profession or on business persons and commercial farmers producing large scale. This effort to substitute the G-Tax with the introduction of LST and HST is yet to raise results, and LGs do not expect that the new taxes will be able to make a substantial yield. The key challenges with the LST and HST include: being biased towards urban areas; formal income and business, having low yield; difficult to enforce and they are also politicized.

[14] A special study under USMID will look into these issues.
[15] Although the graduated tax, which was abolished in 2005, was one of the major ones.

One of the potential revenue sources especially in urban areas is the property tax yet owner occupied residential houses were exempted from paying property rates in FY2006/07 immediately after a new LG (Rating) Act 2005 was approved by Parliament. Recently the Central Government issued directives banning the collection of daily market dues in preference for annual rates. These directives greatly reduced the amounts of revenue collected from market dues, which was a major revenue source for municipalities.In 2010, Central Government guided that taxi parks should be tendered to drivers. The lack of competition is likely to significantly reduce the amounts of funds realized from the parks. Similarly in 2010, Ministry of Tourism, Trade and Industries (MTTI) issued regulations elaborating guidelines on the rates municipalities should charge for trading licenses.

Overall LGs realize low OSRs. The own source revenues (OSR) as percentage of the LG budgets have decreased from about 22% in FY 1999/2000[16] (before the strong increase in grants[17]) to about 13% in FY05/6[18] to only less than estimated 5% at present and a very small share for most of the rural authorities, see Annex 3.2. Notwithstanding the weak tax administration (inefficient collection and ineffective use), there is also inadequate political will whereby the LGs have not been given sufficient freedom to determine rates of what should be collected from all potential sources[19]. As a result, operation and maintenance of physical infrastructure are almost non-existent, except urban roads that are being financed from the recently introduced Road Fund. This has led to poor service delivery in urban areas characterized by dilapidated infrastructure. The municipalities have not been able to provide a conducive environment for investments. This said, it is expected that there is room for better administration and improvement of existing taxes in entire cycle tax administration.

2.2.2 Administrative Relationships Between Central and LGs

The broad issues discussed under the administrative relationships between Central and LGs focusing on their implications on IGFT issues include: LG structural set-up, human resource management and procurement as well as central government oversight.

a) Local Government Set-Up

Article 176 (1) of the Constitution and the LGA Cap 243 (section 3), stipulates that the system of local governments shall be based on a district as a unit under which there shall be lower local governments and administrative units. It further statesthat, the local governments include: district and sub-county councils in rural areas, city and city division councils in a city; municipal and municipal division councils in a municipal; and town councils in a town. In addition, section 45 of the LGA Cap 243 specifies that the administrative units include: the county, parish and village in rural areas; parish or ward, town board and the village in urban areas. Subject to article 197 of the Constitution and section 79 of the LG Act cap 243, a municipal or a town council shall be a lower local government of the district in which it is situated.

[16] Revenues were estimated to about Billion 111 UGSH (estimates) and FY 1999/2000 (budget) grant was Billion 389 UGSH.
[17] See - Steffensen, Tidemand and Ssewankambo, (2004, Volume II).
[18] Revenue estimated to about Billion 114 UGSH and Grants to Billion 741 UGSH, see JICA, Steffensen, Tidemand and Ssewankambo.
[19] For example, the rate of LG hotel tax and schedule for Local Service Tax are set centrally.

Article 179 (4) of the Constitutions stipulates that: "*any measure for the alteration of the boundaries of or the creation of districts or administrative units shall be based on the necessity for effective administration and the need to bring services closer to the people, and it may take into account the means of communication, geographical features, density of population, economic viability and the wishes of the people concerned".*

Uganda has experienced a rapid increase in the number of districts doubling from 56 in 2000 to 111 in 2011 as demonstrated in Table 2.1 below, and new districts are in the pipeline. Since the provisions in the constitution are not restrictive enough (see above), the wishes of the people have tended to override all the other factors. The numbers of districts are likely to increase even faster in future than previously as people are demanding for more districts without knowing the cost and administrative implications.There are a number of reasons why people demand for districts, which include the fact that some of the Government policies/programmes allocate resources to the districts equally without considering the size[20]. As a result, the political leaders at all levels are promising the delivery of a district as a basis for their election. During the ongoing Presidential Campaigns (2011), the President has promised a number of areas with a district status.

Since one of the drivers for demanding the creation of districts in particular and LGs in general is accessing some benefits irrespective of size (see above) whereby the small LGs benefit proportionately more than the big ones, implies that for USMID, the resources for investment should not be allocated in a manner that favors the small municipalities to forestall the demand for creation of unviable municipalities.

Table 2.1 Number of Districts in Uganda Since 1959

Year/Date	Number of Districts
1959	16
1962	17
1968	18
1971	19
1974	38
January 1979	40
May 1979	22
August 1979	33
August 1980	33
March 1991	39
March 1997	45
November 2000	56
2006/07	80
2009/10 (July 2009)	87
2010/11	111[21]

Source: MoLG – Concept paper on the creation and management of districts in Uganda. Since 2000, the year where the increase in number has a fiscal implication is shown.

[20] For example all districts have the same number of politicians and the District Chairpersons and members of the District Executive Committees receive the same remuneration. Other programs include the University Bursary Scheme, which sponsors 10 students per district to Universities irrespective of size. Re: funding of staffing structures there are only 3 models, of which nearly all are in the same category, i.e. a kind of equal share per district.

[21] The number excludes Kampala City Council. The districts were announced in two phases: the first phase included six districts increasing the number of districts to 93 and later to 111.

The arguments advanced for the creation of new districts include: responding to the wishes of the people concerned; bringing appropriate services nearer to the people (but the funding for service delivery is actually affected as the share of resources for LGs is not increasing); creation of jobs for people in the locality (but the current LG staffing structures cannot be fully funded and even if they are funded positions are not fully filled); increasing the effectiveness of administration (which may be difficult to realize without sufficient human and financial resources); and addressing marginalization of the areas demanding a district by the original/mother district (alternative means as strengthening of the sub-counties not explored).

The creation of the districts has on the contrary led to: inadequate human resources in both the new and mother districts whereby only around 62% of the present salary requirements are funded and only 55% of the approved positions are filled hence the amounts actually used are below the MTEF provisions for wages (distorting the LG model structures); affected staffing levels in municipalities, as staff prefer to take up in higher level positions in newly created districts[22]; performance gaps in key functional areas (undoing the performance improvement gains arising out of capacity building efforts as well as the various incentive schemes); inadequate physical infrastructure especially in the new districts; hiking of administration costs and overheads – whereby for example the recent creation of new districts increased the salary bill by 20% (from a requirement of UGX 63.3 billion to UGX 76.0 billion)[23]; and creation of supervision burden to the central government agencies. Furthermore, as documented in Section 3.2, the additional costs of the new districts have not been fully compensated, as the total real value of the grants per capita has declined, and as the UCG has not followed the development in prices and extra costs.

Whereas the number of Municipal Councils was relatively stable since the inception of decentralization, in 2010 nine (9) new municipal councils were created. The trend in the growth of urban authorities is provided inTable 2.2 below.

Table 2.2: Increase in the Number of Urban Councils

Year	City Council	Municipal Councils	City Divisions	Town Councils	Municipal Divisions
1959		4			
1994	1	13		42	
2004	1	13		66	
2008	1	13	5	92	37
2010	1	22	5	165	64

Source: UAAU

[22] The staffing structures provide for principal positions in districts yet only senior positions in municipalities, e.g. there is a provision for principal planners and personnel officers in districts yet, they are not provided for in municipalities.
[23] Please refer to the Technical Assessment of the LGMSD Programme – Input to the Mid-Term Review 2010.

The stated rationale for the creation of new Municipal Councils include: the need for proper prior planning; improved quality of service delivery in the context of accelerated urbanization; and responding to the wishes of the people manifested in the resolutions of the respective councils to be affected by the creation of the municipalities. The foregoing notwithstanding, the creation of some of the municipalities seems to have been more politically rather than technically driven. This is because some of the municipal councils do not meet the requirements for declaring an urban area (see text box 2.1 below). E.g. many of the new municipalities do not have the required one hundred thousand inhabitants.

Text box 2.1. Requirements for declaring an urban area[24]

(1) Except for those areas which are already gazetted, before declaring an area to be a town, municipality or city, the following requirements should generally exist:

(a) The population must be, in case of

(i) A town, above twenty-five thousand inhabitants;

(ii) A municipality, above one hundred thousand inhabitants;

(iii) A city, above five hundred thousand inhabitants;

(b) The area must

(i) Have capacity to meet its cost of delivery of services;

(ii) Have its offices;

(iii) Have a master plan for land use

(iv) Presence of water resources

The MoLG has also submitted a request to have four municipalities upgraded into City Status (Mbale, Jinja, Gulu and Mbarara), which should also be considered in the final design of the USMID project. There is likelihood of the increased demand to create new municipalities, and cities. Whereas the project is targeting 14 Municipal Councils, there is a likelihood of political pressure to increase coverage (number), which if done will reduce the impact of the project, particularly as the project is planned to have a very high per capita contribution to the existing grant system(see Section 3.2 and Annex 3.4), due also to the high fiscal gap and investment costs. The creation of Municipal Councils is also likely to put pressure on the already scarce urban specific staff (Municipal Engineers, Physical Planners, etc.) and increase the supervision burden to the CG agencies.

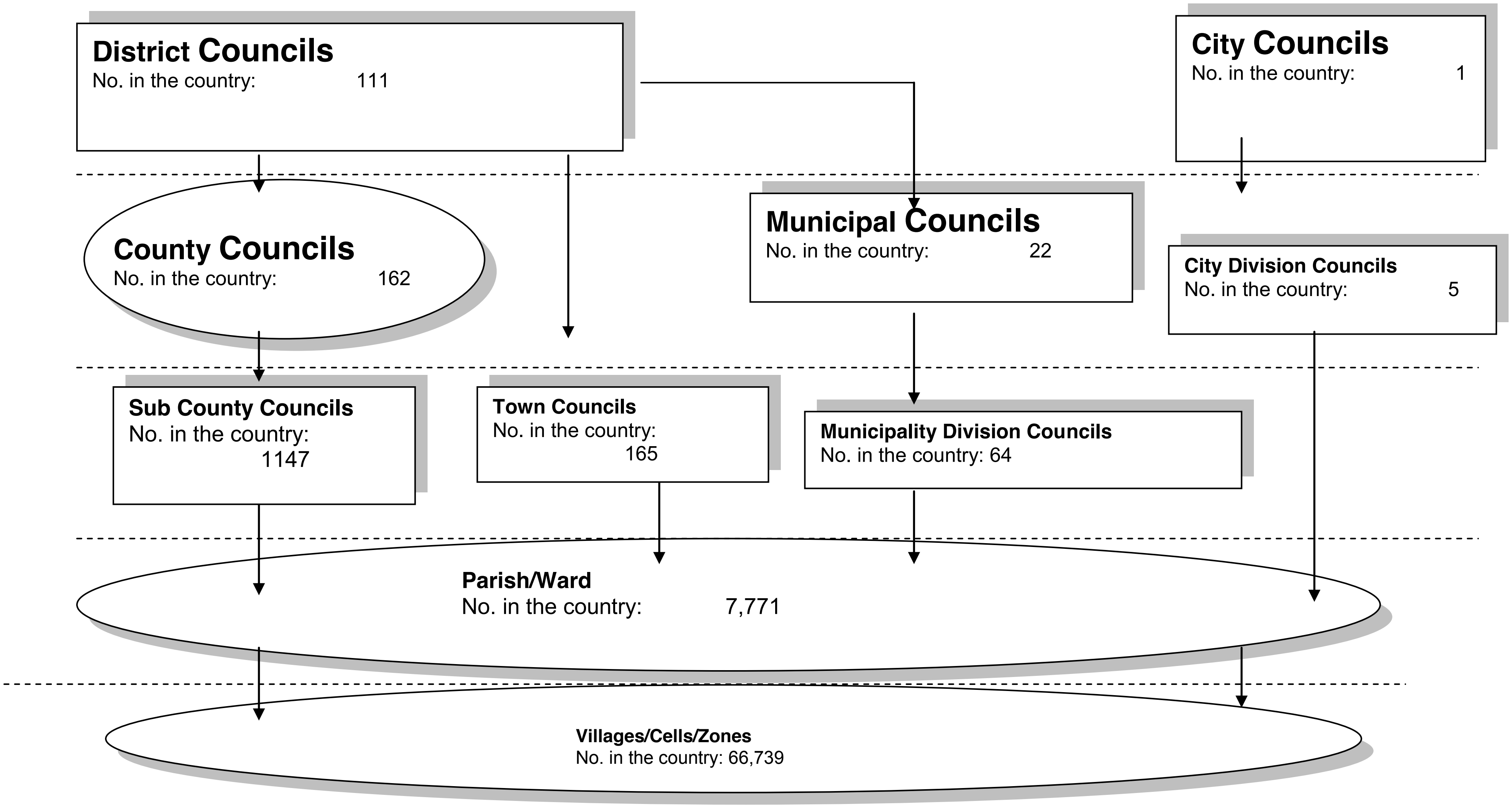
In addition to the creation of districts and municipal councils, there is also a wide spread creation of other local governments and administrative units such as town councils (increased from 66 in 2004 to 92 in 2006, and 165 in 2010). Whereas the creations of local governments in general and municipalities in particular may have some benefits for the people residing in the respective areas of jurisdiction (not for the whole country), the creation of new LGs has to be done whilst giving precedence to technical considerations rather than political influence including consideration of the cost implications of these new units. For any new LG entities to be created, it should be viable, efficient and self-sustaining.

It should be mentioned, that some other countries are also changing their administrative structures over time, but most of these in a more well-planned and structured way, linking

[24] LGA Cap 243, Third Schedule, Paragraph 32 (1)

the new structures with changes in the fiscal system, fiscal compensation, administrative arrangements, etc. The challenge with the existing model is, in addition to the costs, the lack of predictability and uncertainty related to the changes and the lack of administrative and fiscal means to fully implement. The layers, types and number of local governments and administrative units as at 2010 are summarized in Figure 2.1 below.

Figure 2.1: Local Government and Administrative Units: Layers, Number and Size (2010)



b) Human resource issues[25]

Human resources are key in the delivery of services. In Uganda, human resource management was decentralized to the local governments. It is stipulated that subject to the Constitution and any other law, a district or an urban council may establish or abolish offices in the public service of a district or urban council in accordance with staff regulations made under the LGA (Cap 243 section 52). Specifically section 54 (1) of the LGA Cap 243 indicates that there shall be a district service commission for each district. Section 55 (1) says that the power to appoint persons to hold or act in any office in the service of a district or urban council, including the power to confirm appointments, to exercise disciplinary control over persons holding or acting in such offices and to remove those persons from office, is vested in the district service commission.

In 2005, an amendment was made whereby Article 200 of the Constitution and Section 55 (1A) of the LGA Cap 243 stipulate that the appointment and disciplinary control of chief administrative officer, deputy chief administrative officers and town clerks of city and municipalities shall be effected by the Public Service Commission. The arguments for the amendment were that government appointed town clerks will be more suitable, protected from local political interference and pressures; and will be held accountable to minimize resource misappropriation.The foregoing notwithstanding, there is need for continued guidance, support and mentoring of the Town Clerks to ensure effective administration and service delivery. The Town Clerks should also not be transferred so frequently and the Mayors and the respective councils should also be further empowered to hold the Town Clerks accountable (but not to interfere) – through for example the performance appraisal system.

The foregoing notwithstanding, apart from the CAOs, DCAOs and Town Clerks of municipalities, LGs still have substantial autonomy to hire, deploy, promote and fire staff.

In 2003, a consultancy was commissioned by the MoPS in association with MoLG to review the LGs staffing levels with a view to restructuring LGs. Among others, the consultancy recommended three different model structures for district councils as well as urban councils. The MoPS and MoLG supported the LGs to customize the recommended structures. Due to financial constraints LGs have been allowed to fill the structures up to 65% which has been reduced to 62% of the present salary requirementsdue to the creation of new LGs as shown in the table below.

Table 2.3 Salary bill and MTEF provisions, urban & rural LGs, 2009/10

	Nos	Salary Costs per unit in UGX, million	Amounts required, UGX billion	MTEF provisions, UGX billion	Provision as % of requirement
DISTRICTS					
- Model 1	70	685.1	48.0	30.1	62.8%
- Model 2	12	848.4	10.2	6.4	62.8%
- Model 3	5	1,031.9	5.2	3.2	62.8%

[25] It is assumed that detailed discussions of human resource issues including public service reforms will be made under the diagnostic study “assessment of the supporting/oversight institutional framework, systems and capacity building needs of municipalities”.

	Nos	Salary Costs per unit in UGX, million	Amounts required, UGX billion	MTEF provisions, UGX billion	Provision as % of requirement
S/counties	917	43.1	39.6	24.8	62.8%
Total			**102.9**	**64.6**	**62.8%**
URBAN					
- Model 1	100	180.0	18.0	11.3	62.8%
- Model 2	10	291.6	2.9	1.8	62.8%
- Model 3	14	381.1	5.3	3.3	62.8%
Divisions	27	76.0	2.1	0.9	45.8%
Total	**151**		**28.3**	**17.4**	61.6%

Sources: Adapted from Dege/Mentor LGMSD MTR based on the norm amounts for wages (an indicative part of the UCG) and data as provided by MoLG.

Even then, the numbers of actually strategic posts filled are low in both districts and municipalities as demonstrated in tables below.

Table 2.4: Percentage of strategic posts filled in Districts (as at July 2010)

Strategic Position	**Total Positions Available**	**Total Positions Filled**	**Total % filled posts**
Chief Administrative Officer	112	58	52%
Deputy Chief Administrative Officer	112	63	56%
Principal Personnel Officer	112	49	44%
Chief Finance Officer	112	64	57%
District Planner	112	61	54%
District Education Officer	112	66	59%
District Health Officer	112	58	52%
District Production Coordinator	112	46	41%
District Engineer	112	35	31%
District Community Development Officer	112	52	46%
Principal Personnel Officer – DSC	112	43	38%
District Natural Resources Officer	112	28	25%
Principal Internal Auditor	112	55	49%
Total			47%

Source: MoLG

Table 2.5: Percentage of Strategic Posts filled in Municipalities(as at July 2010)[26]

Strategic Position	Total Positions Available	Total Positions Filled	Total % filled posts
Town Clerk	14	6	43%
Deputy Town Clerk	14	6	43%
Senior Personnel Officer	14	8	57%
Principal Treasurer	14	9	64%
Senior Planner	14	7	50%
Principal Education Officer	14	7	50%
Principal Medical Officer	14	6	43%
Principal Municipal Engineer	14	7	50%
Principal Commercial Officer	14	4	29%
Principal Community Development Officer	14	6	43%

Source: MoLG

The low staffing has led to great challenges in the general operations of the LGs, stress on the funds for operational, maintenance and current monitoring and inspection. Several grant schemes have therefore started ensuring funds for some of these core functions, such as the investment servicing cost in the LDG, the school inspection funds, etc., but there may be a need for a new overall funding system withmore sustainable methods to address these gaps, see Section 3.

c) Procurement

Section 94 of LGA Cap 243 stipulated that there shall be an urban tender board for each urban council. In 2006, the LGA was amended and it was stated that a municipal council shall establish a municipal contracts committee to serve the municipality. The tender boards were abolished and contracts committees established under section 91 of the LGA Cap 243. It is stated that the municipal contracts committees shall comprise of a chairperson, and four other members, nominated by the Town Clerk from among the public officers of the district employed in the municipality and approved by the Secretary to the Treasury in the MoFPED.

The challenges regarding procurement that need to be addressed include: the delays caused on one hand by the perceived cumbersome procedures and on the other by the inadequate capacity and experience in the municipalities by both the staff of the procurement and disposal unit as well as the user departments to effectively plan and conduct procurement. Efficiency and effective management of procurement has implications on the absorption capacity as well as value-for-money.

[26] Data is from KCC and the 13 old municipalities. The 9 new municipalities are not included.

The most substantive challenge however, is the planned policy shift from contracting to force accounts. Force accounts could be useful: in emergency cases; where it is difficult to attract private bidders; in remote areas; for contracts not more than 10 million Ugandan Shillings; where there is urgency to execute the works; reducing implementation costs since some overhead costs like taxes, profit and risk can be avoided.

However, force account is in conflict with the Road Fund Act, Clause 29, section 2, which states “payment out of the Fund shall be subject to and determined by an open competitive pricing procedure in accordance with the Public Procurement and Disposal of Public Assets Act, 2003”. Force account has high risks for compromising the quality and timeliness of work; is prone to inefficiencies and abuse especially in regard to the maintenance of equipment and plant and political interferences/pressures hampering proper planning; may promote conflict of interest, marring checks and balances as the implementers will at the same time be the supervisors and may interfere with other routine works; may compromise value for money as resources cannot be directly linked to outputs.

2.3 Drivers and Constraints

Uganda’s policy intention of implementing decentralization as a form of democratization, promoting service delivery and development through devolution to various tiers of local governments was greatly supported by a wide range of stakeholders from the onset, apart from a few people that for example advocated the federalism that was in place between 1962 and 1966.

This led to the initial successes, and drivers of change, which were manifested in among others: having elaborate and consistent provisions in the Constitution and LGA Cap 243 inclined towards devolution which guided the implementation of decentralization reforms in Uganda where the legal framework clearly divided the tasks for service delivery among the different levels of Central as well as LGs. The LGs were mandated for service delivery and the CG Agencies were made responsible for routine inspection, supervisory support and mentoring. There are alsoelaborate political and administrative structures with HLGs and LLGs which provide an opportunity for the local people including the special interest groups to increasingly get involved in planning for, and making decisions about, their localities; the introduction of a very decentralized system of human resource (HR) management where LGs are, through their District Service Commissions, mandated to hire and fire all staff categories, apart from CAOs, DCAOs and TCs as well as the funding channels for recurrent and development costs, and increase in the inputs of this in the first phases of the reform process, and systems for mainstreaming support from development partners.[27] It allowed a great part of the support from various partners to be routed through the GoU system through the intergovernmental fiscal transfer system to reach all parts of Uganda in more balanced manner.

The major drivers for success were that the system was home grown building on the early successes of the Resistance Councils; the high level of political commitment arising out of

[27] See e.g. OECD/DAC: Evaluation of General Budget Support, Uganda Country Report, 2005, by Lister et all, and ODI, Jesper Steffensen (2010) for further information about the alignment and harmonization of development partner support.

the need for the NRM government to ensure a broad political support base; an opportunity for radical reengineering of the public sector in the wake of many years of mismanagement where against this background, the public service could not resist reforms strongly even if transfers to elected local governments appeared threatening; the mutually reinforcing relationship between political commitment and technical will which ensured adherence to the policy objectives. In particular the Decentralization Secretariat under MoLG had an important role in bringing the decentralization issues to the top of the agenda, spearheading and advocating for the course, and providing technical back-up and specific operational tools.

In addition, there was support from the donor community for decentralization reforms which among others enabled Government to increase funding to local governments to unprecedented levels which in turn facilitated local governments to increase service delivery dramatically in primary education, health, rural roads, water, etc. The introduction of the LG reforms coincided with increased aid flows and thus improved service delivery in the areas that LGs were seen to be responsible for. Furthermore, the Local Government Associations were very active in promoting the interests of the LGs and the decentralization policy. The Local government associations advocated and negotiated on behalf of the local governments. However, ULGA would be more effective if it continue to make timely positions and pronounce itself on key issues affecting the implementation of decentralization in Uganda. In the same vain, the establishment of the Local Government Finance Commission, although a number of its recommendations have not been followed, provided a forum for spearheading of studies, dissemination of best practices on LG OSR, FDS implementation support, grant systems, etc.

The introduction of an innovative system for performance-based allocation of grants was first piloted and then gradually rolled out country-wide. The assessment of local government performance with incentives and sanctions as a major mechanism for ensuring compliance to legal and policy provisions as well as for enhancing the performance of local governments was introduced and has had a significant impact on the LG performance and capacity building modalities in the country. Grants for investments, capacity building support and incentives were linked in a mutually strengthening triangle.

However, the good progress made in the 1990s and early 2000s has not been sustained as manifested by a number of **constraints**. Whereas the legal framework is in place with a thrust towards devolution, it was never fully implemented, and there have been tendencies to recentralize some of the functions previously devolved to LGs. There have been interruptions of OSR generation leading to poor local government own revenues now constituting less than estimated 5% of the total LG financing. This has had negative impact on LG accountability, ownership, interrelations between politicians and citizens and the long-term sustainability.

In addition, the proliferation of new districts and other local governments without thorough analysis of the economical sustainability of these new areas to generate sufficient revenues and ensure administrative and political capacity to run the council affairs efficiently is a major challenge. Many of the LGs are not viable because they are too small in population and local revenue potential making them over reliant on CG transfers, which are greatly earmarked. Yet there has been eagerness to create districts as a vote winning strategy with little real risk of generating serious negative consequences for national level politics and policies.

Underfunding of the LG structures coupled with difficulties to attract some cadres of staff in some LGs has led tomany established positions not being filled, in turn leading to inefficiencies, lack of monitoring and follow-up on investments. The situation is exacerbated by the creation of new districts. In addition, there is limited degree of budgetary discretion where most of the grants are earmarked to specific sectors. There are also concerns regarding the falling share of budget allocations to local governments where the services are provided. The share of the budget transferred to local governments dropped significantly over the past 7 years.

The reasons for regression include decreased political commitment to decentralization manifested in political pronouncements and interference. One of the reasons for initial political commitment was ensuring broad political support base. The need for broad political support base has now been turned into a constraint as most of the decisions made on the new structures and administrative set-up, their non-viability notwithstanding, are seen by the wider population as beneficial. The creation of new districts for example, despite all the costs, is currently being used during the ongoing Presidential campaigns as a strategy for mobilization of support and votes, hence what may be good for a specific area, may be detrimental for the entire system of LG operations and funding.

There is also resistance by sector ministries to decentralize as demonstrated by some of the LMs wishing to have a strong control over the finance of LG services through the transfers. Some LMs are issuing sector guidelines, which contradict the decentralization policy, and sectors have been sufficiently strong to resist the implementation of the Cabinet’s approved Fiscal Decentralization Strategy (FDS). The driving force is for the sectors to attain their specific mandates as opposed to overall LG service delivery, and they have not been strongly coordinated in the overall decentralization process. There has been a lack of a strong overarching coordinating ministry/authority to ensure that GoU’s decentralization policy is actually implemented by the sectors.

The recent withdrawal of a number of development partners may weaken the dialogue in the sector and across the sectors on the challenges identified. Some of the DPs have withdrawn due to division of tasks, others due to lack of confidence in the policy implementation and commitment. However the dialogue on the decentralization agenda will continue under the PSM SWG and in the JBSF/JAF arrangement, providing room to link various public sector reforms, although less focused on decentralization challenges and probably less based on “hands on” experiences from the sector. However, it is also recognized that a strong and effective local government system is important to ensure implementation of various sector initiatives.

The tendency to focus too much on central capacity building, with less focus on support to the major intergovernmental fiscal transfer system in the most recent years, since the introduction of the LoGSIP has been a challenge for the local service delivery and operational capacity at the LG level[28]. The major achievements in the mainstreaming of

[28] This problem is described in Danida´s annual review reports on the support to Public Sector Management, 2010 and 2009.

DP support from 2004-07, has not been fully sustained in the most recent years, also due to the failure sufficiently to link the support to investments in service delivery with the CB support.

The lessons for the IGFTS include a need to establish and support through capacity building and institutional strengthening the operations of an institutional framework at the national for supervision and guidance and at the local level for implementation, and the need to combine technical support (to central and LG levels) with support to the actual fiscal transfer system for local service delivery[29].

Given the creation of new LGs, there is need to review the LG political and administrative structures, task assignments, relationships among the different tiers of LGs as well as between LGs and CG agencies; funds allocation, staffing levels etc. to ensure efficient and cost effective service delivery. There is a need to develop and adhere to concrete criteria for creation of the different tiers of LGs (considering different criteria for urban and rural LGs) to ensure that only viable LG entities are created.

There is also a need for rejuvenation of OSR collection efforts at local government level. The legislative initiatives within this area, as well as lack of incentives to tap into the full OSR potential have been major impediments for an effective system of LG finance. This should be done through documentation, sharing and implementation of best local revenue practices; as well as ensuring proper administration and accountability of the local revenues collected for improved service delivery in the localities, to meet council operations as well as operation and maintenance costs. Related to this, there is a need to explore the options for new and more high-yielding LG revenue sources and to avoid political interference in the tax collection.

Reforms of the IGFTS by increasing the size, adjusted for new tasks and functions as well as structures, ensuring a better balance of the conditional and unconditional grants as well as development and recurrent costs, and improving the relative share and importance of the performance-based allocations have been hampered by lack of political willingness and sector-specific interests. In particular there is need to improve on the non-sectoral discretionary development grant system.

Lack of clarity in the functional assignments has blurred accountability. There is need to clarify functional assignments in the light of the new structures and continued capacity improvement through combined demand and supply side interventions, etc.

To strengthen the demand-side, there is need to focus on fine tuning the incentive system in the PBGS (see sections 3.1 and 4 and annexes 3.5, 4 and 5); continue to expand the principles of the PBGS in sectors and improve downward accountability through various means which include publicizing information on transfers, stronger support to civil society to link up with LG as well as employing various accountability tools. The non-sectoral PBGS should focus on the core areas of PFM, governance, transparency and accountability to ensure improved participation from people in decision-making on local

[29] Specific capacity building needs and capacity building strategies will be provided under the diagnostic study "Assessment of the supporting/oversight institutional framework, systems and capacity building needs of municipalities".

matters, and better access to information, and improved tools for citizens to make the LGs accountable.

For more detailed discussions and recommendations on the fiscal implications of the above issues, please refer to chapters 3 and 4.

3. The Intergovernmental Fiscal Architecture for Urban LGs in Uganda

3.1 Framework and Practices of Intergovernmental Fiscal Transfers

This section outlines the policy and legal framework for IGFT in Uganda and discusses some of the international recognized practices and benchmarks for comparison with the system in Uganda in the subsequent sections. The sections also provide an analytical framework with classification of various types of grants, and the links to the various grants in Uganda. The situation in Uganda, particularly with point of departure in the feedback from the 14 municipalities targeted, will then be analysed, focusing on the challenges to be addressed in the future reform work.

3.1.1 Policy Framework - The Fiscal Decentralisation Strategy (FDS)

Fiscal decentralisation was an integrated part of the decentralisation policy announced by the Government of Uganda (GoU) in 1992. The formal objectives within the field of fiscal decentralisation are embodied in: i) the Fiscal Decentralisation Strategy (FDS), 2002; ii) the results and work-plans derived from the JARD 2004 review; iii) the Decentralisation Policy Strategic Framework (2006) and the Local Government Sector Investment Plan (LOGSIP, 2006) and the recently adopted National Development Plan (NDP-2010/11-2014). Finally, fiscal decentralisation issues and the IGFTS are clearly integrated in the overall PFM programme – FINMAP- with various components such as improved accountability and improved intergovernmental fiscal relations.[30]

It is clear from these documents and consultations with various stakeholders, that the overall formal policy is to improve the LG funding available for LG mandatory functions[31], strengthen the targeting of the funding to the most needed areas, improve the objectivity and transparency in the allocation of resources, increase LG autonomy and flexibility in utilisation of funding, improve LG own source revenues, increase the funds transferred to lower local governments, strengthen the downwards accountability and financial management, reporting, monitoring and auditing with the aim to move towards an efficient, accountable, sustainable and performance-based system of LG service delivery.

The most clearly outlined *strategy* for the implementation of the Fiscal Decentralisation Reform Agenda is the FDS, which was based on a thorough study[32] of the then existing challenges in the IGFTS in 2000/2001. The FDS was an attempt to address some of these challenges in an incremental and cautious manner to ensure that all stakeholders, also the sectors, would be brought on board.

[30] FINMAP (2009) Strategy.
[31] This was also clearly stated in the PEAP 2004-2008, which contains clear targets for incremental increase in LG own sources revenues (PEAP, 2004).
[32] See MoPPED (2001): "Fiscal Decentralisation Study", Final Report, January 2001

The FDS is still supported by the GoU; and the NDP (2010, p. 365) mentions the need to fully implement the strategy, address the current challenges in the IGFTS (p.363) and study the ways and means forward to improve the IGFTS (e.g. on p. 365). Furthermore, the recently approved Joint Budget Support Framework (JBSF) and the related Joint Assessment Framework (JAF) 0, I and the draft to JAF-II all contain very specific mentioning of needed reforms to strengthen the funding of LG service and enhance flexibility in LG funding. However, the policy and FDS have faced a number of challenges in the actual implementation, which has been slow, see below.

It is also acknowledged in the recently approved NDP and in the actual work under the Public Sector Management (PSM) Sector Working Group (SWG) that there is a need to study and clarify, refine and further detail the FDS strategy in the light of the recent developments in the political, administration and fiscal contexts as explained in Section 2. A ToR for this review is under development under the coordination of the Local Government Fiscal Commission (LGFC).[33]

3.1.2 Legal Framework – Constitution and the LG Act

As mentioned, in Section 2, Uganda has a relatively elaborated legal framework for decentralisation as well as on the intergovernmental fiscal relationship. The system is generally well described[34], and only the main issues are highlighted in various studies and reviews. The Constitution, 2005 - and further elaborated in the Local Government Act (1997), now the LG Cap 243 with amendments - defined the sources of revenues for LGs in Uganda, divided into the main sources: i) own source (local) revenues, ii) various types of grants and iii) borrowing.

The intergovernmental fiscal transfers (grants) are defined in the Constitution, Art. 193 as conditional, unconditional and equalisation grants, but in practice, the system has evolved over the past 20 years with variants of these. Some of the major changes have been in the area of LG own source revenues with the abolition of the Graduated Tax (G-Tax) from July 1, 2005, introduction of the Hotel and local service Tax in 2008[35], and changes with the introduction of new Rating Act, which introduced a number of exemptions from payment of property tax (for owner occupied properties), which are particularly relevant for the urban authorities.

According to the Constitution, 1995, Art. 193, grants in Uganda are typically classified as Unconditional, Conditional and Equalisation Grants. The Constitution, Art. 193 and the Seventh Schedule, is very detailed on this point, see the text box below.

[33] LGFC, (October 2010).
[34] E.g. NALAD, (2000), NCG/Dege (2004); JICA/Dege (2007) and Dege/Mentor (2010)
[35] LG Amendment Act, 2008

Text Box 3.1: Provisions in the Constitution

Art. 193:
"Unconditional grant is the minimum grant that shall be paid to local governments to run decentralised services and shall be calculated in a manner specified in Seventh Schedule to this Constitution.Conditional grants shall consist of moneys given to local governments to finance programmes agreed upon between the Government and the local governments, and shall be expended only for purpose for which it was made and in accordance with the conditions agreed upon. Equalisation Grant is money to be paid to local governments for giving subsidies or making special provisions for the least developed districts, and shall be based on the degree of which a local government unit is lagging behind the national average standards."

7th Schedule:
It appears from the Schedule 7 that: "Unconditional grant is the minimum amount to be paid to the local governments to run decentralized services. For a given fiscal year, this amount is equal to the amount paid to local governments in the preceding year for the same items adjusted for general price changes plus or minus the budgeted costs of running added or subtracted services; calculated in accordance with the following formula: Y1 = Yo + bYo + X1 = (1 + b) Yo + X1 where Y1 is the minimum unconditional grant for the current fiscal year; Yo is the minimum unconditional grant in the preceding fiscal year, and b is the percentage change, if any, in the general price levels of in the preceding fiscal year, and X (i) is the net change in the budgeted costs of running added and subtracted services in the current year. For the purpose of this formula the current fiscal year shall be taken to commence with the fiscal year 1995/96.

Note (i): that the unconditional grants is equal to the sum of the wage and non-wage components. Therefore the wage components should be adjusted for the wage increase, if any, while the non-wage component is adjusted for the changes in the general price levels.

Constitution, 1995, Seventh Schedule, Article 193.

3.1.3 International Principles for Grant Allocation[36]

Overall principles

Although the manner in which an IGFTS is structured and the method used to divide the funds among eligible LGs should be based on the context specific policy objectives, that the transfer scheme seeks to achieve, and the systems will vary across countries, international experiences have given rise to a number of universal principles and practices that may be pursued in the design of all systems. The Text Box, below provides a summary of some of the core principles in a IGFTS.

[36] This section is largely drawn from Steffensen (2010) "Grant Allocation Principles" and the FDS Study, Final Report, January 2001.

Text Box 3.2: Overall principles

1. Keep the *objectives clear* and transparent and design the system accordingly, and keep the number of objectives behind each grant to the bare minimum;
2. Contribute *adequately* to the funding of the vertical fiscal imbalance between assigned tasks and own revenue sources,
3. Address the differences in *fiscal capacity* and the *expenditure needs* of the LGs;
4. Preserve *budget autonomy*: A transfer system should preserve budget autonomy at the local level within the constraints provided by national priorities
3. Support, not undermine, decentralisation and *local revenue raising*;
4. Ensure a minimum number of different systems of transfers and transfer modalities;
5. *Transparent, formula and needs-based* allocation across local governments enhancing horizontal equity (pro-poor);
6. Ensure stable, *predictable* and timely transfers;
7. Enable LG flexibility & initiative within national policy;
8. Involve and strengthen the *whole LG structure* and consider various types of units;
9. Ensure upward, downward & horizontal *accountability*. This will include simple, targeted, and consolidated reporting systems;
10. Achieve *public participation* and transparency;
11. Base the system on the *availability of data* and keep it as simple as possible;
12. Ensure proper *incentives* to improve on administrative performance and service provision, e.g. through rewarding proper initiatives and penalising inefficiency;
13. Link the transfer reforms to *other LG reforms* and initiatives, especially the LG finance system (taxes, user charges) and the capacity building activities;
14. Keep *track* on the actual implementation of the system, i.e. the transfer flow;
15. Adjust the system to new *LG structures, tasks and responsibilities* and ensure proper transitional schemes;
16. Keep the overall system and the criteria for allocation as *simple* as possible to ensure understanding, support and administrative feasibility.

On the other hand, the transfer system should **not**:
1. Base the size of the transfers on the existing infrastructure and services (service outlets), i.e. should not be a gap filling grant, as this provides disincentives to improve;
2. Bring about sudden and large changes (the system should consider whether the LGs should be held nearly harmless during the transition);
3. Be subjected to political interference in the allocation of funds during the FY;
4. Cover deficit and financial malpractice as this will create disincentives to improve on financial management;
5. Be solely based on an equal share approach as this does not consider the different needs in the various LGs and may create incentives to demand for creation of smaller inefficient LGs;
6. Be based on criteria that can be influenced and manipulated by the LGs
7. Establish multiple conditional grants, which undermine local autonomy and flexibility.

It is important to note that it may not be possible to achieve all the principles simultaneously, that conflicts may emerge and that certain trade-offs are needed, e.g. a flexible system adjustable to new LG functions may not be fully stable and predictable. Similarly a strong incentive system may, if not properly designed, contradict the equity and need-based objective. Please refer to Section 5 for an analysis of how Uganda has progressed against these principles and the implications for USMID.

Specifically on the allocation criteria is it generally accepted that the ***criteria***in grant systems should protect the following:

Box No. 3.3 – Principles for Grant Allocation Criteria

- Pursue the *objective*(s) behind each type of grant and try to balance (appropriate trade off) the objectives if some of these are conflicting;
- Be formula based and based on *objective* criteria, (contrary to discretionary criteria where the grantor is free to determine the amount paid on the basis of subjective assessment or expediency[37]);
- Reflect the variations in *LG revenue raising capacity* (for equalisation grants);
- Reflect the variations in *LG expenditure needs*, i.e. there should be a clear link between each of the criteria and the LG need to spend (especially for equalisation grants). They should respond to the *demand* for, rather than output of public goods such as infrastructure and/or institutions[38];
- *Accurately* reflect the specific characteristics behind each factor;
- *Limit the use of equal shares*, unless there are good reasons for this;
- Be drawn from sources that *cannot be manipulated* by the CG or LGs; They should generally be neutral for LG choice on the input side (unless there are strong reasons to pursue a particular method of service provision), e.g. the grants should not force LGs to establish new service institutions if other means to achieve the same objective are more efficient. A LG should not be able to influence the grant it receives by manipulating its expenditure decisions; An exemption from this may be in situations where there are good reasons for establishment of incentives, e.g. to achieve certain service targets or apply certain methods, e.g. participatory approaches;
- Be kept *simple, transparent, predictable* and stable from one year to another. It is e.g. generally proved that a few criteria can explain the majority of the variations in LG expenditure needs in many countries and few criteria preserve the simplicity and possibilities to achieve a transparent system. The number of criteria depends on the complexity of the LG tasks and the availability of data;
- Avoid *negative incentives* and preferably provide strong incentives for LGs to improve on LG administrative, governance and service provision performance;
- Not display a high degree of interdependence between the criteria and be easy to measure and up-date;
- Designed in a way where the *criteria work together* in a holistic and mutually strengthening manner to achieve the overall objectives, instead of sending conflicting messages and incentives.

The transfers should generally avoid funding:

- ❑ Deficits in LG, e.g. caused by malpractices;
- ❑ Gap in the coverage of infrastructure;
- ❑ Systems which provides disincentives to collect LG own source revenues;
- ❑ Systems which distort service provision and provide disincentives for efficiency;
- ❑ Ad hoc arrangements;
- ❑ A large amount of equal shares transfers (each LG receive similar amount) as one size does not fill all.

[37] Council of Europe, “Limitations of Local Taxation, financial equalisation and methods for calculating general grants”, Local and Regional Authorities in Europe, No. 65, Edited by Mr. Jørgen Lotz, 1999, Council of Europe Publishing.
[38] This does not mean that output related incentives cannot be introduced in certain areas, but that these have to be introduced cautiously.

Typology for Grants

Another important benchmark for comparison of the IGFT in Uganda is the way the funds are allocated vertically and horizontally. Below is a grant typology based on an internationally recognized categorization, adjusted to take into account the new features associated with the Performance-Based Grant System (PBGS) approach[39]. The sections below will provide further details on the system in Uganda Grants can be classified by:

1. The way the overall *size of the pool* of resources is determined, and;
2. The way the *grants are distributed horizontally* across LGs.

Table 3.1: A Taxonomy of Intergovernmental Transfer Programmes and Examples

	Method of determining the total divisible pool			
Method of allocating the divisible pool among eligible units	Share of national tax revenues	Ad hoc decision or programme specific/availability of funds	Reimbursement of expenditures	Allocation based on estimates/measures of the relative total LG expenditure needs and revenue mobilization capacity
1) Origin of collection of the tax	A Philippines	--	--	…
2) Formula	B1 Philippines** Indonesia Ghana (DACF) Rwanda (LASBF) Cambodia (CSF)	B2 India-BRGF Uganda: UCG, tax compensation grants, and most conditional grants (UPE wage and non-wage), SFC, PHC wage and non-wage, agriculture extension grants	--	B3 Some of the Nordic Countries Philippines** Attempts have been made in Uganda to calculate the costs of the National Minimum Standards, but work on this is not completed nor applied.
3) Total / partial cost reimbursement	C1	C2	C3 Many countries in OECD, e.g. Denmark	C4
4) Ad hoc decision	D1	D2 Solomon Islands- recurrent grants Zambia (capital grants) Uganda: Some of the conditional grants	--	D3
5) Performance based (may be combined with 1-4.)	E1 (Ghana-DDF) Tanzania (2009)***	**E2** E.g. Uganda (LDG) and previously PMA non-sectoral grants Tanzania- (LGSP)*** Nepal -(LGCDP) Bangladesh (LGSP/LIC) Indonesia Pakistan and many others.	E3 (E.g. Denmark, Japan and Canada)*	E4

Source: Adapted from Bahl (1999) and Bahl & Linn (1992), combined with the features of the PBGS.

[39] The table is an adaptation of the typology used in Bahl & Linn (1992) and Bahl (1999), adding the PBGS features, see UNCDF/Steffensen, (2010).

* Type of performance-based funding through the many conditions attached to some of the grants.
** A rough estimation of the expenditure needs of each tier was conducted at the start-up of devolution, but this is currently being up-dated. The adjustment has been in group B1 as it is now a fixed % of the national revenues. The coming PBGS (planned) will be based on a rough estimate of the required size, i.e. (E2)
*** Government of Tanzania has moved from a project specific allocation to an allocation based on a specific % of the public revenues.

Transfers can be distributed to LGs as (conditional orunconditional) **formula-based** transfers (Type B1, B2 or B3 transfers). Alternatively, transfers can be designed as "ad-hoc" grants where central government has discretionary power (Type D1, D2 or D3), or as full or partial reimbursement of actual local expenditure (Type C1, C2, or C3 transfers). The formula based transfers, which are often more transparent, are sometimes based on detailed calculations of the overall expenditure needs of the local governments (Type B3)[40]. Even the size of the overall ad-hoc distributed transfer pool (no clear formula applied) may be based on some overall measures of the total need of all LGs (Type D3), but this model is rare, as information about this is often not available.

Transfers can also be provided in the form of revenue sharing, whereby local governments receive a share of certain revenues collected within their boundaries (Type A). Revenue sharing is considered as a form of transfer when the LG has no control over the tax base, the tax rate, tax collections or the sharing rate (e.g. the Local Development Fee in Nepal or the sharing of wealth taxes in the Philippines).

Finally, and more recently, an increasing number of countries[41] have introduced more **performance-based grant systems (PBGSs)**, where the size of the grants is adjusted against the local governments' performance (type E1, E2, E3 and E4), typically based on calculations of the appropriate expenditure needs to be covered by the system, rough estimates or availability of funding, reviews of absorptive capacity, minimum level required for meaningful investments, etc., see also Section 4.

Most PBGSs have been launched by specific projects or national programmes and so they are classified as <u>category E2</u>, as the size of the funds is allocated based on the overall *programme specific* considerations, perhaps with an element of the absorption capacity (E4). Initially some calculations were made on the feasibility of absorbing the LDG amounts, also compared with the size of other grants and the own source revenues, but there were no detailed calculations of the exact level and the reasons behind the notion of providing the LGs in rural areas with in average 1 USD per capita and the LGs in the urban with in average 2 USD per capita in LDG[42]. The LDG under LGDP I, II and LGMSD are therefore to be classified under this category and is combined with a formula based system. A formula-based basic allocation formula is used and allocations are then adjusted against the LGs' performance.

[40] Attempts to make these overall calculations of expenditure needs have been undertaken in a number of countries, e.g. the Philippines, Indonesia, Uganda (2001-02), Latvia and Estonia. Although it is hard to define detailed needs, these surveys have provided some indication of outcomes of existing revenue sharing arrangements and future directions in the allocations.
[41] E.g. Kenya, Uganda, Tanzania, Ghana, Nepal and Bangladesh. Other countries, like the Philippines and Indonesia, are preparing similar schemes, see UNCDF/Steffensen (2010)
[42] The level was based on previous testing, availability of funds and overall comparison with the other funding sources, plus considerations on the level of incentives.

Some of the countries could potentially move towards types E1 or E4 when further studies of the overall fiscal system are conducted[43] and when the overall LGs' fiscal need versus their revenue potential is further defined. In Ghana the system approximates to type E1 features, as the PBGS is funded partly from the revenue sharing grant (the District Assemblies' Common Fund which gets 7.5% of the total revenues collected) and with a certain % (share) of this for the PBGS. Tanzania has also recently moved towards this type of system with GoT's contribution to the overall PBGS funding pool set as a specific percentage (2%) of the Government's total budget[44] (model E1), although the size has not been based on detailed calculations in any of these countries.

Classification in capital versus development

The targeting of grants towards capital and/or recurrent expenditures has been a subject for intense discussions in most countries, and is utmost important for the coming USMID grant schemes.

Grants can be divided in the following way, reflecting two dimensions:
1) Recurrent – capital; and
2) Sector – non-sector specific.

The grants in Uganda can be classified accordingly, see the table below.

Table 3.2: Recurrent versus Capital and Sector versus Non-Sector Specific

Table 3.2: Grant – Taxonomy	**Sector – Specific***	**Non-Sector Specific**
Recurrent (operational and maintenance costs)	A.1 E.g. grants for salaries to finance school -teachers. In **Uganda** most of the recurrent conditional grants (UPE, PHC, Agriculture extension, Environment, etc.)	A2. Non-sectoral grants with earmarking for recurrent expenditures, but LG discretion to use the funds across the sectors according to local priorities. In **Uganda**, the salary component of the unconditional grants can be classified in this group.
Capital	B1. E.g. grants for the construction of classrooms. **Uganda**: Examples of this are: the School Facility Grant (SFC), Primary Health Care (PHC) development, rural water development, road rehabilitation grants in the PRDP areas.	**B.2**. E.g. capital investment grants for discretionary spending on various sectors (typically various forms of local development funds). **Uganda**: This was the typical main focus of the LGDP **I** and **II** and the current LGMSD-LDG grants. However, as defined in the MTR, the LDG grants have in some cases been used on recurrent type of expenditures, e.g. the allowed investment servicing costs, and the some misinterpretation of the guidelines.
No limits on the type of expenditure to be funded in terms of capital or recurrent	C.1. Grants to finance all kinds of expenditure within a specific sector (sector specific	C.2.Unconditional grants with no limitations on utilisation (or a very short "negative list").

[43] Indonesia and Uganda (2004-05) have invested considerable effort into analytical work aimed at defining the expenditure needs of various LG functions.
[44] Excluding budget expenditures for debt-servicing and the like.

Table 3.2: Grant – Taxonomy	Sector – Specific*	Non-Sector Specific
costs	conditional grants). **Uganda**: Parts of NAADs, which may cover both recurrent and development features.	**Uganda**: Unconditional grants (the non-wage component), and tax compensation grants and equalisation grants, although this is supposed to be used fro development activities.

(*) In some cases, spending may be further "earmarked" for specific purposes. In some cases modifications of these standard types are practiced, e.g. capital grant schemes may allow a certain percentage for preparation and monitoring of projects (so-called investment servicing costs) or a share for administrative costs.

Most of the performance-based grants are in **group B.2**[45] as the objective is to promote larger investments in infrastructure and service delivery, but with a maximum percentage set aside to finance investment servicing costs (planning, appraisal, M&E, which may be of recurrent nature). These grants are especially attractive to LGs, as they are largely discretionary in nature and thus allow for a higher level of autonomy on the part of local decision-makers. PBGS are typically targeting capital areas, as they are easier to adjust than recurrent grants (such as those for salaries), which have a high fixed cost element.

A grant may finally be defined along another dimension - as: 1) "development grants", which include some capital investments, but also other types of expenditure (see below)[46]; and 2) non-development oriented grants. It is important in future design of the USMID to clarify these dimensions.

Table 3.3: Capital versus Development

Capital/ development distinction	Development expenditures	Non-Development OrientedExpenditures	No distinction between dev. And non-dev.
Capital expenditures	**A.1.** Capital development investments in development oriented areas, like health centres, schools, roads, agriculture (construction and rehabilitation). **Capital grants in the original sense.**	A.2. Luxury vehicles and administration buildings (depending on the needs). Uganda: In LDG a certain % may be allocated on on-development oriented expenditures (20%), e.g. administration buildings.	A.3: All capital expenditures without limits.
Recurrent expenditures	**B.1.**Capacity building Awareness raising campaigns. Expenses related to the operations and maintenance of core capital investments, (health, education, water, etc.) – investment servicing costs (some development grants allow this within a ceiling) Some parts of the CBG. **Capacity building grants.**	B.2. Administrative expenses in non-core areas. The development grants typically do not allow this.	B3: All recurrent expenditures without limits.

[45] However, there are examples of PBGS with a broad investment menu, including both capital and recurrent costs (e.g. the LATF in Kenya).

[46] See Tidemand, Steffensen, Pyndt et al. (December 2003: Volume II) for a discussion of these issues. Some countries therefore categorize certain grants as "capital development grants", mixing the two concepts to enlarge the investment menu (e.g. Tanzania).

Capital/ development distinction	Development expenditures	Non-Development OrientedExpenditures	No distinction between dev. And non-dev.
	Most of the sector recurrent grants in Uganda.		
No distinction between capital and recurrent	C1: Grant to finance all development- oriented expenditures **Development grants in some countries**	C2: Grants to finance all non-development oriented expenditures.	C3: All expenditures allowed UCG: Part of the UCG (salary component is rather fixed).

Development transfer schemes are frequently supported (or co-funded) by various donor programmes, and may have a restricted investment menu with a "positive" list (of eligible expenditures) and/or a negative list (of non-eligible expenditures, such as expenditures on religious activities or luxury items). This is e.g. the case for the LDG under the LGMSD.

The PBGSs usually focus on capital expenditures (group A.1.), with incentives to use the funds for development oriented expenditure areas[47]. One of the reasons for this is that it is easier to adjust flexible capital investments, rather than the often more "fixed" recurrent costs. This will probably also need to be the case for the coming USMID.It is assumed that the recurrent expenditures are met from CG transfers and own source revenues, which should be strengthened. However, it is important in the future to review the balance between the capital and the recurrent grants to ensure longer-term sustainability of the investments.

The capacity building grants to LGs are defined as recurrent (development oriented)[48] expenditures in group B.1, and are often part and parcel of many grant systems, particularly the PBGSs as in the LGMSD in Uganda.

The following sections below provide further details on the IGFTS in Uganda with particular focus on the development grants for Urban Authorities.

3.1.4 Major Issues on the IGFTS in Uganda

The overall System – and evolution of the IGFTS in Uganda

The overall system of IGFTs in Uganda has developed since the start of the decentralisation process, illustrated by the table below on the objectives of the FDS (2002) and the actual status of implementation.

A formal and regular system to ensure the prescribed adjustment of the grants along the lines of the Constitution has yet not been instituted. Secondly, the existing system, although based on the main concept in the Constitution and the LG Act (now CAP 243), has evolved into a rather complex IGFTS with various types of recurrent and development grants.

[47] Some countries, like Ghana, Nepal and the Solomon Islands allow LGs to spend a certain percentage of their PBGS allocations on recurrent costs, but exclude other types of expenditure, defined in a negative list.
[48] Except in Bhutan where expenditures for training are classified under "capital expenditures".

In brief, the system of IGFTS started from FY 1993/94 with the introduction of the unconditional block grants (UCG), which were phased in geographically – and introduced in batches of districts[49]. The support to the urban authorities started later, and only from 2000/01 were the 13 municipalities included as well in the UCG scheme. A few conditional grants were introduced from 1995/96, with gradual expansion in number, and the equalisation grants were introduced from FY 1999/2000.

The decentralisation commenced with the recurrent budget lines, and only from 1999/2000 with a gradual introduction of development grants. After a short but intensive piloting of development grants in various districts under the UNCDF supported District Development Fund (DDF) and bilateral programmes, e.g. the Danida supported Local Development Fund (LDF), piloting of on-budget performance-based development grants were supported by the Dutch on-budget support to 9 districts in the Northern Uganda and the World Bank Supported LGDP-I[50]. From 2003/04 this system of discretionary development grants was expanded and mainstreamed to cover all (1000+) LGs, supported by the LGDP-II. Several area-based support programmes were then folded into this system. Development grants were also gradually introduced in some of the sectors, including Water, Health, Agriculture (non-sectoral PMA grants) and Education (School Facility Grants) and Roads (rehabilitation of roads).

The size and the structure of the grants were significantly changed with the introduction of General Budget Support - the HIPC/debt relief-, which for a great part was routed through the intergovernmental fiscal system with the establishment of the Poverty Action Fund (PAF) from 1998, see the quote below[51]. On one hand this provided extra funding for the new LG service delivery functions and supported the LG system, but on the other hand, the modalities for the funding largely restricted the LG discretion and local priorities – a problem which still persists in the current arrangement.

"Although the majority of the GBS is not used to finance LG budgets, the majority of the funds available for LGs' services are financed by grants (rising from about 65% of the total LG budget in 1997/98 to about more than 90% in 2003/04), and a large part of these grants are funded indirectly by the GBS. This is particularly the case after the establishment of the PAF in 1998, when Uganda qualified for the HIPC initiative and where resources from debt relief were pooled with donor budget support, and government funds within a "virtual ring-fenced" funding arrangement.

The GBS has build on the existing arrangements and was "delivered" in synergy with the HIPC and the other support arrangements. In the beginning of this process, some funds were earmarked in sector budget support towards e.g. the School Facility Grant and Primary Health Care, but these have gradually moved towards general support for the PAF and/or for the general budget.[52] The support was closely linked to the development of the SWAPs in Education, Health, Roads, etc. as a framework for the implementation of the PEAP objectives[53] and the Poverty Reduction Strategy Credits (PRSCs), starting from 2001, with related undertakings and performance benchmarks and MTEF ceilings.

[49] At this time, there were only 39 districts, see NALAD (2000) for a thorough review of the history up to 2000.
[50] From 1997 there was a prior piloting of development grants under the District Development Project (DDP) in a few districts
[51] From Annex to the Review of General Budget Support – Uganda Country Report by Lister, Williamson, Wilson and Steffensen, (2005).
[52] See the Inventory of the Development in Support, Main Country Report.
[53] See Kasumba and Land: *"Sector-Wide Approaches and Decentralisation – A Case Study for Uganda, January 2003",* for a review of the links between SWAPs and decentralisation.

The PAF ensured additional funding and safeguarded expenditures on areas of particular importance for poverty alleviation (achievement of the PEAP objectives), such as primary education, primary health, agriculture, etc. The PAF increased from less than 250 Billion Ugandan Schillings (Ushs) in 1998/99 to more than Ushs 600 Billion in 2003/04, and the majority (about 75%) was allocated to LGs as conditional grants.[54] Together with other government/donor funds (outside the PAF area), this window caused a significant increase of funds for inter-governmental fiscal transfers from Ushs 118 Billion in 1995/96 to budgeted Ushs 864.9 Billion in 2005/06…"

Since the introduction of the PAF sectoral conditional grants in 1998/99, the grant system has evolved more gradually, and the size of the grants has not even followed suit with the real development in population and inflation rates, see Section 3.2 for further analysis. Please also refer to ODI, Steffensen (2010)[55] for a further description of the evolution of the *development grant system* in Uganda, and the related support modalities.

As the grant system evolved, several stakeholders became increasingly concerned about the modalities, particularly with the large number of conditional grants and the manner in which these were guided by the sector ministries.

In 2000, when the FDS study[56] was commissioned by the GoU, a number of problems were identified such as: Multiple conditional grants, lack of flexibility and fragmentation of the funding system, incoherent and fragmentation system of monitoring, reporting and overall accountability (and poor downwards accountability), lack of incentives for LGs to mobilise own source revenues, lack of a framework for intergovernmental coordination and lack of sufficient involvement and support to the lower levels of LGs (LLG)s. Many of these problems are still relevant in the current IGFTS, see below.

The current IGFTS and its challenges

The current IGFTS reflects a number of achievements, amongst these: i) the introduction of the FDS[57], ii) the establishment of a system of discretionary development grants for all LGs in the country, with procedures to promote good performance, iii) compensation (although insufficient) in case of changes in tax assignments/reductions, iv) support forimproved planning and budgeting systems, v) some reforms in the allocation criteria towards better targeting of resource with formula-based allocation, vi) establishment of an institutional framework for budget dialogue between central and LGs through various committees and the annual grant negotiations between central and LGs, and vii) strengthening of the PFM support and implementation. However, as the table below shows, there are still severe challenges within core areas of the FDS.

[54] See Williamson and Sudharshan, 2003, op. cit, p. 457 for further details.
[55] ODI, Steffensen: Sector Budget Support in Practice, July 2010.
[56] MoFPED, FDS Study, January 2000
[57] It should be acknowledged that the FDS is based on a compromise between many stakeholders and various views, and by no means is a blueprint for reforms. However, it was intended to address some of the realised problems in a strategic, incremental and cautious manner.

Table 3.4: Snap-shot of the FDS development

Reform areas	Achievements	Challenges	Factors/comments
Increased LG autonomy in utilisation of grants	The 10% flexibility across the PAF service areas (non-wage recurrent) was implemented for the first time in FY 2006/07 and many LGs have used the increased flexibility to reallocate funds across sectors according to local needs. This had started a sound dialogue on local priorities across sectors, but was ceased in 2008. The PRDP districts (in the North) were provided with 50% flexibility.	The sector budget guidelines still contain many restrictions in the utilisation of each grant (multiple budget lines) and provide limited local flexibility. The sector *development* grants have not been folded into the non-sectoral grants or targeted by the FDS initiatives; hence the LG flexibility in resource allocation on dev. exp. has not been improved beyond the LGDP. The 10% flexibility in grant utilisation was abolished from FY 2008/09 by the Cabinet due to resistance from some of the Line Ministries (LMs). Similarly the PRDP flexibility was also removed.	Some of the sectors (including Education and later Water) were against the increase in LG flexibility in grant utilisation and as they were concerned that it will compromise the achievement of sector national service delivery targets. The resistance led to an abolishment of the rule on flexibility. On one hand the flexibility introduced healthy dialogue on cross-sectoral priorities, but the resistance and abolishment of the initiatives point in the direction of need for other tools to enhance LGs' discretion.
Better targeting of the allocation criteria in the grants towards poor LGs	New allocation criteria have been implemented for the equalisation grants, LDG and the UCG (however, the latter has some pitfalls, as it is mainly covering fixed salary costs).	Many of the proposed new allocation criteria for the sectors in 2004 have still not been implemented. Many grants need clear and transparent formulas. The equalisation grant is still insignificant (below 0.5% of the total grants).	Some of the sectors, particularly Education have resisted the new transparent formulae with unclear reasons. The regional disparities in Uganda have prevailed, hence a need for stronger allocation formulas, which preserve incentives to improve performance.
Strengthening of the LG budgeting process	FDS piloted better links between budgets, work-plans and	Some of the districts are still not fully on board in the use of the new procedures and	The support to the roll out of the FDS has been inadequate. The FDS reform requires significant CB

Reform areas	Achievements	Challenges	Factors/comments
(LGBFPs and annual work-plans and budgets)	reporting. Requirement to link budget and plans have been strengthened in the annual assessments. The new OBT from FY 2009/10 is focusing on improving and consolidating the annual work-plans using a common format. This is a significant work on ensuring that the LGs are applying these new tools.	formats. The links to the computerised IFMS and the FDS formats has been a challenge. The NDP has introduced 5 year development plans, but this has not yet been implemented due to legal and procedural challenges (the LG Act has a 3 year perspective). Despite the new MoFPED supported OBT - new work-plan formats –some of the sectors are proceeding with parallel systems.	support, but this support has not been timely and has not covered all LGs equally. There is a need for continued interactions and support to the LGs in terms of rolling out of the new OBT (output based tool). The sectors' needs to be brought more on board to ensure linkage with the sector plans.
Reporting systems	FDS reporting formats were elaborated and the reporting has been streamlined on a pilot basis. More recently in FY 2010/11, new reporting formats for reporting under the MoFPED, Form B has been introduced providing a potential link between input and output performance reporting.	Some of the sectors are still using their "old" formats despite the FDS and the MoFPED supported reform. Much of the accountability is still towards the sector LMs. There are still multiple reporting and M&E systems, not sufficiently coordinated. Introduction of the new Form B, supported by MoFPED has not yet led to reduction of the requirements in the other reporting formats, leading to double work for LGs.	Some of the LMs have not supported the FDS due to sector specific interests. MoFPED and MoLG need to strengthen the coordination with the LMs on the required reporting formats and introduction of the new OBT-Form B and improving the links with the sector information required.
Improved LG revenues	A number of activities were launched to	The LG tax base is now extremely narrow, and the revenue autonomy	Incongruence between the political and technical initiatives on LG own

Reform areas	Achievements	Challenges	Factors/comments
	improve LG revenues, including studies, setting up of revenue desk in MoLG, CB support to LGs, sensitization and sharing of best practices, etc. at the technical level and this had a certain impact on the development in own source revenues from 2002, but the abolishment of the major tax (G-tax) and other political initiatives in 2005/06 overshadowed this short-lived improvement.	significantly decreased. The abolished tax sources, and the insufficient and late compensation has impacted negatively on most of the LG core operations, and on the good governance performance, particularly in the LLGs, which were nearly entirely dependent on G-Tax, see below. LGs now finance less than 5% of their expenditures from own source revenues, and have continued to decrease since the FDS was introduced.	source revenues. Legal initiatives have reduced the LG tax assignments prior to establishment of alternative LG sources. The lack of sufficient compensation has worsened the problems within the core functions of the LGs. Need to strengthen existing taxes and identify innovative ways and means to improve LG OSR.
Reduction in the transaction costs and improved predictability and timeliness in the transfers from central government	The accounting and banking requirements have improved, e.g. the number of bank accounts have reduced, and lowered the LG costs of operations. The timeliness of the grants has improved.	The delays in transfers still impact negatively in some LGs on the planning, budgeting and operations within core service delivery areas. In addition, the late and changing announcement of indicative planning figures seem to have worsened. IPFs are announced too late in November or December each year, and there are frequent changes. However, work to improve on this is ongoing.	The late announcement and changes in indicative planning figures (IPFs) from Central Government demoralise and compromise the LG planning process. There is a need to advance the IPFs and make them more robust. However, the picture is better than in many other developing countries.
Improved institutional coordination of	The established LG Budget Coordinating	To bring the sectors sufficiently on board in the FDS implementation is still a	Support to the FDS implementation has been

Reform areas	Achievements	Challenges	Factors/comments
the LG finance issues	Committee is operating and important issues are being discussed on a regularly basis. The associations of LGs are also involved in dialogue on core issues.	great challenge, and it has not been possible to get through with major reforms of the IGFTS.	inadequate.[58]

The following sections will provide further details on these challenges to the IGFTS as they appeared from the fieldwork and the meetings with central government stakeholders, benchmarked against the international good practices.

Overall challenges based on feedback from the 14 municipalities

The feedback from the questionnaire and fieldwork depicts the major challenges in the current IGFS in a prioritised manner as follows:

Table 3.5: Challenges in the existing IGFTS

Challenge	First*	Second	Third	Following
Insufficient size	6			
Lack of flexibility and conditionalities		3	1	2
Delays	1	3	3	
Lack of transparency and predictability (e.g. budget cuts)	1	2		
Allocation formulas			1	1
Legal framework for support, e.g. procurement	1		1	
Problems in the balance between the grants		1	1	1

Source: Based on submission from the following municipalities (Masaka, Gulu, Mbale, Tororo, Hoima, Kabale, Arua, Lira and Fort Portal) with a prioritised list of the major challenges in the IGFTS as perceived by the municipalities. * Mentioned as problem number one, i.e. 6 Municipalities mentioned insufficient size as the first problem.

It appears from the table that the biggest problems with the existing IGFTS are lack of funding, lack of flexibility in utilisation (the great number of conditionalities on spending),

[58] Some of the DP supported programmes have been covering a number of districts in their support, but other programmes have not complemented sufficiently to ensure a balanced and country-wide application.

delays in flow of funds and then insufficient communication and transparency in the arrangements. The following sections throw more light on these major problems.

Vertical allocation of resources in Uganda

Central and local governments

As mentioned in Table 3.1 the overall division of funds between central government (CG) and LGs is determined by historical practices and availability of funds rather than a detailed needs-based calculation or a fixed share of the total public revenues. As it appears from Section 3.2, the share of LG revenues as a share of CG+LG (excl. debt payment and interest payment) has dropped from about 27% in B 2002/03 to 21% in B 2009/10, increasing to 23% in FY 2010/11 due to particularly the increase in NAADs and the cost of the establishment of new LGs. However, as it appears in Section 3.2, the funding has not followed suit with the extra costs in areas such as establishment of new LG structures, the abolishing of taxes, introduction of new functions and population and inflation growth.

The majority of the municipalities mention the overall funding gap as the most severe problem in the existing IGFTS. However, since 2001/02 there have not been any attempts to calculate a reasonable sharing of resources between CG and LGs and/or to ensure a full compensation of new costs and functions[59]. Please also refer to the review of fiscal needs, below, which shows major funding gaps within the areas of urban investments.

Higher and lower levels of local governments

The sharing of revenue sources between various tiers of LGs is defined in Schedule V in the LG Act, and is rather complex. Of the own source revenues, municipalities and divisions are supposed to share 50%:50%, and then the municipality is supposed to equalise between divisions using the 30% of the 50% and to divide this across the divisions according to defined parameters. The divisions are also supposed to share revenues with the ward and village councils. The actual practise for division of revenues differs across urban councils, and as revealed in the LGFC study from 2002[60], there are few LGs adhering fully with the complex revenue sharing arrangements.

Most grants – except the UCG, tax compensation, the LGMSD-LDG grants, and the NAADs grants (going directly divisions) - are only allocated to the upper tier of urban LG and not divided with the LLGs. This limits the impact and relevance of the bottom-up planning process as revealed in the FDS study and in a more recent study by the LGFC.[61]
The urban authorities are divided in their views on the fairness of the revenue sharing between HLG and LLGs. Half of the municipalities agree in the existing system whereas the other half of the municipalities have various concerns. However, the general principle of sharing funds with the divisions and wards is generally accepted for the existing grants which are currently applying this, and particularly for the LGMSD – LDG grants. The

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[59] See LGFC, Revenue Sharing Study, June 2002. The study only covered the recurrent expenditures and estimated an annual fiscal gap in the tune of about 20.3 billion UGSH for the urban authorities.
[60] LGFC, op cit.
[61] LGFC (2007): Study of the Feasibility of Extending Fiscal Transfers to Lower Local Governments in Uganda (September 2007).

sharing arrangement for the LDG is 35% to the districts and 65% for the sub-counties (of which 30% is ring-fenced/earmarked and used for the community development grants (CDG). For the municipalities, 50% is kept at the municipalities and 50% is shared with the divisions (of which 30% goes for the CDD – approach, see, the MTR of the LGMSD, December 2010).

Under the USMID project, given the nature, size and lumpiness of the expected investments, it may be prudent not to split the funds below the divisions.

Fiscal needs
As it was not possible with the existing information at the CG or LG levels to get a comprehensive and reliable exact picture of the fiscal gaps of the municipalities, the tables below provide some indication of the major gaps, areas in needs of investments and unit costs of various types of investments. As municipalities are doing resource-constrained budgeting rather than visionand needs based, none of the municipalities have done detailed calculations of the expenditure need to comply with various national and other standards vis-à-vis their revenue potential. However, most of the municipalities have a good impression of the major gaps. As the table below shows, based on the rough estimates made by the municipalities, there is a significant fiscal gap in the existing system.

Second, the tables show that the unit costs for typical urban investments, which are lumpy in nature, are very high, also compared with the average costs of typical LG investments. E.g. a recent review of the LGMSD revealed that the average costs of the current LDG is investments are only about 5,000 USD, and that there has been a tendency to fragment the limited funds[62].

The standard unit cost provided from some of the LMs (particularly for procurement purposes) is higher than the estimated municipal costs, and most municipalities are trying to reduce the unit costs through the procurement process due to lack of sufficient funding for core infrastructure, such as paved roads. Despite these reductions, it is clear that the existing funding system does not cater sufficiently for these major and lumpy investment needs, and the large investment costs of urban investments. Please also refer to the trends in the intergovernmental funding system, in Section 3.2.

Table 3.6: Major municipal areas in need of additional investments

Areas/priority	First Priority	Second	Third	Fourth	Fifth or later
Roads	6		1		1
Drainage		2			
Sewerage				1	1
Street lighting		1	1		2
Solid waste management		2	1		2
Health	1	2	1	1	1
Buildings	1		1		
Transport means					2
Physical planning				1	1

[62] Note that the size of the average investments e.g. under LGMSD is only about 5,000 USD, see MTR, 2010 (Dege and Mentor Consult).

Areas/priority	First Priority	Second	Third	Fourth	Fifth or later
equipment					
Schools			1	2	1
Water and sanitation					2

Source: Based on information from Masaka, Gulu, Mbale, Tororo, Kabale (NA), Hoima, Arua, Lira, Fort Portalmunicipalities (questionnaire feedback, January 2011).

There is need for more dialogue on the investment menu considering the impact, which will be created as well as the capacity to handle projects, local prioritisation and adherence with the physical plans and other funding scheme for infrastructure development, e.g. there is no current specific funds for road rehabilitation, yet this is a big gap. There is also a need to discuss the division of tasks between the municipality and the divisions, which has implications on the vertical allocations.

The table below shows various estimated unit costs of typical urban investments.

Table 3.7: Unit costs of typical investments – Examples from the Municipalities

Sector	UGSH – example	UGSH – example	UGSH – example	UGSH- example	UGSH – example	UGHS- example	UGSH- example	UGSH – example
Roads	400 million for tar marking of roads per km (real costs are 550 million) Opening up of new road (not tar marked): 200 million per km	1.6 billion for Kampala standard, but according to available funds	700 million per km paved roads	600 million per km paved roads	500 million per km	500 million per km	700 million per km	1 billion per km paved road
Water schemes	5 million per km of extension			10 million per km connectio n		18 million per borehole 6 million for water tank		
PHC	250 million (only maternity)	Maternity: 160 million Staff quarter: 80 million per unit	Health unit IV: 500 million	Health Unit III: 500 million	60 million for ODP	Maternal health care ward: 100 million	PHC-II: 100 million	Health IV: 900 mil. Health III: 600 mil. Health II: 450 mil.
Office building					2 billion			Office block: 300 million
Street lighting	Complete municipality (240 million)							
Bridges		50 million	200 million	50 million	30 million	300 million		450 million

Sector	UGSH – example	UGSH – example	UGSH – example	UGSH- example	UGSH – example	UGHS- example	UGSH- example	UGSH – example
Electrifi-cation		Complete electrification : 2 billion						
Secondary classrooms	17 million each		70 million each		20 million	80 million for 4 class-rooms	15 million per classroom	12 classrooms : 450 million.
Toilets VIP	35 million for 5 stance				20 million for 5 stance			
Abattoir		2 billion						
Garbage truck dumper					150 million			

Source: Based on information from Masaka, Gulu, Mbale, Tororo, Kabale (NA), Arua, Lira, Fort Portal municipalities, questionnaire feedback January 2011.

As it appears from the table above, there is great variation in the unit costs, and expected quality of investments, hence a strong need for guidance on these, also given the engineering inadequacies in the municipalities. The table also shows that the standard unit costs provided by some sectors, are not applied. The table below shows the municipal estimates of the extra resources required to comply with the stated national minimum service standards in various sectors as well as with the mandatory urban functions.

Table 3.8: Estimated Expenditure Needs in %

Municipality	Comments
Municipality I	Not possible to estimate as budgeting method is resource constrained, but the fiscal investment gap is significant.
II	Existing funds are only 30% of the needs if National Minimum Standards should be complied with.
III	Extra needs 80% to comply with standards
IV	Need is twice of what it has.
V	Need 35% more to comply with standards
VI	Need 30% more to comply with standards
VII	NA calculations not made, but significant.
VIII	Grants only cover 30% of the standards
IX	Need 30% more to comply with national standards

Source: Based on information from Masaka, Gulu, Mbale, Tororo, Kabale, Hoima, Arua, Lira, Fort Portal municipalities (questionnaire feedback, January 2010). The table shows the perceived gaps by the Municipalities in meeting the national standards for service delivery in functional areas under the Municipalities. It is based on best estimates, as most municipalities have no conducted detailed calculations. The major areas with gaps are listed in the table below.

The table below shows major infrastructure gaps as reported by 13 municipalities in December 2010.

Table 3.9: Coverage of Major Urban Infrastructure needs

Needs covered in %	More than 50%*	Less than 50%	NA
Paved roads	2	8	3
Water coverage	3	7	3
Electricity needs	3	5	5
Street lighting	2	8	3
Major waste management problems	Yes: 9	No: 2	NA: 2

Source: Based on submission of information from 13 of the 14 targeted municipalities for the workshop on USMID in December 2010. *No. indicated = number of municipalities responded within each group.

It appears from the tables above, that the general pattern is that there are significant investment and funding gaps in all municipalities. This preliminary finding is supported by the analysis of the existing grant system in Section 3.2, and the findings from two on-going studies under the LGFC, see the box below:

Text Box 3.4: Abstract from Draft Findings from Studies under LGFC.

Assessments of the funding gaps for garbage collection and roads have just been completed (not yet published) under the LGFC. The main findings of the study, based on a large sample size of urban authorities, is that only 35% of the garbage in the urban authorities (average) is collected, and that the additional funding required will be annually Million 442 UGSH for recurrent, and one-off investments in development activities in the tune of (average) Million 916 UGSH per Municipality.

On the roads another study in draft (2) shows that there is currently a backlog of approximately 8,900 km of district roads, 3,600 km of urban roads and some 35,000 km of community access roads without appropriate financing The minimum standards for urban council roads require every 1,000 people are served with 1.2km of road, the tarmac road should be 11% of the total road net work, the roads in fair to good condition should be 50%, a 25m interval street lighting coverage of 10% and 10% side walks coverage of 1.5 widths on both sides. These MNSSD were costed and compared with the current capacities in order to determine the capacity gap. This gap was compared to the current funding levels to determine the required funds per-capita for all the sample LGs. Projections of the national results were done using sample per-capita gaps and national urban population figures. The total funding gap was enormous, i.e. USD 7.9 billion of which USD billion 1.55 was for new roads. However, these studies are still in draft and needs to be further reviewed.

Source: Local Government Finance Commission: "*An Assessment to Establish Funding Gaps and Determining a Financing Framework for Garbage Collection in Urban LGs",* Final Draft, June 2010 and LGFC: "*Estimating the Funding Gaps and Allocation Formula for Rural and Urban Access Roads in Uganda",* Draft October 2010.

Horizontal allocation of funds

The horizontal allocation of grants has been subject to intense debate since the introduction of the LG Act, and particularly since the FDS in 2002. Various studies have been conducted[63], but many of the suggested formulas have not yet been implemented, particularly when it comes to the development grants. Some formulas have also been changed without links to the analytical work[64]. As mentioned in the study from Kitunzi, Anka (2008) some of the grants have transparent, formula-based criteria, some have criteria but these are not transparent, and others are allocated without use of formulas

[63] E.g. LGFC, "Grant Allocation Formulas", 2004 and Kitunzi, Anka: Review of the Allocation Formulae, Parameters and Development of an Allocation Database, June 2008.
[64] Based on interviews with LGFC.

and/or clear parameters. The criteria for some of the grants are listed in the National Budget Framework Paper (NBFP – 2009/10-2013/14), and it is clear from the review of these that there is a need to analyse most of the grants against the objectives and against good international practices. It is also clear that despite numerous LGFC recommendations on improvement of various grants, also of all the development grants, it has been hard to get the sectors on board in the reforms. The existing formulas are moving in various directions, and some are even rewarding poor practices[65].

However, the single most relevant grants for the future USMID, **the Local Development Grant**, supported by LGMSD, and funded by the GoU has been revised as far as the districts are concerned from a pro-rate allocation towards a more needs-based, still simple and transparent formula. The existing formula for the LDG for various types of LGs is listed below.

Table 3.10: Overview of the LDG Formula

Type of local government	Criteria applied and weight
Districts	Administrative land area (15%) Size of the population (45%) Number of people below the poverty line (40%)
Sub-counties	Number of people
Town councils	Number of people
Municipalities	Number of people
Divisions	Number of people

During the workshop with the 14 municipalities in December 2010, the existing formula for the LDG was discussed and it was generally believed that the formula for the districts, if applied for the municipalities, provides a good basis for allocation, but that additional indicators should be considered. These could be criteria such as: i) infrastructure, ii) terrain, iii) strategic functionality of the municipality, iv) importance given for the municipality in the National Development Plan and v) others.

The feedback on the formula from the field-visits to Mbale, Gulu and Masaka Municipalities and the questionnaires from some of the other municipalities revealed that the major problem with the existing formula as perceived by the municipalities, is the use of night population by UBOS in the census data, instead of the actual daypopulation, which is several times higher for the urban centres. Hence the formula does not cater for the extra costs of the use of services and infrastructure by the additional users during the day, putting particular stress on areas such as water supply, sanitation, solid waste management and roads. However, it was acknowledged that it is not easy to calculate the exact size of the daypopulation, and that the impact on the expenditure needs will vary across the sectors.

Second, and most importantly, if the calculations and simulations of the urban allocations can be done separately and not mixed with the horizontal allocations for the rural authorities, it was realised that most of the urban authorities have similar challenges with the issue of "day-night" population. Most urban authorities would therefore be pleased with

[65] E.g. LGs have incentives not to report construction of health centres to the Ministry of Health, as this will impact negatively on the PHC grants.

the existing formula for the districts with the 3 criteria. Experts from LGFC who met during the study also support this model, which is simple, transparent and needs-based.

The study team supports this view and *suggests* that the formula, as the current one for the districts, is based on: i) the principles outlined in the box 3.2, ii) continues to be simple and easy to comprehend, iii) be based on data from official government source, and iv) preserves incentives to improve performance, both infrastructure and institutional performance. It is, for instance, clear that inclusion of the existing infrastructure coverage in the formula will create perverse incentives, as non-performing urban authorities will be rewarded, and urban authorities, which improve from one year to another will be sanctioned. The existing formula for the district allocations reflects generally sound and robust principles for grant allocation in a case where limited data is available on the real expenditure needs and revenue potential across the local governments. First, the introduction of land coverage seems reasonable from the perspective of links with the costs of infrastructure. Second, the poverty criterion reflects the fact that there are significant variations in urban poverty levels and derived needs for investments[66]. It is however, acknowledged that there is a need for current improvement of the data applied in the formula, and update particularly ofthe land data. It is recommended that UBOS and MLHUD review the land data for the urban authorities, particularly the 14 municipalities to be included in the system. Cases were mentioned in Masaka where wards were not included in the population figures, and this should be reviewed as well.

Below are listed some of the concerns the study team has in respect of some of the other suggested indicators from the ongoing discussions:

Table 3.11: Discussions of various options new indicators in the LDG grant allocation formula

Possible new criteria for LDG grants	Comments
Existing infrastructure	Will provide incentives not to improve the coverage (this has been observed e.g. in the PHC development grants) Will be complicated as data is not available Will depend on the sectors and make a complex weighting necessary The existing poverty headcount is to be considered as a proxy for this need
Location	There is not a clear-cut link between location and costs –it may be very complicated to determine. The existing poverty headcount caters for some part of this.
Terrain	There is no clear link between the terrain and the costs. A cost index study could be undertaken and cost index of a composite "bag"/index of typical infrastructure services could be initiated (like in e.g. Nepal). However, this will take time to complete and is a major exercise. It could be supported as part of the project implementation. When a robust cost index has been developed, it may be factored into the formula.
Strategic functionality of the municipality	This is not objective or easy to quantify, and should not be included. It will create a lot of debate and unnecessary conflicts about which areas are most strategic.

[66] Although there is no direct link between poverty and infrastructure investment needs it is assumed that there is some correlation. The PEAP also recognizes that urban poverty is a major problem, which was not previously considered.

Possible new criteria for LDG grants	Comments
Equalising revenue potential	The need for this is partly covered by the poverty headcount, as there is an assumed link between poverty and revenue potential. A revenue potential study is a very comprehensive and time-consuming exercise, which could be supported as part of the programme. When data is available, this could be included in various formulas, but perhaps most prudently in the equalisation grants, which should be increased in size over time.
Importance given to the municipality in the NDP	This may not be an objective factor for the needs and revenue potential of the municipality, and is open for subjectivity and against the recognised principles for grant allocation. It will again create conflicts between municipalities and cumbersome discussions and trade/offs.

Finally, and as discussed in Section 3.4, there is room for strengthening and piloting a better link with the **performance component** of the formula. The present system of allocating 20% extra/less to the allocation formula is not seen as transparent for the LGs involved – it is not easy to see how the increases are made in grants against the performance, as funds are not sufficient to ensure a full topping up. A system, which is applied in countries like Ghana, Solomon Islands, and in the future East Timor and the Philippines, whereby the performance measures and the weighted scores are mainstreamed and integrated in the formula with a certain criteria weight should be considered. Annex 3.5 contains an example of this, which shows simulations of a system with 50% based on basic allocation and 50% based on a weighted performance score.[67] The new model has the advantage that it is easier for everyone just to plot in the score in the simulation model.

Secondly, it provides the LGs involved with continued incentives to improve performance, and it provides better checks and balances as the performance enhancement of one LG will impact the allocation of another, i.e. it is more competitive – LGs will have to ensure that they continue to improve performance in order not to lose out to other LGs. Hence, it will reduce the challenges in the existing system. If the system is conducted timely, it will avoid the potential disadvantages in the model of not providing the LGs with a clear predication of the amounts to be achieved from the system. Some LGs may improve their performance, but still be sanctioned, as other are improving even more – i.e. like a “football league”. Please refer to Annex 3.5, which show the results, and which provide a spreadsheet, whereby scores and weights can be changed. It shows what will happen in each case if a LG scores above or below the average score of the 14 municipalities. The system is simple to handle, but requires a change in the existing set-up of the performance indicators and scoring system – and a revision of the Assessment Manuals for Urban authorities.

Horizontal allocations of other grants

Experiences have shown that reform of the horizontal allocations is a lengthy and complicated process, where some of the sectors have refused the recommendations of various studies under the LGFC and MoFPED. The unconditional grants are allocated

[67] However, it is important that the performance-score/the index is weighted against the results of the other criteria in order not to distort the basis formula and in order to provide equal incentives to all LGs. This has not yet been the case in the system in Ghana.

based on two components. The largest part - the wage component - is using a fixed % of the standard structure costs (65% in 2009/10) and the smaller non-wage component is composed of two criteria: 1) land which counts with a weight of 15%; and 2) population for the rural authorities (85%). For urban authorities, 100% of the non-wage UCG is based on the size of the population.

The G-Tax compensation for urban authorities is based on two broad parameters namely 50% of total funds allocated based on what each local government collected in FY 2003/04 and the 50% remaining allocated based on urban council population (with a 100% weight). Other grants, which are intended for development purposes, comprise of the school facility grant, which uses a needs based formula, water grant which uses a rather complicated model based on need combined with use of technology across various LGs and the Primary Health Grant (PHC), which is based on the existing coverage of infrastructure providing incentives for LGs either not to improve, and/or under-report on the existing structures. As mentioned, there is a need to reform these formulas, and it is expected that the coming FDS study coordinated by LGFC will review these as part of the overall analysis.[68]

Timeliness and predictability

The second most frequently reported challenge with the existing grant system was the delays in transfers and lack of predictability, including reductions of the indicative planning figures (IPFs) during, and reduction in the final figures after the budgeting process. Although the problem is not as severe as in some other developing countries[69], it is real and impacts negatively on the planning and project implementation process. Many of the municipalities report about 1-2 months of delays in transferring of funds, lack of communication, etc., but as a comprehensive study from 2004[70] showed, the reason is often a combination of delays in accountability from previous releases as well as procedures from the central government, approval by MoLG/LMs and transfers from MoFPED. However, in the end of the FY, most of the core development grants are transferred (see annexes), and for the LDG in the tune of 96%, see the recent MTR of the LGMSD[71], and the quote from the MTR below:

LDG Out-turn: For the LDG, the releases against budget are high at above 95% as depicted in the Table below. Whereas the total allocations amounts are stagnant, the high levels of the LDG out-turn can be used as a proxy to illustrate GoU commitment to maintain the LDG funding levels to those that were in place by the end of LGDP II (2005/06) – see the MTR of the LGMSD, December 2010.

[68] At the recently completed JARD review on January 14, 2011, it was agreed that this study should be completed before September 2011, as the first undertaken from the review.
[69] E.g. see the review of the Backward Regions Grant Fund in India, 2009, where funds could be 1-2 years late.
[70] *Source:* Release Tracking Study, MoFED, 2004, Kebu Consultants and EPRC.
[71] Drawn from the MTR of the LGMSD by Dege Consult and Mentor Consult, December 2010.

Table 3.12 LDG and CBG – budget and out-turn, FY 2007/08 – 2009/10, in Bln UGX

Year	LDG			CBG		
	Budget	Actual	%	Budget	Actual	%
2007/08	58.6	56.0	95.6%	5.86	5.602	10%
2008/09	58.6	56.2	96.0%	5.86	5.626	10%
2009/10	58.6	56.1	95.8%	5.86	5.614	10%
Total	**175.8**	**168.4**	**95.8%**	**17.58**	16.842	10%

Source: MoLG/PST drawn from the MTR of the LGMSD, Dege Consult and Mentor Consult, December 2010.

The table below shows examples of municipalities' reports on the receipts of development grants:

Table 3.13: Overview of Timing of Development Grants Received from the CG

Municipalities and tranches	Expected data for receiving grants	Actual data of receiving grants
Gulu Municipality		
2nd quarter FY 2010/2011	1st of October 2010	22 November 2010
1st quarter of FY 2010/11	1st of July 2010	25 August 2010
4th quarter of FY 2009/10	1st April 2010	1st April 2010
3rd quarter of FY 2009/10	1st January 2010	10th February 2010
Mbala Municipality		
2nd quarter of FY 2010/11	15 October 2010	Not received
1st quarter of FY 2010/11	15 July 2010	Not received
4th quarter of FY 2009/10	15 April 2010	12 May 2010
3rd quarter of FY 2009/10	15 January 2010	22 February 2010
Lira Municipality		
2nd quarter of FY 2010/11	15 October 2010	End of November 2010
1st quarter of FY 2010/11	15 July 2010	August 4th 2010
4th quarter of FY 2009/10	15 April 2010	June 2010
3rd quarter of FY 2009/10	15 January 2010	February 2010
Fort Portal		
2nd quarter of FY 2010/11	October 2010	NA
1st quarter of FY 2010/11	August 2010	September 2010
4th quarter of FY 2009/10	March 2010	April 2010
3rd quarter of FY 2009/10	January 2010	February 2010
2nd quarter of FY 2009/10	September 2009	October 2009

Source: Submission of feedback on questionnaires, January 2011 as well as field visits in January 2011.

The table shows that there are delays and that these often concern a maximum 1-2 months. However, Mbale Municipality has special problems with the LDG grants, which need to be followedup, as they report not to have received any transfers for FY 2010/11.

The delays in transfer of funds should be reduced with the new Output-Based Tool (OBT) innovated by the MoFPED. In this new system, the quarterly releases will be affected using the "last quarter but one principle", i.e. the funds will be released in the first and second quarter, and only if the reports from the first quarter is not submitted and accountability is not sufficient, this will affect the 3rd quarter. The 4th will be affected by the submission of the accountability for the second quarter, etc. This system will provide sufficient time to submit reports, and for the CG to scrutinize these without causing delays. If this system is applied for the LGD as well, it will be a tremendous support for the efficiency in transfers.

Conditionalities and flexibility

The strong conditionalities and lack of flexibility across the grants, (see the quantitative analysis in Section 3.2), is seen by the municipalities as one of the top 3 challenges in the existing IGFTS. The FDS was supposed to address this problem by reducing the number of grants and allowing some (10%) flexibility across the recurrent non-wage grants, but this has been blocked by LMs' resistance (particularly the Education and Water Sectors), and the number of grants have continued to increase from the start of the decentralisation in 1997 from 12 grants in 1996/97, to 19 in 2000/01 (when the FDS was planned), 37 grants in 2003/04[72] to 40 grants in 2010/11[73].

The flexibility planned under FDS (10% across the non-wage recurrent grants) was abandoned in 2008/09 and the planned PRDP has not taken place, and there are still strict fences between the various grants. The 10% flexibility under the FDS started a dialogue at the local level across the sector departments and provided a more meaningful role for local planning a few years, but was quickly blocked by a Cabinet decision after resistance of some of the sectors. The urban authorities have typically around 20 different grants of which many of these have a significant number of "budget lines" where there is prescribed areas of spending/ceilings, etc. The autonomy has been gradually reduced, with the share of UCG[74] declining from 36.5% in FY 2005/06, 24% in 1997/98, 11.9% in FY 2000/01 (prior to the FDS) and has been stable around 10.6% in the last couple of years.[75].

Secondly, the share of the discretionary development grants has decreased from FY 2003/04 to the present system, see Section 3.2 for further analysis. This has led to less cross-sectoral priorities, less efficiency in spending and higher transaction costs in terms of compliance, accountability and reporting and a stronger need to improve on the discretionary funds available for development and local planning.

As flexibility is going to face resistance amongst the sectors, it is probably more feasible to work on an improved balance between discretionary and non-discretionary funding channels, see Section 3.2. However, it should be mentioned, that the newly introduced "Form B" reporting system under the OBT (MoFPED), is no longer focusing on the compliance with the grant conditions for individual grants as basis for releases, but rather the approved work-plans for the sectors/departments and the sector allocations against these plans. The impact of this on the level of control by the sectors of LGs spending on earmarked areas is still to be seen.

[72] 3 of the grants "counted twice" in 2003/04 as they are divided into urban/rural grants, in 2010/11 this number is 4.
[73] See annexes 3-1-3.3, and Steffensen, Tidemand and Ssewankambo, 2004, World Bank Analysis.
[74] Figures exclude tax compensation, as this was a compensation for abolishing of discretionary tax revenues, see Annexes 3.1-3.3.
[75] Op cit.

Reporting systems

Reporting systems is often one of the largest challenges in any IGFTS.[76] The grant reporting systems continue to be a major challenge in Uganda, although there have been attempts to improve during the FDS piloting in FY 2004/05 and under the recent initiatives by MoFPED with the introduction of the "Output Based Tool" (OBT), with the so-called Form B[77], LGs are facing a number of accountability and reporting systems with different purposes, see below. Some of these cannot be fully integrated, but there is room for improvement – harmonisation and alignment, and rationalization, particularly in the reporting on use of funds.

Table 3.14: Different Reporting Systems for LGs

Major reporting system	Purpose	Comments
IFMIS	PFM system to improved financial management, accounting, reporting, etc. – general system.	IFMIS is being gradually introduced, but it will take many years before it covers all LGs, and the system will vary according to the size and needs of LGs, see the MTR of LGMSD, 2010.
Form B and the new OBT under MoFPED	Accountability tool to review the activities and outputs of the funds allocated from MoFPED against the LGs own work-plans. Focusing on reporting by departments.	Is very comprehensive, not fully applied yet, but evolving – Form B is potentially a significant tool, but needs to ensure that sectors are more on board and that other systems are streamlined accordingly. The system may need to be better linked with reporting on source of funding (coding for source of funding).
LOGIS+	Is a service delivery and fiscal analysis tool - general integrated monitoring tool.	Is not applied in many LGs, and incentive to use it is lacking. The support to apprehend and apply the system is lacking and the last major training event was conducted in 2007. Municipalities visited could not use the system due to lack of internalisation and support.
Sector grant reporting systems	Sector specific requirements on input and outputs.	There is need to align these with the Form B above. The idea is that the sector information should be extracted from Form B.
LGMSD reporting	Rather comprehensive on inputs, activities, output and some intermediate outcomes (e.g. number of beneficiaries) - grant specific tool.	It is grant/project specific and demanding, but provides the grant scheme with useful information about the use and impact. It will need to be aligned with Form B of MoFPED, which may cover some of the reporting needs in the future.
Project reporting	Multiple forms from various DPs/projects.	Need for mainstreaming of all these, particularly with Form B.

[76] See e.g. Kai Kaiser et al. (2009) for a review of some of the challenges.
[77] See e.g. the FDS Study, January 2001 for a review of problems that persist in the present system.

Major reporting system	Purpose	Comments
Annual assessments of LG's performance	Focuses on PFM, Governance, cross-cutting performance of LGs but has in the recent years included some sector indicators of performance.	There is a need review and refine this system, and ensure that it is focusing on the core objectives of the grants - there has been a tendency to attempt to cover all information needs in this system and there are risks of overloading the system, and derailing its original intension, see Section 4. The system can be better positioned to draw some of its data requirements from other systems, such as Form B.

Institutional arrangements

Since 2004, a system of dialogue between CG and LGs was established, spearheaded by the LG Budget Coordination Committee (LGBCC) and the Local Government Releases and Operations Committee (LGROC) for coordination of the releases and accountability/reporting as well as a LG Revenue Enhancement Coordination Committee (the latter is not active). These two committees (LGBCC and LGROC) are still in place, although the funding of operations (meetings, etc.) has been a challenge. The committees have representatives from the LGFC, MoFPED, MoLG and core LMs as well as the LG associations. The LGROC has been particularly active in the dialogue on the new reporting formats for LGs revenue and expenditure – the Form B, and the LGBCC is expected to have a core role in the coordination of the coming study on the Fiscal Decentralisation Strategy.[78] According to LGFC, the system has evolved from a system of mutual distrust between LMs and LGs, to a system where important issues are being cleared on a regular basis.

Another function of relevance for the coming USMID Project is the expected role of the LGBCC (as per its ToR) as an overseer of the **annual performance assessments** of the LGs, as a neutral control/monitoring body. This role has not yet been taken on board, as MoLG has been the sole decision-making body, but if activated, it will facilitate that the system, ensures objectivity, buy-in and ownership in the process, see Section 4. [79]

In addition to these coordination committees, a system of annual cooperation/dialogue on the grant schemes has been running from 2004, facilitated by LGFC and with representatives from the LMs and LG associations. These meetings discuss and agree on issues such as allocation criteria, reporting systems, and sector (including grant) guidelines. More recently, the technical working group under the PSMWG has been a forum for regular consultations on the LG Finance, including issues on the current and future grant system, but this has mostly been limited to a dialogue within the "sector".

[78] Draft ToR for this study, which will be an up-dated of the FDS, is under elaboration. It is expected that the study will be completed by September 2011.

[79] Experiences from committees which finally endorse and/or review assessment results can be gained from countries such as Ghana, Solomon Islands and Nepal.

Furthermore, the JBSF (JAF-0, JAF-I and the coming JAF II) has a number of indicators and issues to promote the improvement of the IGFTS such as: i) support to safeguarding the buoyancy of the core sector grants (the 5 core sectors –water, health, education, agriculture, roads/works) in terms of the salary and non-salary grants, ii) balance between the grants ensuring sufficient funds for the non-salary recurrent expenditure areas, ii) improvement of the budget cycle, iii) improving local PFM performance, iv) strengthening the reporting system and ensuring improvement of LG accountability on use of grants – to mention a few core issues captured in the monitoring matrixes. This will promote that the dialogue on the future reform of the IGFTS can proceed, despite the challenges mentioned in Section 2. A study to update the FDS study of 2001, and the FDS (2002) is under preparation, spearheaded by LGFC**.** Hence the overall framework for institutional coordination is in place, although there is room for strengthening and activation of some of the functions.

3.2 Trends in the Transfers

This sub-section reviews the trends and composition of the overall funding system in Uganda, and in particularly the trends in the intergovernmental fiscal transfers (grants). It is based on data from LGFC's data-bank (drawn on information from budget figures and releases from the MoFPED); and from the feedback on questionnaires from some of the 14 municipalities to be involved in the USMID project (see Annex 2 and annexes 3.1, 3.2 and 3.3).[80]It should be noted that particularly the data on own source revenues (OSR) should be treated with due caution. There is still a strong need to ensure a better consolidation of data on LG finance and quality assurance, particularly on the utilisation of grants (releases are often treated as spent) and on LG own source revenues. Data from various sources are often contradictory, and it is a very time-consuming process to get reliable data on source of funding and actual spending.

The brief overview, below, should be seen in conjunction with the more detailed Annex 3.1 - Overview of the Trends in Funding; Annex 3.2 – Trends in Revenues and Grants, and Annex 3.3 - Field-Findings on LG Finance.

[80] For some of the historical data, the figures are drawn from Steffensen, Tidemand and Ssewankambo (2004) and JICA, Tidemand, Steffensen and Ssewankanbo (2007)

3.2.1 Trends in the Overall LG Finance

The table below provides a brief snapshot of some of the core indicators on LG finance.

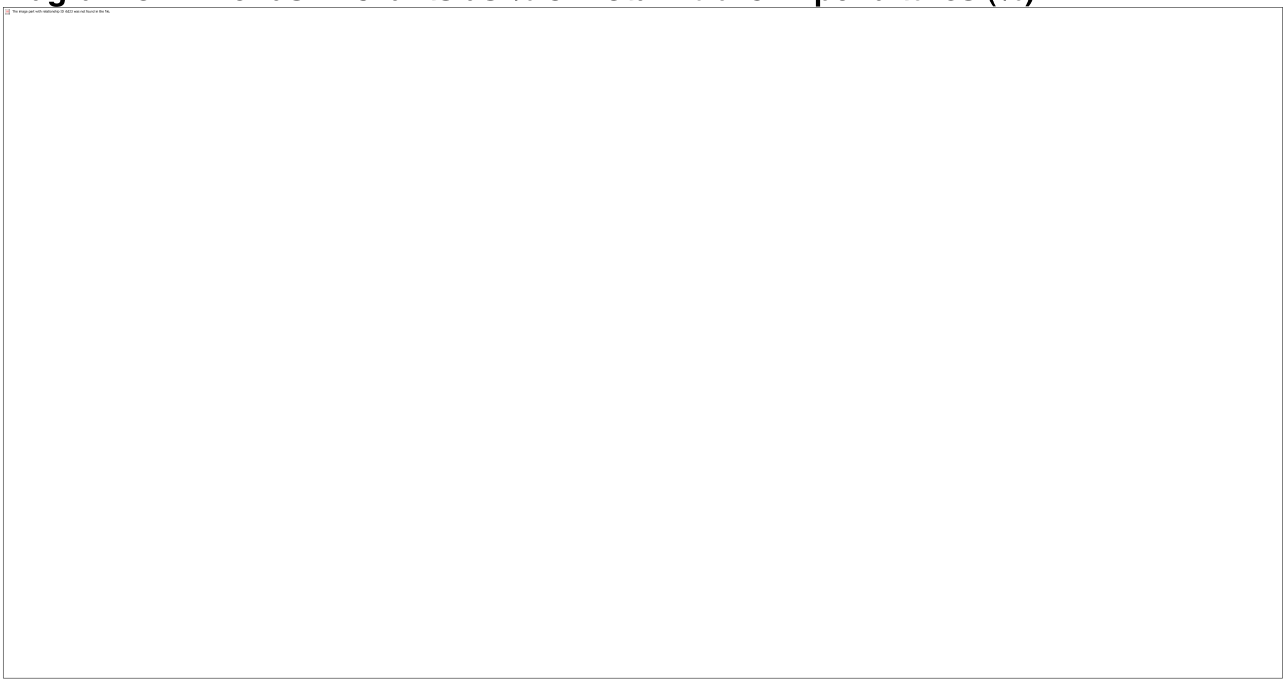
Table 3.15: Overall System of Local Government Finance In Uganda

Text	**1995/96**	**2000/01**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**	**2008/ 09**	**2009/10**	**2010/11**
Total per cap.grants (real figures) (1) UGSH				29,553	29,558	28,659	29,407	28,591	28,436	27,473	26,976
Total per cap. grants (real fig. /adj. (2) UGSH				29,175	28,480	26,190	25,599	25,485	24,102	22,627	21,937
LG grants as share of GDP (3)			5.4%	5.3%	5.0%	NA	4.8	4.4%	3.9%	3.9%	
LG share of total Public Sector Exp. (4)				27.7%	27.7%	27.2%	27.0%	25.1%	22.6%	21.3%	23.3%
UCG grants share of total grants (5)	34.5	15.8%	11.6%	11.2%	10.9%	11.2%	8.6%	11.6%	10.5%	9.7%	10.5%
Devt. grants as share of total grants (6)	0%	22%	20%	22%	19%	17%	13%	12%	13%	16%	17%
Discretionary dev. grants as share of total dev. grants (7)				37.6%	38.4%	35.4%	39.1%	35.5%	28.2%	19.6%	16.2%

Source: Annexes 3.1-3.3 based on LGFC's data-bank and Steffensen, Tidemand and Ssewankambo (2004), JICA, Tidemand, Steffensen and Ssewankambo (2008). Notes: (1): Real per capita figures, i.e. adjusted for inflation and population growth (CPI and population data from UBOS; (2) Real figures, i.e. adjusted for inflation (CPI) and population growth. Grants excl. the following funding: NAADs, increase in salary to secondary education, payment to politicians and tax compensation, these new functions are excluded to promote comparison; (3) see Annex 3.1, (4) Public Sector including all expenditures. Including donor projects, which were only included from 2003/04. (5) UCG: Excluding tax compensation. (6) All development grants as classified as this; (7) Local Development grant (LDG) as share of total development grants.

It appears from Annex 3.1 and the diagram below, that the size of the LG share of the total public revenues have declined over the past seven years, partly due to relative stagnancy in the development in the transfers of grants. This is combined with a negative trend in LGs' own source revenues, which now constitute less than half of the amount in FY 2003/04.

Diagram 3.1: Trends in Grants as % of Total Public Expenditures (%)



Source: See Annex 3.1. Developed by the author based on data from the LGFC data-bank.

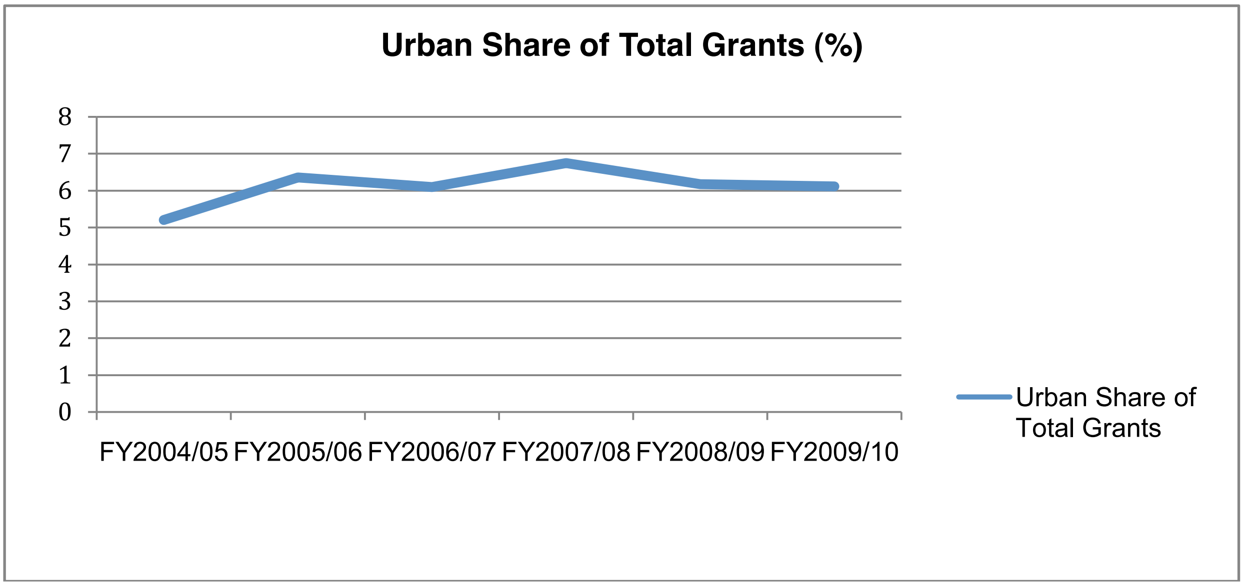
The LG grants as share of the total public revenues have declined from 24.2% (public sector interest and debt payment included) and 27.4% (excluding interest rate and debt payment) in FY 2002/03 to 20.3% and 23.3% in FY 2010/11[81].

As a percentage (%) of the total LG grants, grants to urban authorities have been relatively stable over the period from FY 2004/05-FY 2009/10 (actual figures) but are still rather low around 6%, see below. In terms of population figures, the urban authorities constituted about 14.8% in 2010 (estimates from UBOS), and this figure has increased from 12.3% in 2003.[82]

However, the picture is more balanced for the 14 municipalities, which in 2009 constituted 3.1% of the estimated population and received 4.3% of the total grants in FY 2009/10 (actual figures).[83] However, these figures do not consider the differences in the investment needs of various types of LGs and the fact that a larger number of people are using the urban facilities in the daytime, but that population figures are only applying nighttime population figures.

[81] See Annex 3.1 for further details.
[82] Based on population estimates from UBOS, Statistical Abstract, 2010 (page 96) UBOS.
[83] See Annex 3.2 and data used for the grant allocation in 2009 and 2010 (Ministry of Finance, Letter of 3rd February 2009 from PS/Secretary to the Treasury, MoFPED.

Diagram 3.2: Trends in Urban Share of the Total Grants to LGs (%)



Source: Annex 3.2: Developed by the author, based on figures from LFGF's data-bank. The grants are actual released figures.

At the same time, LGs experienced a number of cost enhancing and revenue reducing initiatives, in particular:

- Introduction of new LG staffing structures in FY 2005/06, which enhanced the costs – (only less than 65% of these are funded);
- New assignments[84] (e.g. new tasks in secondary education and within agriculture – e.g. NAADs), as you may see from the table below, the grants have been declining significantly in real figures if some of these are incorporated;
- Introduction of new LGs- districts (average costs of one districts is calculated to be in the tune of 1.2 billion), new (9) Municipalities from 2010 (average costs per new unit is estimated to be more than 0.4 billion) and town councils, and
- Abolition of some of the core LG taxes, such as graduated tax (by far the most important LG revenue source), changes in the property taxes, with a number of significant exemptions, non-conducive changes in the legal framework and practices for other revenues in market fees, user charges, etc. all insufficiently compensated by the tax compensation grants. The two new taxes – the local service tax and the local hotel tax have so far provided insignificant revenue yields[85]. The revenues from these two taxes were only in total Billion 7.0 UGSH for all types of LGs (of which municipalities generated Billion 4.3 UGSH) against an expected yield of more that 60 Billion UGSH. [86]

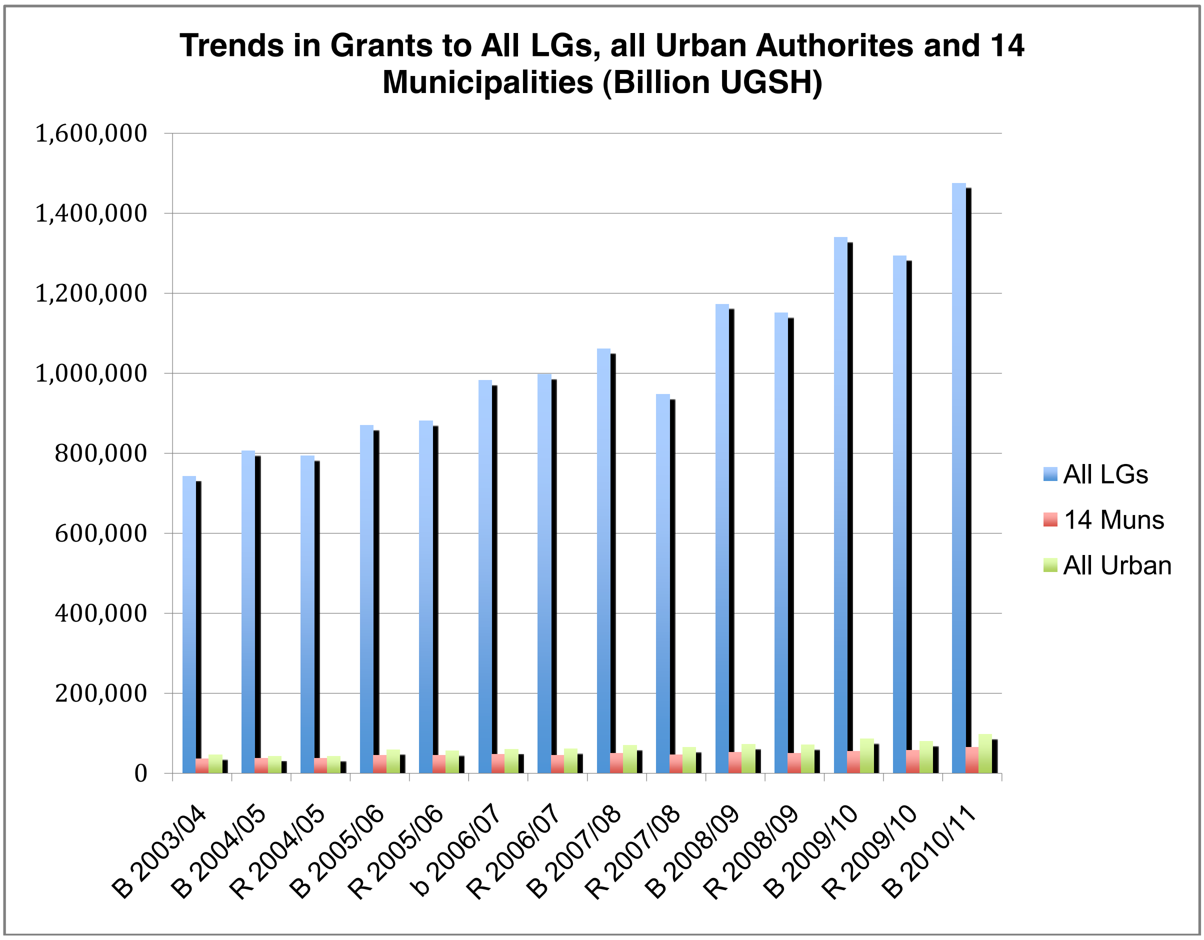
[84] Although the functions in the legal framework did not change as such, the expectations that LGs would now perform these functions have gradually increased, and new programmes introduced to support this leave some of the original tasks less funded.

[85] Local revenues despite national interventions and specific local government efforts are still registering dismal performance, contributing less than 5% to local budgets (most recent reports indicate a further drop to 3%). New taxes (Local Service Tax and Local Government Hotel Tax) were introduced in 2008 but the performance is far below expectation. Central Government is providing Graduated Tax Compensation but for a limited time (information from the LGFC, January 2011).

[86] Data from ULGA, confirmed by LGFC.

The diagram below provides further details on the trends in the grants. The diagram gives a first hand impression about the distribution of grants across LGs, and shows that by far the largest amount is provided to the rural LGs, with an insignificant amount of transfers to urban authorities.

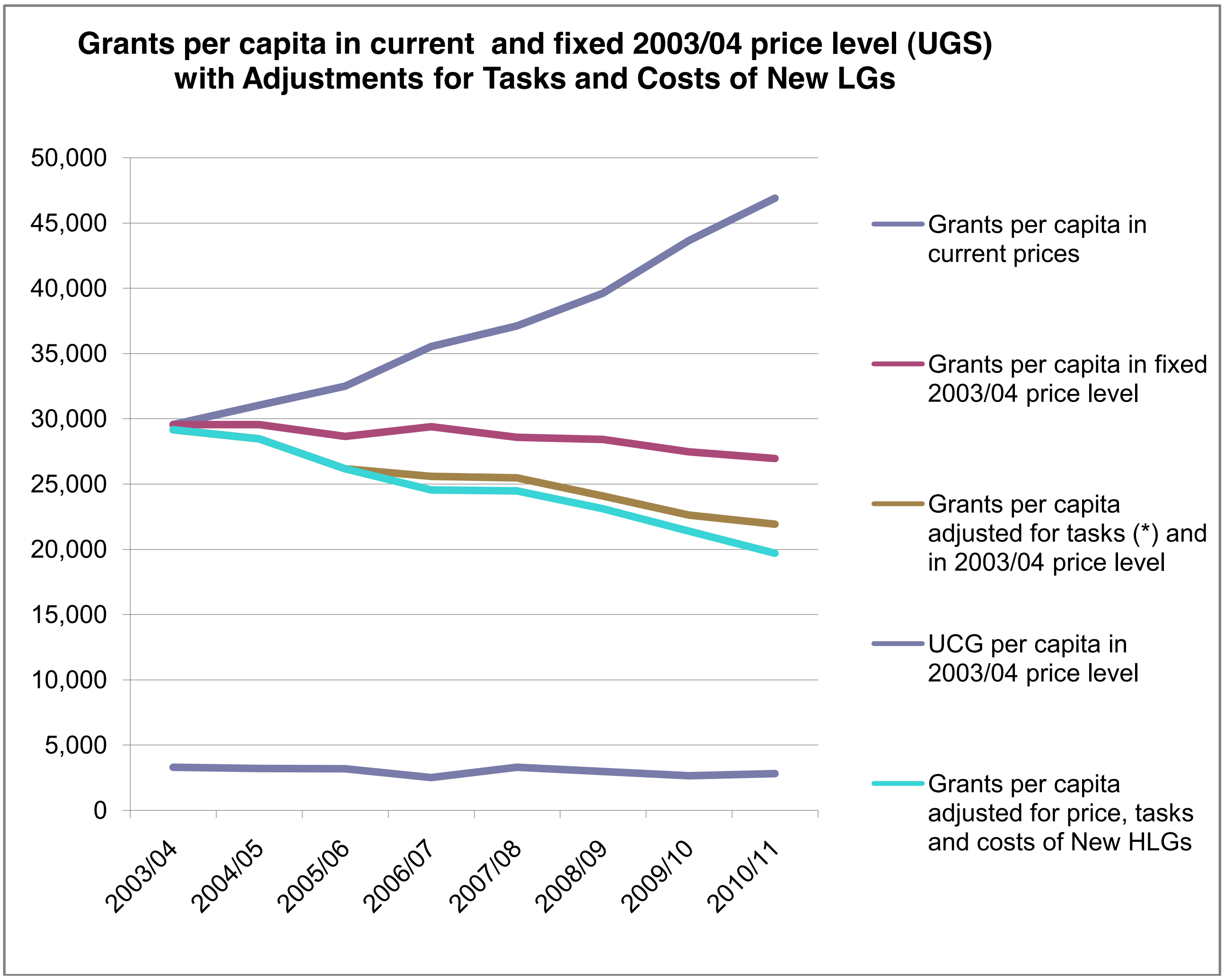
Diagram 3.3: Trends in Grants to Various Types of LGs – (Billion UGSH – Current Prices)



Source: Annex 3.2. Author of this paper based on data from LGFC's data-bank.

The chart above may give the impression of a significant increase in grants over the period from FY 2003/4 until today, but if this is adjusted for the development in: i) population growth (population in Uganda has increased from about 24 million to more than 31 million); ii) inflation rates, which in all years have been above 5%; iii) new tasks and iv) the extra costs of new administrative structures and establishment of a large number of new LGs, the picture will change completely, see below, which considers the these items one-by-one.

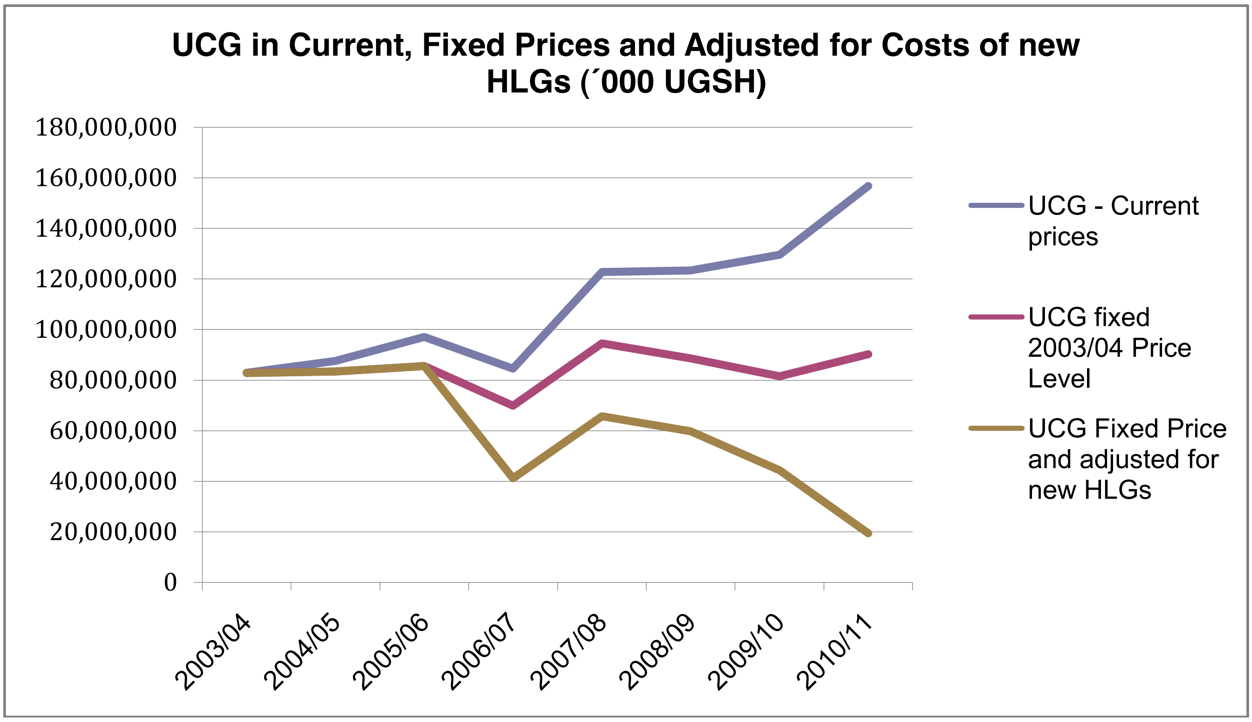
Diagram 3.4: Trends in Per Capita Grants From 2003/04 – 2010/11- Current and Fixed Price Levels (UGSH) – With and Without Adjustment for Tasks and Costs of the new HLGs



Source: The author, based on data from the LGFC data-bank, see Annex 3.1. Note: Adjustment is only made for tasks within NAADs, tax compensation, payment of politicians and increase in grants for secondary schools. Adjustments are made using the deduction of the grants allocated to these new functions to be able to compare similar functions. Adjustment of costs of new LGs (only HLG, i.e. districts and municipalities, see overview in Section 2 of the development in these) is also mad. Adjustment is made for the total grants through the reduction by the extra costs of the 24 new districts from FY 2006/07, 7 new from 2009/10 and 25 extra from FY 2010/11 (in two phases) + 9 new municipalities from FY 2010/11. Unit costs are kept fixed as estimated 1.2 billion for new districts and estimated 0.4 billion for new municipalities. The costs of these new structures compared to FY 2003/04 are deducted in the last line with the adjustment of costs of new HLGs.

The diagram below shows the trends in the UCG when adjustments are made.

Diagram 3.5: Trends in the Unconditional Grants (UCGs) in Current and Fixed 2003/04) Prices, and With and Without Adjustment for Cost of New HLGs



Source: The author based on data from the LGFC data-bank, see Annex 3.1. First line is UCG in current prices. Then the second line is adjusted for development in the price level. The third line has made adjustments due to the costs of the 24 new districts from FY 2006/07, 7 new from 2009/10 and 25 extra from FY 2010/11 (in two phases) + 9 new municipalities from FY 2010/11. Unit costs kept fixed as estimated extra costs in the tune of roughly 1.2 billion UGSH for new districts and estimated 0.4 billion for new municipalities. The costs of these new structures compared to FY 2003/04 are deducted in the last line with the adjustment of costs of new HLGs assuming that all costs of the new structures should be covered by the UCG. The payment to politicians and for tax compensation are not included in the UCG, as they are made as compensations for abolishment of tax assignments.

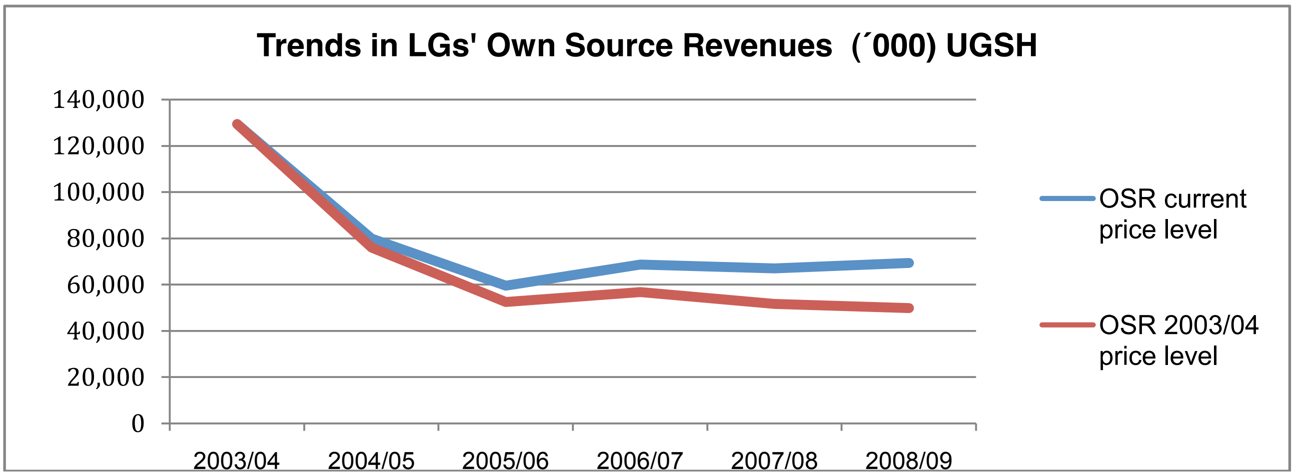
The diagrams above show that the spirit of the Constitutional requirement to adjust the grants over the time against development in prices/costs and new tasks is not adhered to. Grants have not even followed suit with the development in the growth of the population and the inflation rates, leaving alone the development of new tasks transferred to LGs, as well as the costs of the new structures and new LGs units. The estimated costs of the latter is alone for the higher level of LGs (districts and municipalities) in 2010/11 compared to FY 2003/04 in the tune of annually about Billion 71 UGHS or about half of the size of the UCG (not even including the costs of the extra town councils and sub-counties).[87]

Particularly important for the operations of the LGs core administration is the trend in unconditional grants[88], which has also declined over the period in fixed 2003/04 prices per capita from 3,300 UGSH in 2003/04 to only 2,836 UGSH in FY2010/11 (see Annex 3.1). The total grants per capita (fixed price level) have declined from UGSH 29,553 in FY 2003/04 to UGHS 26,976 in FY 2010/11 and from UGSH 29,175 to UGHS 21,937 in FY 2010/11 if new tasks such as NAADs and growth in grants to secondary schools are

[87] The estimates are based on rough estimates from LGFC on 1.2 billion UGSH per districts and about 0.4 billion UGSH per municipality for extra staff and politicians, not including all the start up costs.
[88] Figures exclude payment to politicians and the tax compensation, which were introduced due to the abolishing of various taxes.

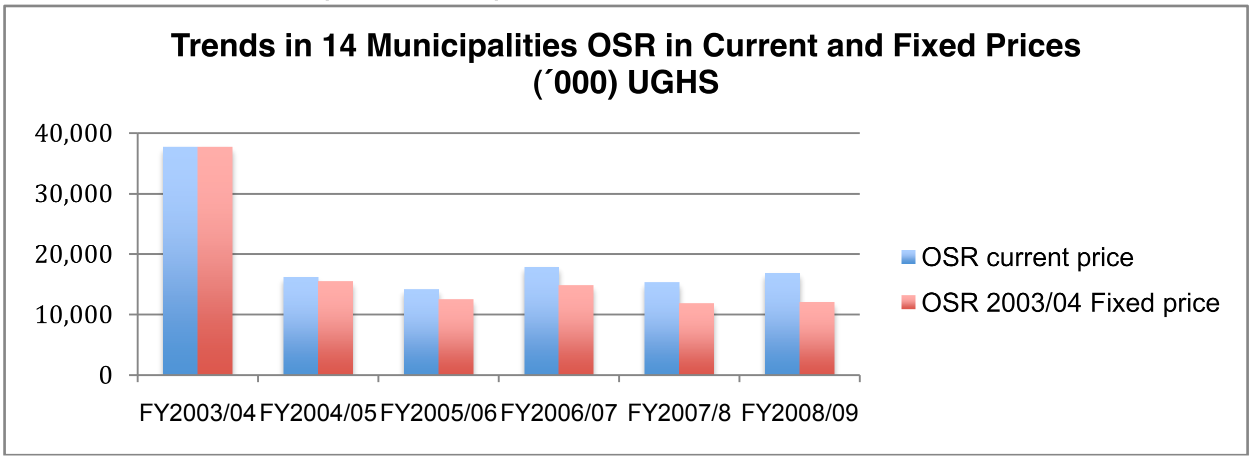
factored in.[89] Hence LGs are supposed to cover an increasing number of new tasks, in an environment of significant population growth and inflation, but with less resources at hand. These trends in the grants are combined with a significant decrease in LGs' OSR from 2003/04 and onwards. The diagram below shows the trends in total own source LG revenues from FY 2003/04 to FY 2008/09 – it is expected that the negative trend has continued, see Annex 3.2.

Diagram 3.6: Trends in total LGs' Own Source Revenues from 2003/04 – 2008/09 (´000 UGSH)



Source: The author, based on data from LGFC's data-bank, see Annex 3.2. Figures are final account figures. The data only reflects the HLG of rural LGs, the municipalities and KCC, and not the sub-counties and TCs. However, these are expected to have minor revenue after the abolishment of the G-taxes.

Diagram 3.7: Trends in 14 Municipalities Own Source Revenues – Current and Fixed 2003/04 Price Levels ('000 UGSH)



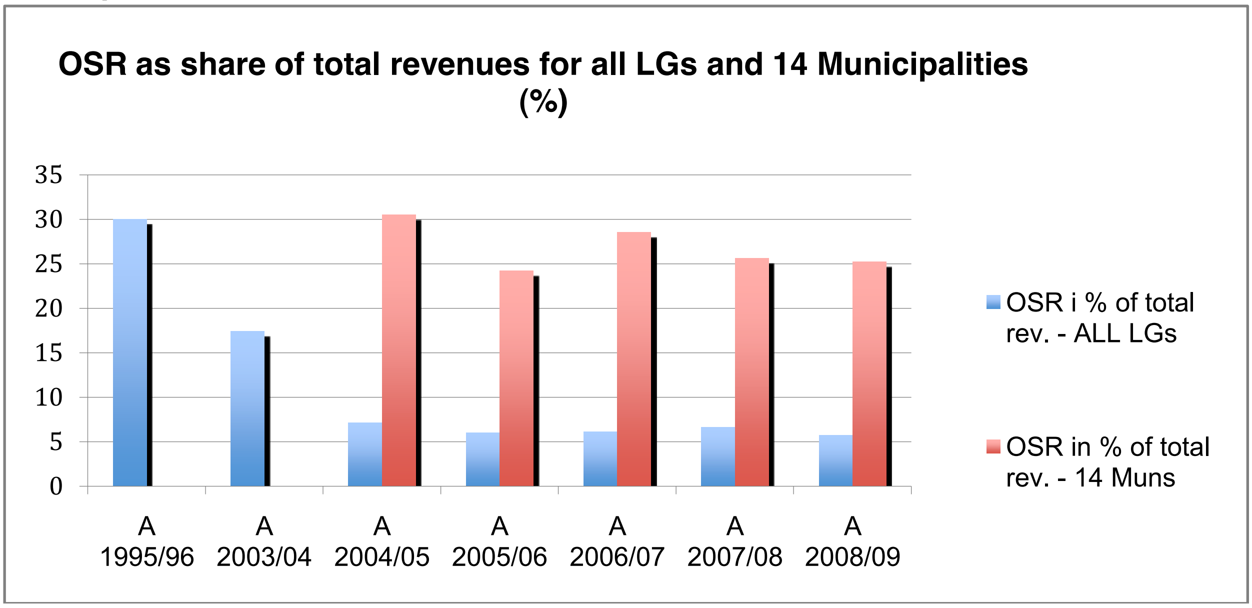
Source: The author, based on LGFC's data-bank, see Annex 3.2. Final Account figures.

Also the 14 municipalities have experienced a significant decline in OSR since 2003/04, see above. Please also refer to Annex 3.3 with specific data for each field-sample municipality.

[89] The grants exclude the payment from the road funds, which are no longer classified as grants.

In the same period, LGs have become increasingly dependant on grants, see below. This trend is reported to have continued since FY 2008/09. The OSR share of total revenues for the 14 municipalities has decreased from 30.5% in FY 2003/04 to 25.2% in FY 2008/09, see Annex 3.2 and for all LGs from 30.0% in FY 1995/06, 7.1% in FY 2003/04 to 5.7% in FY 2008/09, but is expected to have decreased significantly since then.

Diagram 3.8: OSR as share (%) of Total Revenues for all LGs and for 14 Municipalities



Source: Author, based on LGFC's data-bank, Annex 3.2(final account figures). Please also refer to Annex 3.3. with more specific data. The data-bank did not contain data for earlier years for urban authorities.

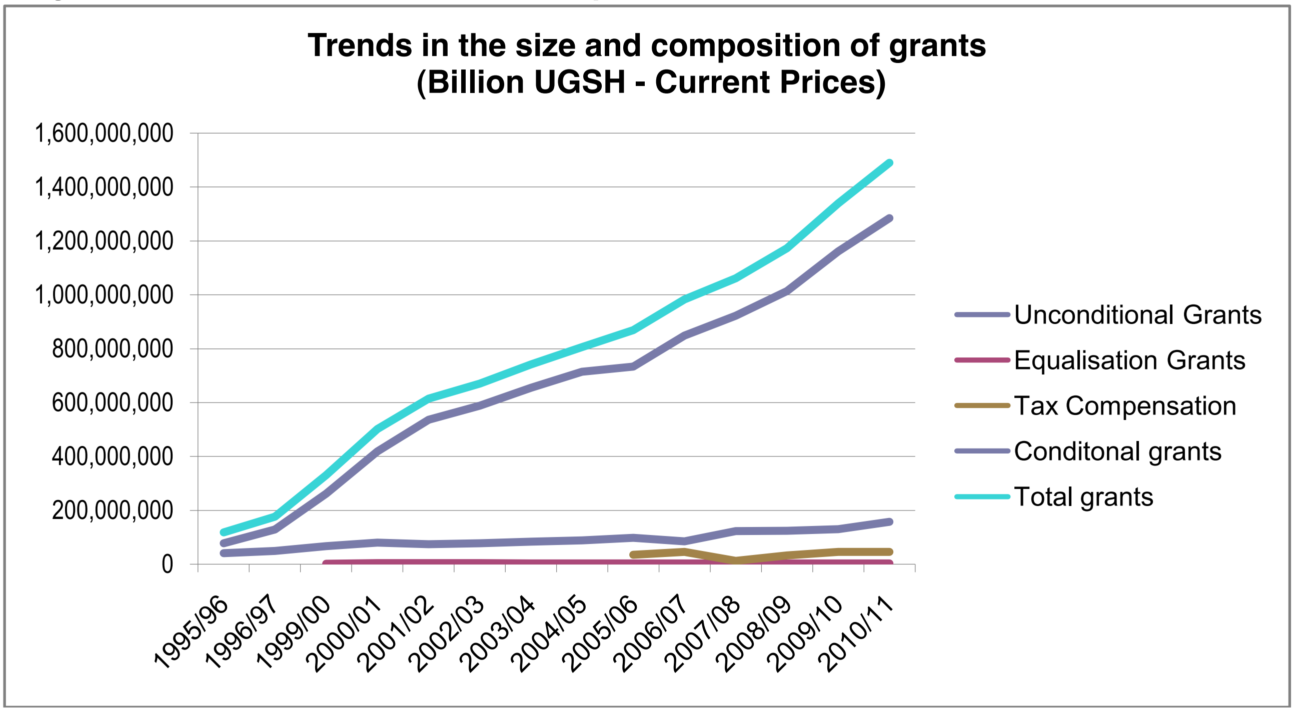
3.2.2 Trends in Composition of Grants

The composition of the grants has continued to change from 2003/04 – FY 2010/11. In previous studies from 2004, 2007 and 2010[90], it was found that there were major changes in the grant architecture, particularly around the introduction of the PAF from 1998, with introduction of a large number of conditional grants. To start with, this "reform" focused mostly on recurrent grants but over the time more development grants were introduced (see the diagram below).

The UCG and the discretionary LDG grants, which are utmost important for decentralised decision-making, local planning and priorities, constituted 11.7% and 8.9% of the total grants (for LGD this was 38% of the total development grants) respectively in FY 2003/04. These grants have continued, but their relative size has decreased to 10.5% and 4.3% of the total grants and for the LDG this is currently only 15.9% of the total development grants.

[90] See Steffensen, Tidemand and Ssewankambo (2004), Tidemand, Steffensen and Ssewankambo (2007), and ODI Steffensen (2010) for a review of the previous trends in composition of grants.

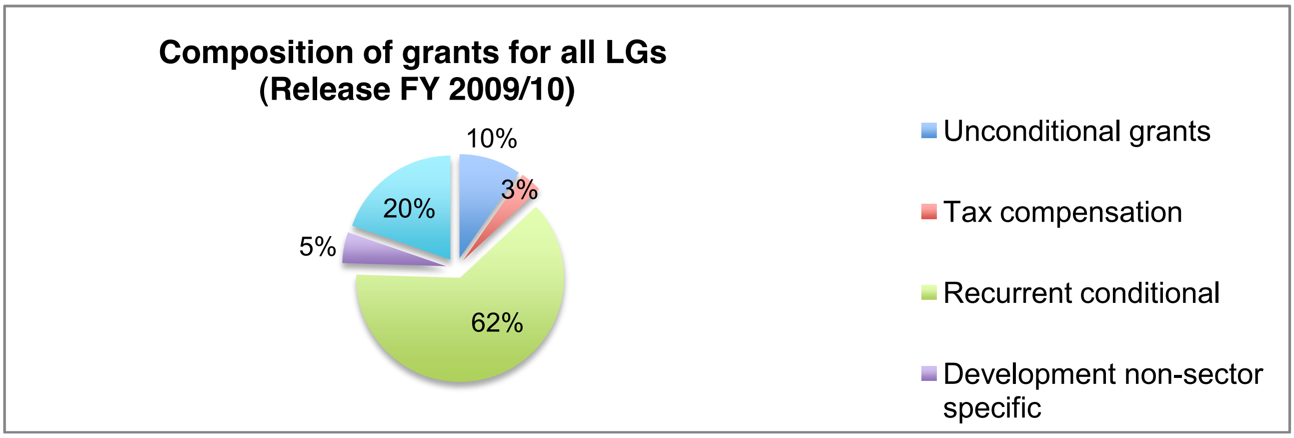
Diagram 3.9: Trends and Size and Composition of Grants to LGs (Billion UGSH)



Source: Annex 3.2. The author based on LGFC's databank. The diagram is based on final budget figures.

The diagram above shows that the crucial balance in grants has significantly changed toward a relatively stronger weight on the conditional grants against the spirit of the FDS. The unconditional grants have remained stagnant whereas conditional grants in sectors such as education, health and education have increased. The piechart below provides further information on the current composition of grants, particularly on recurrent and development components. The piechart confirms the strong feature of conditionalities.

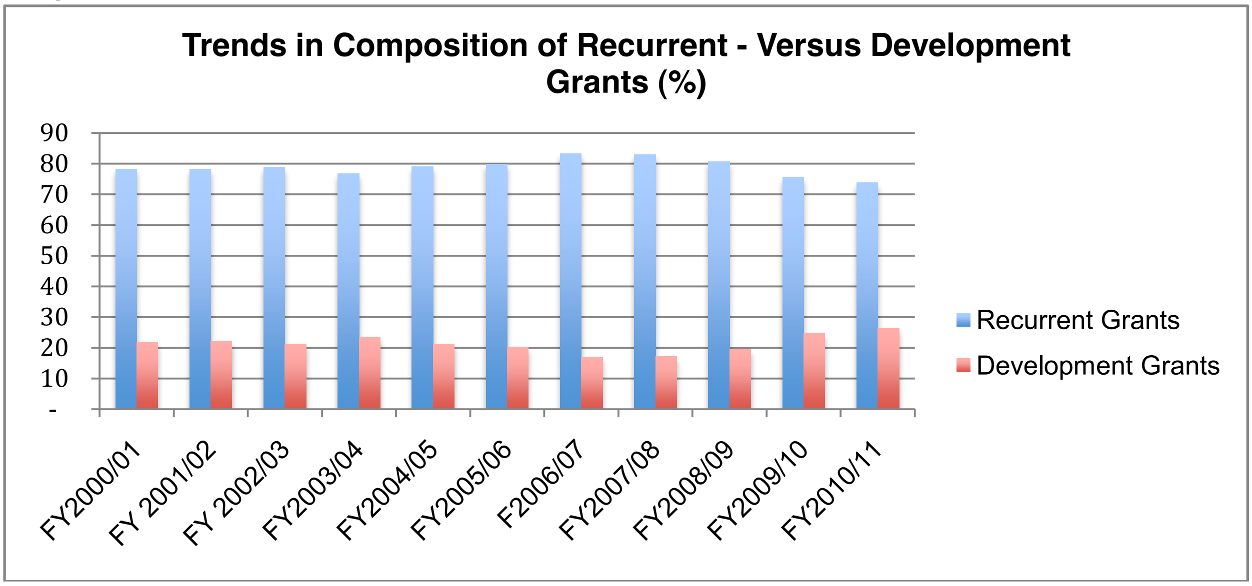
Diagram 3.10: Composition of Grants for All Local Governments – Release Figures FY 2009/10



Source: Author of the Paper, based on LGFC's data-bank. Annex 3.2 – Budget Figures. NAADs grants are classified ad development.

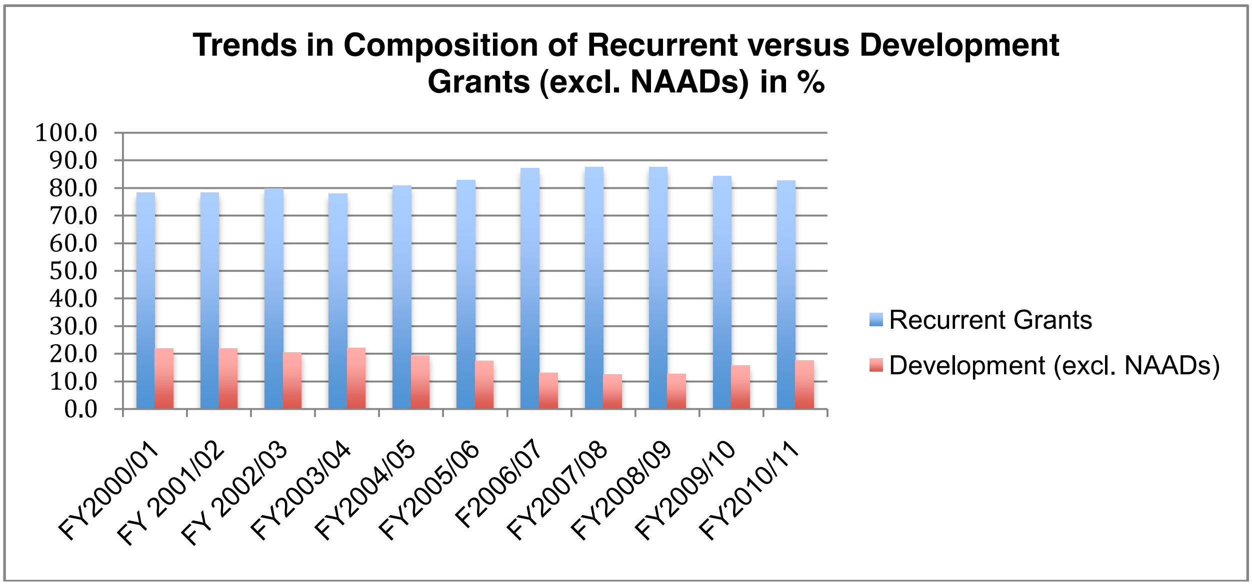
The overview of the trends in the composition of grants between recurrent and development components depends on the classification of the NAADs (see Annex 3.1. – Trends). If NAADs (which has increased tremendously in size over the past 7 years) is included, as per the tables by MoFPED under "development", the development grants have increased as a relative share of total grants, see below. However, without NAADs under development, the share of development grants has fallen, although recapped a bit the most recent years, see below.

Diagram 3.11: Trends in the Relative Share of the Development Grants (%)



Source: The author, based on LGFC's data-bank, see Annex 3.1. Budget Figures.

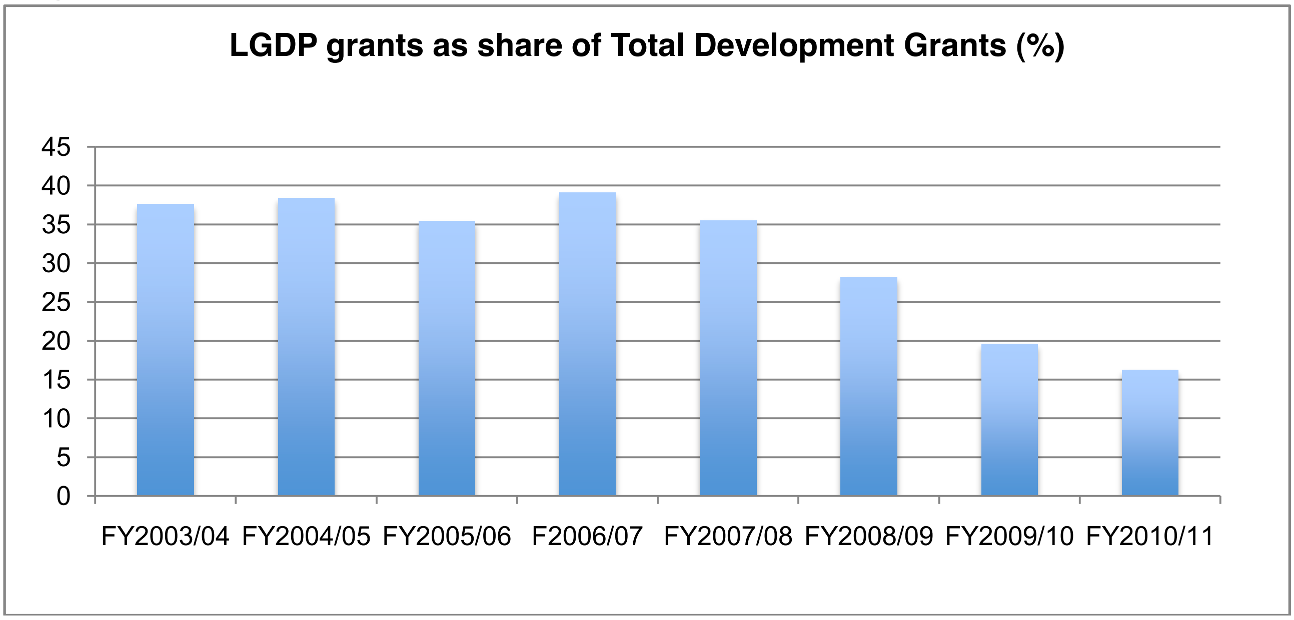
Diagram 3.12: Trends in the Relative Share of the Development Grants (%), Excl. NAADs



Source: The author, based on LGFC's data-bank, see Annex 3.1. Budget Figures.

However, the non-sectoral performance-based discretionary grants as share of the total development grants have decreased significantly, from 38% in FY 2003/04 to 16% in FY 2010/11, see below. This may impact negatively on the overall LG autonomy and the LGs' incentives provided in the system to improve performance.

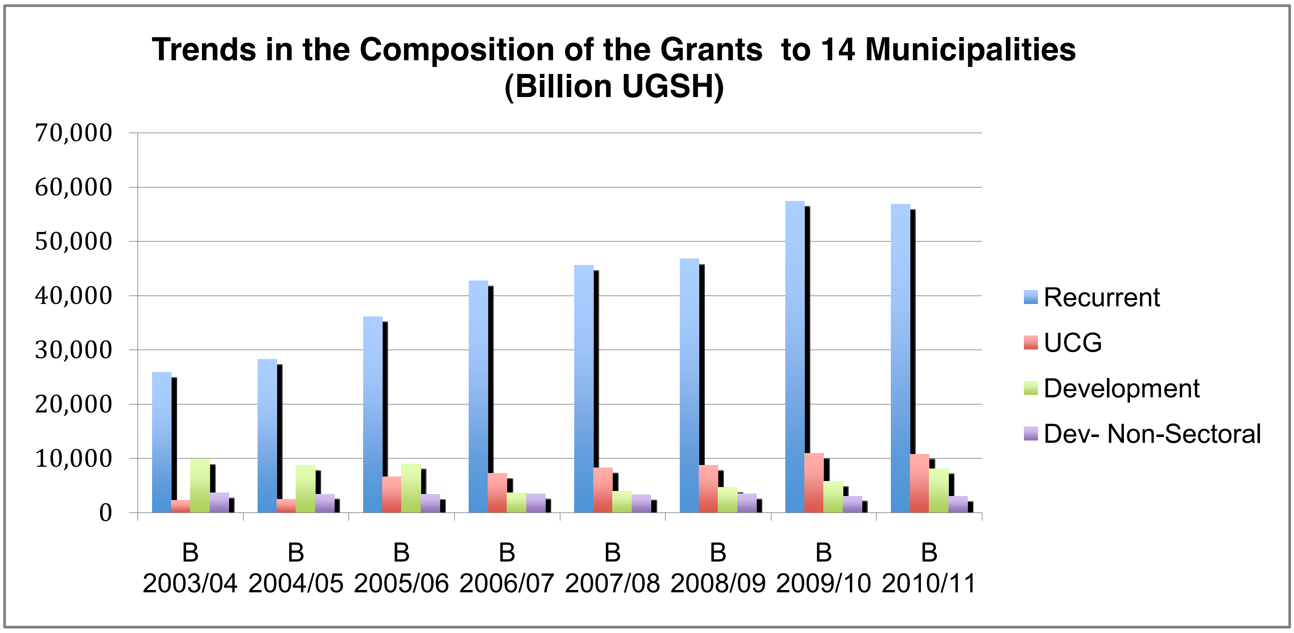
Diagram 3.13: LGD Grants as Share of Total Development Grants (%)



Source: The author, based on LGFC's data-bank, see Annex 3.1. Budget Figures.

The diagram below shows the trends in composition of grants for the 14 municipalities in the survey.

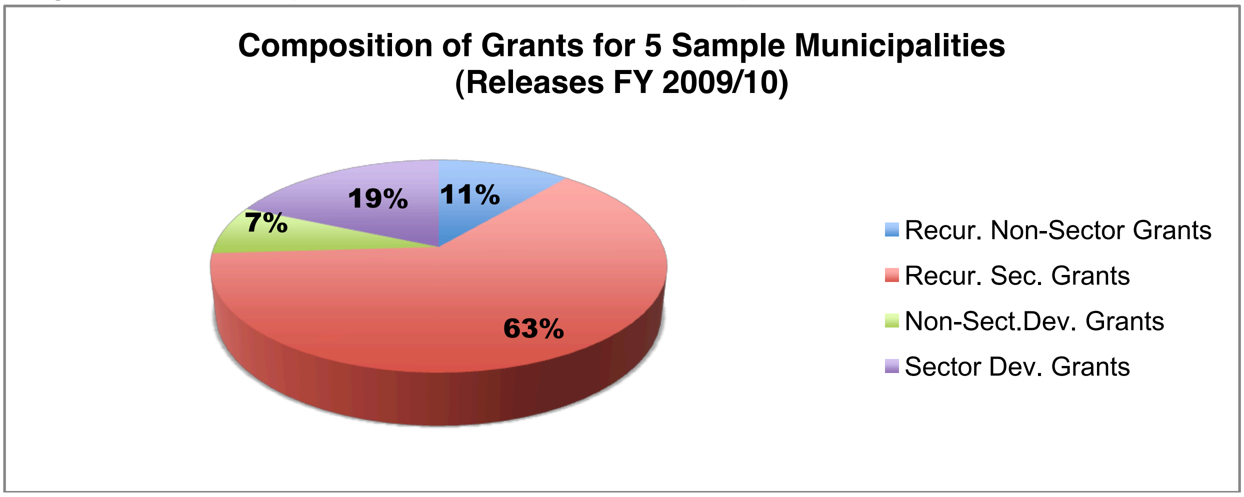
Diagram 3.14: Trends in the Composition of Grants to 14 Municipalities (B UGSH)



Source: The author, based on LGFC's data-bank, see Annex 3.2. Budget Figures.

The piechart below shows the composition of grants as per FY 2009/10 (release figures) for 5 municipalities included in the sample. It shows a strong bias towards recurrent, conditional grants.

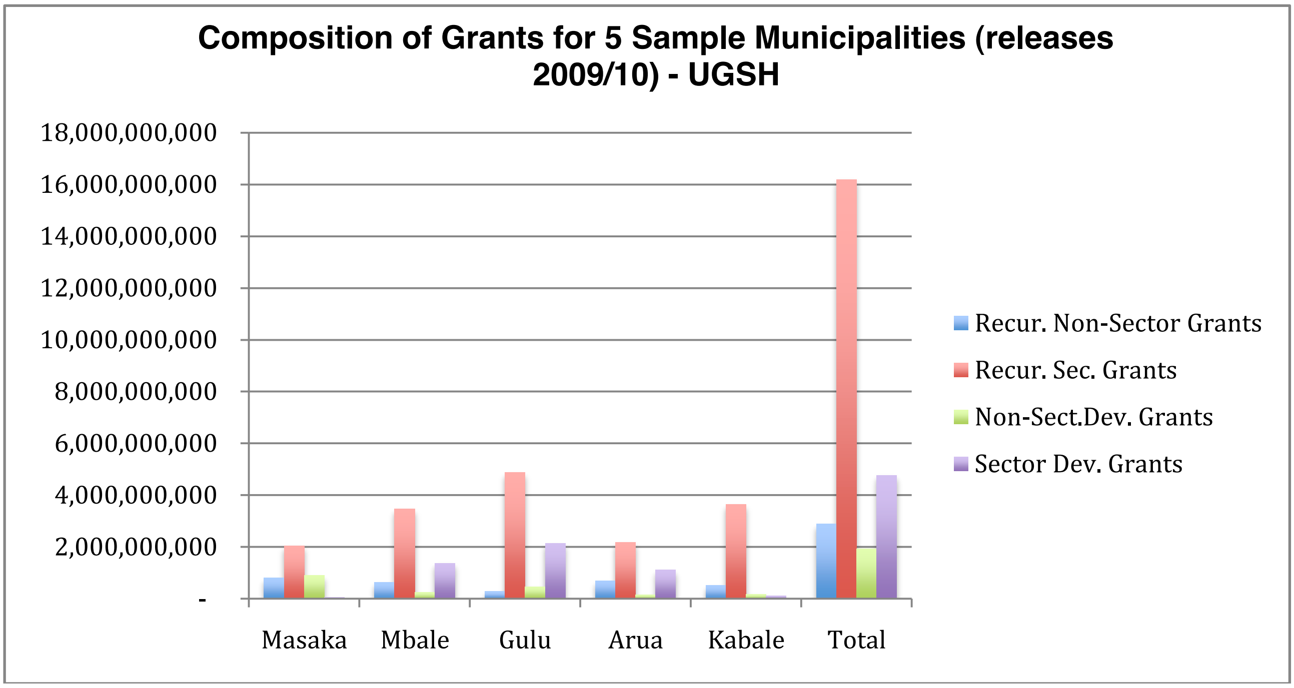
Diagram 3.15: Composition of Grants in 5 Municipalities (releases for FY 2009/10)



Source: The author, based on feedback from 5sample Municipalities- Masaka, Mbale, Gulu, Arua and Kabale, January 2011. Notes: Release data from final accounts of the Municipalities. Lira figures are from FY 2008/09. There are small variations in the break down on types of grants in the data-set from Gulu Municipality. Masaka and Kabale Municipalities' break down includes some smaller project specific transfers.

The diagram below shows the detailed break-down of the composition of grants for the 5 municipalities. The diagram confirms the general picture, that the recurrent sector grants dominates the grants, and that the non-sectoral discretionary development grants compose a smaller share of the total grants in the municipalities as well.

Diagram 3.16: Composition of Grants for 5 Sample Municipalities



Source: The author, based on feedback from 5 sample Municipalities- Masaka, Mbale, Gulu, Arua and Kabale, January 2011. Notes: Release data from final accounts of the Municipalities. Lira figures are from FY 2008/09. There are small variations in the break down on types of grants in the data-set from Gulu Municipality. Masaka and Kabale Municipalities' break down includes some smaller project specific transfers.

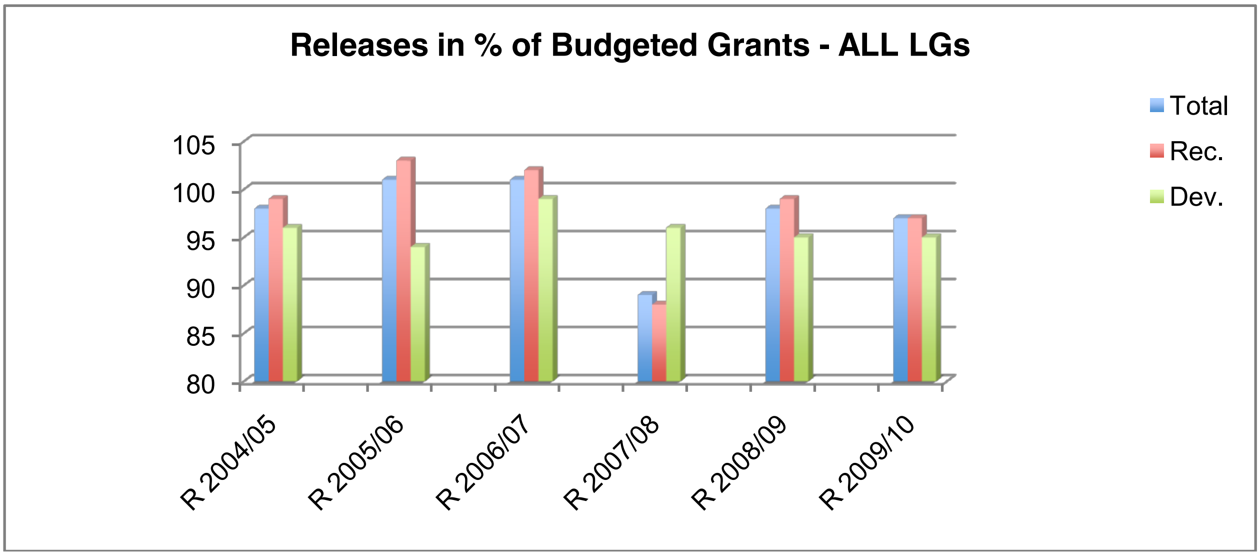
3.2.3 Budget versus Actual Releases and Absorption of Grants

Budget Versus Releases

The review also looked at the budgeted versus actual releases of funds for all LGs as well as for the sample municipalities. The diagram below shows that the actual releases are very close to the budgeted amounts over the past 6 years, and that this goes for all major types of grants (although there may be variations within the groups).

Development grants tend to be released a bit lower than originally budgeted compared to recurrent grants, although 2007/08 was an exception from this. As mentioned in Section 3.1, the LDG grants have been transferred in the tune around 95% of the budgeted amounts, and follow the general pattern for development grants. Hence the overall release performance is generally high, and in some years even above the original budget for some types of the grants.

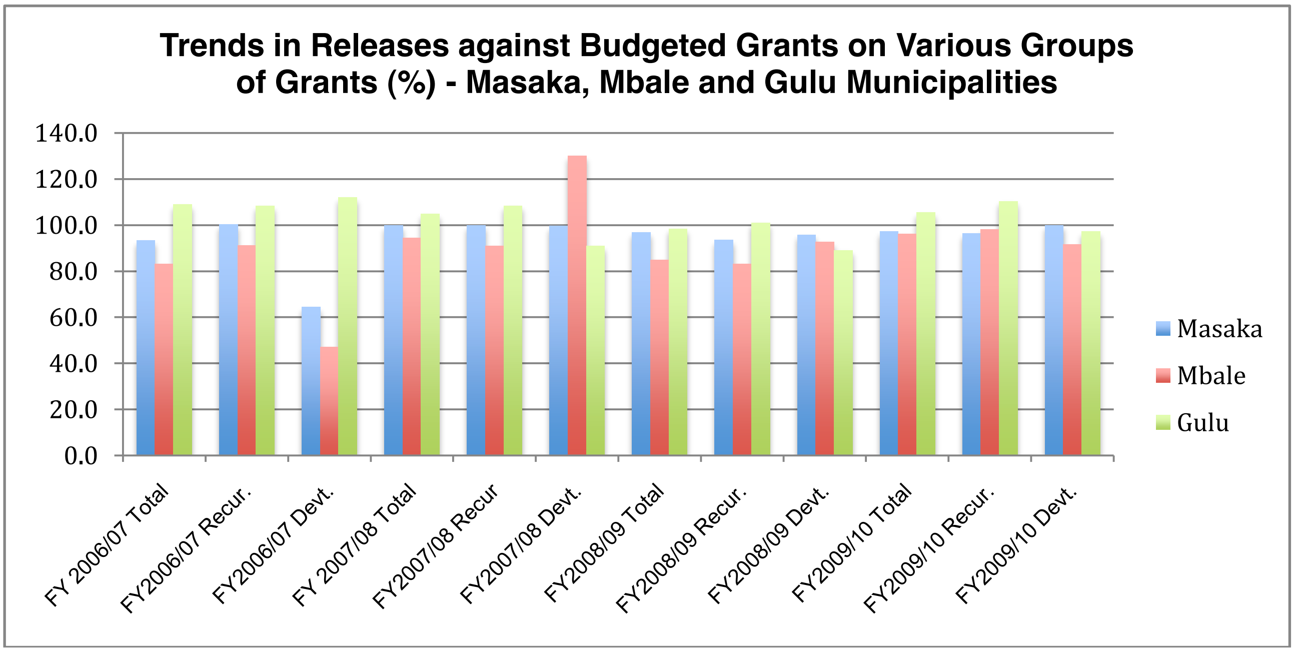
Diagram 3.17: Trends in the Releases against the Budgeted Grants for all LGs (%) FY 2003/04-FY2009/10



Source: The author based on LGFC's data-bank, see Annex 3.2.

For the municipalities visited during the fieldwork, the picture is rather similar, see below with a stable trend in the releases against budgets, however with some variations across the grants, see the diagram below. It should also be noted that the previous problem with a large number of the releases in the final part of the FY, seems still to be an area in need of improvement.

Diagram 3.18: Trends in the Release against the Budgeted amounts of Grants for Sample Municipalities (%)



Source: The Author, based on information provided by the 3 sample Municipalities in January 2011. Note: Total= total grants, Recurrent= Total recurrent grants, Devt= total development grants. See Annex 3.2 for further details.

Absorption Data

Data on utilisation of grants is generally not available on an aggregate level. The table below shows the level of utilisation of the grants in the past two FYs. Additional and more detailed data is also available from Annex 3.2 based on the submissions from the municipalities. The table shows, that although most of the previous transfers have been utilised, several municipalities have bottlenecks with the procurement process and the delays in releases, which is often partly due to delays in accountability/reporting. In a case with significant increases in the annual grants, these capacity gaps will have to be addressed. Procurement and project implementation capacity should also have a strong weight in the performance-based allocation.

Table 3.16: Municipal Absorption of Total Grants

Municipality	FY 2008/09	FY 2009/10	Reasons for challenges in the utilization
Gulu	About 90%	About 90%	Delays in procurement Delays in releases of funds
Masaka	100%	94.2%	Releases in transfers towards the end of the FY
Mbale	87%	90%	Procurement process – combination of cumbersome procedures and low capacity
Hoima	70%	NA	Delays in the procurement process Late releases
Fort Portal	85%	90%	Late releases Procurement capacity Procurement law
Lira		100%	If previous delays, then due to procurement
Kabale	100%	100%	NA
Tororo	100%	100%	NA
Arua	100%	100%	If unspent funds, these have been due to late releases and the procurement process

3.3 Issues on Future Support to the IGFTS

A quick assessment has been made of the possibilities and constraints for increasing the quantum of intergovernmental transfers to address the increasing infrastructure backlogs at the municipal level. The political environment for increase in the grants to LGs is uncertain, but will be guided by the coming major study of the entire LG funding system, agreed under the JARD 2011, and under the JBSF/JAF – budget support arrangement.

The study will be completed in September 2011, and will guide the future allocations before next budget cycle.

The existing MTEF includes some increases in the allocation of LDG to the LGs over the medium term budget framework even in the outer years, but GoU has only committed itself to the first year's increase, i.e. an increase from the existing Billion UGSH 63.3 in FY 2010/11[91] to Billion UGHS 79.45 in FY 2011/12 and following years for the performance-based LDG allocations. The allocation for the future years will depend on availability of funds and GoU priorities and the MoFED did not want to commit itself in the JAF to these subsequent increases.

Only a smaller part of these grants goes to the urban authorities, although the per capita allocation (average 1.57 USD) is a bit higher than for rural ones (average 0.84 USD), see the table from the MTR of the LGMSD, 2010. It appears that the size of the per capita allocations have decreased over the years due to increase in number of people. Secondly, the grants are not adjusted against the inflation rate.

Table 3.17: LDG releases and per capita amounts, urban and rural LGs

	2007/08	2008/09	2009/10
Municipal Councils & KCC			
- Release in UGX, '.000	7,002,615	7,109,308	6,488,388
- Population	1,933,722	2,001,402	2,071,451
- Actual allocation per capita in UGX	3,621	3,552	3,132
- Actual allocation per capita in USD	**1.81**	**1.78**	**1.57**
Districts			
- Release in UGX, '.000	49,024,428	49,131,389	49,635,284
- Population	27,593,878	28,559,664	29,559,252
- Actual allocation per capita in UGX	1,777	1,720	1,679
- Actual allocation per capita in USD	0.89	0.86	0.84

Source: MoLG/PST, MTR of the LGMSD.

The table below shows the impact of the expected increase in funds compared with the existing funding, provided that the USMID grant is using the existing allocation formula for the LDG – District Allocation, see **Annex 3.4** – Allocation Simulations for USMID funds. The table shows that the USMID project funds are significant compared to the existing municipal revenues, grants and non-sectoral grants.

[91] Note that the amount has been stable around 64 billion in the last 8 years. The intended increase was also communicated in a Letter from PS/Secretary to Treasury of October 7 2010, which provides comments to the proposed point 3.1.2. in the draft JAF-II, which mentioned that: "*Implement MTEF commitment to support LG services through enhanced Performance-Based Grants (PBGs) in 2011/12 budget[91].* The comment for MoFPED was: "*The above action is agreeable for FY2011/12 based on the UGX 79.45 Bn commitment stipulated in the FY2010/11 BFP (which provides a 20% increment on the base of the LGMSD grant to local governments. However, this figure will be maintained at 20% of the grant for all subsequent outer years so will not rise to UGX 95.34 Bn as stated in footnote 4 of the matrix (listed below). It is proposed that the footnote is revised accordingly*".

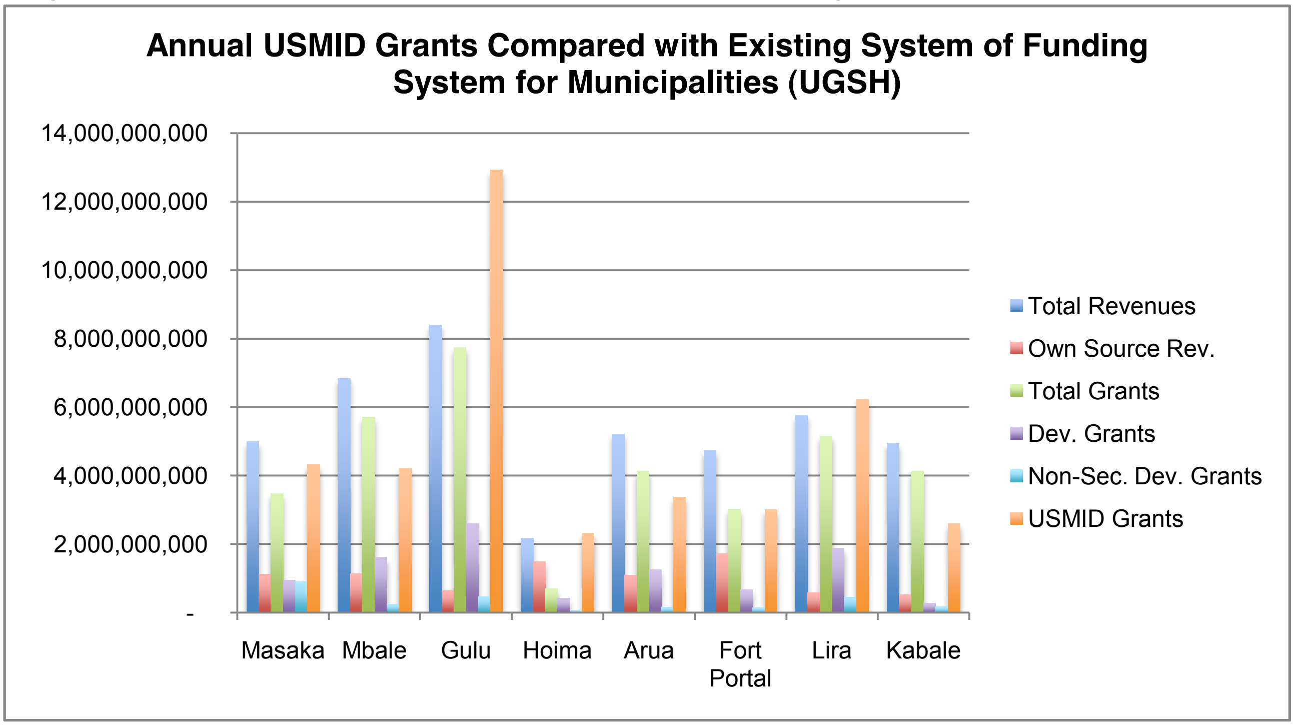
Table 3.18: Comparison of the Size of the Expected USMID Grants with the Existing IGFTS

Municipality	USMID in % of total revenues	USMID in % of total grants	USMID in % of total development grants	USMID in % of Total non-sec. dev. grants
Masaka	86	124	453	480
Mbale	61	74	261	1,711
Gulu	154	167	496	2,807
Hoima	106	334	550	4,501
Arua	65	82	268	2,255
Fort Portal	63	99	453	2,128
Lira	108	121	331	1,397
Kabale	52	63	931	1,539

Source: Based on the information on revenues and grants provided by the municipalities in January 2011. Note: Account data from 2009/10 and grant release data from FY 2009/10 is used. The allocation formula for the USMID grants is using the LDG district formula in the existing system. Re. Lira: Development and non-sectoral development grant figures are from FY 2008/09. See Annex 3.2 for further information and Annex 3.4 for the simulations of the future USMID grants.

The diagram below provides additional information on the relative size of the planned grants.

Diagram 3.19: Annual USMID Grants Compared with Existing IGFTS of Municipalities



Source: Based on the information on revenues and grants provided by the municipalities in January 2011. Note: Account data from 2009/10 and grant release data from FY 2009/10 is used. The allocation formula for the USMID grants is using the LDG district formula in the existing system. Re. Lira: Development and non-sectoral development grant figures are from FY 2008/09. See Annex 3.2 for further information and Annex 3.4 for a review of the simulations.

The USMID funds will lead to a doubling of the total municipal revenues in some cases (from 52% in Kabale to 154% in Gulu). It will also lead to between 3 to 9 times increase in the existing development grants, and a many-times increase in the amount available for discretionary funding, in a tune never experienced before at the municipal level.

However, the funds available should be compared with the costs of typical larger and lumpy urban infrastructure projects, see Annex 3.1, which are high. An urban government may typically be able to do the following with the new funds: 1) up-grade (paving) 3-4 km of roads, or 2) establish 4-5 new health centres, depending on the level of these, and cover the needs for streetlights, or 3) develop 50 classrooms (1 billion) + expand the water connections with 50 km (0.5 billion).

The planned USMID project will be a welcomed contribution for the large uncovered municipal infrastructure needs, and will be a very significant boost to the urban capital investments and urban planning and prioritisation process. However, considerations needs to be made on the possibilities to include additional project features for the sake of enhancing the capacity of the municipalities to handle this significant increase of funds, both in terms of administrative capacity as well as augmenting of additional funds to LGs for operations and maintenance. This may include considerations to allow a part of the funds to be applied for maintenance, i.e. instead of the present co-funding requirement under the LGMSD (which is currently 10%). Revenue enhancement initiatives as part of the project are equally important for longer-term sustainability of the projects, but may not be sufficient in the short term. Although the road maintenance funds have increased recently – now outside of the general grant system through the Road Maintenance funds[92] - and although a large amount of the funds are expected to be used on rehabilitation of *existing* infrastructure, particularly roads, there may be need for some new investments, which will create need for additional operational and maintenance costs. On the administrative side, there will be a need to strengthen particularly the current procurement, engineering and physical planning sections of the urban administrations, in addition to current improvements of basic financial management and internal audit[93]. Incentives should also be strengthened in the performance-based allocations to address these sustainability issues.

3.4 Overall Findings and Conclusions on the IGFTS for Urban Authorities

Main Findings

In summary, the following conclusions can be drawn from the analysis of IGFTS in Uganda:

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[92] The funds for road maintenance has increased from budgeted Billion 67,2 UGSH in 2008/09 prior to the introduction of the Road Fund to now Billion 98,5 UGSH in the FY 2010/11 (under the Road Fund).

[93] A parallel diagnostic work will focus on the needs for capacity strengthening within these areas.

Overall policy and legal framework

- The formal policy and overall legal intergovernmental fiscal framework is in place, and is supported by the new National Development Plan (2010/11-2014/15). There are plans to update the policy framework on Fiscal Decentralisation to address some of the challenges observed during the implementation of the FDS (2002), issues, which has also been brought up during the annual JARD reviews. This Section has provided a wealth of more detailed data on the core constraints in the system, which will be an important point of departure for the coming comprehensive study on up-date of the FDS, planned to be completed on September 2011;

Trends and overall size

- Overall, the revenues of LGs, including the urban authorities, are dominated by central government transfers, and this dominance has been increasing over the past seven years due to significant decreases in the LG own source revenues (nominal and in real figures);
- The **size of the grants** increased significantly in the early years of the decentralisation process, particularly with the introduction of the HIPC and the PAF in 1998, whereby the conditional grants were used as vehicles for on-budget transfers of funds for local service delivery, but this has changed over the research period from 2004/05 to 2010/11 where there has been a decline in real per capita figures;
- The **LG share** of the total public expenditures has decreased from 27.7% in FY 2003/04 to **23.3% in FY 2010/11**, but even more if the large increase in the funding of NAADs is factored in (as this is a relative new function of LGs). If the costs of the new administrative structures and the establishment of the new LGs are factored in, the decrease is even more substantial;
- The **size of the grants has also declined** when adjustments are made. Despite the "safeguards" in the Constitution, the LGs (and the municipalities) have not been fully compensated for the new tasks, the abolishment of taxes, non-conducive changes in the legal framework on OSR, and the growth in population/inflation figures over the period;
    - The real per capita allocation of grants has decreased significantly from 2003/04 to FY 2010/11 by 8.7% in real figures and by 24.8% if some of the core schemes to adjust for changes in mandates are controlled for (NAADs, tax compensation, payment of politicians, and extra costs of secondary education, which are new schemes);
    - The UCG has decreased significantly since FY 2003/04 if inflation rates and costs of new HLGs is factored in, hence the Seventh Schedule of the Constitution (1995) has been waived/re-defined;
- The data on the grant trends, shows that **urban authorities are getting a very low share** (6.5% in FY 2010/11, see Annex 3.2) of the total grants and that the overall grants have been decreasing over the past years in real per capita figures;
- At the same time, the LG tasks have increased, e.g. with the NAADs and secondary education, and there has been tremendous **extra costs from the creation of the**

new districts and the municipalities, alone these costs are expected to take up about Billion 71 UGSH compared for districts/municipalities alone, leaving Town Councils and new sub-counties alone;

- The introduction of the new administrative structures has only been financed in the tune of less than 65% of the costs, and it has been hard to fill in the staffing positions in the standard structures;
- The municipalities identified lack of funding and conditionalities in the grant utilisation as some of the core challenges in the IGFTS;

Specific urban funding issues

- The urban authorities is getting a small share of the grants, also compared to the population size of the urban versus rural segments of the population;
- Municipalities have great funding gaps in core infrastructure areas (roads, street lighting, solid waste management, drainage, health, peri-urban water supply, and classroom construction), and **very large and lumpy investment needs**. Most of the urban authorities identify a funding gap in the tune of 30-100% of the existing level of funding, and most of the typically urban investments have unit costs in the tune of between UGSH 100 million-1 billion (this is compared to the smaller rural investments under the current LGD /LGMSD which are in average tune of about UGHS 10 million), hence the existing funding systems does not suit the urban investment needs. Large funding gaps have also been documented in the draft results of studies made by the LGFC of two sectors – roads and solid waste management;
- Some grants have mixed urban and rural issues in the allocations, without specific attention to the peculiar urban needs;

Conditionality and flexibility

- The FDS reforms of the **conditional** grant system have not been implemented, and there is a need to review the entire system – the present system **allows very limited and decreasing autonomy to address local needs**, both in terms of recurrent cost areas and development investments;
- The discretionary development funding level has decreased in real figures as well as relative to other funding schemes from 2004/05 – 2010/11.
  - The UCG has decreased from about 35% of the total LG revenue in 1995/06 (the onset of the decentralisation process) to about 10-11% in the existing system;
- Most of the **UCG is fixed on payment of fixed staffing positions**, leaving very limited amount left for other activities – the current UCG does not function as a genuine discretionary UCG;
- The municipal **equalisation grants are insignificant**, thinly spread and have no tangible impact on the urban service delivery;
- The level of **discretionary development grant funding has decreased** as share of the total development funding from 38.4% in FY 2004/5 to 16.2% in FY 2010/11;

- The level of **conditionality has increased** since the FDS, and there is need to change the balance in the grants towards more discretion to promote local planning and reap the benefits of decentralisation as prescribed in the policies;

Horizontal allocations

- The reform of the horizontal allocation of funds, recommended by various studies and reviews, have not yet been implemented, partly due to resistance by line ministries;
- The LDG formula for *urban authorities* has only one criterion- the size of population - and **there is room for improvement**, keeping the formula simple and in adherence with international principles. There is also need for more discussions and sharing of information amongst stakeholders on the criteria, as most stakeholders believed that the district and urban formula was similar;
- The performancerewards and the way in which they are administered in a system with declining per capita allocations leaves room for improvement. Options to **integrate the performance component stronger and more directly** in the allocation formula should be considered, see Annex 3.5;
- There is a need to separate the urban and the rural allocations of LDG as per the other grants in Uganda such as unconditional grants and equalisation grants[94], as the rural and urban finance systems are driven by different considerations. This will also solve most of the problems identified with the "night" and "day"time population, as these problems are persistent in all the municipalities, hence if municipalities are compared with other municipalities the problem in the existing model will diminish. Second, the allocation formula-calculations should be separately from the rural formula, as well as there is a need to have special assessment indicators for urban authorities' performance (already the case, but this could be strengthened in the future model).

Predictability, releases and absorption

- A positive note is that there is a high level of resemblance between the budget and released grant figures. Most of the grants are released within +/- 5% of the budgeted amounts by the end of the FYs;
    - The discretionary development grants have been released to the tune of 95% per year since their introduction;
- Although the municipalities identify the delays and non-predictability as one of the problems in the transfer system, most delays are within 1-2 months, and part of these are often due to delays in the accountability, also caused by the previous system of demanding accountability from one quarter prior to the next release. It is

[94] This is different from e.g. Ghana where all LGs – urban and rural authorities – are included in the two main formulas – the District Development Facility and the District Assembly Common Fund with similar criteria for allocation, but similar to other countries, e.g. Nepal, which treat urban authorities separately, as they have different functions, responsibilities, expenditure needs and fiscal capacities.

expected that the new Output Budget Tool (OBT) will resolve many of these issues, and the releases are now based on the submission of last quarterly report but one;

- There are still multiple reporting requirements, but it is hoped that the Form B, supported by MoFPED can be a vehicle for coordination. There is a need to bring the line ministries stronger on board in this new system to avoid overlaps;
- The absorption capacity and use of grants is generally high amongst the sample municipalities, but there is lack of consolidated data on the use of funds for all LGs; Procurement and delays in transfer of funds are amongst the major bottlenecks to be addressed in the future system. Secondly, there is a need to strengthen the physical planning and the links to the development plans;

Own source revenues

- The **LG dependency on grants has increased** over the period;
- **LG own source revenues have continued to decline**, both in nominal and particularly in real figures over the period from 2003/04 to 2010/11, specifically due to a combination of abolishment of tax assignments and political interference, and lack of sufficient incentives and capacity to improve – the future grant system could provide strong incentives to tack the latter two issues;
- The relative share of OSR for municipalities is much higher than for rural authorities, and there is a greater potential for future improvements.

How will the USMID respond to these challenges?

- The planned USMID grants will be a **welcomed boost of municipal finance** for across the board investments in urban infrastructure. The amounts are very significant compared to the existing funding available, and will enable the municipalities to make meaningful investments to a tune not hitherto seen;
- A balance will need to be stroked between full discretion and targeting of funds towards core urban infrastructure areas;
- However, the **large amount of per capital USMID grant** (average 28 USD per capita) will call for a strong level of CB support, boosting of the municipal administrations in core positions such as procurement, engineering and physical planning – filling up the vacant positions, combined with options to ensure sufficient funds for investment servicing costs (planning, monitoring, etc.) and some rules on maintenance implications and cost recovery. The MCs on core staffing conditions have to be strengthened prior to transfer of these amounts of funds;
- In addition to this, there is need to combine the grants with **strong support and incentives for the municipalities** to tap into the area of own source revenue mobilisation. Locally raised revenues are very low compared to transfers for rural local bodies, but relatively more significant in urban local bodies. However for all types of LGs, OSR represents a declining share of total LG revenues;
- The options for increasing the GoU funded grants in the short term is perceived as relatively modest, however, MoFPED has agreed to increase the LDG by 25% from

FY 2010/11 (where the level is Billion UGSH 63.3) to FY 2011-12 (Billion UGSH 79.45 and there are expectations that the coming FDS review spearheaded by the GoU, coordinated by LGFC, will provide information to an update of the FDS and new momentum for discussions on the size and composition of grants. For core sector areas, covered by the JAF matrix, GoU has under the JBSF agreed to ensure a 3% annual increase, but this is not even following the annual growth in population size.

Recommendations

The diagnostics lead to the following general IGFTS - and project specific recommendations:

General recommendations on the IGFTS

- Ensure a system whereby the **grants follow and are commensurate with the development of tasks**, inflation rates/price level and population growth in order to not undermine LG finance over-the-time. The prescriptions in the Constitution on the adjustment of the UCG need to be followed;
- Ensure a **better balance between "earmarking" and discretion**, providing a larger share for cross-sectoral prioritisation and local planning according to local needs;
- Increase the **discretionary performance-based development grants** (both relatively to other development grants and nominally), as this level has been undermined since 2005;
- Improve on the **allocation formulas** to ensure better targeting of the objectives and adherence with good practices for allocations of grants as listed in Section 3.1;
- Ensure that the new **reporting system** - Form B - will be applied across the board as the major reporting system for LGs; and avoid double reporting/requirements from the LMs. Under this, ensure a better linkage between the existing M&E systems;
- Strengthen the storing, processing, and **consolidation of data on LG expenditure and revenues** and improve the coordination between the agencies – MoFPED, LGFC, MoLG and others. Feedback on collected materials to the various stakeholders is equally important;
- Improve on the LG revenue assignments, and strengthen the capacity and incentives of LGs to mobilise own source revenues from existing assignments;
- Ensure that the **committees** - LGBCC/LGROC - are strengthened and take up their roles in overall coordination and monitoring of the LG finance, including the monitoring and approval of the annual performance assessment results;
- Ensure that there is a real, **genuine component for unconditional gr**ants, by dividing the current UCG into a clear and transparent UCG salary component as a salary grant for LG structures and a second component of genuine UCG for LG

discretion for all activities, and ensure a system for annual adjustments of the UCG against new tasks, inflation/price changes and (if possible) population growth;
- **Review the functional assignments** in the view of the current configuration of the LGs (smaller units);
- Ensure that the **model staffing structures are updated** in the light of the new LGs, and ensure a full funding of these structures;
- Ensure that new LGs are established in accordance with the legal framework and considerations on efficiency and costs, sustainability of the funding system. A more detailed costing of the new structures and LG system needs to be the first step.

Recommendations Targeted towards the coming USMID and the LDG

- Separate the **urban and rural allocation** of LDG to ensure that they are not impacting each other;
- Improve the **allocation formulas for the LDG on urban authorities** – the new USMID should use this new improved formula for districts, which should apply the 3 criteria – i) population, ii) poverty count and iii) land and the current weighting. Future improvement, e.g. inclusions of cost index, review of weights, and other criteria should only be included after detailed review and improved (official) data;
- Ensure that the **performance results are integrated** in the formula for the urban authorities as per Annex 3.5. A review of the entire assessment manual, systems and procedures for assessments, adjustment of the scoring system, should be completed prior to the first assessment of funds with impact on grants under the USMID;
- Ensure that the **LG capacity in physical planning, procurement and engineering is strengthened**, both through CB support and MCs/PMs in the future annual assessment system;
- Strengthen the **incentives** for project implementation and operational/maintenance in the new funding system, see Section 2 – the new grants may adjust the MC on co-funding (10%) towards a system whereby a minimum LG funding level (or capacity) for operations/maintenance is guaranteed, to improve the sustainability of the future investments – e.g. no street lighting without evidence that O/M costs can be met;
- Ensure that the new USMID supported grant has a clearly defined multi-sectoral **investment menu** targeting urban infrastructure (roads, drainage, solid waste management, etc.), responding the to core functional mandates of the urban authorities;
- Provide support to physical planning, planning for operational and maintenance implications of investments and improved links between plans and budgets, through CB-support, mentoring and strengthening of the incentives in the annual assessments.

4. Review of the Current LG Assessment System

4.1 Introduction

The PerformanceBased Grant Allocation system (PBGS) with the non-sectoral local development grants and capacity building support was piloted in Uganda under the DDP-Pilot in the late 1990s and rolled-out countrywide under the LGDP-I and LGDP-II[95]. The performance assessment is annually conducted and has been institutionalized as a GoU process. The objectives of the assessment are summarized in text box 4.1 below.

Text box 4.1: Objectives of the Assessment of Minimum Conditions and Performance Measures[96]

a) Verify compliance of the Local Governments to the provisions of the laws and national guidelines especially the Local Government Act 1997, Finance and Accounting Regulations 1998 and Tendering and Procurement Rules and Regulations 2000;
b) Determine the LGs that have the capacity to manage discretionary development funds and therefore eligible to access the Local Development Grant (LDG) under LGMSD;
c) Provide incentives for LG performance through rewarding good and sanctioning poor performance by Local Governments;
d) Assist the Local Governments to identify functional capacity gaps and needs. The assessment is a major input in the development of an appropriate capacity building plan;
e) To promote good practice in administration and service delivery at the LGs by linking all central government transfers to LG performance;
f) Encourage local governments to adhere to national sector specific targets and standards by incorporating local government performance on these targets in the reward/penalty scheme of the LGMSD; and
g) Enhance downwards accountability and closer coordination and integration of development activities at the local government level.

The main features of the LG performance assessment system in Uganda[97] are:

a) All levels of LGs are being assessed because they are eligible to receive the Local Development Grant (LDG) and Capacity Building Grant (CBG);
b) It has both Minimum Conditions (MCs) and Performance Measures (PMs). The MCs are basic requirements that provide the safeguards to ensure the proper utilisation of funds,which the LGs must fulfil in order to access the grants.On the other hand, the PMs which are assessed in retrospect allow a more gradual measurement/"scoring" of the LGs performance and adjustment of the grants against this performance in order to ensure strong incentives for the LGs to continuously improve performance in the administration of service delivery and resource management;
c) It is "*multi-sectoral*", aimed at improving the overall generic institutional and organisational performance of local government (LGs);

[95] Please refer to ODI, Steffensen (2010) for a detailed review of the experiences with this piloting and roll-out.
[96] The Assessment Manual of Minimum Conditions and Performance Measures for Local Governments, September 2010.
[97] Please refer to UNCDF, "Performance-Based Grants, Concept and International Experience" Steffensen (2010) for a detailed review of the experiences with performance-based systems in 15 countries. Uganda was the first country to introduce this system, but other countries have moved fast in developing "second" and "third" generations of the system.

d) The indicators assessed mainly focus on the generic/institutional areas of benefit for all sector areas – (and not sector specific performance/outcomes) and are both quantitative (e.g. development in own source revenues) as well as qualitative (e.g. process oriented indicators like whether the planning and budgeting processes have been participatory or not);
e) The indicators are derived from the existing statutory requirements/legal framework as well as guidelines and also consider good institutional performance, good governance and accountability not yet stipulated in legal framework but seen as important areas of performance.

Based on the responses from the Municipal Councils, the LG performance assessment system, and its objectives, is appreciated as being relevant to municipalities, seen as fair, neutral and professional with mechanisms for identification of capacity building gaps as well as incentives to improve performance as depicted in Table 4.2, below. Only one of the 9 municipalities that responded did not find that the performance assessment had an impact on the incentives. It is generally accepted by both local and central government representatives, that the system provides good incentives to improve performance within core institutional areas, and that the system, despite the structural challenges mentioned in Section 2, has kept the LG officials and politicians on track in troubled times. It has also been a strong learning tool, as expressed by the Development Planner in one of the municipalities: "*When I came to the Municipality, the LG Assessment Manual made me clear upon my duties and responsibilities and provided incentives to improve my performance*".

Table 4.1 Municipalities Perceptions of the LG Performance Assessment

Municipal Council	Fair and neutral	Professional	Timely	Relevant to Municipalities	Incentives to improve	Identify CB gaps
Arua	No	No	No	No (Targets districts)	No	No
Fort Portal	Yes	Not in all areas	No	Yes	Yes	Yes
Gulu	Yes	Yes	No	Yes	Yes	Yes
Kabale	Yes	Yes	Yes	Yes	Yes	Yes
Lira	Yes	Yes	Generally	Yes	Yes	Yes
Masaka	Yes	Fairly, Yes	Yes,	Yes	Yes	Yes
Mbale	Yes	Yes	Yes,	Yes	Yes	Yes
Tororo	Yes	Yes	No	Yes	Yes	NA
Hoima	Yes	Yes	Yes	Yes	Yes	Yes

Source: Questionnaires submitted by the respective Municipal Councils

The foregoing positive perception notwithstanding, the LG performance assessment also has a number of areas (systemic and operational) that can be improved to make it a robust and more effective system. The following sections discuss the assessment process, the indicators, and the administration of rewards whilst identifying the strengths as well as areas that need improvement, particularly when linked with the major increase in funding to urban authorities from the USMID project.

4.2 Analysis of the Assessment Process

The first phase of the annual assessment process is the **internal assessment** by the districts and municipalities of their sub-counties and town councils as well as their divisions to identify the level of compliance with the Minimum Conditions and the results on Performance Measures. The process involves among others: composition and orientation of the multi-disciplinary internal assessment teams; distribution of the assessment manual; internal assessment supposed to be conducted one month before the national assessment; and preparation of the internal assessment reports. HLGs have pertinent roles in monitoring and mentoring of LLGs. Hence, the discussion and use of internal assessment results by the districts and municipalities as a basis for mentoring the respective lower local governments to improve their performance as they prepare for the national assessment should be further consolidated. The internal assessment should therefore not only be conducted one month before the national assessment but rather be a continuous process.

The internal assessment is followed by the **national assessment,** which involves the steps that are elaborated below.

Timing of the national assessment: The national assessment is supposed to be conducted in July and August but is often conducted in November and December. The rationale for the timing was in harmony with the planning and budgeting cycle and intended to allow for incorporation of LDG allocations (including rewards and penalties) in the Mid-term Expenditure Framework (MTEF) and the first announcement of IPFs for planning purpose. However, given the fact that the IPFs are changed several times from the first announcement in November/December during the national budget workshops, typically in both April and June, the delayed assessment has minor implications to the issuance of firm IPFs. However, as the LGs are supposed to submit their Local Government Budget Framework Papers on January 15 every year, it is prudent to ensure that the results are available to fit into this submission to ensure that the planning is based on the best possible estimates on available funding.

Composition and orientation of the National Assessment Team (NAT): The NAT is a multi-disciplinary team representing expertise in: finance management; planning; administration; and crosscutting issues. The NAT is supposed to be drawn from Ministry of Local Government (MoLG), Local Governments (LGs), line ministries, Government Agencies, the private sector, donors and NGOs. However, in reality the current NAT is composed mostly of only representatives from central and LGs drawn from the national resource pool of trained experts. The NAT is oriented in Kampala (centrally) for two days on the manual and reporting before conducting the assessment. In the years preceding 2010, a private and independent quality assurance team was being commissioned to ensure that the NAT adheres to the prescribed procedures. In 2010, because of financial constraints, the quality control function was performed by Commissioners and Assistant Commissioners from the MoLG, hence internally by the MoLG itself.

The areas that need to be improved regarding the composition and orientation of the NAT include: ensuring that the NAT is composed of individuals who not only possess the required knowledge and skills, but who are also neutral actors in the process of assessments. It would also be prudent to elaborate and publicize the criteria that should be used for selecting a person to be a member of the NAT and ensuring that it is followed to maintain the objectivity and integrity of the system; and maintaining and strengthening the quality control function with an independent, competent and objective team. When QA is done by the same institution/agency, which is in charge of the assessment and by colleagues, the principles of neutrality in the assessments may be questioned. A clear system and transparent system of reconciliation between the original assessments and the QA work also needs to be developed.

Conduct of the national assessment: The process of conducting the national assessment involves: an introductory meeting to discuss and agree on the modus operandi and the programme that will be followed; reviewing the results of the internal district/municipal assessment and sample of lower local governments[98]; assessment and debriefing of the district/municipal on the assessment results including performance status per indicator, general strengths and weaknesses but not decision on qualification. There were concerns that the amount of time spent in a particular local government (varying depending on size of the district but normally two days per municipality) is insufficient considering the large number of performance measures. However, it is our view that the amount of time spent in a LG should not be increased per se but rather some of the indicators currently assessed from the LGs could be captured from secondary data, and that the overall number of indicators may be reduced somehow through a stronger prioritisation.

Report compilation and approval: The report compilation and approval process involves: preparation and submission to MoLG of district specific reports by the NAT; preparation of the synthesis report by the secretariat at the MoLG; discussion of the report by Senior Management of MoLG discerning policy issues and later to approve the report. To improve the authenticity and use of the assessment results, there is need to discuss the results of the LG performance assessment beyond the MoLG. One of the options is to have the results discussed by the LG Releases and Operations Committee (chaired by MoFPED) as provided for in the Assessment Manual or by the LG Budget Coordination Committee. It is also the practice in many other countries, such as Ghana, Nepal, Kenya, Solomon Islands and Bangladesh, that a committee with a broad group of stakeholders scrutinises and monitors the system to ensure buy in, ownership, neutrality and credibility.

Grace period: In order for an LG to have access to the LDG, it should meet all the minimum conditions. If the minimum conditions are not met during the national assessment, the LG are given a time limit (grace period) of one month. The challenges with the grace period include: the results are submitted to the MoLG and are not verified as stated in the Assessment Manual; the time-limit in the grace period is not always kept, and since after the grace period most of the LGs meet all the MCs, it implies that some of the requirements may be 'stage managed'. An associated challenge is the waivers often given to the LGs not meeting the MCs as manifested by all LGs receiving the grants in the previous two FYs. The reasons given by MoLG is that the practice for assessing the MCs has been strengthened, since 2007/08, and that additional requirements to meet the MCs have been introduced, leading to waivers in the interim period. But the basic system and

[98] In Municipal Councils, all Divisions are assessed.

experiences from the PBGS is that waivers may easily lead to less trust in the overall system, less transparency and in the end a reduction in the incentives the system was supposed to provide. Since this practice may destroy the incentive, it is proposed that the grace period be removed. Instead the minimum conditions should be kept as basic safeguards to ensure capacity to handle discretionary development funds (and not mixed with general performance of LGs) and communicated well in advance.

Dissemination of the results and feedback: The LG performance assessment results are disseminated at district level. To stimulate action and make greater impact, there is need to widely publicize these results including the implications on the size of grants, for example in newspapers[99]. Secondly, regional workshops could be held to give the local governments an opportunity to compare notes regarding their respective performance, as well as using the Joint Annual Review (JARD) of Decentralisation, to publish the results in a wider forum. Currently everything is done by one agency including selection of the assessment team, QA and approval of the results, information on allocation, etc. – quite different from the system practices in many other countries.

Funding of the Assessment: The performance assessment was previously funded under the LGDP I and LGDP II. After the end of LGDP II, the assessment was funded by the DPs under the LGSIP basket (2007, 2008 and 2009). The LGSIP Basket stopped in 2010 and the assessment for 2010 was co-financed by Danida. Since the future funding of the assessment is not certain, various ways and means to reduce the costs have been discussed. It has been explored whether there is a possibility of complementing the independent national assessment team with the use of secondary data for the assessment. Such secondary data could be obtained from routine LG inspections, sector MIS, audit reports as well as other M&E systems. This would lead to both cost effectiveness as well as integration of sector ministries in the process[100]. However for certain indicators there is still a need to verify the indicators on the spot. Another measure is to reduce the number of people in the assessment team. This year the number was reduced from 6 to 4, and 3-4 people should be the maximum number, also considering the international experiences from various assessments, see Annex 4 for a review of the pros and cons of various assessment methods. The critical issue is to ensure a high level of credibility, professionalism, transparency and quality assurance, and at the same time provide this in a cost-effective manner. It is recommend that further review of the process and the cost of this – over the years – where various systems have been applied, is undertaken prior to the final decision on the future system is made.

4.3 Analysis of the Indicators

A comprehensive Assessment Manual (AM) was developed from the onset of the PBGS in Uganda, and this is being used to guide the assessment exercises. It has been slightly changed over the years since the first Manual with nation-wide application was introduced

[99] This has been a powerful measure in other countries such as Ghana and Nepal where it has created debate on how to improve performance. It was also a measure during the LGDP I and II.
[100] Technical Assessment of the LGMSD Programme – Input to the Mid-Term Review, Final Report, November 26, 2010, page 12.

in 2003[101]. Most of the indicators in the AM are derived from the existing laws and guidelines. In addition, the performance assessment has been broadened to cover sector issues related to local governments' operations, whereby sector indicators were included with input from the respective ministries. Since 2007 there has been no major revision to the Assessment Manual but some indicators have been added to address policy changes and ensure linkage to other CG oversight institution findings. The indicators are generally appropriate, compared to the objectives of the system to improve institutional performance, (and as it is targeting a non-sectoral grant), first and foremost of generic nature, and most indicators are still focusing on cross-sectoral performance areas. The areas where the assessment manual and indicators could be strengthened include:

a. Maintaining MCs with the purpose of ensuring that sufficient safeguards are in place to handle and absorb the funds efficiently. The examples of MCs in the current AM that are beyond safeguards include: *establishing whether the annual financial statements conform to the prescribed formats in the LG financial and accounting Manual 2007; The annual financial statements are; balance sheet, statement of revenue and expenditure, statement of cash flow and trial balance.* The complexity of preparation of the statement of cash flow and trial balance led to the poor performance of most of the LGs in 2008 (probably the worst ever) and led to some subsequent waivers in the MCs. The demands in the MCs should be reduced, combined with 100% adherence to these without waivers.

b. Inform the LGs of the revisions to the indicators in time and provide support to the LGs to meet the requirements of the new indicators. The indicators, which have been regularly introduced, have not been communicated well in advance to LGs and examples where LGs were not sufficiently supported include:*performance of the LG on LOGICS M&E system in 2010*. This indicator was not assessed in the previous two years and hence LGs were not prepared for the assessment in 2010.

c. Include indicators where LGs have control on their attainment. Examples of indicators where LGs have limited control include: *overall P.7 pass rate -%age in the previous FY for Government Aided primary schools*. Some of the key challenges regarding such indicators are:the question of attribution, as LGs can often legitimately claim that despite being their mandate, such outcomes are not entirely under their direct control, but influenced by other (external) factors; and that such outcomes are often only to be observed after several years of operation, fitting poorly with the annual assessment cycle and the incentives to be provided. Furthermore, it may lead the LGs to focus only on a few sectors, leaving other sectors without intension.Instead, efforts to improve the quality of education, for example reducing teacher absenteeism, strengthening monitoring, etc. could be assessed. Please refer to <u>Annex 5</u> for a discussion of the

[101] Both the DDP-Pilot from 1997-2000 and the LGDP I from 2000-2003 had assessment manuals as well, but this was refined during the LGDP-II preparation and a new tool was introduced from 2003/04.

focus of the future assessment system and the reasons why a multi-sectoral PBGS is typically focusing on the cross-sectoral performance areas and not short-term outputs.

d. Ensuring that indicators can be met by all LGs if they "put strong efforts in place" (level playing field). Some of the indicators that are difficult to meet by poor LGs include: *% of locally raised revenue on the total actual revenue received in the previous FY.* Such an indicator can adversely affect the performance of poor LGs and does not put into consideration the increase of the other funding sources to local governments. Instead we should consider *efforts* made by the local governments to improve local revenue performance.

e. Ensure that urban peculiarities are addressed: It is proposed to either develop a separate assessment manual or a specific section within the existing manual customized to urban areas, depending on the performance areas to be included. The additional areas to be considered for development of indicators under minimum conditions include: ensuring linkage between physical planning, development planning and budgeting (physical planning as a starting point); and having in place the core staff responsible for designing and implementation of the infrastructure development project (Physical Planners, Engineers, etc.). The additional areas to be considered for development of indicators under performance measures include: physical planning (the existence, quality and implementation of physical plans as a theme)[102]; strengthening of accountability indicators focusing on the demand side which may require the programme to support the demand side (e.g. areas of transparency, involvement, social audits, citizen surveys, etc.)[103]; ensuring adherence to the investment menu but not necessarily PAF areas as some aspects of the investment menu may not necessarily be under PAF for example street lighting; contract management and supervision; project implementation, absorption capacity and operation and maintenance - for example assessing the amount of own source revenues (OSR) spent on O&M (instead of having 10% co-funding as a minimum condition); and strengthening OSR enhancement strategies.

f. Strengthening of indicators that reflect the importance of having capacity to implement larger projects, i.e. strengthen indicators on project implementation rate, procurement, etc.

g. There is need to consider identifying performance priorities based on existing performance deficiencies and weigh them accordingly whereby the indicators prioritised are allocated a higher scoring weight relative to other, less important,

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[102] Currently, it is an indicator under development planning *"b) Clear description of the planning process with evidence of wide consultations and linkage between the structural/physical and development plan (Municipal specific).*

[103] The current indicators in this area of communication and accountability focus on posting of information to the lower local governments and public places. However, this has not been an effective mechanism of informing and eliciting the beneficiaries to demand for accountability from the LGs.

performance indicators. Identifying such performance priorities and then according them greater prominence is one of the key design issues that should be addressed.

h. Avoid introducing outputs and outcomes indicators. There are number of good reasons for this, see Annex 5 for a detailed discussion of this issue. Firstly because of the high costs and complexity; the attribution problem; a need to ensure high levels of flexibility in use of funds; and the fact that outputs and outcomes are often only seen after several years of operations, and as the intermediate indicators, if properly designed are more sustainable interim steps towards efficient service delivery, than short term improvements in specific areas[104].Moreover, the results of the assessment have not impacted on the sector grants as quite often sector ministries argue that the poor performers should be the ones to receive more grants which is contrary to the general principle of PBGS. This does not mean that the indicators cannot be more action-oriented, see below.

i. Overall, all indicators should not be processes per se (although some processes such as involvement of citizens are values in themselves), but should to the extent possible be more action oriented, they should be designed in manner to ensure the maximum linkage between input, process and outputs, focusing on these processes which are likely to lead to the desired outputs and outcomes (i.e. the causality should be considered in the design).

j. All indicators should be harmonised with the revisions in laws and guidelines. For example instead of assessing sector reporting, it could assess submission of the Form B, developed by the MoFPED in collaboration with sectors and LGs.

4.4 Administration of Rewards and Sanctions

The vertical and horizontal allocation of resources under the LDG was discussed in Section 3.1, and reference is made to these. It is recommended to consider moving to a more competitive system of relative performance. Please refer to annexes 3.4 and 3.5 for simulations based on this new system of adjustment of rewards and sanctions. It is also recommended that the performance component of the formula is given a strong weight, 50 %, and that the scores are included, weighted with the basic allocation formula. As mentioned, there is also a need to strengthen the basic allocation formula for urban authorities, which today only is based on one criterion – the size of the population, and it was recommended that the district formula is used in the short term, but with a separate calculation and allocation for the urban authorities, i.e. with clear fences between the two groups of LGs. This will mean a stronger prioritisation of indicators.

[104] Please refer to Annex 4 for detailed analysis of the Performance Based Grant Systems (PBGS) and the links between Input and Outputs. It is also important to note that value for money audits during the LGDP-II proved a link between the intermediate indicators such as good PFM and good governance and efficient service delivery, hence a good argument to focus on these processes.

4.5 Impact of the Assessment System

From its inception in Uganda, the LG performance assessment demonstrated improvements in a number of areas as demonstrated in the text boxbelow[105]. Such improvements in performance have also been noted in many other countries where the system has been introduced including Nepal, Tanzania, Ghana, Bangladesh, the Solomon Islands and many other places[106].

Text box 4.2 Impact of the LG Performance Assessment

a) Improves LG compliance to the law(s) as indicators are linked to the Local Government Act 1997, Finance and Accounting Regulations 1998 and Procurement and Tendering Rules and Regulations 2000 – a good example of this has been the submission of final accounts;
b) Helps the LGs to identify weaknesses and functional gaps that are a basis for the formulation of the capacity building strategy and plan;
c) Has had significant impact on a number of administrative areas including among others development planning, financial management, and procurement, particularly from 2000-2007;
d) Enhances the incentives for own revenue collection because of the requirement for LGs to co-fund 10% of LDG resources (90% matching fund), particularly in troubled times with a non-conducive environment for revenue collection;
e) Has enhanced dialogue between staff and politicians on how to improve performance;
f) Provides guidelines on where the expected performance areas are, particularly for new officials;
g) Has enhanced staff awareness and expertise due to the participation in the internal and national assessments as well as benefiting from the capacity building activities;
h) Introduced a fruitful sense of competition amongst LGs, which however, could be stronger with more transparent communication of the results.

However, in Uganda, after a longer period with quantitative and qualitative improvements on a range of areas there was a decline in the assessed performance in 2007 and 2008 as demonstrated in text box below[107]. It should be noted that the decline in LG performance was largely due to violation of some of the design principles discussed above especially the introduction of complicated MCs without sufficient communication and support rather than the decline in LG performance per se. In addition, the fragmentation of districts, abolishing of revenue assignment, pertinent for core LG activities, problems in the North and other structural factors may also have played a certain role, as well as the changes in the administration of the assessment system, including the emerging knowledge that waivers could be given in cases of lack of first hand compliance with the MCs.

Text box 4.3: LGs Performance

In 2007, after a long period with significant improvement in performance, there was a sharp decline in performance from 82% in 2006 to 50% of LGs that met the minimum conditions. This was mainly due to stronger requirements in the MCs, including failure on the linkage between the plan, BFP and budget. In 2008 performance continued to decline as it was discovered that most LGs failed TPC because of presenting dates of minutes that were either on weekends or public holidays. In 2008 also, many LGs failed because they did not provide evidence of

[105] Extracted from MTR of LGDP I 2002.
[106] More recently there are plans to introduce similar systems in some of the states in India as well as in China and the Philippines.
[107] Annual Assessment of MCs and PMs for LGs 2009, Synthesis Report March 2010.

existence of all the components of the Final Accounts e.g. cash flow statements, balance sheets, financial statements among others – issues which were not detailed in the manual. In 2009, performance has greatly improved from 34% to 61% of LGs meeting all the minimum conditions in the first place, and most of them seem to have passed the three areas i.e. linkage, TPC and Final Accounts among others, a trend which is expected to continue in the ongoing assessment (based on interviews with MoLG). This trend in performance may indicate some laxity in compliance with the laws and regulations by LGs hence the need for continued monitoring, supervision, mentoring and capacity building and in exceptional cases more stringent measures, no waivers combined with – in some cases - disciplinary actions need to be taken. Ways and means to combine the institutional performance incentives with more staff related incentives as being practiced in e.g. Nepal could also be considered.

4.6 Overall Conclusions and Recommendations

Overall, the PBGS model and its objectives are still relevant but management of its implementation needs to be strengthened and some procedures improved. It is important to stick to the design principles and not to move to too complicated models when there is stillroom for improvement and strengthening of the robustness of the existing system.[108]

It is also important to adjust the Manual to the fact that urban issues are becoming more pertinent and to either split the manual into two clearly designed sections or develop a special municipal manual.

It is **recommended** that the overall principles to be pursued in the future design improvement of the system include:

a) Keeping it simple;
b) Keeping it transparent, objective and fair;
c) Keeping the assessments neutral and firm;
d) Selecting assessment team members that are competent in the areas that they assess and that have time to commit to the assessment activities;
e) Training and orienting the assessment teams to the assessment exercise to ensure standardization of the assessment across the LGs;
f) Ensuring that the “assessors” should not be the same as the “decision-makers” (who decide on the actual allocation and transfer of funds);
g) Having quality assurance and control from an independent organization to avoid conflict of interest;
h) Selecting cost-effective approaches that can be sustained without compromising the integrity of the system;
i) Link it better with information which can be derived from other sources;
j) Widely publicizing of results as well as their implications;
k) Ensuring the administration of rewards and sanctions and making these known;
l) Keeping the design issues for the indicators in accordance with good practices for design of indicators which involves selecting indicators that: are under the control of the LGs; underlie all service delivery areas (rather than being sector specific); are easy to

[108] For an overview of the design and implementation pitfalls of the PBGS in various countries, see UNCDF, Steffensen, Performance Based Grant System – Concept and International Experience, 2010.

measure, could act as a proxy for performance outcomes; where LGsare informed of and supported to meet the indicators before they are assessed and used to administer rewards and penalties; and are linked to the existing government assessment systems and M&E.

Whereas the PBGS in Uganda is well developed, the foregoing analysis points to a number of areas that need to be addressed to further consolidate the gains and facilitate further improvement of the system.

The **specific recommendations**/**implications** for Uganda and USMID project include:

a) Strengthen the **internal assessment** by making it a continuous process (rather than one month before the national assessment), discussing and using the results as a basis for HLG mentoring the respective lower local governments to improve their performance.

b) Notwithstanding the fact that the IPFs are changed several times from the first announcement in November/December, it should be ensured that the **timing of the assessment** make the results available to fit into the Local Government Budget Framework Papers submitted January 15 every year, so that the planning is based on the best possible estimates on available funding.

c) Ensure that the **national assessment team** is composed of a mix of individuals (small team), from various places, who not only possess the required knowledge and skills, but who are also neutral actors in the process of assessments. This would require elaboration and disseminating the criteria that should be used for selecting a person to be a member of the NAT and ensuring that it is followed to maintain the objectivity and integrity of the system.

d) Maintaining and strengthening the **quality control function** with an independent, competent and objective team. When QA is done by the same institution/agency that is in charge of the assessment and by colleagues, the principles of neutrality in the assessments may be questioned.

e) The assessments should be **contracted out** to a private firm with the overall responsibility for the quality of the results. This private team should work with members drawn from the national resource team. MoLG will have the responsibility to quality control the process and outputs as per rules for normal contracting arrangements.

f) Instead of increasing the **amount of time spent in a LG** during the assessment exercise, it is proposed that some of the indicators currently assessed from the LGs could be captured from secondary data, and that the overall number of indicators may be reduced through a stronger prioritisation process.

g) There is need to **discuss and approve the results** of the LG performance assessment beyond the MoLG. One of the options is to have the results discussed by the LG Releases and Operations Committee as provided for in the Assessment Manual to ensure buy in and integrity of the results.

h) The **grace period** be removed and instead the minimum conditions should be kept as basic safeguards to ensure capacity to handle discretionary development funds (and not mixed with general performance of LGs) and communicated in well advance.

i) To stimulate action and make greater impact, there is a need to **widely publicize assessment results** including the implications on the size of grants for example in newspapers, regional workshops and JARD. The experiences from other countries in this area are useful, as well as from other initiatives such as publication of league tables for schools, etc.

j) There is need to explore ways of reducing the costs of the assessment without compromising credibility, professionalism, transparency or quality assurance of the system. Some of the options include complementing (not substituting) the independent national assessment team (fieldwork) with the use of secondary data and reducing the number of people in the assessment team as well as the time spent in each of the LG.

In addition, there are **recommendations** needed to improve the indicators being assessed, which include:

a. Maintaining MCs with the purpose of ensuring that sufficient safeguards are in place to handle and absorb the funds efficiently - combined with 100% adherence to these without waivers.

b. Informing the LGs of the revisions to the indicators in time and provide support to the LGs to meet the requirements of the new indicators.

c. Include only indicators where LGs have control on their attainment.

d. Ensuring that indicators can be met by all LGs if efforts are put in place (level playing field).

e. Ensure that urban peculiarities are addressed by either developing a separate assessment manual or introducing a specific section within the existing manual customized to urban areas.

f. Avoid introducing outputs and outcomes indicators but rather make the indicators more action oriented ensuring the linkage between input, process and outputs and focusing on processes that are likely to lead to the desired outputs and outcomes.

Recommendations to improve the administration of rewards include:

a. Strengthening the mutual competition across the LGs in the reward system (zero-sum game) as per Annex 3.5;

b. Re. Horizontal allocation: Making it more simple for the Ministry to calculate the allocations and ensuring that funding is available for rewards/sanctions by integrating the performance criterion in the system with the other indicators – e.g. population, etc. The performance index should be weighted with the results of the basic formula as per good practices in handling of indexes (see Annex 3.5);

c. Making it clearer for the LGs how much they receive from the performance rewards/sanctions, combined with a clear overview of the impact of the performance, and results of the others.

   Please refer to annexes 3.4 and 3.5 for a review of the suggested tool for adjustment.

   It is **finally recommended** that the **revision of the manual** should be done before the end of June 2011 to allow orientation and support to LGs in the new system prior to the internal assessments.

5. Concluding Comments and Recommendations

The diagnostics of the fiscal relations with focus on the current IGFTS in Uganda, and particularly with focus on the urban authorities, and the trends in grants, have shown that the framework conditions for local government service delivery have changed since the onset of the decentralisation process in 1993/94 and the Constitution in 1995.

The stated objectives in the policy, NDP and the legal framework are still intact, but a number of changes such as creation of new LGs, abolishing of LG tax assignments, elements of centralization in funding system and staffing control procedures, payment system for politicians, and the continued increase in conditionalities in the funding system, etc., have posed certain challenges on the overall operations of the local government system, including the IGFTS. However, as pointed out in the various sections, there is room for technical improvement and capacity enhancement within this(less than previously conducive) framework. There are also initiatives in place to try to address some of these challenges, especially around the JBSF/JAF, and the planned fiscal study on the update of the FDS.

The new USMID project is exactly planned to address a number of the weaknesses in the current IGFTS for LGs, focusing on the 14 municipalities to start with. As the table below shows, USMID is addressing a number of current constraints, if designed in accordance with the recommendations put forward in this report, keeping in mind that the USMID will target 14 municipalities and not the entire grant system for LGs in Uganda.[109].

The size of the USMID grants, which are higher than the existing total municipal grants per capita, will enable the LGs to respond to some of the major investment gaps in the existing system. The diagnostic review showed that the unit costs of these urban investments are completely out of tune with the smaller grants provided from the existing system, and there is a need for a fundamental shift in the IGFTS to address this challenge.

Secondly, the USMID project is well placed to address some of the other constraints in the existing system identified during the diagnostic work, see the table below.

[109] However, the UMSID may be rolled-out after the first piloting.

Table 5.1 Overview of the Core International Practices in IGFTSs, the Current IGFTS in Uganda and the Recommended USMID Project Design

International Principles (*)	Existing system of IGFTS in Uganda (**) (A)Good – (B)Fair-(C)Problematic	The Expected Impact of the USMID and Design Issues
Clear objectives in the grant schemes and limit the number of these	(B) (Fair) Most of the grant schemes have stated objectives, and are targeting these (with the in-built challenges in the selectedcriteria), but there arealso e.g. equalization, conditional and unconditionalgrants with various purposes.	The grant will be clearly focusing on support to improvement of the Urban Infrastructure- and it is to be classified as an investment grant to promote urban infrastructure investments.
Contribute adequately to the funding of vertical fiscal imbalances	(C) (Problematic) There is no system in place to guarantee buoyancy of the grant system, and to ensure that it follows the economic development, price and costs. There is a tremendous fiscal gap. The per capita allocations are small and have been decreasing since 2003/04. LGs have not been fully compensated for new costs drivers.	USMID will address some of the fiscal gaps in funding of infrastructure in the selected municipalities. It is much more significant than any of the other known grants in Uganda, to ensure tangible impact and to respond to the special urban needs for larger lumpy investments.
Address differences in fiscal capacity and expenditure needs of LGs	(C) (Fair/problematic) Some of the grants have indicators on fiscal needs. However, the main grant, which should tackle these issues, the equalization grant, has been insignificant and declining. The LDG for urban authorities does not cater for this.	USMID should ensure that poverty count is included in the allocation formula to address the poverty pockets in the urban authorities.
Preserve budget autonomy	(C) (Problematic) The large number of conditional grants with multiple budget lines and conditions undermines LG autonomy.	USMID address this problem, as it improves the funding available for cross-sectoral investments based on local planning needs within a defined investment menu. It should provide strong incentives to promote OSR and thereby enhance the room of local decision-making.

International Principles (*)	Existing system of IGFTS in Uganda (**) (A)Good – (B)Fair-(C)Problematic	The Expected Impact of the USMID and Design Issues
Support not undermine local revenue raising	(C) (Problematic) Only the LDG grant supports the OSR, through the incentive system, and this grant has been reduced in real figures over the year - especially when compared to other grants	USMID should support the introduction of stronger incentives to enhance OSR, both in the indicator system in the assessments and in the CB support to strengthen OSR.
Ensure a minimum number of different system of transfers and transfer modalities	(C) (Problematic) The number of different grants in Uganda is very high and has been increasing since the FDS (2002) to now about 40 grants. It reduces flexibility and enhances transaction costs.	USMID will be based on the existing LDG system, as a topping up of the urban grant envelope. I.e. it should not establish a number of separate new flows of funds.
Transparent and formula based formula, addressing the variations in needs	(B) (Fair/problematic) This depends on the specific grants, some have clear and simple formulas, others are not transparent/problematic.	The USMID grants should be based on simple, transparent and needs based formula with 3 criteria to start with: 1) population, 2) number of poor people (reflect the needs) and (3) the size of the LG territory (proxy for costs of services)
Ensure budgeted amounts are released	(A) (Good) Fairly good as the outturns are more than 95 % for most of the grants, which also high compared to other countries	The USMID should use the existing GoU procedures for transfers. There is need to ensure that the funds for the 14 municipalities are ring fenced for these units.
Ensure timely transfers	(B) (Fair) This has improved over the time. However there are still challenges in late and changing indicative planning figures, and in the fact that a large share of grants is transferred in the last quarter.	The USMID grant will be based on the existing system for GoU releases, and support the timely announcement of indicative planning figures and transfers.
Enable LG flexibility within national policy	(C) (Problematic) This is identified as one of the major problems by the LGs. There are too tight fences around the large number of conditional grants. Provisions in the Constitution to increase UCG over time have not been implemented.	USMID will provide flexibility in spending within the broad investment menu, but the grants will focus on municipal investments in core infrastructure sectors (roads, solid waste management, drainage, street lightning etc.

International Principles (*)	Existing system of IGFTS in Uganda (**) (A)Good – (B)Fair-(C)Problematic	The Expected Impact of the USMID and Design Issues
Involve and strengthen the involvement of all tiers of government and participation of these	(B/C) (Problematic) Some grants have tried to involve LLGs and promoted participation, e.g. LDG, NAADs etc. – but most of the grants are just involving the HLGs and are not promoting this objective	USMID should support municipalities as well as divisions, but is focused on larger investments, hence cannot be fragmented below divisions. Second, USMID through the planning and decision-making process should promote involvement and participation. There is a need to strengthen the incentives to involve citizens in planning and decision-making.
Achieve public participation and transparency – including up-ward, downward and horizontal accountability	(C) (Problematic) Most accountability is directed towards the CG, and not downwards to the citizens.	USMID will have to strike a balance and support all three lines of accountability, e.g. through the indicators in the national assessments.
Ensure strong incentives to improve incentives to improve administrative performance and service delivery	(B/C) (Fair/problematic) Uganda was amongst the first countries to introduce the PBGS, but the relative and real sizes of the grants have decreased, and the incentives, which to certain extent are still promoted, have decreased. Some of the grants have problematic allocation criteria, e.g. in PHC grants have been reported to create negative incentives to improve service, as improvements lead to less grants.	USMID will provide prudent opportunities for the municipalities to strengthen the incentives for institutional improvements. There is a need to improve on the annual assessment process as well as on the indicators to make them more simple, action-oriented, transparent and targeted towards important urban issues, such as physical planning.
Base the system on availability of data and keep in simple, to ensure support and buy-in and to ensure actual implementation.	(B) (Fair) Mixed across the grants. Some formulas are simple and transparent, others very complicated.	The USMID formula should be very simple, robust and based on existing official data.
Links between various LG reforms, e.g. taxes and grants	(C) (Problematic) The FDS was introduced to address this, but has not been implemented. The tax compensation has addressed some of the problems created in the tax assignments, but has not really tackled these.	USMID will support the grant system as well as the OSR mobilisation, performance and capacity of municipalities in core functional areas.

International Principles (*)	Existing system of IGFTS in Uganda (**) (A)Good – (B)Fair- (C)Problematic	The Expected Impact of the USMID and Design Issues
Keep track on the implementation	(C to B) (Problematic to Fair) A number of problems have been observed, multiple, not linked reporting systems, and inspections, lack of consolidated data on use of grants and LG revenues and expenditures etc. A new OutputBased Tool for work-planning and reporting has been rolled out by MoFPED, but the impact is still to be seen. However, it provides certain opportunities.	USMID will need to build up its M&E system, but should - to the extent possible - base the information on existing formats, incl. the new OBT and the national assessments.
Adjust the system to new structures and LG systems	(C) (Problematic) The continuous establishment of new LGs (non-planed and non-coordinated) put stress on the entire LG system, which is hard to cope within the IGFTS. There are attempts to compensate the LGs, but it is piecemeal and not sufficient to cope with the new costs.	USMID will be based on the existing system, but will have to adjust in case, that municipalities are changed in status/etc. USMID will have to introduce some conditions within the areas of core municipal staffing.
Issues to avoid in the IGFTS design		
Transfers should not be based on size of existing infrastructure level as this provide disincentives to improve	(B) (Fair) Only some of the transfers have this problem.	It is important that the USMID allocation criteria are not based on the existing infrastructure level /service gaps, but on objective data, which preserves incentives to improve performance and which can be monitored easily.
Grants should not be subject to political interference	(B) (Fair) Most of the grants have clear allocation criteria and have no reported direct interference in the formulas. However, a number projects and allocations are based on political considerations.	USMID should have a clear allocation formula, which reduce the risks for political interference. There should be a system to check that allocations adhere to the formula.
Should not be designed as deficit grants	(A) Good	USMID will not support coverage of fiscal deficit, but contribute to

International Principles (*)	Existing system of IGFTS in Uganda (**) (A)Good – (B)Fair-(C)Problematic	The Expected Impact of the USMID and Design Issues
	Although there are numerous grants, which support the poor LGs and areas in Uganda with problems, these are not to be classified as the problematic deficit grants seen in some other countries, e.g. not designed to bail out LGs in financial troubles.	closing the fiscal gap in infrastructure investments. It will not be allocated according to level of fiscal gaps, which could be a risk for the incentives.
Should not be solely based on equal share approach	(B) (Fair/Problematic) Most grants do not have a strong element of equal share. However there are incentives to create new districts, as the standard staffing structures per units are applied, and as all districts and all municipalities gets the same payment for politicians etc. etc. Hence the system has some incentives for fragmentation.	USMID should not be paid on an equal share method.
Should not be based on criteria which can be manipulated by LGs	(B) (Fair) Most grant schemes use objective data, but some of the grant schemes have incentives for the LGs e.g. not to report about new structures created, e.g. health centres.	USMID criteria should be based on officially approved data from UBOS, and not on LGs' self-reported data. UBOS should be active in responding and verifying complaints from LGs about data, so that they see this as being fair.
Should not establish multiple conditional grants, which undermine LG autonomy and flexibility	(C) (Problematic)	USMID will to the extent possible be based on a "topping-up" of the existing LDGs, with a more targeted investment menu.

(*) Based on a review of literature – see Danida, Steffensen, 2010for a review of the literature on intergovernmental fiscal transfers. (**) Assessment is ranked as good, moderate/fair, and problematic.

As mentioned, the recommendations on the IGFTS are included in sections 2-4. However, in terms of the future process and the way forward on the design of the grant system for USMID, it is ***recommended*** to:

- Start the preparations of the reform of the National Assessment System, including the Manual – the process and the indicators for the annual assessments. The work for urban and rural should be separated (although linked) with development of two different"third generation" assessment tools – one for the rural and another for the urban authorities,the latter focusing more on the specific urban peculiarities;

- Support and follow the work on the update of the FDS study commissioned by GoU and coordinated by the LGFC (planned completion September 2011). It is important to keep this study managerially feasible and focusing on the overall principles for the fiscal reforms. One study cannot capture all details on LG finance ranging from all the specific grant allocation formulas to the legal framework for each type of own source revenue, PFM, etc. There is a risk of overloading this study. The study should mainly focus on areas where information is missing;

- Ensure a strong linkage between the various diagnostic studies under USMID, to ensure that e.g. the study on assets management and infrastructure reviews the expected size of the grants and its implications on operational and maintenance, compared with the expected revenue information generated from the PFM/Revenue study – and linked to the study of the institutional framework and capacity of various institutions to handle the new project, also planned under the USMID preparatory work;

- Review the functionality of the existing database systems on LG finance and service delivery, including particularly LOGIS+, databases in LGFC, MoFPED and the linkages between these.

6. Annexes

Annex 1 Terms of Reference

Diagnostic of the Intergovernmental Fiscal System

1. Introduction

Government of Uganda has approached the International Development Association (IDA) of the World Bank to support the urban development agenda in its National Development Plan (NDP). Since the Bank has already an on-going support for Kampala City, it is considering providing support to secondary cities (municipalities). This will be a long-term engagement and the Bank intends to provide support for institutional strengthening at both center for ministries responsible for urban development and management (Ministry of Lands, Housing and Urban Development and Ministry of Local Government) as well as at the municipalities. The first phase of the support will focus on addressing infrastructure gaps and institutional strengthening of fourteen municipalities[110] so as to achieve the desired impact. At the same time, Danida is planning a new phase of its support to local governance and local service delivery, with targeted support to the funding arrangements for local service delivery, capacity building/institutional support to MoLG, LGFC and ULGA. The support is to be done within the existing intergovernmental system and legal framework.

As part of conceptualization and preparation of the support to the urban agenda, consistent with the Government NDP, there is need to conduct a number of background diagnostic assessments. The intention of the diagnostic approach versus more detailed studies is to (i) establish the primary issues that would determine/influence future support for the urban sector and the linkage between this support and the ongoing support to the existing local development grants and capacity building support for local governments; and (ii) provide sufficient information for design of the key parameters of the support and linkages between the various initiatives to support local service delivery. In keeping with the diagnostic approach, existing data will be used to the maximum extent possible. Where necessary, analytic techniques will focus on simple tools for data gathering and analysis, such as sampling, limited/focused surveys where essential, and representative interviews. Areas for more detailed study, if identified, will be considered for inclusion under the project support itself. Close collaboration between the parties conducting the assessments will be required. The proposed diagnostics include the following:

v. Assessment of the evolution of the Intergovernmental Fiscal System (IFGS), with particular reference to urban (municipal) requirements;
vi. Assessment of municipal financial management;
vii. Assessment of the supporting/oversight institutional framework, systems and capacity building needs of municipalities; and
viii. Assessment of baseline municipal asset inventories and preparation of asset registers.

[110] (i) Arua MC, (ii) Gulu MC, (iii) Lira MC, (iv) Moroto MC, (v) Soroti MC, (vi) Tororo MC, (vii) Mbale MC, (viii) Jinja MC, (ix) Entebbe MC, (x) Masaka MC, (xi) Mbarara MC, (xii) Kabale (xiii) Fort Portal and (xiv) Hoima MC.

This ToR is intended to address the first of the above-four diagnostic assessments – an assessment of the evolution of the IGFS with reference to urban authorities - and it outlines the key tasks and responsibilities to be performed by the consultants. The services of an intergovernmental specialist and a local counterpart to carry out the assignment are required. This ToR outlines the key tasks and responsibilities to be performed by the consultants.

2. Background

The decentralization policy announced by Government in 1992, embedded in the Constitution and further elaborated in the LG Act, 1997 Cap 243, devolved substantial powers and functions to Local Governments (LGs). The policy redefined the intergovernmental system and relationships between central and LGs. Administrative, political, fiscal and the bulk of service delivery have been devolved to LGs, with the exception of urban water and sewerages, and electricity, which are provided by national corporations. Line ministries retained the roles for setting national policies and standards, inspecting, monitoring, technical advice, support supervision and training LGs[111]. LGs hire and fire staff[112], prepare three year rolling development plans and appropriate annual budget without recourse to the centre. The policy intended LGs to be run as fully-fledged governments with legislative and executive powers.

Although Uganda has all the elements of traditional intergovernmental fiscal transfers, i.e. conditional grants, unconditional grants, equalization transfers, the share of conditional grants as a percentage of total Intergovernmental fiscal transfer (IGFT) has increased from 66% in FY95/96 to about 95% now. This shift seems to have been less a function of declining unconditional transfers (though these have remained more or less static in absolute terms since FY95/96), and more the result of the local governments increasingly being assigned health and educational responsibilities at the same time that government has accorded these two sectors high priority. More recently, there are indications that the discretionary transfers (the Local Development Grant - - LDG) will be nearly doubled over the forthcoming fiscal years under the MTEF, roughly restoring it in real terms to its original levels or approximately 1.5 USD per capita. However this amount still remains small in comparison with the other conditional allocations, and the net effect may have been that there has been a loss of incentive for the LGs, particularly in the urban areas, to perform effectively in such areas as budgeting/development planning, and consultative and accountable investment implementation practices. The impact of these allocatory trends has been even more marked for urban LGs, partly a function of the flat levels of discretionary funding and partly attributable to the distribution formula which appears not to recognize the higher per capita costs of urban infrastructure requirements and the rapid growth of urban populations - in FY2008/09 urban LGs received only 3.4% of the total UGX1.2 trillion transferred to LGs. The current trend of IGFT architecture therefore may no longer be fully consistent with the decentralization policy adopted by government.

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[111] LG Act CAP 243 Sections 95 – 99 (GoU: 2000, p77-79)

[112] With the exception of the Chief Administrative Officer/Town Clerks and their deputies which have been recentralized and now being appointed by the National Public Service Commission, not the LG Service Commission.

The proposed support to the urban sector can at best only begin a process both for addressing the infrastructure backlog funding requirements, and for keeping pace with the investments the rapidly growing cities are going to need. Therefore, a key challenge will be to use any future urban project to either pilot or establish, over a relatively short timeframe, a fiscal support system that can be expected to meet urban investment requirements in the long term, and that is integrated with the government's fiscal architecture and falls within its resource constraints. The support will be closely linked with the ongoing nation-wide systems and procedures for allocation of funds under the performance-based local government and capacity building grant schemes. Part of the fiscal gap can be addressed by improving own source revenue generation (see separate diagnostic), but it is well acknowledged that a significant portion of the funds will have to come from central transfers. Recent oil discoveries in Uganda are seen by the government as an opportunity to open a window focused on addressing infrastructure development requirements in the country generally, and urban investment demands specifically. Government has indicated concern regarding both funding constraints that set limits on the current transfer system as well as urban LG capacities that raise risks to the efficient use of these resources if they were to become available in the relatively near future. Government has therefore indicated that they would like to see support to the urban sector designed as a transitional (and additional) vehicle for establishing and testing suitable transfer mechanisms that create the right incentives for capacitated and effective performance by the urban LGs.

3. Scope of Work

In order to undertake these ToRs, the services of an international and local intergovernmental fiscal specialist are required. The consultants will carry out an assessment of the Uganda IGFS clearly documenting the policy and operating practices including the legal and regulatory framework of decentralization in Uganda, their implications for the effective functioning of a devolved local government system, how they affect the intergovernmental fiscal transfer system (IGFTS), and will propose options for strengthening urban local government performance from the perspective of a more effective, capacitated and incentivizing fiscal structure.

4. Tasks

The consultants will undertake rapid diagnostic that will include the following:

iv. A synopsis of the fiscal and administrative relationships between the central and LGs, (with focus on municipalities) within the decentralization policy framework adopted by Government and a brief summary of the practice vis a vis the policy and how it has evolved over the years. Taking into consideration the political economy and other factors, a brief analysis on the drivers and constraints for effective intergovernmental fiscal reforms should conclude this section.

v. A review of the current Intergovernmental fiscal transfer architecture for urban local governments and assess how the proposed future municipal support program could contribute to strengthening and improving the current system. Specifically the assessment should describe the framework (policy and procedural) and practice for the vertical allocation of resources (i.e. between the central government and municipalities) and the horizontal allocation of resources (among municipalities), a brief analysis on the typical gaps[113] (if any) between the existing transfers and development requirements of municipalities in infrastructure provision, measured as type and costs of investments in the urban areas compared with the existing level of grants, and weaknesses in the design and practice of the IGFS as compared to international good practices.

As part of this exercise, the consultant should compile data relating to the actual fiscal transfers – **focusing on development grants -** from central government to the 14 municipalities for the past five to seven years and the difference, if any, between actual transfers and entitlements during this period. The data relating to transfers should be disaggregated to the various components of the intergovernmental fiscal transfers as well as classify the transfers based on the nature i.e. whether they are conditional or unconditional transfers.

In addition the assessment should also assess the possibilities and constraints for increasing the quantum of intergovernmental transfers to address the increasing infrastructure backlogs at the municipal level and recommend potential cost effective mechanisms for implementing these and for improved municipal service delivery as per municipal mandates provided for under the LG Act CAP 243.

vi. As part of the IGFS relationship, a review of how the current LG Assessment process under the LGMSD works (with specific focus on municipalities) and its suitability and adoption for the proposed future municipal support program, including the links between the ongoing assessments and the future support to urban authorities.

5. Deliverables

Prior to the start of the assignment the consultant is expected to discuss and agree with the World Bank Task Team Leader for this assignment, the Danida task manager for support to governance/local service delivery support, other relevant development partners and officials from the MoLHUD and MoLG on the schedule and methodology for undertaking the assignment as well as the contents and organization of the draft/final report. The consultant will first submit a draft report for comments on January 18, 2010, and will finalize the report after receiving feedback by the end of January 2010. The draft/final report will include separate chapters on each of the three tasks outlined above.

6. Timing

The assignment is expected to be completed within 3 months, starting from the beginning of November 2010, with a total input of 30 days of work for an international consultant and 15 days of input for the national consultant for data collection/processing, and support to the international consultant. This assignment requires literature review and limited field visits to selected (2-4) municipalities to validate findings and recommendations. The field-work will be conducted in January 2011.

113 This part will not encompass a full fiscal needs/gap study, which is largely outside the scope of the analysis, but will review the type of investments required, the typical unit costs, compared with the available funding from existing development grants to urban authorities.

7. Reporting arrangements and support

The consultant will primarily report to the Task Team leader from the World Bank, but work closely with the Danida task manager for support to local service delivery in collaboration with the Government[114] team, which is responsible for the preparation of the future municipal support program through the Commissioner Urban Development (MoLHUD). The World Bank will through the ministry support the consultant in submission of questionnaires to the municipalities with requested data need for the quantitative part of the survey. The World Bank will also support the consultant in organization of needed meetings to complete the assignment.

[114] Government team will comprise of officials from MoLHUD and MoLG as the secretariat.

Annex 2 Questionnaire for the Field Work

Questionnaire - Assessment of the Evolution of the Intergovernmental Fiscal System (IGFS) with particular reference to the urban (municipal) requirements

Introduction to the Questionnaire – to the Municipalities

Enclosed is a simple excel sheet for data filing by the Municipality. The data required are explained below:

I. Overall Revenues and Expenditures
The first table concerns the overall **budget** and **actual use (outturns)** of **expenditures** and budgeted revenues and actual collected **revenues**. This is to establish an overview of the total available funds and the relative share of the grants from central government.
The table to be filled in is broken down in:

Total Revenues
of this own source
Revenues
of this grants
of this project
revenue, etc.
Total expenditures

i) Own source revenues are revenues from taxes, user fees charges etc., i.e. revenues where the municipality has a say on the size of the collection
ii) Grants= transfers from central government
iii) Projects and other funding: Could be support from development partners, borrowing etc.

2. Grant data:

Data is requested for:

A) Entitlements (= budget as informed by MoFPED), 2) actual transfers, 3) use of grants

The data required should be broken down on:
Total grants
Recurrent grants
Of this non-sectoral*
Of this unconditional**
Sectoral grants
Development
Of this non-sectoral***
Sectoral

The total grants are all grants transferred from central government for this FY.
This is to be broken down in:

- Recurrent grants – of this:
  - (*)Non sectoral grants, i.e. all grants which are not related to a specific sector
    - (**) Of this the **unconditional** grants
  - Sector grants
- Development grants……..of this:
  - (***) Non-sectoral grants – this include e.g. LGMSD grants and grants not earmarked for a specific sector
  - Sector grants

Qualitative questions – Please fill in

Municipality:………….
Name and position of respondent……….
Size of the population (year…):………..

A) THE GRANT SYSTEM
Please fill in the questions below, with brief concise answers:

- What are the main constraints in the grants from central government? Please rank the top 3 problems
  - 1)…………………………………………..2)………………………………..3)………………………..

- *Allocation of resources*: Your views on the existing vertical allocation of resources between tiers of local government (e.g. fair, equitable, efficiency)….: ……………….
  - Proposed changes?.....................

- *Allocation of resources*: Your views on the horizontal allocation of resources across the same tier of government, i.e. between the municipalities?..........
  - Proposed changes?....

- *Predictability of grant allocations*: Are the allocations predictable? …..why not? ….
  - When did you receive the last 4 transfers (tranches) of grants?.............when were these expected?.................
  - Major reasons for delays (if any)?
  - When did you receive the information on the actual allocation for FY 2010/11?...

- *Conditionality*: Does the existing conditionalities (e.g. earmarking) pose any problems for the Municipality? … which (if any)?.....

- *Balance in the grants:* What are your views on the balance between the various types of grants?
  - The recurrent and development grants?
  - Wage and non-wage?
  - Other issues on the balance of grants

- *Size of the grants compared with the funding gaps* – Your views on the funding gaps?........ (what are you gaps, maybe in rough % of existing budget available if you should comply with national minimum standards)……
  - Have any calculations been made of the need for investments in infrastructure and services compared to the availability of resources?.....
  - What was the original budget compared to final budget in FY 2009/10?
  - Average costs of typical infrastructure investments?
    - Km of paved roads………
    - Bridges…….
    - Water facilities?... (specify type of facility)
    - Secondary school?....
    - Health unit?....
  - Major areas in infrastructure and services where there are funding gaps?
  - Size of future major planned investments ? - site examples and the costs of these…….
  - If funding gaps – are there any plans to address these?....

- Absorption capacity: Which share (in %) of the allocated grants have you spent in FY 2008/09?....... and FY 2009/10? ……………………
  - If unspent funds – what are the reasons for this? …..

B) THE LG ASSESSMENT PROCESS UNDER LGMSD (PREVIOUS LGDP)

Assessment process of the performance-based LGDP/LGMSD grants

- Your views on the annual performance assessment system?...
  - Is it fair and neutral?
  - Is it professional?
  - Is it timely?
  - Is it relevant for municipalities?
  - Does it provide incentives to improve performance?
  - Is it used to identify CB gaps?
  - Your view on the performance indicators?..... (MCs and PMs)…
  - Your views on the process (timing, team approach etc.)?
  - Appeal options?
  - Grace periods?
  - Suggestions for future improvements?

Annex 3.1 Trends in Grants (Separate File)

Annex 3.2 Trends in Grants and Own Source Revenues(Separate File)

Annex 3.3 Data on the Sample Municipalities (Separate File)

Annex 3.4 Simulations of LDG/USMID Grants (Separate File)

Annex 3.5 Simulations of LDG/USMID – PBGS – Simulations (Separate File)

Annex 4 Various Assessments Methods in Annual PBGS Assessments[115]

The table below shows the advantages and disadvantages of using different modalities and procedures in a PBGS assessment – one of the core components of any PBGS.

Assessment method and examples	Advantages	Disadvantages
1)External assessment (fully and entirely out-sourced model) *Examples:* *Nepal, Bangladesh, Ghana and the Solomon Islands*	❑ May be seen as impartial (neutral), objective and fair ❑ Avoids conflicts of interest, which may arise in other models ❑ Ensures capacity and multi-disciplinary skills needed to carry out the assessment on a timely basis ❑ Increases the likelihood of capturing economies of scale as a few assessment teams can be involved in several assessments ❑ Ensures a standardized and professional approach to the assessment ❑ Provides incentives to carry out assessments in a timely and efficient manner ❑ Provides scope for QA/control from government institutions ❑ Ensures a clear division of roles and responsibilities such that the "assessors" are not the same as the "decision-makers" (who decide on the actual allocation and transfer of funds) ❑ Assessments are often short-term assignments (1-2 months), hence it is more efficient to contract in resources as and when required	❑ Entails additional costs[116] ❑ May not ensure sufficient interaction with the various stakeholders, especially citizens (depends on the organisation). It may not lead to direct dialogue between citizens and LGs, unless this is combined with a participatory process (see below) ❑ The external teams may lack local knowledge about the situation in the LGs. However this can be mitigated when the teams include resource persons from the CG and LGs ❑ May lack the checks and balances introduced in model 6, where teams are of mixed composition ❑ The strengths of the model will depend on the capacity and integrity of the private sector and level of quality assurance
2)Government institutions/departments	❑ Institutionalized ❑ Integral to overall monitoring and evaluation functions ❑ Possible to establish linkages with general inspection functions where some data may be easily available. Builds up the capacity of the government institutions	❑ Government may lack the necessary capacity and human resources ❑ This is a new function, which requires extra work for staff who are often already overburdened. ❑ Regular functions may then suffer from less attention as staff dedicate their time to assessments

[115] This annex has been drawn up based on the experience of various countries which have applied or are planning to apply PBGSs, particularly: Bangladesh, Bhutan, Indonesia, Nepal, Kenya, Uganda, Ghana, Tanzania, the Solomon Islands and the Philippines (which is at the design phase). The typology and examples used should nonetheless be of general relevance for the design of new systems in other countries as well.

[116] Experience from countries where external assessments have been conducted have shown that the costs of assessments have been in the range of 1-3 % of the total performance-based grant (0.6 % in e.g. Nepal).

Assessment method and examples	**Advantages**	**Disadvantages**
Examples: *Kenya, but with involvement of the Kenya Local Government Reform Programme and supervision from a Steering Committee, composed of members representing various stakeholders, including the private sector.* *Sierra Leone* *Pakistan (Baluchistan)* *System in Bhutan (only with MCs)* *East Timor, although with support from project staff (LGSP)* *Uganda: Has moved towards this model although the team are combined with external resource persons from other ministries and LGs.*	❑ Typically relatively modest costs ❑ Typically feasible where only a limited number of performance indicators are used, which can often be measured through desk/office reviews of existing reports and documents. ❑ Government official have important skills in core areas of the performance assessments.	❑ May not always be perceived as fully independent and objective by all observers ❑ Government staff may not have sufficient incentives and time to take on such a time-consuming task (travel etc.) ❑ The government will endorse its own assessment results, i.e. there will be fewer checks and balances and more conflicts of interest ❑ The experience in testing this method in some countries has not been encouraging[117]. ❑ Does not ensure a clear division of roles and responsibilities vis-a- vis the actual transfer of funds and capacity building support ❑ If Government is responsible for some LG capacity building and monitoring activities, there may be a conflict of interest in assessing LG performance, which is largely dependent on the quality and appropriateness of this support.

[117] E.g. Tanzania, Pakistan, and during the early stages of testing/piloting and Bangladesh.

Assessment method and examples	**Advantages**	**Disadvantages**
3) Self-assessment by the LGs in dialogue with citizens ("social audit") or internal assessments *Examples:* *Tested in Bangladesh from 2003-2005.*	❑ Promotes interaction between citizens and LGs, ownership and accountability ❑ Promotes awareness raising on the problems and challenges associated with LG systems and procedures ❑ Improves local knowledge about LG activities and performance and ownership ❑ Ensures a clear division of roles and responsibilities vis-a-vis the actual transfer of funds	❑ Not fully neutral as unfavourable assessments by citizens of their own LGs' performance will lead to fewer or lower grants to the local area/communities ❑ May be of low quality due to lack of sufficient time and skills to properly and fully assess LG performance ❑ Not standardized across LGs, which is important if all LGs are involved in the same grant scheme ❑ May be difficult to organise in many LGs without a large number of local facilitators (hence very expensive and time-consuming) ❑ May compromise the relationship between LGs and citizens, as citizens may hesitate to raise their concerns openly – it will also blur accountability relationships ❑ The objectives behind this are better served by other tools such as user-surveys, scorecards, etc. ❑ *Reviews of this system show that it is prone to subjectivity*
4) Assessment performed by the Government's Audit Institution *Examples:* *In Bangladesh the Comptroller & Auditor General is supposed to approve the outcomes of external audit assessments, conducted by out-sourced audit (accountancy) firms.*	❑ Audit skills (needed to cover an important part of the performance indicators) are available in the assessment teams ❑ Lower transaction and logistical costs compared to the out-sourcing model (contracting out) ❑ Ensures a clear division of roles and responsibilities vis-a-vis the actual transfer of funds ❑ Enables the auditors to move towards performance auditing as a supplement to financial auditing – combining the assessment missions with the audit missions	❑ May be to biased towards financial issues ❑ It is debatable whether financial auditors have the capacity to carry out more comprehensive assessments which go beyond financial auditing. This may result in a compromise in the quality of the financial audit ❑ Some issues will probably be far beyond the normal scope of audit functions, especially if performance indicators of good governance and transparency are included ❑ May create a number of timing problems, especially concerning the availability of staff ❑ May drain staff from the general financial audit ❑ The working style of financial auditors may be different from the style required during a performance assessment. It may, for instance, be difficult to combine purely financial audits with a participatory approach and the involvement of communities

Assessment method and examples	**Advantages**	**Disadvantages**
In Solomon Islands the Office of the Auditor General supports the contracted consults to perform the assessments, but they keep their independence. However, it means that the assessments are seen as very "serious" events		
5) Combined external and internal participatory assessment (models 1 and 3 with internal assessments) *Examples:* *Some countries such as Uganda have tried to involve citizens in the dialogue on the assessments, but this is not a "clean model"* *In Tanzania the LGs conduct an internal assessment 1-2 months prior to the external assessment to identify gaps and to prepare for the external*	❑ Ensures sufficient capacity and resources to carry out assessments on a timely basis ❑ Easier to adjust human resource requirements and timing ❑ As a limited number of teams can cover several LGs, this increases the opportunities for capturing economies of scale ❑ Ensures a standardised approach ❑ Provides incentives to carry out assessments in a timely manner ❑ Involves local knowledge about the situation in the LGs ❑ Scope for quality assurance from Government /Programme ❑ Ensures wider citizen participation/involvement ❑ Promotes interaction between citizens and LGs, strengthens accountability and increases citizen awareness and understanding of the functions and responsibilities of LGs ❑ May be seen as impartial, objective and fair. However, it requires a clear separation of tasks and responsibilities between the two approaches ❑ Ensures a clear division of roles and responsibilities vis-a-vis the actual transfer of funds	❑ Significantly more costly and administratively demanding compared to the other options ❑ May require a large number of additional resource-persons to facilitate internal assessments and community involvement; this may compromise sustainability if the approach is intended to become a part of general government procedures (rather than those of a specific project) ❑ May lead to conflicts between community-based and external assessments ❑ It is a relatively complex and time-consuming model ❑ May lead to protracted discussions about the indicators to be used/measured and final decisions on assessment outcomes

Assessment method and examples	Advantages	Disadvantages
assessment, but it is more focused on the internal dialogue between staff and politicians in a local government		
6) External assessment, contracting out, combined with inclusion of various stakeholders – CG and LG representatives, NGOs and CBOs co-opted in the teams as resource persons *Examples:* *Previously, Uganda (organized by the Ministry)*[118] *Tanzania (organized by consultants).* *Nepal (out-sourced*	❑ May be seen as impartial (neutral), objective and fair ❑ Ensures the capacity and multi-disciplinary skills required to carry out the assessment on a timely basis ❑ Increases the possibilities for capturing economies of scale as a limited number of teams can be involved in several assessments ❑ Ensures a standardized and professional approach to the assessment ❑ Provides incentives to carry out the assessment in a timely and efficient manner ❑ Scope for QA/control from Government institutions (however this may diminish if the Government representatives are lead representatives in the assessments) ❑ Ensures a clear division of roles and responsibilities vis-á-vis the actual transfer of funds, although less clearly than in model 1 ❑ Has been evaluated as an appropriate arrangement in a number of countries, based on piloting experience	❑ Will add some extra costs[119] ❑ May not ensure sufficient interaction with the various stakeholders, especially citizens (this depends on the organisation). It may not lead to direct dialogue between citizens and LGs, unless this is combined with a participatory process cf. above ❑ May be a bigger challenge to organize as a variety of stakeholders have to be coordinated and brought together ❑ If it is led by Government and the consultants only play a secondary role in managing logistics and in ensuring some QA, many of the disadvantages from model 2 may appear here as well. It may be difficult for neutral stakeholders to exert sufficient influence ❑ The number and level of influence of the consultants may vary, but a strong neutral role is important.

[118] In Uganda the system has changed from a system managed by contracted private consultancy companies, with co-opted representatives from central and local governments, development partners and NGOs (the so-called “trained resource pool”), and organized by a dedicated Project Coordination Unit (PCU) in the Local Government Development Project, under Ministry of Local Government. This approach was changed in 2007-08 to one whereby the Ministry of Local Government took charge of the assessment, with some (limited) quality assurance from private consultants. There are some concerns that the quality of the assessments has declined over time. The quality assurance is in the ongoing assessment conducted by the Ministry itself in order to safe funds. The present teams are composed from MoLG, LMs and various LGs.

[119] Experience in several countries where external assessments have been conducted shows that the costs of assessments have been in the range of 0.5-4 % of the total grant.

Assessment method and examples	Advantages	Disadvantages
to private consultants, visits involve government representatives in the assessments as observers/QA) *The model has also been considered in the Philippines.*		

Various models can be combined. It should be noted that the assessment teams in model 1 can be made up of a combination of private assessors, civil servants from central government and LG and NGO representatives (i.e. a variant of model 6). A pool of resource persons can be established from which the private contractor can select qualified experts from different disciplines. Model 6 can also be combined with internal prior assessments (as in Uganda and Tanzania, where LGs conduct a prior internal assessment before the arrival of the combined teams of consultants and government officials).

Furthermore, any assessment model will require proper preparation and planning, training and capacity building of the assessment teams and prior notification of the LGs to be assessed. In addition, systems for **quality** assurance are equally important, as well as widespread publication of, and full transparency in, the results.

Many countries have established steering committees (or the like) to finally and formally endorse the results of assessments (e.g. Nepal, Bangladesh, Solomon Islands, Tanzania and Ghana). This is important from strong acceptance, credibility and buy in to the results.

A decisive consideration is whether the assessments can be done from the **desk/office** in the headquarters of the Ministry /Programme concerned, or whether field visits/on-the-spot checks are required. The choice of model will depend largely on the complexity of the indicators that are used to measure performance. Simpler indicators (e.g. the extent to which LGs have submitted final accounts on time) can be measured from the "desk", whereas more nuanced and complex indicators, (e.g. the quality of the planning process) require on the ground assessments. Experience shows that unless the indicators are very simple (e.g. on-off triggers such as the existence of timely final accounts[120]), assessments should be field-based in order to get a real sense of performance, particularly when it comes to using the more qualitative performance measures. The field-based assessments also provide an opportunity for the assessors to interface with the LGs and offer on-spot feedback and guidance.

[120] The simple indicators applied in the system in Kenya and the existing system in Bhutan, which may be made more sophisticated by the use of more qualitative performance measures.

Annex 5 Focus of Performance- Based Grant Systems[121]

1. Inputs Versus Outputs

In the recent years, the core focus on the PBGS has undergone discussions under many of the countries, which have designed and/or are implementing PBGS, including **Uganda**. This note intends to present some of the core issues for considerations in selection of focus areas and main features of the system. The focus of performance-based grant systems (PBGSs) may vary – and, accordingly, these grants can generally be categorised along two basic dimensions:

1) The type of performance which the grant is trying to leverage, particularly generic **institutional** versus **sector**-specific/service delivery performance; and
2) Use of funds, i.e. either **sector-earmarked** or broad non-sectoral/LG **discretionary** funds[122].

The Table, below, identifies four options along these two dimensions:

Table 1: Type of Performance and Use of Funds

I. TYPE OF PERFORMANCE THAT IS TARGETED IN THE INDICATOR SYSTEM	II. USE OF FUNDS – MULTI-SECTOR VERSUS SPECIFIC (EARMARKED)	
	MULTI-SECTOR USAGE	SECTOR-SPECIFIC USAGE
SERVICE DELIVERY	**A.Multi-Sector Usage** **Service Delivery Focus** (e.g. pilot testing in Nepal of grants to urban authorities, but still only few indicators).	**B.Sector- Specific Usage** **Service Delivery Focus** (e.g. Uganda - School Facility Grant, Philippines- Health Grants).Numerous grants within the education area, such as grants linked with enrolment rates (capitation grants in Kenya and Ghana) and/or specific outputs (level of students passing exams with certain quality, etc.)
INSTITUTIONAL	**C.Multi-Sector- Usage** **Institutional Focus** (e.g. **Uganda**, Tanzania, Kenya, Mali, Sierra Leone, Nepal, Bangladesh, Ghana, Indonesia, Solomon Islands, Bhutan and emerging systems in the Philippines and India).	**D.Sector-Specific Usage** **Institutional Focus** (e.g. Uganda - functionality of the LG education[123], health, water and sanitation, roads and building production, environment and natural resources sectors; Philippines (Health), new sector-development grants in Tanzania (Agriculture, Health, Water).

Source: Adapted and updated from a table developed by Roland White and Jesper Steffensen in 2005.

[121] This annex is largely based on the PBGS publication: "Performance-Based Grants – Concept and International Experience", 2010, UNCDF, by Jesper Steffensen and has been used on other assignments as well.
[122] In Uganda the LG discretionary fund is called the Local Development Grant. In other countries these LG discretionary funds are called "block grants" or non-sectoral/non-categorical grants.
[123] Although one of the indicators "*overall P7 pass rate -%age in the previous FY for Government Aided primary schools*" is more service delivery.

A. Multi-sector versus sector-specific performance indicators

PBGSs may be designed as "*multi-sectoral*", aimed at improving the overall generic institutional and organisational performance of local government(LGs), or *"sector-specific"*. Most experience in developing countries has been within the first category. If the focus is on multi-sectoral performance, the PBGS typically tries to leverage broad improvements in overall *institutional capacity* and performance, in areas of benefit for all sectors – the type "C" grants in Table 1[124]. Access to performance-based funds would here tend to be dependent on LG improvements in broad, cross-cutting areas – such as planning, financial management and good governance (e.g. transparency and accountability). Examples of this could be requirements to have clean audit reports, timely approval of development plans, transparency and open citizen involvement in planning and budgeting processes, etc.

In *sector*-specific systems, the performance criteria would tend to focus on achieving certain service-delivery targets, such as the number of classrooms constructed or number of pupils passing various exams, or measures of various unit costs[125] (the focus being more on specific – and often more short-term – improvements in sector outputs). It is important that goals are not too numerous or too mixed within the same grant mechanism. Laying multiple sectoral delivery objectives over institutional development objectives may send conflicting messages to the target LGs, and will either set the bar too high for them to meet or will tend to incentivise mediocrity (as local authorities will shoot for the middle on most things). Choosing between an emphasis on B and C type grants (see table 1) involves a decision about the extent to which one wishes to focus on developing institutional capacity, versus a more output-oriented focus on sectoral delivery goals.

It is important to bear in mind that unless basic **institutional capacity** is built at the LG (sub-national) level, sustained sectoral service delivery is unlikely to emerge. Institutional capacity and performance are important intermediate means to achieve outputs and outcomes.

In countries where decentralization is a relatively recent phenomenon, and LG capacity remains a major challenge, focusing on cross-cutting *institutional* strengthening is probably the key priority – type (C) systems are therefore often applied in such contexts, in fact in most PBGS in developing countries. Type (A) grants are most appropriate for more mature institutional environments where (i) the basic structures have relatively few weaknesses; (ii) local systems are robust, effective and accountable; (iii) when sectoral responsibilities are fully devolved to and under the control of the LGs and (iv) where there are strong M&E systems in place to capture required information. Where sector decentralisation is strong, and sector-specific grants are in place, models B and D are often more feasible. However, there is also an important interplay with the next dimension, the use of funds.

B. Use of funds

This dimension reflects the extent to which the PBGS should allow local discretion over the use of the grant funds and to what extent these funds should be earmarked for expenditures determined by the centre. Invariably, national governments (and/or donors) will apply parameters for local discretion in some areas to ensure adherence to national targets. They may specify that funds

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[124] Institutional strengthening is here taken to mean the combination of enhanced organizational capacity (achieved mainly through improvements in functional/administrative systems and human resources) and deepened accountability (bottom-up, top-down and horizontal). The particular focus will vary from country to country.

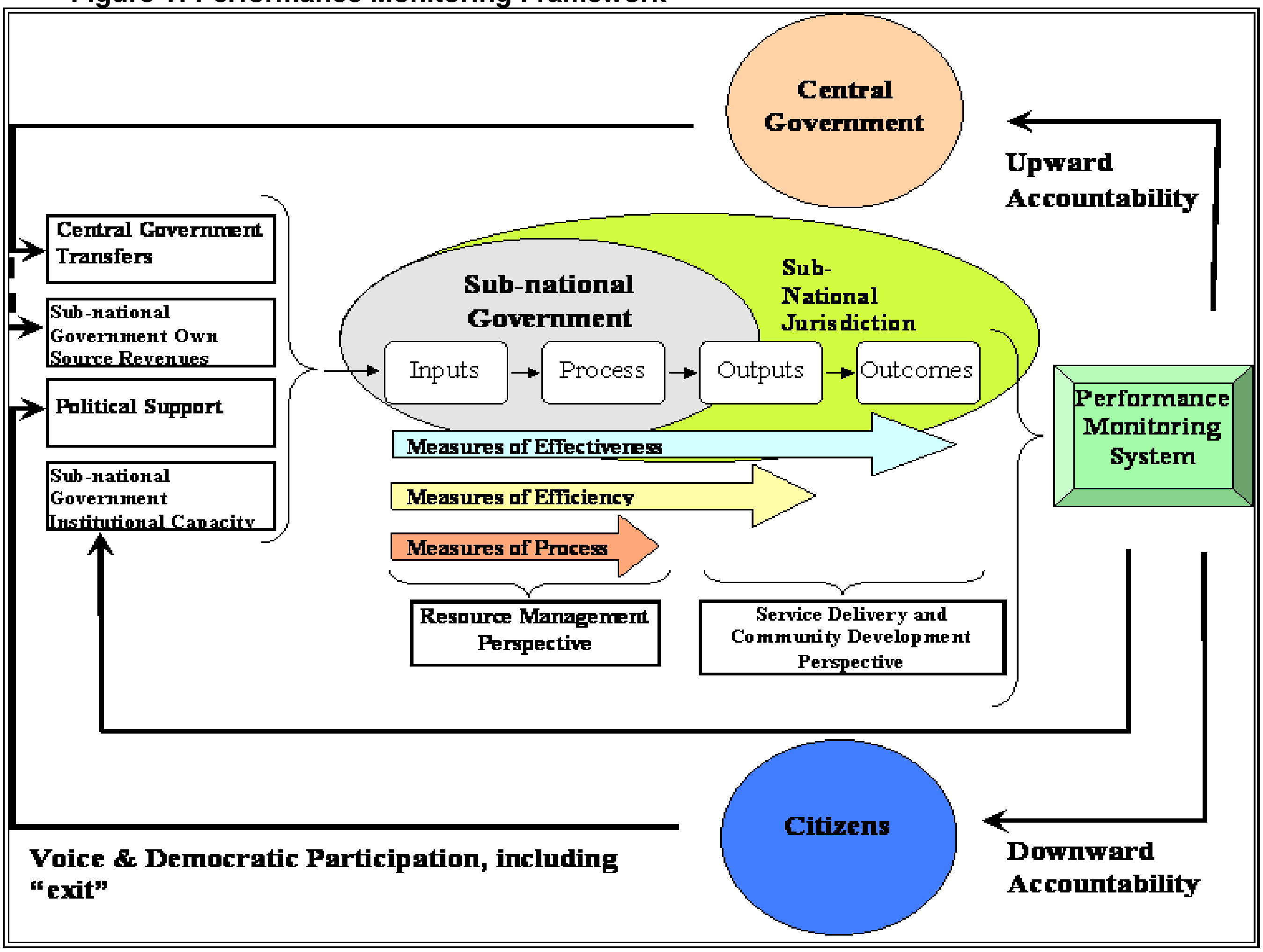
[125] As mentioned by Shah (2006: B), very few countries are using these output-oriented transfer schemes, despite their obvious potential. Shah mentions the dearth of incentives for politicians and administrators to introduce these systems as the main reason for this. However, there may be other reasons, such as technical challenges in design and monitoring, as there are some areas where service outputs can be more easily compared than in others. Secondly, a focus on sector-specific outputs requires that **such services are fully devolved to LGs**.

should be used for capital investment (as the case is for the LDG in Uganda) and/or they may proscribe certain types of expenditure (e.g. purchase of motor vehicles for the use of elected officials). Beyond this, there are many points on a spectrum whose end point is defined by very highly specified usages (such as a grant where the funds may be spent only on, for example, classroom construction). However, there is a trade-off here, as tight control and earmarking of funds will constrain the space for the emergence of efficiency in resource allocation based on local priorities, thus compromising the overall objectives of devolution. Systems with more autonomy in resource utilization will typically be supported by stronger incentive systems/performance measures.

C. Trade-off between various focus areas

A PBGS may focus on inputs, processes, outputs and outcomes. However, it is important to note that results in one phase of the process, such as final audit reports, will be perceived as inputs in the service-delivery chain, but will be outputs in another chain – the public financial management performance cycle, where there are a number of other inputs prior to this result (such as accountants in core positions, production of accounts, etc). Figure 1 below illustrates this.

Figure 1: Performance Monitoring Framework



Adapted from Kai Kaiser in a forthcoming publication on: "*Intergovernmental Performance Grants – A Synthesis of Issues and International Experiences*", prepared for the 13th India IFC, Revised Draft, July 31st, 2009

Many of the PBGSs focus on the **resource-management perspective**, systems, procedures and processes.

Moving toward sector output or outcome indicators may be a great temptation, but is not without caveats, particularly in multi-sectoral grant systems.

First, it may tend to distort the use of funds toward certain sector outputs (hard to balance these) and thereby move the system toward non-discretionary sector grants with strongly **"guided spending"**[126], i.e. an LG may be sanctioned if it focuses on water instead of roads, or vice versa, and these may not be in accordance with local needs and priorities.

Second, there is the question of **attribution**, as LGs can often legitimately claim that such outputs and (especially) outcomes are not under their direct control, but influenced by other (external) factors, e.g. the efforts of the line ministries or the level of resource available.

Third, the LGs may use funds from grants for quite **different purposes**, making it hard to compare their performance in terms of outputs, particularly for multi-sectoral grants, e.g. how to compare quality of a road with the quality of a school building, solid waste management etc., and which area should have the highest score here.

Fourth, the assessment will require a very **detailed assessment tool** with specific definitions and targets, and this is likely to lead to a very complex and expensive assessment process with significant field-work on a regular basis. It may lead to further delays in the assessment process experienced in some countries, and very high costs of the assessment, which is already an issue in some of the countries.

Fifth, outputs and outcomes are often only to be observed after **several years of operation,** fitting poorly with the annual assessment cycle and the incentives to be provided.

It may be argued that strong systems of **process indicators** (those reflecting planning, budgeting, financial management, good governance, etc.) will be important **prerequisites** in any case for the achievement of all service- delivery outputs and it has been documented in various audits that stronger PFM procedures, including governance and transparency is often related with improved local services[127]. If these systems are stronger and more robust, there is a greater likelihood that the actual services will be produced more efficiently and transparently. It may finally be argued that certain processes, particularly in areas of good governance, can be seen as **ends in themselves** – e.g. if people participate in decision-making and monitoring[128]. However, it is also a question of sequencing, getting the basics right and then moving on toward the next stage. Sector-specific output indicators are easier to handle in *sector-specific grants*, where they will be aligned with the specific sector needs and targets, and where they will not distort local priorities across service-delivery areas. However, even for these grants, there are additional demands on the assessment teams and the issue of quality assurance on these.

For these reasons, **unconditional block grant** funding/discretionary funding within the PBGS has been more closely tied to performance seen through the prism of "process indicators/intermediate

[126] LGs will rapidly work out in which sectors they will obtain high performance scores and thus target their investments toward these, compromising and blurring the local priority setting process.

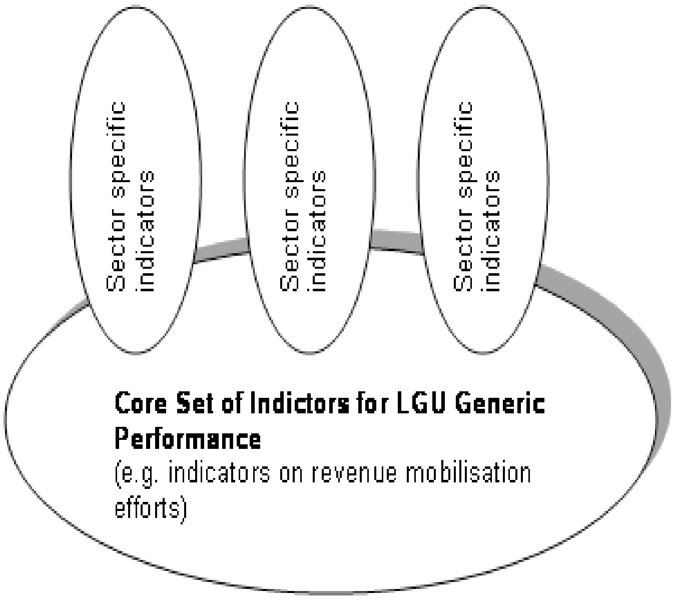
[127] This was also convincingly argued in a recent review of LGDP in Uganda (World Bank 2008) and was a key assumption underlying the entire review of General Budget Support under OECD (see IDD et al 2006). In the review of GBS, the PFM results were treated as **immediate effects leading to outputs such as improved service delivery and accountability**.

[128] In most definitions of poverty, people's empowerment is an important part, including the options for participation in decision-making.

indicators", as more easily measured proxy measures for likely performance outcomes, but also because some of these indicators constitute benefits in themselves (e.g. participation of citizens in local decision-making, involvement of women and disadvantaged groups, targeting of investments and empowerment vis-à-vis the LGs[129]).

It is also possible to combine the systems in the sense that the PBGSs for multi-sectoral grants focus on generic institutional performance improvements, whilst sector grants also include more sector-specific and output-oriented indicators (see the diagram below)[130].

Figure 2: Links between the Multi-sectoral and Sector Performance-Based System



2. Conclusions on the Limitations in the Overall Focus of the PBGS – From Inputs to Outcomes

Ideally, it should be possible to tie the funding of LGs to their success in improving service delivery and in reducing poverty. Most systems influence this in a largely indirect manner, by providing incentives for improvements in the ways that LGs work and function. They also do so directly, by improving governance practices (e.g. enhanced participation, citizen involvement, etc.), often seen in themselves as important elements of poverty reduction[131]. But the fact remains that the PBGS model used to date does not directly link LG funding to service-delivery and poverty-reduction outcomes, but address intermediate indicators of importance for these objectives.

[129] In many measures of poverty reduction (the end target for many grants),"empowerment of citizens" is one of the core dimensions and an end it itself.

[130] This is the case for the system in Tanzania and is also under development in countries like Uganda and the Philippines.

[131] This section draws on Shotton & Winter (2006: 74).

However, it is often neither practical nor useful to attempt to institute direct links between measures of such outcomes/impacts and annual PBGS funding. Several reasons underlie this, *inter alia*:

- The ***high costs and complexity*** of undertaking regular annual surveys of outcome/impact indicators in every LG area and the wish to ensure that the assessments are kept simple and manageable – how e.g. to compare the quality of a school with the quality of the roads;

- The ***attribution problem*** that would have to be addressed, since LGs can often legitimately claim that such outcomes derive partly from factors outside of their control and which may depend on the service-delivery performance of line ministries – it is nearly impossible to distinguish between these factors[132]. It may not, for example, be fair to sanction LGs for a low enrolment rate in schools (output) if the education sector is not fully devolved to LGs or for a low literacy rate (outcome) as factors other than LG activities/performance have an impact on this (typically the poverty level, distance to service facilities and economic potential of an area and/or historical/cultural reasons);

- The wish to ensure a high level of ***flexibility*** in the use of funds. As PBGSs are often applied to non-sectoral block grants, neighbouring LGs may use funds for quite a different mix of service expenditures[133], greatly complicating the comparison of the performance outcomes. It may also indirectly defeat the purpose, if outcome indicators are focusing on a few sectors (non-balanced), or it may be very hard to balance across the sectors in terms of scoring weights[134]. Giving all sectors equal weightwould also be wrong, as all sectors should not have the same share of investments. Giving some sectors a higher weight could lead to bias toward these sectors, even in local areas where there is no need for this, e.g. agriculture interventions in urban areas;

- Process and intermediate indicators can be formulated in manner where they are important for the subsequent outputs and outcomes;

- The fact that outputs and outcomes are often only seen after ***several years*** of operations, fitting poorly with the PBGS assessment process and the incentives to be created.

There are therefore good reasons why non-sectoral block-grant funding within PBGSs has been more closely tied to performance measured against *process* indicators and *institutional* outputs (such as participatory planning and budgeting processes, revenue mobilisation and transparency and good governance in administration). This type of performance underlies all service delivery, is more easily measured, and can act as a proxy for performance outcomes[135].

For sector grants, the problems associated with sector-specific output indicators are somewhat reduced. Nonetheless, care must be exercised in ensuring that such indicators (i) measure what is wholly attributable to LG actions; (ii) are poverty sensitive; (iii) are not too complex and time-

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[132] E.g. LGs in the Philippines have complained that the M&E system established should make it clearer which indicators relate to areas under their control (often more input-, process- and output-related) and which relate to areas outside of their control (often more outcome- and impact-related indicators).

[133] This is actually also promoted by one of the objectives behind decentralisation, which is to ensure a close link between targeting of investments and local needs.

[134] This has, for example, been a problem in the previous draft assessment manual for municipalities in Nepal. The proposed system would (as it was tested) provide incentives to municipalities to focus on a limited number of sectors, which may not necessarily be the most important ones for poverty reduction and addressing local needs.

[135] One of the important findings in a value-for-money-audit in Uganda was that there was a direct link (correlation) between the LGs which have improved performance in institutional areas such as PFM and in their efficiency and effectiveness in service delivery, World Bank (2004), pp 7, 12 and 27.

consuming to collect; and (iv) are fair. However, even in this area there are major challenges in defining specific and feasible indicators – an indicator such as the unit cost of classroom construction may be influenced by conditions in the environment, logistical conditions, economic and historical factors. It is perhaps a gradual process whereby the core processes – such as planning, PFM, interactions with citizens – are fixed as the first step in measuring progress toward effective decentralisation, and then gradually moving toward more output-based systems, particularly for sector funding schemes. M&E system needs to be able to support the annual assessment systems.

When the decision on the objectives and basis design are taken, the next step is the design of the MC/PMs. Below is a brief summary of the some of the main considerations.

3. Design of MCs and PMs

Minimum conditions (MCs) – these are the basic conditions with which LGs need to comply in order to access their grants, and they are formulated to ensure that a minimum absorptive capacity/performance (e.g. in terms of planning, financial management and administration) is in place to handle additional funds. They are most often formulated as on-off triggers for the release of funds, and ideally the entire set of MCs should be complied with before LGs can access their performance grants. It is important to ensure that there are no waivers from these critical conditions as this will undermine the overall trust in the system and the incentives it is supposed to support.

Performance measures (PMs) – are more qualitative and variable measures of LG performance, and will typically go into more detail within each functional area, such as the quality of the planning, quality of environmental management, etc. The measures are used to adjust the level of funds made available to LGs as and when they have complied with the basic MCs.

There are many pitfalls in the design of these indicators. In defining indicators for minimum conditions and performance measures, the following principles need to be borne in mind:

- Utilise the experience gained from previous testing and piloting, and from other countries which have introduced similar systems with encouraging results;
- Support LG compliance with statutory requirements (government laws and regulations). Although this is a guiding principle in most places, the performance measures may also target areas outside of these (be ahead of the legal framework), particularly with respect to good governance and transparency indicators. But in these areas it is important that LGs, through capacity-development activities or other kinds of guidance, receive support and advice on how to improve performance before the assessment is conducted. It is not advisable to assess compliance with very complicated new requirements and systems if LGs have not been sensitized and trained in their utilization and/or informed about these;
- Try to ensure good coverage of the existing government assessment systems and M&E indicators and results (such as those used by the inspection function, statistical surveys, available audit reports, etc.), and make use of these results to the extent possible with sufficient quality assurance. This will reinforce subsequent efforts to harmonise and align the systems and ultimately help move toward the use of a single common assessment tool for LG performance. The PBGS assessment often function as a useful sub-set of the overall M&E and performance monitoring system, but cannot fulfil all objectives;
- Use a combination of minimum conditions (MCs), designed as on-off triggers, with which compliance provides some basic safeguards against the misuse of funds, and more qualitative performance measure (PMs), used to adjust the size of the grants) to promote

better performance. However, some countries have begun their PBGSs by focusing only on the core MCs to keep things simple in the first phases;

- Endeavour to ensure that the core areas are well-targeted and avoid too many indicators of minor importance. However, some such indicators may be included to raise future awareness and identify capacity building gaps, and these may be increased over time;
- Start with the core generic areas of performance under LG control, such as financial management, participation, transparency and good governance. Generally, it seems more appropriate to avoid indicators of service delivery outputs in the initial stages of establishing a PBGS, as these types of indicators (i) often cover aspects of performance that are not under LG control; (ii) can make the system overly complex; and (iii) can bias LG-funded investments into certain sectors and away from others;
- All the indicators should cover functions or activities that are under the control of LGs and for which performance is genuinely attributable to LG management. In other words, the system should not use indicators of sector outputs and outcomes in countries with a limited level of decentralisation, precisely because these areas are still largely outside of LG control. However, as and when sector functions are genuinely devolved to local governments, it may become appropriate for a PBGS to use indicators of sector outputs and outcomes as measures of LG performance, particularly for sector grants;
- Seek to identify performance priorities and then weight the indicators accordingly. Thus, participatory planning and revenue mobilization may be seen as some of the core areas where improvements are most urgently required – and indicators for them can therefore be allocated a higher scoring weight relative to other, less important, performance indicators. Identifying such performance priorities and then according them greater prominence is one of the key PBGS design issues to address. This will often require a detailed prior review of LG performance in various areas, and identification of weaker areas, benchmarked against international/regional standards;
- Whilst a PBGS is designed primarily to provide incentives for improvement in LG performance, it is also intended to identify capacity-building gaps and provide input to the overall M&E system of LGs. Ensuring linkages between the PBGS and other M&E systems and their indicators is therefore critical;
- Ensure that a PBGS addresses LG functional weaknesses, as identified through consultations with various stakeholders and through previous piloting;
- The requirements imposed by minimum conditions and performance measures should be realistic, achievable and objectively verifiable, i.e. clearly defined, but still sufficiently demanding to promote improvements;
- Try to design a PBGS in a manner whereby the system can progressively cover specific sectors (and sector grants), using the generic indicators as the core basic framework, but adding sector-specific indicators for sector grants if these are in place,
- The system should be based on a clear and simple scoring system. More-qualitative indicators (e.g. levels of participation in planning) require more field testing and control than do simpler, quantitative indicators.

The definition of MC/PM indicators and the way the scoring system is structured have an important bearing on the acceptance and credibility of the PBGS when applied at the local level. The main guiding principles for the final selection of appropriate indicators will typically be the need to achieve grant *objectives*, combined with practicality and *simplicity* in the selection of various options and the need to harmonise different assessment systems so as to avoid duplication and confusion. Too simplified a system may hinder buy-in and lead to alternative (and more sophisticated) performance-measurement systems, designed by other agencies. In any case it is important that the indicators are clear, transparent and cover key performance areas consistently, promoting the overall objectives of the transfer scheme.

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