

## Strategy note

# Executive Summary: Rwanda Strategy Note

## 1. Country context

In the two decades since 1995, Rwanda has managed to emerge as one of Africa's leading performers in economic growth, poverty reduction, and improvements of social indicators. Incomes have risen at an average rate of more than 7 percent annually, infant and maternal mortality have fallen, literacy and educational attainment rates have improved, and poverty has declined from 45 percent in 2011 to 39 percent in 2014.

This emergence from the depths of massive social tragedy resulting from the 1994 genocide has several foundations: strong leadership that enforced a social peace; the adoption of progressive economic and social policies to promote growth and political legitimacy; and substantial donor support that, while conflicted and chaotic in the early days, gradually came to coherently support government initiatives (see Murray et al, 2017).

The government has played a leading role in catalyzing growth. With the onset of peace in 1995, the recovery period which lasted until 2000 saw wide-ranging state-led reconstruction of infrastructure, public services, and utilities financed by donor funds. Public investment continues to be the main driver of Rwanda's economic growth. The public investment strategy comprises forward-looking infrastructure projects in transport, energy, and health services. Because of its small size and absence of large firms, Rwanda's private sector plays a marginal role in capital investments compared to neighbouring East African states, even as the government has encouraged the growth of the private sector. Foreign savings as a share of GDP reached 13 percent in 2017, while private investment was 9 percent. Nevertheless, the post-reconstruction period has witnessed productivity gains accompanied by structural transformation into off-farm sectors. Annual growth rates which have averaged about 8 percent since 2000 are thus largely attributed to sound public investment policies.

Recent macroeconomic developments have uncovered the limitations of Rwanda's reliance on public investment. Economic growth dropped to 6 percent in 2016, compared to 7.5 percent in 2010-15. On the supply side, growth in services declined from 10.4 percent 2015 to 7.4 percent in 2016, due to reduced aggregate demand. In addition, a severe drought affecting East Africa slowed agricultural growth from 5 percent to 3.9 percent. On the demand side, private consumption was constrained by a depreciation of the exchange rate by 10 percent, and reduced public investment. However, a combination of fiscal adjustment, exchange rate flexibility, and rebounded export commodity prices led to an improved trade deficit. The country's trade deficit dropped by 5.9 percent in 2016 (representing \$1649.7m) from \$1752.5m in 2015.

Rwanda's transformation out of the agricultural sector is well reflected by employment patterns and shifts in intersectoral contributions to GDP. Workers employed in agriculture fell by 24 percentage points from 2000 to 2014 (from 89% to 68%), while the percentage of households engaged in any off farm activity more than doubled to 70%. At the same time, the services sector grew by over 7 times from 1995 to 2015, largely driven by trade and education, while the agricultural output grew by almost 5 times the level in 1995. This coincided with a drop in agriculture's share of GDP from 44% in 1995 to 50% by 2015, while the share of services grew from 40% in 1995 to 50% by 2015. Although the importance of agriculture has declined, it still plays a crucial role in poverty reduction and macroeconomic stability.

The Economic Development and Poverty Reduction Strategy II (EDPRS2) (2012-17) and the National Strategy for Transformation I (NST1) (2017-2024) stress that maintaining Rwanda's

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growth momentum, and the country's continued social progress, requires overcoming three main obstacles: raising domestic savings, particularly government savings, to replace reliance on foreign savings; increasing exports and attracting more foreign investment as a means to mobilize foreign exchange; and orchestrating increases in labor productivity with key sectors (notably agriculture) through structural transformation as workers move to higher productivity jobs in cities.

Low domestic savings places a binding constraint on Rwanda's economic prospects, particularly amid declining foreign savings. This was clearly seen when aid was temporarily cut in 2012, causing GDP growth to fall to 4.7 percent, against the period average of 8 percent (World Bank, 2017). Domestic public savings have increased from 14 percent of GDP in 2011 to 18.5 percent in 2015, driven to a large extent by stronger VAT collections supported by a range of administrative reforms, especially the use of electronic billing machines. Rwanda's standard tax rates are roughly in line with other countries in the region, but large exemptions corrode revenue. Although these measures are meant to promote investment, there is an urgent need for efficient targeting to avoid depleting tax revenue. Tax collection can be improved through better monitoring, and targeting incentives for compliance activities (Mascagni et al, 2016). Rwanda's weak collections from property taxes are another high-priority reform area (IMF, 2013).

Rwanda faces significant logistics barriers in accessing regional and global markets for its products. The DRC is a high potential market for Rwandan produce due to proximity and Rwanda's comparative advantage in many products. Exports to DRC in 2015 accounted for a quarter of total exports and twice the amount exported to the EAC. Easing of logistics constraints is paving the way for exports to play a stronger role in Rwanda's development. Export volumes increased threefold between 2010 and 2015, even with significant shocks to commodity prices. Diversification, value addition, and exchange rate policy, which have been central to the resurgence of exports, remain key priorities for further export development.

Labour productivity is a key growth challenge for firm productivity, as well as for poverty reduction and broader economic growth. Most Rwandans still work in agriculture, but labour productivity is far higher in off-farm sectors. Rwanda is therefore promoting urbanisation as a means to expand off-farm job creation, raise productivity, and improve livelihoods. Rwanda's urban structure is dominated by Kigali, although six secondary cities are being promoted. Substantial public resources are directed towards urban planning and infrastructure investment. To sustainably finance these large investments, revenue collection from land and property taxes must be raised. Furthermore, to enhance the productivity of workers and firms located in urban areas, the challenge of affordable commercial spaces and housing must be addressed.

## 2. IGC Rwanda Country Programme

IGC Rwanda was founded in 2010 at the request of President Paul Kagame. Guided by a Memorandum of Understanding with the Ministry of Finance and Economic Planning (MINECOFIN), IGC has provided demand-driven research and has strengthened the evidence base for growth-promoting policy in Rwanda. The close engagement between international researchers and government partners engendered by the IGC provides a unique opportunity to enhance policy dialogue.

The programme focuses on three main thematic areas: state effectiveness, firm capabilities; and cities. The Rwanda team comprises of a Country Director (Richard Newfarmer), a lead

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academic (Andrew Zeitlin) and three Country Economists (Jonathan Bower, Derek Apell, and Anna Twum).

### 3. Thematic Areas

#### (a) State

*Strengthening tax revenue collection:* Low levels of domestic savings are a risk to Rwanda's long-term growth. However, high poverty rates and dependence on subsistence agriculture limit private savings and the government's ability to mobilise tax revenue from citizens. Tax revenues are further corroded by large tax exemptions, a large informal sector, and compliance gaps. Furthermore, additional avenues for revenue collection such as property tax are yet to be fully developed. The IGC has analysed Rwanda's tax policy and administration, including administration of VAT, compliance strategies, the ease of paying taxes, and decentralised revenues. Going forward, research will further address taxpayer compliance incentives, compliance monitoring, and tax policy optimisation.

*Strengthening public spending efficiency:* Financing Rwanda's ambitious development targets in the face of reduced donor funding necessitates efficient public spending to complement the government's tax collection efforts. Senior policymakers have often called for strengthening incentives and performance measurement to improve service delivery. IGC research has explored the productivity and incentives of public sector workers, and provided recommendations for improvement of performance contracts. IGC has also advised on broader macroeconomic reforms necessary for strong regional integration. Future engagement will continue to address opportunities for improved spending efficiency.

#### (b) Firms

*Export development:* Rwanda's 2016 export strategy demonstrates its commitment to diversify its export base by adding value to key tradable commodities and developing high value services. For instance, in addition to eco-tourism the government has refocused attention towards business tourism through the Meetings, Incentives, Conference and Events (MICE) initiative. IGC Rwanda's research in this area has highlighted the domestic barriers faced by exporters as well as opportunities for Rwandan products in new markets. Furthermore, the IGC's regional research on value chains facilitated deeper understanding of the constraints to productivity and value addition in markets such as maize, dairy, tourism, coffee. Additional work has also addressed the institutional and regulatory barriers to the performance of Rwanda's mining sector. The portfolio will continue to focus on diversification through research on firm linkages and networks, and on constraints to the productivity of mining operations.

*Domestic market recapturing:* Rwanda's widening trade deficit constrains its ability to invest in the physical capital needed for productivity growth. To address its rising import bill, the government has focused efforts to promote locally manufactured goods under its Made in Rwanda initiative, identifying three key sectors (light manufacturing, construction, and agro processing) for targeted support under the Domestic Market Recapturing Strategy (DMRS) (import substitution). IGC research in this area focuses on informing deepening of supply chains and strengthening backward linkages. Ongoing work will look at supply chains in tradable sectors to highlight the barriers to firms sourcing locally and identify highest potential value chains for domestic market recapturing.

*Promoting a conducive business environment:* Attracting FDI is important for investment financing and enhancing firm productivity through technological transfer. The Government in the Vision 2020 demonstrated commitment to address regulatory constraints to private investment in export sectors. Progress towards this goal has been mixed. Although investors

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view favourably the registration process, they cite post-registration issues such as “unclear decision making”, tax processes and land registration as constraints to their businesses. IGC research in this area has facilitated a better understanding of the impact of investor promotion incentives. Future work aims to optimize targeting of these initiatives. This work brings together research across themes such as, tax administration and policy, macroeconomic analyses, energy, and urban management.

*Raising labour productivity:* As Rwanda aspires to achieve a knowledge based society, human capital investment is crucial for employment and poverty reduction, as well as productivity and growth of firms. To date however, local manufacturing firms cite shortfalls in technical and soft skills as a severe impediment to their productivity and expansion. This challenge is evident when comparing literacy rates to EAC neighbours. The government has responded to the shortfall by investing heavily in technical education and skills training, but primary education has received less attention. Ongoing IGC work in this area seeks to inform the delivery of quality education through incentives for teachers. Future research will continue to look at human capital constraints to labour productivity, in particular the challenges in tertiary and vocational training.

### (c) Cities

*Managing cities and spatial development for growth:* Closely related with labour productivity, urbanisation provides employment opportunities in more productive off farm sectors. Vision 2020 recognises urbanisation key to building a middle income society. The national urbanisation policy identified affordable housing and sustainable financing of infrastructure as key challenges to be addressed. The IGC Rwanda’s cities portfolio has studied strategies for raising the supply and quality of low income housing; sustainable municipal financing; and urban transport for employment. Future work will continue to address these areas, and extend research into the role of cities in the broader development of Rwanda.

## 4. Engagement strategy and collaborations

Theme	Relevant Stakeholders and Partners
<b>State</b>	<ul style="list-style-type: none"> <li>• Rwanda Revenue Authority</li> <li>• Ministry of Finance and Economic Planning</li> <li>• Strategy and Policy Unit, Office of the President</li> <li>• Ministry of Education</li> <li>• Development partners: DfID, GIZ, AGI</li> </ul>
<b>Firms</b>	<ul style="list-style-type: none"> <li>• Ministry of Trade and Industry and East African Community affairs</li> <li>• Rwanda Development Board</li> <li>• National Agricultural Export Board</li> <li>• Development partners: TMEA, DfID, GIZ, ODI</li> </ul>
<b>Cities</b>	<ul style="list-style-type: none"> <li>• Ministry of Infrastructure</li> <li>• City of Kigali</li> <li>• Ministry of Finance and Economic Planning</li> <li>• Development partners: The World Bank, GIZ</li> </ul>
<b>Cross-cutting</b>	<ul style="list-style-type: none"> <li>• National Bank of Rwanda</li> <li>• Ministry of Finance and Economic Planning</li> <li>• Strategy and Policy Unit, Office of the Presidency</li> </ul>