



REPUBLIC OF MOZAMBIQUE

TECHNICAL ASSISTANCE REPORT — MANAGING FISCAL DECENTRALIZATION AND STRENGTHENING CASH MANAGEMENT

January 2023

This technical assistance report on Republic of Mozambique was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in June 2019.

Disclaimer:

This report was prepared in 2019 and the Republic of Mozambique consented to its publication in 2023. The report is being published as it was written at the time.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

**International Monetary Fund
Washington, D.C.**

F I S C A L A F F A I R S D E P A R T M E N T



I N T E R N A T I O N A L M O N E T A R Y F U N D

Mozambique

Managing Fiscal Decentralization and Strengthening Cash Management

Sailendra Pattanayak, Felipe Bardella, John Gardner, Elizabeth Kariuki, Juliana Pigey, and Esther Palacio



Technical Report

June 2019

The contents of this report constitute technical advice provided by the staff of the International Monetary Fund (IMF) to the authorities of Mozambique (the "TA recipient") in response to their request for technical assistance. This report (in whole or in part) or summaries thereof may be disclosed by the IMF to IMF Executive Directors and members of their staff, as well as to other agencies or instrumentalities of the TA recipient, and upon their request, to World Bank staff and other technical assistance providers and donors with legitimate interest, unless the TA recipient specifically objects to such disclosure (see Operational Guidelines for the Dissemination of Technical Assistance Information—

<http://www.imf.org/external/np/pp/eng/2013/061013.pdf>).

Disclosure of this report (in whole or in part) or summaries thereof to parties outside the IMF other than agencies or instrumentalities of the TA recipient, World Bank staff, other technical assistance providers and donors with legitimate interest shall require the explicit consent of the TA recipient and the IMF's Fiscal Affairs Department.

CONTENTS

| | |
|--|-----------|
| ABBREVIATIONS AND ACRONYMS | 5 |
| PREFACE | 6 |
| EXECUTIVE SUMMARY | 7 |
| I. MANAGING FISCAL DECENTRALIZATION | 12 |
| A. Introduction and Background | 12 |
| B. Current Budget and Financial Execution Processes and Systems | 13 |
| C. Overall Strategic Context and Setting the Stage | 15 |
| D. Establishing a PFM Framework and Legal Landscape for Provinces | 17 |
| E. Provincial Responsibilities | 27 |
| F. Provincial Resources – Transfers from the State | 30 |
| G. Provincial Resources – Own Source Revenues | 35 |
| H. Transitional Approach for Fiscal Decentralization Law | 36 |
| II. STRENGTHENING CASH MANAGEMENT AND EXPENDITURE CONTROL | 38 |
| A. Introduction | 38 |
| B. Budget Execution Reform | 39 |
| C. Active Cash Management Operations | 47 |
| D. Summary of Required Activities | 49 |
| E. Summary of Recommendations | 49 |
| III. STRENGTHENING CONTROL OF WAGEBILL AND MANAGING ARREARS | 50 |
| A. Controlling Wage Bill Expenditure | 50 |
| B. Managing Historical and New Arrears | 52 |
| C. Summary of Recommendations | 54 |
| BOXES | |
| 1.1. Potential Functions for Provinces and Districts | 28 |
| 1.2. Comments on Initial Proposals for Decentralization in Education Sector | 29 |
| 1.3. International Lessons Learned: Setting the Size of the Transfer Pool | 33 |
| 1.4. Criteria for the Design of Fiscal Transfers | 34 |
| FIGURES | |
| 1.1. Structure of the Education Budget by Level of Implementation | 14 |
| 1.2. Public Financial Management Cycle | 20 |
| 2.1. Building Cash Flow Forecasts | 45 |
| 3.1. Mozambique’s Estimated Wage Bill in 2019 Compared to Other Low-Income Countries in the Region | 51 |

TABLE

1. Summary of Key Recommendations _____ 10

ANNEXES

I. Example of Types of Expenditure Functions for Regional/Provincial Level of Decentralized Governance _____ 55

II. Sample Terms of Reference for a Cash Management Committee _____ 56

ABBREVIATIONS AND ACRONYMS

| | |
|-----------|--|
| AL | Autarquias locais and local authorities (<i>autarquias locais</i>) |
| AT | Administrative Tribunal |
| ANE | National Roads Agency (<i>Agencia Nacional de Estradas</i>) |
| BoM | Bank of Mozambique |
| CoA | Chart of Accounts |
| CMC | Cash Management Committee |
| CMU | Cash Management Unit |
| CN | Commitment Note |
| CUT | Treasury Single Account (<i>Conta Única de Tesouro</i>) |
| DNB | Directorate of National Budget |
| DNT | Directorate of National Treasury |
| e-SISTAFE | Computerized Finance Management System of the State |
| FCA | Local authorities Compensation Fund (<i>Fundo de Compensacoes Autarquicas</i>) |
| IGF | General Inspectorate of Finance |
| MAEFP | Ministry of State Administration and Public Service |
| MEF | Ministry of Economy and Finance |
| MOPHRH | Ministry of Public Works, Housing and Water Resources |
| MEX | Transaction and Accounting Module of e-SISTAFE |
| MPE | State Assets Module of e-SISTAFE |
| PES | Economic and Social Development Plan (<i>Plano Economico e Social</i>) |
| PFM | Public Financial Management |
| PQG | Programa Quinquenal do Governo |
| SISTAFE | Finance Management System of the State (<i>Sistema de Administracao Financeira do Estado</i>). |
| SNG | Subnational Governments |
| SNGRH | Human Resource Management Information System |
| SSA | Sub-Saharan Africa |
| SU | Sectorial Spending Units |
| VAT | Value Added Tax |

PREFACE

In response to a request from the Minister of Economy and Finance, Mr. Adriano Maleiane, a technical assistance (TA) mission from the Fiscal Affairs Department (FAD) visited Maputo, Mozambique during the period February 18 to March 1, 2019 to advise on strengthening expenditure control and cash flow management, and ensuring effective fiscal coordination and reporting in the context of the planned fiscal decentralization.

The mission was led by Mr. Sailendra Pattanayak (FAD Deputy Division Chief), and comprised Mr. Felipe Bardella (FAD Staff), Mr. John Gardner, Ms. Elizabeth Kariuki and Ms. Juliana Pigey (all FAD Experts), and Ms. Esther Palacio (IMF TA coordinator based in Maputo). The mission benefitted from the support of Mr. Ari Aisen, IMF Resident Representative in Mozambique, and the local office.

The mission would like to express its gratitude for the close cooperation and fruitful collaboration provided by the authorities, especially Mr. Domingos Lambo, Permanent Secretary, who guided and coordinated the work of the mission. The mission would also like to thank CEDSIF and Treasury staff for their valuable support, and all the participants to the various meetings and workshops for their active and constructive participation, including staff from Ministries of Public Administration, Health, Education, and Public Works.

This mission is part of the “Strengthening Fiscal Institutions in Mozambique Project” that is funded by the Government of Denmark and implemented by the IMF.

EXECUTIVE SUMMARY

The Constitutional amendment of June 12, 2018 has placed a major decentralization reform front and center of the Government of Mozambique's agenda. The political pillar of this decentralization reform is the creation of directly elected provincial assemblies with an elected Governor, and directly elected district assemblies with their elected district administrator. The first elections for Provincial Assemblies/Governors under this reform will take place in 2019, along with the national elections. The first elections for District Assemblies and Administrators will take place in the next mandated elections of 2024. The administrative pillar of this reform is the definition of a significant set of service delivery and public administration competencies. The third core pillar of the decentralization reform is financial.

The fiscal decentralization of provinces and districts will build on the already highly deconcentrated public financial management (PFM) system. Around 38 percent of the State budget is currently spent at provincial and district levels. Provinces and districts already execute their budgets with a high degree of administrative and financial autonomy.

The operationalization of the decentralization process should be gradual and take account of four factors: maintaining overall macro-economic stability; ensuring allocation for national priorities; developing local capacity for budget management/PFM; and managing expectations of elected bodies at sub-national level to address local priorities and take budget policy decisions.

The fiscal decentralization law for the provinces should be comprehensive and cover the following key areas: a clear budget calendar for coordination between provincial and central level, including sharing of key fiscal information at specific points in the calendar; timing, frequency and content of fiscal reporting by provinces; common chart of accounts (CoA) and budget classification architecture for all levels of government; banking arrangements/CUT for execution of provincial budgets; restrictions on borrowing by provinces or setting clear rules if they are allowed to borrow and issue guarantees; transfer of staff and assets (e.g., buildings and equipment) relating to the competencies that are decentralized; transparent rules/criteria for transfer of funds to provinces, including block and conditional transfers; and whether the provinces will continue to use the State budget execution system (e-SISTAFE) and treasury services (including cash management operations). There are pros and cons to various options and the report lists these but does not recommend specific options which the government should decide. For maintaining the unity of the structure of the budget, the budgets of the provinces could be incorporated as annexes in the State budget that is submitted to Parliament.

The fiscal decentralization law should include transitional provisions for budget management at provincial level until specific options are chosen in the above listed areas. Further preparatory work will be needed in certain areas before decisions could be taken. For example, a survey or census will be required to identify the specific staff and assets to be transferred to the provinces based on the competencies transferred to them.

A step-by-step approach should be followed for developing a system of fund transfers to provinces. The Ministry of Economy and Finance (MEF) should review with respective sectorial

ministries the current amount of budget allocation for the provincial competencies and determine an allocation formula. The allocation formula should be simple and based on objective factors, with available data; predictable with shares to remain stable for the first few years to support provincial planning and service delivery; and transparent so that the basis of the allocation is clear. The MEF could consider an operating transfer which would consist of the following types of envelopes: one conditional grant for covering payroll expenditures; a basic pool with discretionary allocation for provincial executive council, administration and assembly operational costs, allocated among provinces by a clear formula; and one individual envelope per sector for goods and services (such as for provincial/regional roads maintenance, environmental protection), each allocated among the provinces according to a formula which could include general criteria (population, surface area) and specific criteria relevant to the specific area of competency. The formula used should be in an annex to the State budget. The fiscal decentralization law should also include rules for addressing any persistent cash surplus build-up at the provincial level.

The Government of Mozambique has received substantial technical assistance in the last decade – from the IMF and other partners – on budget execution and cash management.

This has been primarily diagnostic and has focused on issues arising from a lack of budget credibility, lack of enforcement of controls during budget execution, and poor cash management. These issues have resulted in a large stock of expenditure arrears and the imposition of strict cash rationing when responding to requests for payment of budget expenditures by sectorial spending units (SU). The authorities have prepared a strategy for strengthening expenditure control and cash management with support from AFRITAC South.

Based on previous FAD advice, there has been progress in validating and clearing the stock of arrears accumulated by end 2017, but substantial amounts of new arrears are emerging.

All the three sectorial ministries (health, education, and public works) that the mission met indicated that they have accumulated large amounts of unpaid invoices that were received during the FY 2018. The reasons for the emergence of new arrears are three-fold. First, actual revenues are typically lower than the forecast, partly due to non-realization of aid committed by donors. Second, due to weak ex-ante payroll control, some sectors recruit more staff than the number authorized in the budget and are provided additional allocation. Third, there is currently no system of controlling commitments/contracts by SUs within an authorized ceiling, which is a standard practice in many Sub-Saharan African (SSA) countries.

Weak ex-ante control over commitments and payroll, coupled with strict cash rationing, undermine the credibility of the PFM system and pose a serious risk to the build-up of further arrears. Cash rationing has caused payments to be reduced at such times even though government obligations continue to be incurred. While some of these problems have been a legacy of the past, in the context of the upcoming decentralization there is an opportunity for the MEF to strengthen budget execution and cash management processes.

The only way to deal with the effects of non-credible budget and prevent expenditure arrears is to enforce controls at the commitment/contracting stage. This would prevent

further arrears by reducing payment obligations before they are incurred. The report proposes a two stages approach which starts with making correct use of the commitment methodology.

- The MEF – specifically the Directorate of National Budget (DNB) – should issue and enforce a commitment ceiling for SUs for the period ahead through the e-SISTAFE system by making it mandatory for SUs to have a system generated commitment note (CN) as a requirement for signing contracts. This will also help capturing the value of commitments in real-time in e-SISTAFE to facilitate monitoring of SUs’ obligations by the MEF.
- A high-level cash management committee chaired by the Minister of Finance or the Permanent Secretary should be established to decide the quarterly budget release envelope which would apply to commitment ceilings given to SUs by the DNB.
- In the first stage, the current practice of reducing the available budget allocations on expenditure classification heads by withholding ten to fifteen percent of their value should be used to constrain commitments of SUs and enforced through the e-SISTAFE system. The SUs will see no difference in their budget execution other than the requirement to undergo a commitment ceiling check by the system in real time before signing a contract.
- An official circular is required to specify the new commitment control process and its commencement date. This should also be accompanied by an outreach to sectorial ministries to explain the changes and to indicate to all government suppliers that, from the date of implementation of the new process, no contract entered into with a government entity will be valid for subsequent payment unless it is attached to a unique, and verifiable, CN.
- In the second stage, reasonably accurate cash flow forecasting should be performed by a skilled cash management unit (CMU) with access to SU capital expenditure plans (when the MPE module is rolled out). Realistic revenue, debt and aid projections will also be necessary. The NDB would decide where the commitment restrictions would fall. This would entail consideration of procurement plans and apply to large, volatile expenditures whose delay would not impact adversely on government policy delivery or essential government services.
- In the second stage, with an effective budget management system which anticipates cash shortage effects of a non-credible budget, there should be little need for cash rationing. The development of the Treasury bill market – separately from its use for monetary policy purposes – is therefore a medium-term goal to facilitate active cash management operations.

There is also a need to control wage bill expenditure. Two key areas undermining government’s ability to control wage bill expenditure relate to bonuses and overtime payments, and staff establishment controls. The Ministry of State Administration and Public Service (MAEFP) identifies only ex-post the cases where staff ceilings have been exceeded. As new recruits are already on the e-payroll, the MEF is obliged to request for additional budget allocation to absorb the additional wage bill costs. The following measures are recommended.

- The General Inspectorate of Finance (IGF) should undertake an audit of sectors where this problem is acute (e.g., agriculture, education and health) to identify the control weaknesses.
- The MAEFP should verify ex-ante each request for new recruits against the approved staff ceiling, prior to its submission to the Administrative Tribunal.

Table 1 summarizes the key recommendations of the report.

Table 1. Summary of Key Recommendations

| Recommended Measure (including recommendation no.) | Indicative Timeline | Responsible Agencies |
|---|------------------------|---------------------------------|
| 1. Managing Fiscal Decentralization | | |
| 1.1: Consolidate the PFM related laws (Sistafe law, PFM law for <i>autarquias locais</i> , planned fiscal decentralization law) in an overarching comprehensive PFM law covering all levels of government. | 2020-2024 | MEF |
| 1.2: Incorporate a coordinated budget calendar, standard reporting and transparency requirements, and harmonized budget classification and accounting standards in the fiscal decentralization law. | 2019 | MEF |
| 1.3; 1.4; 1.5: Don't provide for short term/long term borrowing and PPP operations by provinces in the first provincial mandate | 2020-2024 | MEF |
| 1.6: Develop the necessary rules for borrowing and debt limits for provinces and districts in the future and incorporate these rules in the proposed overarching PFM law (Recommendation 1.1). | 2025 | MEF |
| 1.7: Provide guidance to sectorial ministries of some key norms and principles to take into consideration in the identification of competencies and authorities to be transferred to provinces and districts. | 2019 | MEF |
| 1.8; 1.9; 1.10: Instruct sectorial ministries that transfer of competencies to provinces should be accompanied by the transfer of related personnel, equipment and buildings. | 2019 | MEF/MAEFP |
| 1.11: Establish in the fiscal decentralization law basic principles and guidelines to support preparing the transfer allocations to finance provincial competencies. | 2019 | MEF |
| 1.12: Review with sectorial ministries current amount of budget allocation for the proposed competencies and determine an allocation formula. | 2019-2024 ¹ | MEF/ Sectorial Ministries |
| 1.13: Identify what service fees, charges or other non-tax revenue may be associated with the competencies to be transferred to provinces and districts. | 2019-2024 | MEF/MAEFP |
| 1.14: Include transitional provisions in the fiscal decentralization law focused on the budget cycle for the coming years, in particular, the first autonomous provincial mandate. | 2019 | MEF |
| 1.15: Design the transitional provisions with a two-phase approach to be implemented over the first autonomous provincial mandate. | 2019 | MEF |
| 2. Strengthening Cash Management and Expenditure Control | | |
| 2.1: Configure e-SISTAFE to control commitments through commitment ceilings and the issuance of commitment notes | April 2019 | Treasury, CEDSIF |
| 2.2: Conduct outreach to all sectorial ministries and government suppliers on the appropriate use of commitment notes | May 2019 | MEF |
| 2.3: Use the current budget withholding methodology to set ceilings for commitment controls by Sus, and issue a circular specifying the new commitment control process | Start May 2019 | MEF, DNB, SUs |
| 2.4: Establish a Cash Management Unit (CMU) within the National Directorate of the Treasury to perform government cash flow forecasting and active cash management operations | July 2019 | Treasury |

| | | |
|--|--------------------|------------------------------|
| 2.5: Establish a skilled macrofiscal unit in the MEF tasked with producing realistic revenue forecasts both for multiannual fiscal policy and in-year budget management purposes | July 2019 | MEF |
| 2.6: Develop a capacity building program for CMU cash flow forecast modelling and the production of expenditure plans at large SUs | Start July 2019 | Treasury |
| 2.7: Establish a high-level Cash Management Committee (CMC) chaired by the Minister or PS to decide the quarterly commitment envelope for implementation by the DNB | January 2020 | MEF, DNB |
| 2.8: Consider centralizing the payments process within the e-SISTAFE once commitment controls are effective | Start January 2020 | Treasury, CEDSIF |
| 2.9: Consider standardizing suppliers' payment terms within the e-SISTAFE system and using these to develop more accurate short-term payment forecasts | Start January 2020 | Treasury, CEDSIF |
| 2.10: In coordination with the BoM and the debt managers, commence plans to develop the T-bill market specifically for cash management purposes | Start July 2020 | Treasury, BoM |
| 3. Strengthening Control of Wage Bill and Managing Arrears | | |
| 3.1: Undertake an audit of the processes and controls to safeguard staff establishment and payroll control in agriculture, education and health | December 2019 | IGF |
| 3.2: Institutionalize mechanism for verifying actual against approved establishment prior to each new recruitment | July 2019 | MAEFP |
| 3.3: Extend arrears clearance to cover the arrears accumulated during 2018 | Start April 2019 | Treasury, IGF |
| 3.4: Prepare a strategy for clearing VAT refund arrears | Start April 2019 | Treasury, Revenue Authority |
| 3.5: Regularly monitor and report on arrears in budget execution and year end fiscal report | Start July 2019 | Treasury, Accounting, CEDSIF |

¹ Until the allocation formula is defined, shorter-term indicative targets could usefully be set for the first few years.

I. MANAGING FISCAL DECENTRALIZATION

A. Introduction and Background

1. The Constitutional amendment of 12 June 2018 has placed a major decentralization reform front and center of the Government of Mozambique's agenda. The implementation of decentralization is part of the country's peace accords. This reform aims to associate citizens in resolving problems of their communities, promote local development, and deepen democracy, within the overall unity of the Mozambican state (Constitution Article 270-A). The decentralization reform comprises three pillars: political, administrative and financial.

2. The political pillar of this decentralization reform is the creation of directly elected provincial assemblies with an elected Governor, and directly elected district assemblies with their elected district administrator. The first elections for Provincial Assemblies/Governors under the revised Constitution will take place in 2019, along with the national elections. The first elections for District Assemblies and Administrators will take place in the next mandated elections of 2024.

3. The administrative pillar of this reform is the definition of a significant set of service delivery and public administration competencies (further discussed in section E, below). Provinces, districts and municipalities (*autarquias locais*, AL) are to enjoy administrative autonomy (Constitution Article 270-C) and will have their own personnel, who are part of the overall state civil service (Constitution Article 270-I).

4. The third core pillar of the decentralization reform is financial. Provinces, Districts and AL will have autonomy in the management of their financial affairs and properties. The analysis and recommendations of this chapter will focus on the public financial management (PFM) framework and principles for the financial resources of Provinces, that will make the Provincial Assemblies a reality starting 2020, while taking into consideration the fragile macro-economic environment and PFM challenges of the Mozambican State. There is a very short time in which to define clearly the financial, staffing and asset / equipment transfers that will accompany the new competencies so that the provincial elections can take place with clarity on the roles for which assembly members and the Governors will be elected.

5. This reform will create two new levels of decentralized government in addition to the *autarquias locais*. These are expected to be subject to a dual accountability, upwards to the central government and downward to their respective constituents, thus being able to improve the quality of local and regional public services in line with local priorities. Among the many challenges which will have to be addressed in setting up the new Provincial Assemblies and Executive Councils in 2020 are ensuring that national priorities remain addressed and that PFM capacity is developed.

6. The Government has begun the preparatory work for the legal framework that will accompany the decentralization reform. The initial package of laws to enable the reform implementation were adopted by the Cabinet and submitted to the National Assembly by mid-February 2018. This package consists of the following texts:

- Law on the Organization and Functioning of the Executive Bodies of Decentralized Provincial Governments
- Law on the Organization and Functioning of Provincial Assemblies
- Law on the Organization and Functioning of State Deconcentrated Services in the Provinces
- Law on the State Administrative Supervision (*Tutela do Estado*) on Decentralized Provincial Governments and on Local Authorities (*Autarquias Locais*)
- Law for the Election of Members of the Provincial Assemblies

The consultations and review of these draft texts are ongoing.

7. The last core element of the legal package is a law on the finances and PFM framework (fiscal decentralization law) for the provincial decentralized bodies. This report examines the key principles, the current legal PFM framework and international experience to propose targeted recommendations. These are for consideration of the MEF in the development of the legal text itself as well as for beginning to plan the actual implementation subsequent to the elections and launch of the mandate of the Provincial Assemblies and Provincial Executive Councils. The legal framework that will apply for the Districts can be developed over a longer period of consultation and discussion and will thus benefit from the lessons learned during the implementation of the first mandate of the new Provincial Assemblies.

8. A definition of financial autonomy has been provided in the draft Law on the Organization and Functioning of the Executive Bodies of Decentralized Provincial Governments, comprising three key elements:

- Develop, approve, amend and execute its program of activities and its own budget
- Develop and approve management accounts
- Dispose of own revenues, mandate (*ordenar*) and process expenditures, record revenues that according to law are authorized for decentralized governments, have recourse to loans, in the terms of the law.

This initial definition is sufficiently broad to ensure the key elements of financial autonomy which will be further elaborated in the forthcoming fiscal decentralization law.

B. Current Budget and Financial Execution Processes and Systems

Current share of provinces and districts in the State budget

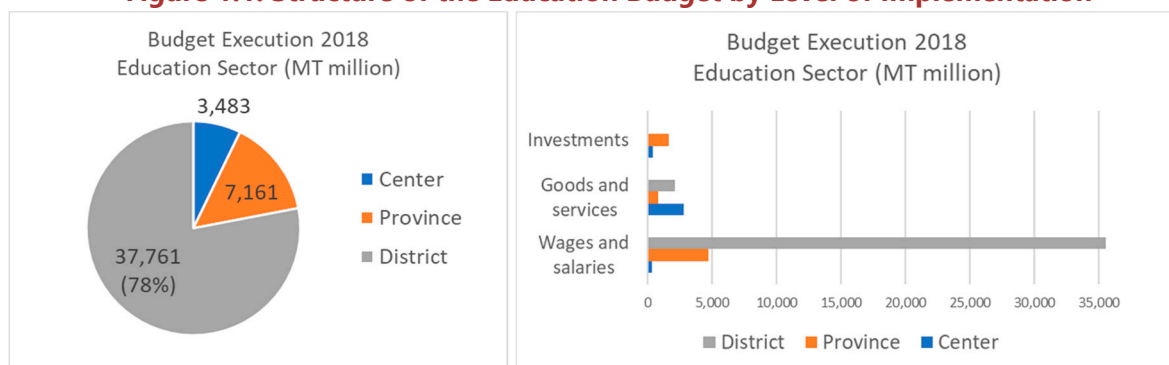
9. Public service delivery in Mozambique is already highly deconcentrated at the provincial and district levels. Government units directly in charge of provision of public services in several sectors are administered by local bodies, such as Provincial Directorates and District

Entities (*Delegações Provinciais e Servicos Distritais*). For example, in the health sector, such bodies have ultimate management responsibility in large provincial hospitals, rural hospitals and health centers dispersed all over the country. Although authorities are upwardly accountable to the central government, the administration of public services is clearly conducted at local level.

10. Budget and financial execution reflects this high degree of administrative deconcentration. Provincial and district bodies comprise around 1300 sectorial spending units (SUs - around 85 percent of total) in the Mozambican national budget, representing approximately 38% of total government expenditure in 2018. They manage procurement processes, payroll (including recruiting and salary decisions) and operating expenses (electricity bills, water bills). The major exception in the health sector is the procurement of medicines, equipment and medical supplies, which is carried out centrally by the Ministry of Health.

11. Currently, 78 percent of total expenditure in education (largest function in the national budget) is executed at local level, mainly in the Districts. This reflects operating – by educational district entities (*Servicos Distritais de Educacao e Desenvolvimento Humano*) –the network of more than 12,500 primary and secondary schools, which includes recruiting teachers, controlling working hours and managing salary sheets. Furthermore, the major part of investments in the education sector in 2018 was developed by the Provinces (Figure 1.1). At central level, Ministry of Education focuses on the acquisition of goods and services, notably importation of textbooks, organizes national exams and standard learning tests, and establishes the strategic educational objectives and policies.

Figure 1.1. Structure of the Education Budget by Level of Implementation



Source: Authorities and staff estimates.

Allocation criteria and coordination mechanism

12. There is no predetermined rule guiding budget allocation among the three administrative levels; but the payroll imposes some rigidity. The discretionary allocative decision is taken each year by the Council of Ministers when preparing and submitting the budget proposal to the National Assembly. Such decision is subject to the approval of the parliament which has the constitutional prerogative to deliberate on the composition of the state budget. However, compulsory expenses impose certain rigidity in this composition, the most

relevant being the wage bill, pension payments and interest. Current payroll management practice drives towards deconcentration since the management of civil servants is carried out by local bodies, while the payment of pensions and interest is executed centrally.

13. However, administrative (and budgetary) deconcentration has been increasing in Mozambique in the last decade. By 2008, only 24% of the state budget was executed at the provincial and district level, 14 percentage points less than in 2018. This evolution is explained, to large extent, by the administrative deconcentration of personnel management and payroll expenditure, which currently represents a major challenge for the country (see Section III).

14. On the other hand, the resource envelope and corresponding budget ceilings for Provinces are determined through a fixed formula. The equation is based on a weighted average of population and poverty index of each Province, with a 70/30 percent weighting ratio, respectively. The rule is disclosed in the Medium-Term Fiscal Scenario, but it is not enforced by any legal or regulatory instrument. Although this approach has an equalization component (mainly per capita) for the distribution of resources among Provinces, it should be noted that the ceilings apply only to acquisition of goods and services and capital expenditures (investments), which have more discretionary characteristics.

15. Similar procedure is in place for Districts. The formula, however, incorporates a territorial component and a measure of local capacity to raise own resources, in addition to the aforementioned population and poverty parameters. The ceilings apply only to capital expenditures in this case.

16. Fiscal coordination between the three administrative levels is closely monitored by central government due to the absence of political autonomy in the Provinces and Districts. Public policies and government priorities are centrally decided, and the implementation responsibility is then delegated to local officers, with some administrative autonomy. Although there is some degree of discussion at the provincial and district levels about allocations of budget ceilings for goods and services and investments, the central government closely oversees the whole process since main provincial and district authorities are directly appointed by the president.

C. Overall Strategic Context and Setting the Stage

17. A strategic medium-term vision for decentralization should be developed in parallel with the immediate steps to ensure that the Provincial Assemblies can launch in early 2020. There are some decisions which may require longer term planning, development of the required legal amendments, revised regulations and systems preparation. This is likely to be the case especially for some of the resources which will be transferred to the Provinces. Thus, operationalization of the decentralization process should be gradual.

18. Decentralization has many moving parts. As discussed above, there is a political pillar, an administrative pillar and a fiscal pillar to decentralization. The three pillars need to work together and be consistent. When the three “legs” of the decentralization stool are not aligned, the new decentralized entities will not be able to provide the public services as expected and may be set up for failure. For example, establishing elected Provincial assemblies can backfire if there are no real decision-making powers to set local priorities, or if the all budget decisions appear to be imposed by the central government. Allocating service delivery competencies and responsibilities without adequate funding (unfunded mandates) will also weaken the newly decentralized governments as they will not be able to meet their constituents’ expectations.

19. Within this context it is also important to balance four factors/dimensions while rolling out fiscal decentralization:

- First, there are important national priorities, as well as standards and requirements that the newly decentralized provinces will have to respect. Examples may include:
 - Basic standards required for a regional (provincial) or unclassified (district) road.
 - Medium-term goal of number of students per classroom.
 - Health and safety considerations in the construction of classrooms / schools.
- The second dimension is to ensure overall macro-economic stability. The PFM rules (further discussed in section D, below) will have to ensure that provinces will not be in a position to take decisions which could affect the debt position or the overall budget deficit of the central government. For example, should a Province guarantee a loan for a local public or private company which provides regional services (such as public transport), the question is what happens should that enterprise default on the loan guaranteed by the Province? It could then be potentially the responsibility of the Province to ensure the debt payment, but from which revenues? This would thus create a potential risk on the overall budget.
- The third dimension pertains to the local capacity for budget management and PFM processes, including adequate IT equipment and infrastructure. With budget autonomy the provinces will be responsible for preparing, executing and reporting their budgets and ensuring efficient management of public funds which are entrusted to them. Thus, it will be essential to develop systems of initial training and capacity building in PFM, both within the Provincial administration (under the Provincial Executive Council) as well as among the elected members of the Provincial Assembly.
- The fourth dimension concerns a political economy consideration. As the overall PFM framework and resource envelope and their allocation mechanisms are developed, it should be borne in mind that there will be considerable expectations on the elected bodies to address local priorities and make decisions. Ensuring an effective decentralization in the medium term and enforcing increasing autonomy at the provincial level over time are more likely to help guarantee the success and the stability of Mozambique’s decentralization reform.

D. Establishing a PFM Framework and Legal Landscape for Provinces

Current PFM legislation

20. The legal framework for budgeting and fiscal management in Mozambique is comprehensive yet very fragmented. The Constitution includes several articles on development planning and the budget process and defines the roles of the executive branch and the National Assembly in the preparation and approval of the annual budget (notably Articles 130, 179 and 204). Additional aspects of budgeting, accounting, fiscal reporting and auditing processes are legislated the by SISTAFE Law (9/2012), which is complemented by the SISTAFE Regulation (Decree 23/2004). There are other laws and decrees regulating specific areas within the PFM framework; the more relevant ones being summarized below:

- **The Constitution:** besides the annual budget, it also includes provisions for the government five-year development plan (*Programa Quinquenal do Governo - PQG*) and the annual Economic and Social Development Plan (*Plano Economico e Social - PES*). It clearly requires that the executive branch prepares the draft PQP, PES and budget and sets out the competency of the national assembly to approve them.
- **Sistafe² Law:** this is the core of the PFM legislation in Mozambique. It sets out a clear timetable for budget preparation and approval and the key contents of the budget documentation. It also includes provision for a standard budget classification structure to be used by all public entities. In addition, it defines the national accounting and transparency standards, including requirements for in-year and end-year fiscal reporting, and timeframe for preparation and auditing of annual financial statements. The law requires the chart of accounts to be updated on a regular basis. It also legislates on treasury operations, for example, by establishing guidelines for financial programming procedures and, more important, defining the centralization of all cash operations in the treasury single account (CUT). Finally, it makes provisions for internal control at all government levels.
- **SISTAFE Regulation (Decree 23/2004):** it sets out operational regulations on the matters covered by the Sistafe Law. For example, the decree provides the full architecture of the budget classification framework and the complete chart of accounts for the accounting system.
- **Lei de Bases (Tax system law):** it defines the principles and the design of the taxation system in Mozambique, which has the PIT, CIT and VAT as the main components of tax revenue in the country. The law also sets the tax rates for each tax. It is not applied to the *autarquias locais* (AL) that have their own PFM and tax system law (PFM law for *autarquias locais*).

² SISTAFE means "Finance Management System of the State" (*Sistema de Administracao Financeira do Estado*).

- **PFM Law for *autarquias locais*:** this is a specific PFM and taxation law applied only to *autarquias locais* (AL). It defines the budget procedures for the *autarquias locais*, including a timetable for budget preparation and approval. It also establishes a revenue sharing mechanism called *Fundo de Compensacoes Autarquicas* (FCA), under which the central government transfers to *autarquias locais* 1.5% of its total fiscal revenue. This is an unconditional transfer distributed to local administrations through a fixed formula that considers as parameters *autarquias locais*' population and the territorial area, with a 70/30 percent weighting ratio, respectively. The law establishes the same national CoA to be adopted by *autarquias locais* and requires them to submit budget execution outturns to MEF on a quarterly basis and annual financial statements to corresponding local assemblies and to administrative tribunal. It also mandates each municipality to have its own treasury and to centralize its cash operations in a single account. Finally, the law allows *autarquias locais* to undertake short-term debt transactions with local creditors but limited to three twelfths of their FCA transfers, and the debt should be repaid within the same fiscal year. For long-term borrowing from international creditors, approval of the Ministry of Finance is required.

21. Any ambiguity as to whether the *autarquias locais* are subjected to the Sistafe law or not should be avoided when drafting the fiscal decentralization law. The Sistafe law does not explicitly refer to *autarquias locais* since they were not operational by the time the law was enacted. On the other hand, the PFM Law for *autarquias locais* refers to Sistafe law only in article 12, which deals with budget formulation and execution, by stating that *autarquias locais* should observe Sistafe's rules and procedures. Therefore, on all other PFM matters, the effectiveness of Sistafe law over the municipal administrations is unclear. For example, *autarquias locais* may not fully comply with Sistafe's transparency standards and reporting requirements. Care should be taken when drafting the fiscal decentralization law to avoid grey areas and ensure complete applicability of Sistafe's discipline to the Provinces.

22. Furthermore, in case the FCA-type of unconditional transfer mechanism is to be adopted for the Provinces, it would be recommended to empower the MEF to block the transfer if provinces do not submit fiscal data on a regular basis. This is a very effective way to ensure MEF receives the necessary information to proceed with systematic monitoring of fiscal performance of the Provinces.

23. In the medium-term, effort should be made to consolidate the PFM laws in one comprehensive legal instrument. This opportunity will come by 2024 before the fiscal decentralization to Districts become operational. There is a five-year period for MEF to plan ahead and design a comprehensive PFM law covering central government, provinces, districts and *autarquias locais*. If such initiative is not moved forward, by 2025 Mozambique will have four PFM laws, one for each level of government. This will be a very peculiar situation in which the multiple overlapping legislation can be potentially conflicting and adversely affect the orderly functioning of the PFM system.

Recommendation 1.1. In the medium-term, consolidate the PFM related laws (Sistafe law, PFM law for *autarquias locais*, planned fiscal decentralization law) in an overarching comprehensive PFM law covering central government, provinces, districts and *autarquias locais*.

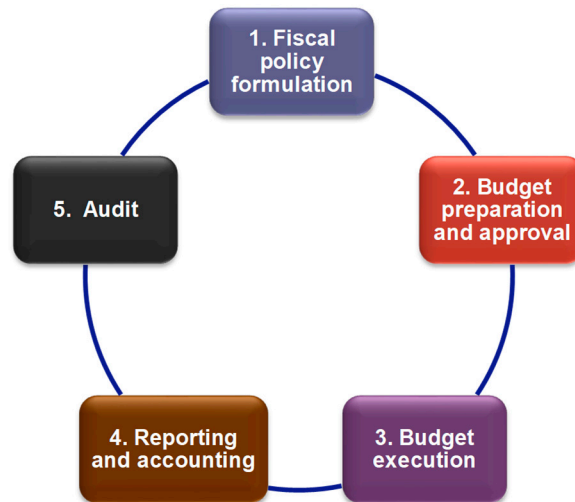
The new fiscal decentralization law: key principles

24. Fiscal decentralization is the transfer of financial responsibility and authority to the local governments and requires establishing a sound PFM framework. Enhanced budgetary and financial management practices enables fiscal authorities to properly play their role in the preparation of policies and planning, as well as the appropriate allocation of available funds to effectively carry out activities and spending. More broadly, implementing fiscal decentralization relies on four main building blocks:

- **Expenditure Assignment:** The expenditure assignments transferred from the center to the Provinces/Districts must be clearly defined.
- **Funding:** Revenues at the disposal of the Provinces/Districts should be sufficient to finance their assigned expenditure responsibilities. Resource/budget envelopes should be determined through a transparent criterion.
- **Budget Planning:** PFM framework should enable Provinces/Districts to define their priorities and development needs but should also ensure sound fiscal coordination among different levels of government.
- **Budget Execution & Financial Audit:** PFM framework should provide for integrated financial management systems and centralization of cash operations, as well as standard reporting schemes and regular auditing processes.

25. Transfer of expenditure responsibilities and public resources to SNGs should go hand in hand with rolling out a complete PFM framework at local level. Provincial authorities will be called to plan, budget, and execute government programs and activities with a greater sense of accountability, since local voters will demand more effective spending, accompanied by strengthened control and audit processes. Therefore, the overall PFM architecture for Provincial governments should be similar to national government (Figure 1.2), except for macro-fiscal policy formulation which, in most countries, is determined by central government as SNGs do not have the necessary tools to take part in the process.

Figure 1.2. Public Financial Management Cycle



Budget preparation and approval

26. As part of the new fiscal decentralization law, the MEF should consider a clear and coordinated budget calendar. Such a calendar should be designed to allow the MEF to provide key budget information to the Provinces in a timely manner and to accommodate consultations with the Provinces during the central government budget preparation. The information to be provided by the MEF to the Provinces would include estimates for fiscal transfers (conditional and unconditional grants) from the state budget, shared macroeconomic assumptions to ensure consistent budgetary projections across all levels of government and other relevant data.

27. The composition of provincial and state budgets is a key decision to be taken. Currently, the state budget comprises all SUs at provincial and district levels which might not be an appropriate set up under fiscal decentralization. From 2020, Provincial budget allocations will be debated and approved by elected provincial assemblies; therefore, submitting it to the national assembly as part of the main state budget documentation will mean a second layer of legislature appreciation. Alternatively, the approved budgets of the 10 provinces and the city of Maputo could be introduced in the state budget proposal as an annex to allow for a consolidated view of the total budget in the country, but not subject to national assembly approval. The national assembly would be approving the overall transfer amount for conditional and unconditional grants from the state budget to the Provinces. Other pros and cons of keeping the provincial budgets within the main state budget documentation can be cited:

Pros:

- Reduces initial cost of reform implementation, since there will be no change in the current practice. Potential costs related to changing processes in the MEF, Provinces and assemblies will not be incurred.

- State budget main documentation consolidates all levels of government, which allow for a comprehensive view of the programmed budget for the entire country in a single document.
- Place more direct oversight of compliance with national priorities in the Provinces given that the national assembly will debate on the approved provincial budgets

Cons:

- Requires more careful review of Provincial draft budget to allow for a full consolidation into the state budget proposal. Coordination in budget calendar and exchange information processes becomes even more relevant
- Potentially implies national decision on Provincial budget because national assembly will be forced to deliberate on it. It can be seen as a limitation for the administrative, financial and patrimonial autonomy granted by the constitution
- Maintains pre-decentralization practice (current), which can be understood as a step back in the decentralization process and inconsistent with the Constitutional Amendments

Budget execution

28. Budget execution in central, provincial, and district levels is mainly performed through e-SISTAFE, the Mozambican integrated financial management system. The system currently covers over 90% of the 1629 SUs but it does not track the transactions through the entire expenditure cycle, only payments. This happens because, although the functionality to input transactions on commitment and verification phases are fully operational, the current practice adopted by MEF and line ministries is to record all spending stages simultaneously at the time of payments. This is a major drawback in the current PFM framework, which prevents the proper control of commitments and leads to persistent accumulation of arrears and cash rationing (see Section II).

29. Maintaining the budget execution of provincial SUs in e-SISTAFE is another key decision to be taken under the new PFM framework. Pros and cons of such decision can be cited:

Pros:

- SUs at provincial/district level already operate through e-SISTAFE. This is an advantage in terms of reducing potential costs related to changing processes in the Provinces.
- The system has the required functionalities/tools.
- It enforces a common Chart of Accounts and classification architecture in the Provinces, since e-SISTAFE operates with a single accounting and budget classification for all SUs
- It allows real time access to financial information of the Provinces by the MEF, which can facilitate monitoring of provincial fiscal indicators and policy coordination

Cons:

- It can be seen as a limitation for the administrative, financial and patrimonial autonomy granted by the constitution.

30. Another valuable feature of e-SISTAFE is its interoperability with the treasury single account at the central bank (CUT). Although some SUs still hold accounts in commercial banks under special circumstances, the transactions undertaken through e-SISTAFE are paid against the CUT. Therefore, expanding the coverage of the system among budget units leads to a broader use of the CUT within the government, with clear positive implications for cash management.

31. Therefore, an important decision that comes next is whether the Provinces will continue to operate under the CUT or not. Having the provincial cash resources in the CUT allows the treasury to manage and control overall government's cash balances more efficiently. A mechanism of sub-accounts (or virtual accounts) embedded in the single account ensures the provincial ownership over the resources belonging to them. Alternatively, in case Provinces leave the CUT, it is desirable for each Province to set up a similar single account structure at the local level. Other pros and cons of continuing operating under the CUT are cited:

Pros:

- The CUT enhances cash management operations by centralizing the government's liquidity within a single account
- It prevents diversion of resources in multiple bank accounts leading to additional financial costs and hampering control of public funds
- It limits accumulation of arrears by reducing the possibility of idle cash
- It improves financial discipline and transparency of local governments

Cons:

- It can be seen as a limitation for the administrative, financial and patrimonial autonomy granted by the constitution
- There is a need to implement several sub-accounts (or virtual accounts) in the CUT, which would require reconfiguring the CUT architecture.
- There would be challenges to operate the CUT in a way to ensure that subnational governments have access to their own cash resources in the CUT and their finances are not impacted by possible liquidity constraints of the central government.

Fiscal reporting and accounting

32. The new fiscal decentralization law should define standard reporting and transparency requirements, in addition to the provisions of the SISTAFE law. This should

include budget execution reports, financial statements and fiscal statistics for both in-year and year-end reporting schemes. In-year reporting should ideally be undertaken on a monthly basis, or at most quarterly. The reports should be submitted to the MEF, to Administrative Tribunal, to provincial agencies and should be made public for easy access of civil society. MEF should be responsible for consolidating in-year reports and statistics as well annual accounts and financial statements for the general government. Moreover, MEF should also rely on such reporting framework to actively monitor provincial fiscal performance and to carry out macro-economic and fiscal analyses and policy.

33. The legislation should provide for harmonized budget classification and accounting standards, including a common chart of accounts (CoA) to be used by all levels of government. This is critical to ensure consistent consolidation of public finances and to make information comparable across jurisdictions. National accounting standards should be mandatory for Provinces as well as common budget classification structure; economic and functional classification should also be aligned to international standards, such as the IMF GFSM 2014, to the extent possible. Such an approach will enhance international comparability of Mozambican fiscal data, and contribute to improve budget processes, control and accountability. Standardizing accounting and budget classifications is even more important in the case Provinces will be operating under separate information management systems.

34. Enhanced transparency practices are essential to successfully implement the concept of fiscal decentralization. The main justification for decentralized fiscal government operations is improving the quality of service delivery through a dual accountability approach for local administrations. Provincial authorities will be accountable to the central government and to the local voters and civil society, who should be able to exert effective oversight on the local budget decisions and spending process.

35. The *Tribunal Administrativo* – the supreme audit institution – is to play an important role to ensure accountability and governance standards.³ Regular auditing by the independent external auditor is required to strengthen controls and improve procedural weaknesses at the local level, in particular, by addressing capacity constraints, providing better guidance and documentation, and stronger accountability arrangements. The tribunal should also be in charge of auditing the provincial financial statements before appreciation by the provincial assemblies.

Fiscal coordination and macroeconomic stability

36. Fiscal decentralization requires sound coordination among different levels of government to ensure macroeconomic stability in the country. Provinces need a clear understanding of their likely transfers from the state budget for the year and for the medium-

³ A comprehensive review of the role of the *Tribunal Administrativo* was beyond the scope of the mission; the point here is to ensure that the *Tribunal Administrativo* audits the provinces the same way it does for the center.

term and an opportunity to comment on the formulation of any national policies with implications for their expenditures, revenues, or financial management. On the other hand, it is critical for the central government to monitor provincial fiscal performance to mitigate potential fiscal risks from the provincial level that could potentially jeopardize the overall fiscal position.

37. It will be essential that key macroeconomic rules are established to ensure that Provinces (and later Districts) do not negatively impact on overall country macro-fiscal imbalances, in respect to deficit and budget balances (discussed above), borrowing and issuance of guarantees. Within the legal package which was submitted to Parliament on February 15, there are some general provisions on the authority of provinces to contract loans. For example, in Article 6 of the draft Law on the Organization and Functioning of the Executive Bodies of Decentralized Provincial Governments, financial autonomy is defined to include having recourse to loans, in accordance with the law (*...bem como recorrer aos empréstimos, nos termos da lei*). Further, Article 15 1.h of the draft Law on the Organization and Functioning of Provincial Assemblies provides that the assembly approves loan contracts as per the law, provided that the corresponding annual loan service is supported by a table attesting borrowing capacity.⁴

38. The question of borrowing by the provinces is one of the very key issues which will need to be decided by the forthcoming fiscal decentralization law. The first consideration is to understand that the proceeds of borrowing are not a revenue, but a source of financing. The proceeds obtained from the lending financial institution will need to be paid back, with interest. Future flows of revenues of provinces should be adequate for debt service, including repayment of loans. The first question, therefore, is about the creditworthiness of the Provinces. Are they able to repay a loan? Are they willing to repay a loan? These questions should be examined separately for each of the two key types of borrowing which are most frequently defined as part of local government borrowing frameworks and regulations: short-term loans and long-term loans.⁵

39. Short-term borrowing for liquidity/cash management purposes would imply that there is some initial provincial control over its cash management processes. Within local government borrowing frameworks, short-term loans (< 12 months) are often used to resolve a temporary cash shortage or address liquidity needs when there is a mismatch between ongoing expenditure commitments and the calendar for incoming revenue. For example, a key property tax could be collected during the month of September, while ongoing current operations need to be funded from January 2020. In many countries, subnational governments negotiate a short-term credit line at the beginning of the fiscal year, which they may draw down and replenish based on their short-term funding needs and cash availability. At present, there are many unknowns for the establishment of Provinces and their PFM frameworks. It is clear, however, that

⁴ Article 15 1.h - *aprovar a contracção de empréstimos nos termos da lei, desde que a sua amortização anual seja fundamentada em mapa demonstrativo da capacidade de endividamento.*

⁵ Issuance of municipal bonds is another form of subnational debt instrument, but it is not necessary to further elaborate on this question at present.

in an initial period, and given the current cash management problems and undershooting of revenue targets for the overall central government, regulating liquidity needs with short-term borrowing by the Provinces could create short-to medium-term macro-fiscal risks.

40. International experience in short-term borrowing and the pros and cons. Some countries limit short term borrowing to a share of current year budget revenue or calculated on previous year revenues.

- Counties in Kenya may borrow up to the equivalent 5 percent of their last audited revenues; these loans must be repaid within twelve months.
- Ethiopia's States and Addis Ababa City Government may borrow short-term to manage their consolidated fund, with the approval of the Federal Government (Ministry of Finance and Economic Development) and which must be repaid in the following fiscal year.
- So, while an argument in favor (*pros*) of short-term borrowing would be to enable the Province to cover necessary short-term budget items, a clear risk (*cons*) is that repayment of such loans within the fiscal year may be compromised if the revenue shortfall is not made up or cash shortages reduce central government transfers that were initially budgeted for the Provinces.

41. Long-term borrowing to finance infrastructure investment would require that provinces have significant and dependable own-source revenues. It is expected that at the start of Provincial decentralized government operations, the transfers from the central government will be required to cover payroll and goods and services expenditures. These funds will be committed/engaged quite quickly. In order to reimburse a long-term loan, Provinces will need to have access to own source revenues which are not earmarked for a specific service. In the absence of such own source revenues, the provinces would not have any financial basis on which to service the debt payments for a long-term loan.

42. International experience in long-term borrowing and the pros and cons. The frameworks to regulate long-term borrowing may function based on an *ex ante* direct control framework (pre-approval by national government, preferred lender; controls on loan conditions such as pricing, loan maturity) or according to a rule-based framework (setting of caps on debt service and outstanding debt; pricing and loan conditions based on negotiation between lender and borrower, due diligence carried out by lender who assumes non-payment risk).

- Kenya is an example of a direct control framework to regulate borrowing by Counties: long-term borrowing requires an approval and a guarantee of the National government and therefore approval by Parliament.
- Colombia is an example of a rules-based framework with caps set on debt service (40% of operating surplus); and outstanding debt (80% of current revenues). Such caps were introduced by the so-called "Traffic Light Law" (Law 358 of 1997). Under this law, SNGs were given a rating based on their ratios of debt to payment capacity. If one of the caps has been exceeded, the SNG is rated in the red-light zone and prohibited from further

- borrowing; those complying with both caps are permitted to borrow up to limits based on debt sustainability calculations. In addition, departments and large *autarquias locais* must get a satisfactory credit rating from rating agencies before they borrow.
- Arguments in favor (*pros*) of long-term borrowing are that access to such funding would enable more rapid realization of strategic provincial investment projects and would enhance intergenerational equity (future generations benefitting from the infrastructure would contribute indirectly through their tax or fee payments to the debt service).
 - Arguments which suggest caution in authorizing long-term borrowing by provinces (*cons*) include fiscal risks and the current overall national debt profile; risk of implicit sovereign guarantee once MEF approves / authorizes specific borrowing by provinces; lack of availability of provincial own-source revenues to ensure debt payment.⁶

43. In addition to regulating provincial borrowing, the fiscal decentralization law should provide guidance on issuance of loan guarantees. Depending on the competencies which will be transferred to the Provinces, some services may be associated with public companies for service provision or with private companies that are licensed to provide regular services (such as intra-provincial public transportation companies). This is a sensitive issue which could lead to a negative impact on macro-fiscal balances. Similar to long-term loans, should the initial borrower of a guaranteed loan default, there are not actually any revenue sources of the Province which would be available to ensure debt service. The debt could by default end up as the responsibility of MEF.

44. The law should also provide for central oversight of Public-Private Partnership (PPP) arrangements at sub-national level. In PPP arrangements, the private sector provides infrastructure assets and services that have traditionally been provided by the government, such as hospitals, schools, roads, bridges, railways, and water and sanitation plants. In some PPP contracts, the government may provide a revenue or demand guarantee that requires it to make up the difference if revenue or demand falls short of an agreed level. Other contracts may include exchange rate or price guarantees. Such arrangements are complex to design and manage and require well-developed technical capacity to conduct proper project appraisals and detailed assessment of project-specific risks. PPPs generate long-term obligations to the government and expose the government to a wide range of associated fiscal risks. For this reason, central oversight and monitoring of sub-national PPP contracts—for example, by setting up a gateway function at the MEF to assess and approve all PPP proposals—will be important.

Recommendation 1.2. The fiscal decentralization law should provide for a coordinated budget calendar, standard reporting and transparency requirements, and harmonized budget

⁶ Rather, as the own source revenues for provinces are not yet clearly defined, the amounts which may be available are presently unknown and there will need to be a few years to get this aspect of provincial management up and running.

classification and accounting standards, including a common chart of accounts (CoA), to be used by all levels of government.

Recommendation 1.3. Short term borrowing by provinces should likely NOT be authorized at the present time, as their funds will derive essentially from central government transfers and their liquidity position will be determined by central cash management and budget releases.

Recommendation 1.4. Long term borrowing and issuance of guarantees by provinces should likely NOT be authorized at the present time as they will not have access to significant own source revenues; were provincial loans to be approved by MEF, this could be viewed as a potential guarantee and create moral hazard risks.

Recommendation 1.5. PPP operations by provinces should likely NOT be authorized at the present time as they will not have the technical capacity to properly appraise projects, assess the long-term obligations to government and mitigate the associated risks.

Recommendation 1.6. During the first mandate of Provincial operations, their fiscal and financial performance can be observed in order to consider the necessary rules for borrowing and debt limits to establish for a later time when their finances are more stable and greater own source revenues available. The same scheme should be replicated for districts.

E. Provincial Responsibilities

45. The decentralization of competencies to provinces and districts is potentially quite extensive. Article 270-J of the amendment to the Constitution, adopted on 12-June-2018, provides a detailed list of sectors (see Box 1.1, below). The proposed general areas of competencies are to be exercised where they do not overlap with current functions of the *autarquias locais* and which are not exclusive competencies of central state bodies (*órgãos centrais*). The Constitution does not indicate what are to be the specific respective competencies of the provinces and the districts. The content, organization and functioning of these decentralized competencies are to be set in law.⁷

⁷ The National Assembly has already requested the government to prepare a new law defining the allocation of competencies between the central government and provinces. The MEF is working on a draft of this new law.

Box 1.1. Potential Functions for Provinces and Districts

As per Article 270-J of the amended Constitution

- a) agriculture, fisheries, cattle, forestry, food security and nutrition
- b) land management (according to measures defined in law)
- c) public transport in areas not under AL responsibility
- d) management and protection of the environment
- e) plant and animal life in conservation areas
- f) housing, culture and sports
- g) primary health care
- h) primary, secondary and technical and vocational education
- i) tourism, folklore, handicrafts and local fairs
- j) hotel management (up to 3-star establishments)
- k) promotion of local investment
- l) water and sanitation
- m) industry and trade
- n) roads and bridges of local, district and provincial interest
- o) prevention and fight against natural disaster
- p) promotion of local development
- q) territorial planning and development
- r) rural and community development
- s) other competencies, as determined by law

46. The subsequent laws and implementing regulations should clearly define the specific respective competencies of provinces and districts, including their role in the investment and development of infrastructure or equipment; the transfer of and responsibility for required staffing, operations and associated assets. As was discussed above (see Section B), many functions have already been deconcentrated to the province and especially district level. For example, in the education sector, districts receive funding for the operation of primary schools from the Ministry of Education while the construction of primary schools is handled by the provinces. In the area of public works, districts receive an allocation from the Road Fund of two million meticaís per district for the repair and maintenance of unclassified (district) roads.

47. Some inherent responsibilities for ensuring management and organization of public space are included as competencies of the Provincial Executive Council in the draft Law on the Organization and Functioning of the Executive Bodies of Decentralized Provincial Governments. For example, article 42 of the draft includes the authority of the Executive Council to propose declaration of public need with effect of expropriation (h); order the total or partial demolition of buildings or other construction which pose a threat to public health and safety (k); decide on the administration of public water sources (*águas públicas*) under their jurisdiction (j); and, propose to the Assembly and the tutelle the attribution of place names (atribuição de topónimos) (i). The table in Annex 1 indicates the types of functions / responsibilities that are under the responsibility of the regional / provincial level in a range of other countries in Africa, Asia and Europe.

48. The sectorial ministries are currently in the process of developing proposals for the decentralization of specific functions to provinces and districts, as per the request of the Ministry of State Administration and Public Service. As of this writing, proposals had been received for the areas of health; education; roads; and, water resource management and water supply. The proposals for health and education have been communicated to the FAD team. Based on these proposals as well as the discussions with the three sectorial Ministries, there is clearly some confusion between the notions of deconcentration (already widely implemented in Mozambique) and decentralization (See Box 1.2). The implications for financial decentralization of elected Provincial / District Assemblies and Governors / Administrators are not clear, as is a confusion between a unitary system and unified budget (see discussion in paragraph 30, above).

Box 1.2. Comments on Initial Proposals for Decentralization in Education Sector

The Ministry of Education has proposed competencies to be transferred to decentralized governance organs (Provinces and Districts) in the areas of primary and general education as well as adult literacy. The competencies and functions proposed appear to be quite extensive, including management, oversight, policy (development of local curriculum content), training, etc.

However, there are also considerable overlaps between the functions for the Provincial Executive council and the District Executive Council. For example, both are expected to:

- Develop the content of local curricula
- Plan, organize and promote school sports
- Plan, build and maintain school infrastructure and equipment

The text does not indicate what is the difference between the detailed overlapping activities that would be the responsibility of both Province and District level, which would make the management and allocation of funding challenging and risks creating confusion on the ground in practice.

49. The fiscal pillar of the decentralization process will necessarily involve the transfer of respective staff, equipment, building and other related assets. It is not clear in the instructions provided to the sectorial ministries for the elaboration of their proposals whether it was indicated that the decentralization process would necessarily involve such transfers. However, as was clear from the team’s discussions with three sectorial ministries (Health, Education, and Public Works), this issue did not appear to have been previously mentioned/discussed between the MAEFP and the respective line Ministries.

50. There exist some key principles to consider in the allocation of expenditure responsibilities to decentralized entities.

- a. **Exclusivity:** Expenditure responsibilities given to subnational government should generally be exclusive to ensure accountability for resourcing and delivery of the related services;
- b. **Authority:** Subnational governments should be given the full range of powers associated with the fulfillment of their responsibilities including ownership of assets used in their delivery, employment of relevant staff, and regulation of related activities;

- c. **Compensation:** Local authorities should be given adequate revenues to cover their expenditure responsibilities through a combination of own revenues, shared taxes, and intergovernmental transfers;
- d. **Subsidiarity:** Expenditure responsibilities should be assigned to the level of government best able to execute them efficiently and effectively; and,
- e. **Equity:** All citizens should be entitled to a basic level of public services with redistribution of resources where necessary.

Recommendation 1.7 - IMMEDIATE

- Guidance should be given to the sectorial ministries of some key norms to take into consideration in the identification of competencies and authorities to transfer and the adoption of some key principles, for example:
 - **Exclusivity** to the specific entity to ensure accountability for resources and delivery.
 - **Authority** on full range of powers to exercise the respective responsibilities.
 - **Compensation** with the provision of adequate revenues to cover expenditure responsibilities.

Recommendation 1.8 - IMMEDIATE

- Information / instructions should be given to the sectorial ministries that every transfer of competency / function that is being proposed is to be accompanied by the transfer to the authority of the provinces of the related personnel, equipment and buildings associated with their effective implementation.

Recommendation 1.9 - 2-3 MONTH HORIZON

- The MEF jointly with the MAEFP should prepare a methodology for a survey/census process to identify the specific personnel and assets to be transferred to the provinces based on the proposed competencies they have proposed.

Recommendation 1.10 - 5-8 MONTH HORIZON

- Relevant sectorial ministries should establish survey sector teams and train in the survey methodology
- The sectorial ministries with MAEFP and MEF should prepare a census/survey of existing buildings / equipment / etc. for each of the proposed competencies and identify any existing liabilities and debts which should not be transferred.

F. Provincial Resources – Transfers from the State

51. Intergovernmental transfers for the financing of decentralized entities can usually be divided into two main categories: unconditional transfers and conditional transfers.

Within these categories are a number of variations, for example on how the overall pool for transfer is defined, the types of formulae for allocation of the funds among the Provinces or

Districts, the extent of equalization which is built into the system and the allocation formulae. In all cases it is important that the process of determining the overall pool, and the allocation formulae (criteria and their respective weights) are transparent and published.

52. Unconditional transfers are usually allocated for general budget support with no strings or conditions attached (other than the funds must be spent on the legally attributed functions and services of the decentralized entity). In many decentralized countries, such an unconditional transfer serves to address the vertical fiscal imbalance between the expenditures under local jurisdiction and their revenue raising responsibilities. Such transfers are typically mandated by law and are usually formulae-based. At the start of the first mandate of the new Provincial decentralized entities, it would be possible to develop an unconditional transfer for the Provinces that covers their basic expenditure needs (single pool) only if their functions and competencies have been clearly defined. It would also require that there are good skills in budget planning, development and management within the provincial administration.

53. International experience in unconditional transfers and the pros and cons.

- Mozambique already has an example of an unconditional transfer for the *autarquias locais*, the Local Authorities Compensation Fund, which is based on a formula with two criteria (FCA, which was described above under paragraph 23). Other international examples of unconditional transfer include:
 - France which distributes the *Dotation globale de fonctionnement*, allocated to communes and *départements* according to a formula that includes a fixed amount per commune, land area, compensation for past local resource modifications, a revenue guarantee and the presence of national parks on communal territory.
 - Kenya distributes a county equitable share which includes five criteria in the allocation formulae: population (45%), equal share (26%), poverty index (18%), land area (8%), fiscal effort by countries (2%) and a development factor (1%).
- Arguments in favor (*pros*) of a single unconditional transfer is that it would give Provinces greater autonomy in the development of their own budgets and could require only a simpler budget line management and reduce the number of transfers to Provinces that would need to be tracked. Arguments that are against (*cons*) adopting such an unconditional transfer for Provinces include that it will entail more careful review of the Provincial draft budget and could *a priori*, result in less protection for national priorities, as well as place greater burdens on Provincial budget management.

54. Conditional transfers are attached to specific purposes and the conditionality can be more or less broad. For example, a conditional block grant for roads could cover maintenance, rehabilitation and investment in Provincial (regional roads). Separate conditional envelopes could be proposed in the education sector, where there could be separate envelope each for payroll, for goods & services and for investment. These would be an example of input-based condition. Such transfers require reporting on the actual spending and the budget and

service delivery performance linked to conditions. Conditional grants, whether block or input-based can also be allocated among the Provinces according to a formula.

55. International experience in conditional transfers and the pros and cons. Many decentralized countries have implemented conditional sectoral grants.

- In Uganda and Rwanda, there are sector conditional grants which are subdivided by type of economic expenditures (payroll, goods and services). In the case of Rwanda, non-payroll conditional grants are allocated according to a formula developed by the respective line Ministries and published by the Ministry of Finance.
- Colombia distributes a conditional fund (the SGP) which requires that specific percentages be allocated to targeted sectors: education (59%), health (25%), water and sanitation (5%), and general purpose (11%).
- Arguments in favor (*pros*) of a sector block or conditional transfers is that funding would be ensured for payroll; there could more oversight on the funding for national priorities; and based on the formula, it could ensure better correction of past inequitable revenue allocation.
- Arguments against (*cons*) instituting conditional grants include that each sector line Ministry would have to develop a formula for allocation, and make sure that this formula corrects for past inequitable allocation; and, it places more limits on provincial decision-making.

56. In addition to general unconditional and conditional transfers, many countries have instituted separate allocations for capital projects. Many of these funds are generated through development partner financed programs and often involve an element of performance and the meeting of certain required conditions.

- Examples of performance based conditional capital grants include Ghana's District Development Fund and Tunisia's *Dotation Globale Non-Affectée*. In both cases, the local governments (District Assemblies in Ghana, communes in Tunisia) can select the specific projects, but they must be infrastructure projects.
- Rwanda has its own domestically developed capital projects grant, which is administered by the Local Authorities Development Agency to which 10% of Rwanda domestic budget revenues are allocated. About 75% of that amount is allocated to the districts by a formula (40% population / 20% surface area / 40% poverty). Each District then takes its capital grant envelope and allocates the funds among projects, with some guidance based on national priorities. In recent years, about 60% of the amount had to be allocated to national priorities (education, health, feeder roads, environmental protection and agriculture) and the remaining 40% could be allocated to other District priorities.
- Arguments in favor (*pros*) of a specific resource envelope for capital expenditures is that this financing approach could ensure a minimum of capital development in provinces; help correct for past inequitable development; and, enable provinces to select their priority projects within the limits of the conditionality.

- Arguments that are against (*cons*) adopting such an unconditional transfer for Provinces is whether there would be sufficient funds available to enable development of more than micro-sized projects.

57. For both unconditional and conditional transfers, a clear system for determining the pool of funds will be an essential step in setting the Provincial resource framework (see Box 1.3). In the first year, the total amount will likely be determined by the amount of existing budget which has been allocated for the respective services (or the total for all the services to be transferred to the Provinces). In the case of a single amount, the total could be associated with or calculated according to a share of central government fiscal revenues (as is the case currently with the FCA). If the transfers are broken down by sector envelope the law should set principles for how these conditional grants will evolve over time. In both cases, these approaches would provide some predictability to the provinces on the overall resource pool to enable them to prepare their medium-term expenditure framework.

Box 1.3. International Lessons Learned: Setting the Size of the Transfer Pool

From the points of view of both the grantor and recipient governments, it is generally advisable that the total pool of resources to be distributed in general-purpose transfers be set in a stable but flexible way (for example, as a percentage of central taxes, adjustable every few years). (Smart, 2007)

Pools based on a predefined portion of national revenues in the current or recent fiscal year can provide an increased degree of certainty to subnational authorities that they will, in fact, receive the transfers. This approach can also ensure a growing source of revenues for subnational governments if the pool is tied to buoyant revenue sources such as income tax. The potential downside is that, by inflexibly dedicating a proportion of national revenues to subnational governments, the center will lose some control over macroeconomic fiscal policy. (Schroeder, 2003)

58. There are also some general guidelines to consider in the development of allocation formulae. These general criteria are presented in Box 1.4 below. It is important in considering the types of allocation criteria that information be easily available, viable, reliable, and cannot be manipulated.

Box 1.4. Criteria for the Design of Fiscal Transfers

Predictability. Shares of Provincial governments in the formula should remain stable over the medium-term (once a system is established). The grant mechanism could ensure predictability of subnational governments' share by publishing multi-year (say, 3-5 years) projections of funding availability.

In accordance with changes in the economic growth rate. The design should account for the central government's capacity to provide transfers. During periods of fiscal austerity, transfers to subnational governments may have to decrease. When the economy improves, transfers may increase.

Simplicity. The allocation to subnational governments should be based on objective factors over which individual Provinces have little control.

Transparency. The transfer formula should be disseminated widely, and the basis of allocation should be clear.

Non-Discretionary budgetary allocation/Not subject to manipulation. Formula-based revenue sharing is consistent with this objective. Potential recipients should not be able to manipulate their eligibility, nor the amount received.

Revenue adequacy Subnational governments should have adequate revenues to carry out their designated responsibilities.

Equity. Allocated funds should vary directly with fiscal need factors and inversely with the revenue raising capacity (fiscal potential).

Incentive for sound fiscal management. The proposed design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance operational deficits of subnational governments.

Generally perceived as fair. The design should be perceived by all as objective and fair. It should rely on data that is readily available and recognized as valid and reliable.

Recommendation 1.11 – 1-2 MONTH HORIZON

- Pending greater clarity on the specific competencies for Provinces and their costs, the fiscal decentralization law should establish basic principles and guidelines which would need to be met by the MEF and sectorial ministries that are preparing the transfer allocations to finance Provincial competencies. These include:
 - Required development and documentation of formulae for allocation among provinces
 - Required consideration of the key guidelines pertaining to formula development (as proposed in Box F.2)
 - Justification that the funding allocation is more equitable than the past distribution of resources

Recommendation 1.12 - 4-8 MONTH HORIZON

- MEF should review with each Ministry current amount of budget allocation for the proposed competencies and determine an allocation formula.

- Allocation formulae may in an initial period be determined by each overall sector, taking into consideration that a formula should be:
 - **Simple** and based on objective factors, with available data
 - **Predictable** with shares to remain stable of first few years to support Provincial planning and service delivery
 - **Transparent** so that the basis of the allocation is clear
- The MEF could consider an operating transfer which would consist of the following types of envelopes
 - One conditional grant for covering payroll expenditures
 - A basic pool with discretionary allocation for provincial executive council, administration and assembly operational costs, allocated among provinces by a clear formula
 - One individual envelope per sector for goods and services (such as for provincial / regional roads maintenance, environmental protection, each allocated among the provinces according to a formula which could include general criteria (population, surface area) and specific criteria relevant to the specific area of competency
 - The formula used could be included as an annex to the State budget

G. Provincial Resources – Own Source Revenues

59. The Constitutional Amendment does not provide any detail about the potential sources of financing of the provinces and districts. The Constitution does state that the creation and modification of taxes is an attribute of the State (Article 139 (n)). Only in the draft Law on the Organization and Functioning of the Executive Bodies of Decentralized Provincial Governments, does the definition of financial autonomy mention that Provinces may dispose of own revenues.

60. Provinces' own source revenues may be limited in first period to service charges and fees. While the provinces will not be able to create their own taxes, it is understood from discussion with officials of the MEF that the intention is that they should be able to levy service charges and fees. MEF officials are also concerned that the provinces do not abuse this fiscal prerogative by imposing numerous new charges that weigh on the population.

61. Service charges and fees can generally be categorized in three general types: i) a direct charge for a service (water usage, public transport); ii) payment for a license or permit to carry out an activity or obtain some certificate, etc. (restaurant liquor license, issuance of copy of birth certificate, construction permit, etc.); and, iii) payment for use of public space (outdoor advertising supports, restaurant sidewalk terraces). In a first period, the specific charges and fees to be transferred to the provinces should be directly linked to the functions and competencies which are to be transferred to them.

62. It needs to be identified whether the legal framework has to be amended for provinces to levy service charges and fees. As the list of potential provincial charges and fees is speculative, a key unknown is how these revenue sources are presently regulated in law and or other legal or regulatory instruments. In considering this framework, it could be possible for the central government to set rate ceilings or ensure that there is some guiding process to avoid overcharging of residents.

Recommendation 1.13 - 3-8 MONTH HORIZON

- During the process of identification of competencies, the joint Ministry – MEF – MAEFP teams should identify what service fees, charges or other non-tax revenue may be associated with the competencies to be transferred
- Identify the legal framework for the levying and collection of those fees and whether amendments will be required to enable transfer of the revenue source to the authority of the province
- Identify as well if any personnel, assets or equipment are associated with the respective charges and fees to be transferred

H. Transitional Approach for Fiscal Decentralization Law

Decentralized Provinces – Kick off – January 1st, 2020

63. The fiscal decentralization law should include transitional provisions given the short time left until the elections, scheduled to take place in October 2019. The available timeframe is not sufficient to properly plan and build consensus on all competencies, resources, staffing and asset/equipment to be transferred to Provinces. In some matters, time consuming survey/census processes will be necessary to identify the specific personnel and assets to be transferred. Furthermore, the mission noticed some confusion between the notions of deconcentration and decentralization among government officials taking the lead in the process within the MEF and relevant sectors. Therefore, very specific transitional provisions are essential to make decentralized provinces operational beginning January 1st, 2020.

64. Such provisions should focus on the budget cycle for the coming years, in particular, during the first provincial autonomous mandate 2020-2024. In accordance with the current legal calendar, the state budget proposal should be submitted by September 30th and approved by December 15th, which means that, as per the law, the provincial elected Governors would execute in 2020 a budget formulated in 2019; therefore, not deliberated by the incoming elected provincial legislature. The mission was informed that, although not provided for in the PFM legislation, it is common practice, in electoral years, to postpone budget formulation to the beginning of the following year. Therefore, it is expected the 2020 budget to be submitted to parliament by March and approved by April/May 2020. The legal frameworks

provide the rule of twelfths⁸ to be put in place whenever the budget law is not approved by the beginning of a fiscal year.

65. The mission recommends a two-phase approach. For the first phase to take place in 2020, transitional provisions should set up budget allocations for all provincial SU based on the rule of twelfths, for a maximum of six months, to allow for the budget law to be approved by the incoming provincial legislatures. The approved 2020 budget law should allocate budget ceilings for operational expenditures of provinces following the same approach currently in use. Furthermore, the same current resource envelope rule (see paragraph 13) regarding acquisition of goods and services and capital expenditures (investments) should be in place. Continuity of ongoing investment projects should be mandatory.

66. The second phase to commence in 2021 should provide for more aggregate budget ceilings for provinces, by sector, based on their competences which were decided in the previous year as a result of decentralization. Going forward, the changes in the budget cycle will evolve progressively over the first provincial mandate as PFM capacities at the local level are built and decentralization decisions are taken. Decentralization of responsibilities and resources should follow the principles described in previous sections.

67. Analyzing the activities already under provincial administration and the corresponding SU's budget structure would be helpful for deciding on decentralized provincial responsibilities and resources. For example:

- **Health Sector:** Provincial governments already administer large provincial hospitals, rural hospitals and health centers dispersed all over the country, including running procurement processes, the payroll and operating expenses. The provincial hospitals are SUs in the state budget while the other health units are financed by the health provincial directorates; directorates being SUs in the state budget. All these health institutions carry out programs and activities to provide health services, mainly primary health care, which is subject to decentralization. Therefore, the decentralization of competencies to Provinces can be linked to existing primary health care units.
- **Education Sector:** Provincial governments execute the major part of investments in the education sector through the provincial directorates for education and human development. Such directorates are SUs in the state budget running investment projects in primary and secondary education, mainly construction and renewal of schools. The decentralization of competencies to Provinces in education can be linked to those directorates.
- **Road Sector:** Provincial directorates for public works are responsible for maintaining the 18,000 km long regional highway system under desirable conditions, while the national agency for roads takes responsibility over the 12,000 km long national highway system. Both

⁸ Article 27 of Sistafe law. The rule of twelfths authorizes monthly spending ceilings of one twelfth of the budget appropriations for the preceding fiscal year.

systems are integrated in the so-called “classified” highways network, funded by earmarked revenues through the road fund. 80% of the fund resources, collected in the form of excise tax on fuel, is devoted to the network. All directorates and the agency are SUs, allowing for anchoring the decentralization in the road sector on those directorates.

Recommendation 1.14. Include transitional provisions to the fiscal decentralization law focused on the budget cycle for the coming years, in particular, the first autonomous provincial mandate 2020-2024.

Recommendation 1.15. Transitional provisions to be designed on a two-phase approach to take place over the first autonomous provincial mandate (2020-2024).

II. STRENGTHENING CASH MANAGEMENT AND EXPENDITURE CONTROL

A. Introduction

68. The Government of Mozambique has received substantial technical assistance in recent years – from the IMF and other partners – on budget execution and cash management. This has been primarily diagnostic and has discussed issues arising from a lack of budget credibility, ineffective budget execution processes, and poor cash management.⁹ These problems are evidenced by the existence of a large stock of expenditure arrears and the imposition of strict cash rationing when responding to requests for payment of budget expenditures by SUs. With support from the IMF, the government has prepared a strategy to clear the arrears accumulated by end 2017 and take measures to prevent emergence of new arrears.

69. The current mission has, at the express request of the authorities, concentrated on determining and discussing various actions to resolve the issues found during previous diagnostic TA and implement the strategy mentioned above. The mission has looked at the budget execution process and how it could be reformed to deal appropriately with the effects of non-credible budgeting and the avoidance of expenditure arrears. The government has not yet started to implement effective cash management. The mission provided guidance on the steps needed to build capacity in the MEF and the SUs for effective use of commitment controls, producing the required cash flow forecasts, and active cash management operations.

⁹ In particular, see FAD-AFRITAC South ‘*Strategy for Restoring the Expenditure Chain and Improving Financial Programming*’ Helis *et al*, June 2018.

B. Budget Execution Reform

70. Despite a comprehensive expenditure arrears clearance program put in place since an inventory was determined by end 2017, further arrears continue to arise. It is clear that attempts to execute a non-credible budget lead to the inability to make payments on all government budget obligations during the fiscal year. Such obligations, having already been committed by SUs – mostly under their legally appropriated budgets¹⁰ – for the delivery of required goods and services, add to the existing stock of expenditure arrears and continue to adversely affect the reputation of the government and the cost of the goods and services it needs. At the time of this mission, the Ministries of Education and Health indicated that they were likely to accumulate significant amounts of additional arrears; the total amount of accumulated unpaid invoices in these ministries during 2018 were MT 2 billion (US\$ 32 million) and MT 40 million (US\$ 0.64 million) respectively.

71. The budget has lacked credibility in past years in the estimates of all elements making up its composition – revenues; expenditures; and deficit financing. Overestimation of revenues coupled with unanticipated increases in payrolls have contributed to recent shortages of cash resources during budget execution. In addition, previous large expenditure arrears were caused by sudden withdrawal of budget support from donors.

72. Little or no control to adjust budget expenditures has occurred during times of cash shortages. Strict cash rationing has caused payments to be reduced at such times even though government obligations continue to be incurred. The recommended method of managing execution of the budget during periods when cash shortages are anticipated is to control commitments of budget expenditures. This means that the level of obligations is reduced rather than deferring payments for previously incurred obligations. This process of budget management is used by many countries in the region and across the world where there is a reasonably high possibility that revenues may fall short of budget estimates.

Initiating Active Use of Commitment Controls

73. The e-SISTAFE system and the SISTAFE law are already designed to handle commitment controls¹¹. However, the business processes have not been implemented. SUs do not enter commitments as they are made and the system does not check proposed commitments against the remaining level of budget appropriation or commitment ceiling. As described in previous reports, SUs sign contracts to obtain goods and services and wait until they receive these before informing the system of these obligations. The system does, however, require recording a commitment but this is only performed after the Treasury provides a cash

¹⁰ Issues concerning expenditures in excess of appropriations – particularly payrolls – are considered in the section on expenditure controls.

¹¹ June 2108 report – *Ibid.*

ceiling to the SUs based on their requests for paying the associated invoices. This process occurs on a weekly basis with the Treasury providing cash releases against requests determined by the available cash resources.

First stage of implementing commitment control (through e-SISTAFE MEX module)

74. To reform these processes, it is necessary to implement a step-by-step approach which starts with making correct use of the commitment methodology. Initially, the MEF must configure the e-SISTAFE to accept commitment proposals as they are made by the SUs against an authorized commitment ceiling. The system, at this stage, needs to be able to accept commitment ceilings for SUs for a longer time horizon at a high-level of economic classification – payrolls; recurrent expenditures; capital expenditures. Only at a later stage, will a more detailed level of classification be needed for control purposes. The MEF should be able to change these ceilings at any point in the fiscal year.

75. When a commitment proposal is entered by an SU in real time, the system will check to see if the available commitment ceiling is adequate to allow it to proceed. If not, it will be rejected. If it is allowed, a commitment note (CN) is produced by the system for printing. The CN will have a unique code number which identifies that particular contract. At the same time, the commitment ceiling will be provisionally reduced by the contractual amount. For contracts covering a multi-year period, the reduction amount will be the value expected to be paid in the current fiscal year only.

76. Once the system has accepted the commitment and the CN has been produced, the contract should be signed in conjunction with its lawful approval by the Administrative Tribunal. Following the legal finalization of the contract, the commitment must be formally entered into the e-SISTAFE where the appropriate commitment ceiling reduction is confirmed in real time for the contracted financial value. If the contract does not come to fruition, the SU should enter this fact into the system where the CN will be cancelled, and the commitment ceiling returned to its pre-proposal value. If the SU fails to return to the system for a formal confirmation or cancellation of the proposal, its commitment ceiling will remain at the reduced level and a reminder sent after a fixed time to demand a conclusion to the commitment proposal.

77. This use of the CN is designed to provide a strict incentive to the SUs to adhere to this business process for entering all commitments into the system at the point of contracting. An official circular is required to specify the new process and its commencement date. In addition, the MEF must use outreach methods to indicate to all government suppliers that, from the date of implementation, no contract entered into with a government entity will be valid for subsequent payment unless it is attached to a unique, and verifiable, CN. If this outreach is successful, no contracts will be signed which have not been passed by the commitment control functionality of the e-SISTAFE and recorded in the system.

78. For this first stage of commitment control, it is recommended that the budget is managed in the same way as at present. Currently, the MEF uses its authority to reduce the available budget allocations on expenditure classification heads by withholding ten to fifteen percent of their value. This constraint is applied in a broad manner across the SUs and should be formally used to operate as a commitment ceiling. With the new automated commitment control process, the same constraint can be set through the commitment ceilings entered into the system. In this manner, the SUs will initially see no difference in their budget execution other than the requirement to undergo a commitment ceiling check by the system before signing a contract.

Second stage of implementing commitment control (through the MPE module)

79. While the first stage of commitment control described above will be a good start to capture all commitments in real time, it should be followed by further measures during the second stage to fully resolve the problem of over-execution of a non-credible budget.

Unless the broad budget withholding factor is equal to, or greater than, the overall budget resource shortfall, it will not be capable of avoiding unpaid expenditure obligations. Moreover, the blanket reduction envisaged will be unsuitable for certain expenditure lines. These could include non-discretionary items such as debt service, salaries, continuous contracts such as utilities and medicines, and other vital government services.

80. As described in the June 2018 TA report,¹² the most appropriate method of ensuring that expenditure arrears are unlikely to occur is through active budget management. This entails deciding, at certain points during the year, what level of commitments are to be permitted. The cash flow forecasts for the period ahead should provide suitable information to show whether commitment levels need to be reduced. If revenues are projected to fall short of the budget estimate, and assuming the fiscal deficit target is fixed, expenditures must be reduced accordingly before they have been committed.

81. Decisions restricting permission to make appropriated expenditures must be taken with sufficient authority. The establishment of a high-level cash management committee (CMC) at the MEF should normally command this level of seniority. For this purpose, it should be chaired by the Minister of Finance with delegation, as necessary, to the Permanent Secretary.¹³ The committee should consist of senior management officials of the MEF including those responsible for budget, Treasury (including the cash management unit (CMU) – see below), macrofiscal unit (see below), revenue authority, and senior officials of the BoM. The committee should have the authority to invite senior management officials from large sector ministries to attend its meetings as necessary. Sample terms-of-reference for the CMC is provided in Annex II.

¹² *Ibid.*

¹³ The CMC would be more strategic than the current Ministerial Consultative Council which meets weekly to determine cash availability and urgent needs.

82. A regular senior MEF management decision is required to issue commitment ceilings through quarterly budget releases to SUs. Using information provided by its members – particularly the CMU cash flow forecasts (see below) – the CMC would decide the overall commitment envelope suitable for the forthcoming quarter of the fiscal year. It would instruct the Directorate of National Budget (DNB) to issue the necessary commitment ceilings to the SUs. The ceilings would then be entered into the e-SISTAFE for automatic control in the same manner as described above.

83. Quarterly budget releases have been found to be the most suitable in countries which use this method of budget management. Many governments have moved gradually from strict cash rationing to monthly budget releases and then to quarterly releases. During this process, it is often found that monthly releases do not provide sufficient time for control of the one-off, large, volatile expenditure items usually targeted. These items normally have significant contractual lead times and they need to be committed early in the fiscal year. Effective control of commitments is often performed later in the year when revenue shortfalls become more evident.

84. The DNB should be responsible for allocating the requisite commitment ceilings to those SU expenditure lines which are discretionary in nature and would not adversely affect government business. Given its close relationships with SU budget managers, the DNB should have the experience to decide where commitment cuts could be most effective for dealing with an expected drop in available cash resources in the coming three months. Those expenditures planned to be committed during the coming period would be carefully analyzed and one-off items which least affect the provision of government policy would be selected for reduction or delay. These would normally be related to new or continuing project implementation. Depending on the size of the required cuts to committed spending, further discretionary lines would be reduced.

85. For this budget management process to be effective, the MEF needs to be able to forecast future government cash flows with reasonable accuracy. This entails understanding the procurement plans of the SUs; debt servicing flows; payrolls and emoluments; and recurrent expenditures. These would need to be modelled as projected outflows from the treasury single account (CUT). Relevant projected inflows would be projected revenues, debt issuance, and aid receipts. Consequently, it is unlikely that this stage can be implemented before the MPE module of e-SISTAFE is configured for the provision of such data and rolled out to those SUs which have a significant impact on the overall government cash resource envelope.

86. The same commitment control process through the e-SISTAFE system set up in the first stage would be used to control budget execution. The quarterly budget releases would act as commitment ceilings within the system but would need to be highly flexible and subject to change. It should be planned to control budget releases quarterly, but the associated commitment ceilings should be capable of amendment as soon as significant new information on future cash resources (higher or lower) was available.

Establishing a macrofiscal unit for improving the credibility of revenue forecasts

87. The cash flow forecasts leading to flexible budget management are critically dependent on accurate, realistic revenue forecasts. For this purpose, a macrofiscal unit should be established with experienced macroeconomists responsible for forecasting the effects of changing economic variables and conditions on the budget revenue estimates. Instead of creating a new unit, one of the existing units analyzing macrofiscal related issues—Either the Macro studies unit or Fiscal Risks Management Unit—could be assigned this task of preparing and updating revenue forecasts. This is a specialized task and will require some technical assistance to implement.

88. It should be noted that, although information from the revenue authorities is a necessary input, it should not be the sole basis for forecasting future revenue flows. Revenue authorities have collection targets to meet and their forecasts will often not be realistic. If revenue collection amounts are showing a shortfall during the year, the revenue authorities will be tempted to predict that they will raise enough revenue during the remainder of the year to meet the budget target. Even though they may understand that this is unlikely due to macroeconomic developments, they are not likely to admit this in their projections. Once a macrofiscal unit is established, its projections should be used by the cash flow forecasters since these should incorporate all realistic factors.

Establishing a cash management unit in the Treasury

89. A cash management unit (CMU) should be established in the Directorate of National Treasury (DNT) to perform suitable cash flow forecasting for CMC decision-making. This unit should comprise four to six operational staff who should be proficient in spreadsheet data operations. The spreadsheet data should be provided by various parts of the government and it will be important for these staff to be able to establish good working relationships with their counterparties. The process of compiling and aggregating this information within a comprehensive spreadsheet is not complex and the required staff would not need to be highly skilled since no mathematical calculations are involved. Templates for the required cash flow information spreadsheets themselves have already been provided through other TA. The format of these spreadsheets and the responsibilities for populating them at specified intervals, including the reporting obligations of the SUs to the CMU, should be backed up by legally-binding provisions such as Regulations.

90. The objective of the spreadsheet analysis is to produce a profile across the fiscal year of the expected balance in the CUT. This would show the aggregate cash resources available to the government at each point in time and would highlight the periods where it is predicted that cash shortages would arise. It should be emphasized that this profile is a forecast and does not need to be of accounting accuracy. Therefore, much of the input data can be derived from historical understanding of expenditure patterns. For example, salaries should follow the same pattern each year and would be expected to be reasonably smooth in profile

across the year unless certain special payments and bonuses exist which could be incorporated from their regular pattern. Goods and service expenditures are also likely to follow similar patterns to those in preceding years and can therefore be extrapolated in the model.

91. The expenditure projections which need to be obtained directly from individual SUs are those which are likely to be significantly large and volatile. That is, they cannot reasonably be assumed to follow previous patterns. The overall objective of this work is an aggregate of a large amount of individual expected payments. This means that the relevance of small items can be low and only those items which are large in comparison to the aggregate totals have to be reasonably accurate. Effort should be concentrated on such items and relationships should be established by CMU staff with those SUs where they are likely to exist. Such expenditures are likely to be related to reasonably large projects.

92. The cash flow forecast model should be maintained continuously which implies that all information which changes projections significantly should be incorporated as soon as it becomes available. The model is a dynamic projection of government cash resources and will also need to be updated as budget releases are decided and implemented. It will also need to incorporate details of large commitments which are entered into the e-SISTAFE system since these should provide accurate information on forthcoming contract payments as they are agreed.

93. Modeling government cash flow forecasts takes a long time to come to fruition. The model is large and contains many variable amounts at any one time. The accuracy of the modeling will vary a great deal but should rapidly improve once it has begun. It is of the greatest importance, therefore, that this work is commenced as soon as possible. Even if the information is, at first, not particularly useful due to its inherent inaccuracy, it can never be improved until it is started. The cash flow forecasting work of a CMU is described in Box 2.1.

Box 2.1. Building Cash Flow Forecasts

Building reliable cash flow forecasts is clearly a prerequisite for a successful budget and cash management strategy. The forecast period should extend for at least six months, although should ideally be at least twelve months (some governments, e.g., France, Australia project daily flows for the rolling period of one year ahead). This relates to the time period within which offsetting action may usefully be taken, e.g., by budget releases, adjustment to the bond issuance program, or by the issue of T-bills. The design of an effective forecasting and monitoring capability is likely to be built around the following elements:

- A database of actual daily cash flows, as a means of identifying patterns for monitoring. Actual cash flows should be closely tracked against departments' profiles and major divergences investigated, as part of improving the forecasting processes.
- Information flow to the cash managers from revenue and spending departments. The preparation of short-term cash flow forecasts cannot effectively be done only at the centre, i.e., ignoring the knowledge of those budget agencies that are closer to the interface between government and other sectors. Budget agencies are also best placed to supply information when actual flows are diverging from the budget.
- A network of contacts, voice and electronic, with the main spending and revenue departments, which would be used both to develop forecasts and monitor current flows.

The cash managers should ideally know precisely the timing of some major cash flows, e.g., debt servicing and redemptions, for which data should be available directly. Some payments will have a regular monthly pattern (e.g., payment of salaries or some transfers to individuals or to lower levels of government), and for others there may be an historical pattern.

In an ideal world, efficient cash management systems enable daily forecasts of cash flows across the TSA, together with the monitoring of actual changes close to real time. There is no simple technical short cut that facilitates this. In general, it has been found that econometric techniques are not useful for daily or monthly projections—their main role is to help forecast annual or quarterly aggregates, which are used to act as a budget management constraint or release. Daily/monthly cash flow forecasts are built up from a mixture of knowledge about specific flows, historical experience of patterns, and judgments about the impact of any recent changes in policy or application of administrative rules. There is often a difference between the compilation of "above the line" (i.e., revenue and expenditure) forecasts, which may fall to those monitoring budget execution or receipts, and those "below the line" (debt and other financial transactions), where the cash and debt managers take responsibility.

Typically, country experience dictates starting with rough monthly projections and gradually building up these rough projections towards weekly and finally daily forecasts. This type of process does not need sophisticated modelling techniques. The patterns in cash flows can be examined, e.g., by plotting individual time series on a year-over-year basis to reveal annual seasonality. Many government expenditure and receipt data, and movements of cash balances, may exhibit strong and predictable seasonal variations.

Equally important is to:

- Identify the key people at the working level in the selected revenue and spending departments, who will be able to supply the relevant information.
- Set up formal requirements to ensure that profiles are supplied and updated.
- Back the latter by informal arrangements, whereby the cash managers are given early notice of any major changes. In many countries these changes will need to be communicated not only in advance of the day being studied but also on the day itself, to ensure that any offsetting action can be taken by the cash managers.
- The focus should be on those sums that are large in size, most variable and most unpredictable. In the U.K., for example, the more detailed information is collected from just 15 departments who together account for over 80 percent of government spending.

Outcome of effective budget management

94. Once the process of budget releases is established and operational, it should have a significant effect on the operation of budget execution. If cash flow forecasts are reasonably accurate for the quarter ahead – in particular the revenue forecast – controls on commitments should automatically mean that sufficient cash is available for their payment obligations. By understanding the payment dates and amounts of committed items in advance, and by restricting these to the projected cash resources, there should be no further need for cash releases to be made at the time of payment. Since all commitments will be entered into the system, no ‘surprise’ invoices should arise for which there is no available cash.

95. The current budget execution process comprises a deconcentrated payments system. This means that payment instructions for invoices are given by the responsible SUs using the e-SISTAFE system. SUs request cash releases for amounts which have been invoiced or expect to be invoiced during the following four weeks. Weekly cash releases are then issued by the Treasury. Once the cash release amount is known, the SU selects the invoices to be paid and enters these into the e-SISTAFE. The system compiles an electronic payment instruction file which is sent to the BoM. The BoM makes the required payments from the CUT account to suppliers detailed on the file.

96. The current deconcentrated payments system is sub-optimal because the Treasury does not have full information on invoices which need to be paid. In a cash rationing environment, SUs select invoices for payment at their discretion. This can lead to corrupt practices and also avoidance of payments. When an invoice is not selected for payment because the cash release cannot cover it, the invoice may be put out of sight along with other similar invoices. These invoices become unpaid expenditure arrears which are non-transparent to the Treasury or other authorities.

97. However, once the budget release process is operational through commitment controls, the payments system can effectively be centralized. Without the need for cash requests and cash releases, there should be no obstacle to SUs entering all their invoices directly

into the system. The system would be configured so that the payment instruction file would be produced automatically. This file would then need to be verified to ensure that sufficient cash is available in the CUT. This verification process could be automated in the system based on some clear criteria to prioritize payments; in the interim, the Treasury could verify to ensure that payment instructions sent to the bank are within the available cash balance in the CUT.

98. If a continuing unanticipated cash shortfall was experienced, these withheld invoices would again build up a stock of expenditure arrears. This would indicate poor cash flow forecasts and that the budget management process was operating ineffectively. However, the major benefits of the centralized payments system at this point would be (i) that the arrears would be fully transparent; and (ii) that a clear, decision-free automated system could be devised to select delayed invoices for payment when cash was available. This could be, for example, on a first-in – first-out basis. It is recommended that the Treasury should actively consider moving to a centralized payments system when feasible during the second stage of commitment control and quarterly budget release system.

C. Active Cash Management Operations

99. A primary task of the CMU is to provide the CMC with monthly and quarterly cash flow forecasts to inform decisions on budget management and releases. Once the budget is managed in an effective manner through this process, budget execution should become reasonably credible. This implies that annual committed expenditures will approximately equal available revenues plus budget deficit financing. In other words, the starting balance of the CUT will be the same as the balance at the end of the fiscal year. At that point, temporary periods of cash shortages and surpluses will only occur during the year as timing mismatches between revenue collections and expenditure payments arise.

100. It is the task of active cash management operations by the CMU to manage these temporary mismatch periods efficiently. The CMU should investigate whether the timing of revenues, expenditures, or debt transactions can be moved to reduce these periods since this is the most cost-effective way of handling mismatches. Any such movement must be agreed to by the parties concerned so that the process does not lead to a return of enforced cash rationing.

101. Alternatively, periods of cash shortage need to be filled by short-term borrowings and periods of surplus are used to repay the borrowings and invest excess cash efficiently. In this way, it can be assured that expenditure payments will be made as and when necessary without abnormal delays. This enhances the credibility of the government and generally reduces its costs.

102. As described in Box 2.1, cash flow forecasting for cash management purposes needs to be finer in detail than for budget management purposes. The CMU will need to become more proficient in producing these forecasts when deciding to embark on active cash management operations. It is necessary to have sufficient confidence in the cash flow forecast

accuracy to ensure that financial transactions are appropriate to the coming cash situation and will not be an additional cost.

Using suppliers' standard terms of payment

103. The current payments system does not utilize cash efficiently and provides little assistance to the task of cash flow forecasting. The existing system, in common with many other countries in the region, creates a payment instruction file from selected invoices which is then transmitted to the central bank for immediate payment. The government payments system can become more effective by using invoicing practices which are commonplace in the private sector.

104. Private sector businesses usually provide their main clients with standard payment terms. These normally include a provision that the payment is not due until a specified period following issuance of the invoice – very often 30 days but possibly up to 90 days – following which the client is considered to be in default. The government should commence a program to request similar terms from all its major suppliers. The e-SISTAFE should then include the payment period allowed by each supplier in its file of suppliers' details.

105. The e-SISTAFE would be configured to ensure that invoices were put on the payment instruction file only at the latest date of payment – 30 days after the invoice date. The government would hold its cash resources for longer than at present which is more cost-efficient. Additionally, a major benefit would be that the e-SISTAFE can then be programmed to produce the payments scheduled for the following 25 days, or so. If all suppliers were on 30-day payment terms, this payment schedule would be a precise projection of all payments due by the Treasury for almost the whole coming month. Such accurate cash flow projections would greatly assist in active short-term cash management operations.

Developing the use and depth of the Treasury bill market

106. The need to incur short-term borrowing to counteract timing mismatches between revenues and expenditures is usually managed by issuing Treasury bills (T bills). The T bill market is normally the most liquid and cheapest way for a government to borrow for a short-term. In Mozambique, this market will need to be developed substantially before it can be used for active cash management operations.

107. At present, the government uses an informal and convoluted method of access to the T bill market for fiscal purposes. When necessary, the government requests the BoM to borrow on behalf of the Treasury in the T bill market when it performs open market operations for monetary policy purposes. The BoM lends the proceeds to the government which takes responsibility for the repayment of the T bills when they mature. This methodology is cumbersome and confuses the operations of monetary policy and fiscal policy which is inefficient for market liquidity and pricing. It is recommended that the Treasury, the debt managers, and the

BoM coordinate a market development program once active cash management operations can be implemented feasibly.

D. Summary of Required Activities

- Configure e-SISTAFE to produce commitment notes and enforce commitment ceilings
 - Inform private sector on commitment note rules
 - Ensure e-SISTAFE has commitment controls/ceilings in place
- Set up CMC
 - Terms of reference
 - Composition
 - Meeting schedule
- Training for DNB to select and enforce commitment ceilings
- Refresh rules for compliance with entering commitments into the e-SISTAFE system as soon as they are made
- Set up CMU
 - Staffing
 - Spreadsheet model
 - Training
 - Capacity building for large SUs
- Configure e-SISTAFE (MPE Module) to report committed payment schedules to CMU
- Set up MFU
 - Training
- Refresh rules for producing, updating, and distributing procurement plans
- Consider benefits of moving to centralized payments system
 - Configure e-SISTAFE to handle invoices directly
 - Determine rules for payment prioritization and train Treasury
 - Rules disseminated to SUs
- Discuss and implement rules to implement suppliers' standard payment terms
 - Configure e-SISTAFE to determine correct payment dates for approved invoices
 - Configure e-SISTAFE to report near-term payment schedule to CMU
- Coordinate with BoM and debt management to develop short-term T bill market for cash management

E. Summary of Recommendations

Recommendation 2.1. Configure e-SISTAFE to control commitments through commitment ceilings and the issuance of commitment notes.

Recommendation 2.2. Conduct outreach to all sector ministries and government suppliers on the appropriate use of commitment notes.

Recommendation 2.3. Use the current budget withholding methodology to set commitment ceilings for enforcing commitment controls, and prepare and issue a circular to SUs specifying the new commitment control process.

Recommendation 2.4. Establish a Cash Management Unit (CMU) within the National Directorate of the Treasury to perform government cash flow forecasting and active cash management operations.

Recommendation 2.5. Establish a skilled macrofiscal unit in the MEF tasked with producing realistic revenue forecasts both for multiannual fiscal policy and in-year budget management purposes.

Recommendation 2.6. Establish a high-level Cash Management Committee (CMC) chaired by the Minister or PS to decide the quarterly commitment control envelope for implementation by the NDB.

Recommendation 2.7. Develop a capacity building program for CMU cash flow forecast modelling and the production of expenditure plans at large Sus.

Recommendation 2.8. Investigate the need for regulations on the provision and updating of procurement plan information, expenditure plans, revenue projections, and anticipated debt and aid flows to the CMU under the authority of the CMC.

Recommendation 2.9. Consider the advantages of centralizing the payments process within the e-SISTAFE once commitment controls are effective.

Recommendation 2.10. Consider standardizing suppliers' payment terms within the e-SISTAFE system and using these to develop more accurate short-term payment forecasts.

Recommendation 2.11. In coordination with the BoM and the debt managers, commence plans to develop the Treasury bill market specifically for cash management purposes.

III. STRENGTHENING CONTROL OF WAGEBILL AND MANAGING ARREARS

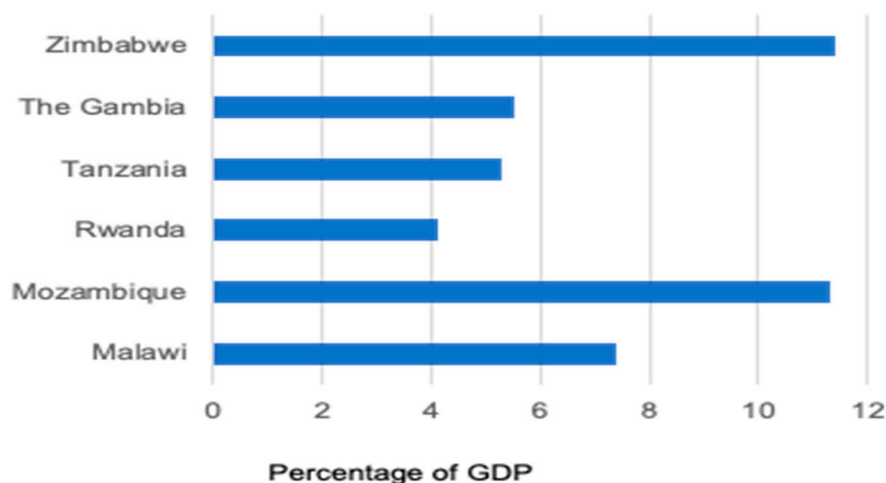
A. Controlling Wage Bill Expenditure

108. The authorities have successfully implemented an initiative to minimize the number of ghost workers on its payrolls. A proof of life exercise conducted by the Inspectorate of Finance (IGF) covering the period from 2015 to 2017, identified 30,000 ghost employees, costing government USD 250 million. The proof of life initiative has been institutionalized. Specifically, the e-payroll has an inbuilt control to prompt SUs to notify civil servants of their month of birth. The onus is on each civil servant to physically prove continued employment every year during his/her month of birth. A failure to do so leads to the immediate suspension of a non-compliant civil servant's salary on e-payroll.

109. However, control of wage bill expenditure remains an area of major concern.

Mozambique's wage bill as a percentage of GDP is one of the highest among low income countries in the region (see 3.1). The estimates and projections of Mozambican authorities and IMF staff indicate that employee compensation in 2019 could be as high as 11.3 percent of GDP, and may grow to 12.2 percent of GDP by 2022.¹⁴ Two key areas undermining government's ability to control wage bill expenditure relate to: weak establishment controls (particularly in the health and education sectors); and bonuses and overtime payments arising from double shift teaching and the long hours worked by medical staff.

Figure 3.1. Mozambique's Estimated Wage Bill in 2019 Compared to Other Low-Income Countries in the Region



Source: IMF staff reports.

110. A 2017 study of wage bill and civil service reform identified that, in 2016, bonuses and overtime payments comprised 26.2 percent and 1.5 percent respectively of the total wage bill.¹⁵ The report estimated that by eliminating bonuses and overtime by 25 percent per annum over a four-year period, government could reduce the wage bill by one percentage point of GDP. It does not appear that the authorities have factored this recommendation to reduce the wage bill. At the time of this mission, the authorities indicated that there were pending arrears on overtime estimated at MT 3 billion.

111. Staff establishment controls remain weak. Although Statutory Decree No 1 of 2018 delegates oversight of this function to the Ministry of State Administration and Public Function (MAEFP), procedural guidelines to implement this oversight process have yet to be developed. At present, the authorities mainly rely upon the Administrative Tribunal (AT) to approve new

¹⁴ IMF (2018) Republic of Mozambique: 2017 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the Republic of Mozambique. Report No. 18/65.

¹⁵ Xiao, Y., Abdullah, C., Bender, C. and Martins, R. (2017) Republic of Mozambique: Wage Bill and Civil Service Reform. IMF. Technical Assistance Report.

recruits. However, the scope of AT's verification is limited to ensuring that all the supporting paperwork has been completed for a new recruit. Once the AT approves a new recruit, it issues an approval number. A new recruit's personnel details can only be entered onto the payroll when an AT approval number has been issued. No overall check is undertaken to ensure that recruitments are made within the approved establishment.

112. The MAEFP only identifies cases where establishment ceilings have been exceeded after the event. As new recruits are already on the e-payroll, the MEF is obliged to request for additional budgetary allocations to absorb the additional wage bill costs. No action appears to be taken to recover any resulting over-expenditure and/or to sanction this practice. There is, therefore, a need for the MAEFP, in collaboration with the MEF, to issue a decree to SUs reiterating the steps to be taken to strengthen ex-ante controls over their staff establishments, and sanctions to be enforced when establishment ceilings are flouted.

113. Going forward, the monitoring of establishment ceilings would be easier in an automated environment. The authorities anticipate that the ongoing development of a national human resources management information system (SNGRH) will enable the MAEFP, MEF and the AT to monitor whether new recruitments are within the establishment ceilings, and link/integrate the three personnel control functions—establishment control, payroll administration and the wage bill—through concurrent updates of the personnel database in SNGRH and the e-payroll. The MEF would thus be in a position to incorporate establishment ceilings in the budget law and enforce them properly.

114. However, in the short-term, the following measures could usefully be undertaken. The IGF could be requested to undertake a targeted audit of the process in the agriculture, education and health sectors with a view to assessing compliance with regulations and ascertaining the effectiveness of internal controls for payroll. In addition, the SUs should be required to maintain up to date records of actual staff numbers against the approved establishment, and the impact that any new recruitment will have on the establishment. These establishment records, which could be maintained on a spreadsheet by each SU, should be provided to the MAEFP to carry out checks prior to submission to the AT to approve a new recruit.

B. Managing Historical and New Arrears

115. Following a stock-take of arrears for the two-year period ending December 31, 2017, the authorities computed the total amount owed to suppliers at MT 19.3 billion (USD 308.8 million). A subsequent verification exercise undertaken by the IGF validated MT 13.4 billion (USD 214.4 million) of the total stock of arrears as bona fide. In 2018, the government liquidated MT 4.2 billion (USD 67.2 million) of the validated claims using resources from capital gains tax received from the sales of natural resource assets. In 2019, the authorities indicated that they will liquidate another MT 2.7 billion (US\$ 43.2 million) through securitization.

116. It will be necessary to undertake a second stock-take of further arrears that have accumulated from January 1, 2018. The stock take could be partly informed by a report from MEX (as at December 31, 2018) on the amounts requested by SUs to settle invoices from suppliers but not allocated by Treasury. This information would need to be supplemented by data from SUs on unpaid invoices, which have not been posted on MEX. To guide the process, the MEF should issue a decree to guide SUs on the process and timetable. Once the stock-take is complete, as before, the IGF should validate the claims for their accuracy and credibility. The validation process is intended to verify the documentation and transactions supporting the claims, and ensure that costs are bona fide and have not been inflated, fraudulently claimed or previously settled. The validation process could also help verify whether transactions complied with the regulatory framework for procurement.

Arrears on VAT refunds and related weaknesses

117. Until recently the VAT refund process was cumbersome and undermined the government's ability to repay taxpayers promptly. The Decree 17 of 2017, which became effective on January 1, 2018, seeks to simplify the process. For example: (i) taxpayers with a credit balance of more than a specified threshold (domestic MT 500,000 and exporters MT 20,000) can apply for a refund after 4 months as opposed to the previous 12 months; and (ii) an earmarked fund account number 1598 operated by the Treasury has been opened at the BoM with a fixed percentage of VAT revenue to finance refunds.

118. As at November 2018, the potential maximum accumulated amount of VAT refund arrears stood at MT 22.8 billion (representing about 2.6 percent of GDP). The authorities are still in the process of validating most of these refund requests, but would not have the funds at hand to clear them in one go. A strategy for clearing VAT refund arrears has yet to be developed. Furthermore, the authorities should amend, as soon as possible, the VAT law to set a time limit for claiming VAT refunds.

Maintaining an arrears monitoring system

119. Currently, SUs' payables and payment arrears are not systematically recorded, monitored or reported. Going forward, it will be important for the authorities to institutionalize regular monitoring and reporting on arrears. This could be done through e-SISTAFE (MEX module), for example, by requiring SUs to register all invoices in the system as and when they are received, including their respective amounts and due dates for payment. The system could profile arrears by their size, maturity and composition. A close monitoring of arrears will enable more effective management of the existing stock of payment arrears and provide an early warning signal of any risks of emerging arrears.

D. Summary of Recommendations

Recommendation 3.1. The IGF should undertake targeted audit of the processes and controls related to establishment and payroll for sectors where the problem is most prevalent (agriculture, education and health sectors).

Recommendation 3.2. The MAEFP should verify information against the approved establishment with each request to approve a new recruit, prior to submission to the Administrative Tribunal. Furthermore, once the SNGRH is operational, the MEF should incorporate the staff establishment ceilings in the budget law.

Recommendation 3.3. Stock-take and validate the arrears accumulated during 2018 and provide for their clearance in the arrears clearance strategy.

Recommendation 3.4. The MEF should prepare a strategy for clearing VAT refund arrears.

Recommendation 3.5. Regularly monitor and report on arrears in in-year and year-end fiscal reports.

Recommendation 3.6. The MAEFP should issue a decree to SUs reiterating the steps to be taken, including sanctions to be enforced, when establishment ceilings are flouted.

Annex I. Example of Types of Expenditure Functions for Regional/Provincial Level of Decentralized Governance

| COUNTRY | ANGOLA | SOUTH AFRICA | PHILIPPINES | CROATIA | CZECH REPUBLIC | DENMARK | FRANCE | ITALY | NETHERLANDS | NORWAY | POLAND |
|------------------------|-----------|--------------|-------------|----------|----------------|---------|---------|---------|-------------|----------|---------|
| INTERMEDIATE - TYPE | Provinces | Provinces | Provinces | Counties | Regions | Regions | Regions | Regions | Provinces | Counties | Regions |
| INTERMEDIATE - NO. | 18 | 9 | 81 | 21 | 14 | 5 | 18 | 20 | 12 | 18 | 16 |
| RESPONSIBILITIES | | | | | | | | | | | |
| Regional planning | X | | | X | X | X | | X | X | X | |
| Economic Development | X | | | X | X | | X | X | X | | X |
| Education (Secondary) | X | X | | X | X | | | X | | X | |
| Health Care (Tertiary) | X | X | X | X | X | X | | X | | | X |
| Social Welfare | X | X | X | X | X | | | X | X | | X |
| Social Housing | | X | X | X | | | | | | | |
| Environment | X | | | | | X | X | X | X | X | X |
| Roads / Transport | | X | | X | X | X | X | X | X | X | X |
| Solid waste management | | | | X | | | | | | | |
| Wastewater | | | | X | | | | | | | |
| Culture | | | | | | | | X | X | X | |
| Agriculture | | X | | | | | | X | | | |

Annex II. Sample Terms of Reference for a Cash Management Committee

The Cash Management Committee (CMC)

The CMC is a high-level decision-making committee for commitment and cash prioritization and allocation purposes. It provides high-level support and authority for the work of the CMU. A broad framework of the CMC is described below.

Objectives of the CMC

- The CMC shall advise the Minister on the processes for optimum management of the budget and government cash resources;
- It shall provide the government and BoM revenue and expenditure forecasts, and its analysis based on these forecasts. It shall project the financing gap between government inflows and outflows for each quarter, or with such periodicity as may be asked for by the MEF;
- It shall advise the government and BoM on the best modality for financing the gap;
- It shall direct the Head of the Budget Directorate regarding any commitment ceilings decided at each meeting for the specified period ahead;
- The CMC shall work under the overall guidance of the Minister of Finance and shall take directions from the Minister on its mandate and objectives;
- The CMC shall issue directives as necessary to SUs, revenue projection officials, and the debt managers to improve the accuracy of their forecasts;
- The CMC shall decide when the cashflow forecasts are sufficiently accurate that the CMU should commence active cash management operations;
- The CMC shall supervise and approve in advance, as necessary, all active cash management transactions and instruments undertaken by the CMU.
- Membership
 - The membership of the CMC shall comprise of the following.
 - a. The Minister of Finance—Chair (Alternate – Permanent Secretary)
 - b. The Permanent Secretary
 - c. The Head of Budget Directorate
 - d. The Head of the Treasury
 - e. The Head of the macrofiscal unit
 - f. The Heads of other MEF Directorates as necessary
 - g. A nominee of the BoM
 - h. A nominee of revenue authority
 - i. A minimum of two nominees of high-spending ministries
 - j. CMC may invite any nominee as a temporary member or an observer
- The secretariat of the CMC shall be the CMU

- Meetings
 - a. The CMC shall meet monthly unless otherwise determined
 - b. The agenda for the meeting shall be prepared and all information provided to the members at least three work days prior to the meeting
 - c. Any member of the CMC may call for such additional information as may be needed.

Fiscal Affairs Department

International Monetary Fund

700 19th Street NW

Washington, DC 20431

USA

<http://www.imf.org/capacitydevelopment>