

Public Financial Management Reforms in Nepal

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Nepal is one of the recent entrants into the democratic system of governance after having a long history of monarchy and progressive adaptation of the internationally recognized systems and practices. In this paper, we are presenting the analysis and scrutiny of the evolution of the public financial management system and recent efforts of reforms. Some description of the historical background will help understand the subject and issues better; and hence, it has been included in the write up.

Nepal Administrative System

Historically, the *panchayat*² system represented "democracy at the grassroots," and until April 1990 it included four integrated levels: local or village, district, zonal, and national--the *Rashtriya Panchayat*. Only the village *panchayat* was directly elected by the people. Championing *panchayat* rule as a political system, the then King Mahendra was able to tap into nascent Nepalese nationalism and also to outmaneuver the evolving political parties which had posed a challenge to the monarchy's vested power.

The country was divided into fourteen zones and seventy-five districts in support of the complex hierarchy of the *panchayat* system. The lowest unit of government was the *gaun panchayat* (village committee or council), of which there were 3,524. A locality with a population of more than 10,000 persons was organized as a *nagar panchayat* (town committee or council). The number of *nagar panchayat* varied from zone to zone. Above the *gaun panchayat* and *nagar panchayat* was the district *panchayat*, of which there were seventy five. At the apex of the *panchayat* system was the *Rashtriya Panchayat*, which served as the unicameral national legislature from 1962 until 1990.

Political Liberalization

A drive for political liberalization that began shortly after the 1959 constitution, was abrogated and all political activities were banned in 1960, did not revive until the pro-democracy movement of 1990. At that point, ongoing debilitating inter-party conflicts and demands for reforms of the political system ended, and a movement to achieve democratic rights caught up.

The interim government that was installed in April 1990 consisted people with contrary views; yet the nation had its first free and fair elections in thirty two years. In April 1990, the *nagar panchayat* was renamed *nagar palika* (municipal development committee), and the *gaun panchayat* became *gaun bikas samiti*, or village development committee. The Ministry of Local Development posted an officer to each district to help the various programs of the development committees. In mid-1991, a Nepali Congress Party government came to power, and a conglomerate of communist parties was playing the role of

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² Panchayat means a body of elected representatives for local self government; later it was also used for denoting assembly at the national level

opposition. At that time, there were 4,015 village development committees and thirty-three municipal development committees. Elections for the heads of the development committees were scheduled for June 1992. In Nepal, after restoration of democratic government in 2006 tried to initiate the economic strategy of maximizing public participation by promoting the changing role of the government from a controller to facilitator for the economic development of the country. Liberal and market oriented economic policy is followed against the inward looking and controlled economic policy for the attainment of sustainable higher growth rate in non-agricultural sector.

PFM Systems

The PFM and budgetary policies of the Nepal Government during the Nineties were directed towards economic liberalization, privatization, poverty reduction and decentralization. Policies and programs of the budget were mainly concerned with agriculture, modernization, employment promotion, women's empowerment, financial sector reform, government expenditure management, tax reform, good governance, social service and the development of basic and physical infrastructure.

PFM system of Nepal, like most developing countries, continued to be dominated by the traditional objectives of control and accountability rather than a concern for allocating limited public sector resources to well defined programs and projects that were intended to serve a set of national objectives. The extension of the budget coverage involved a combination of formal and informal incorporation of expenditure activities. The other formal extension involved the incorporation of foreign assistance programs, which were previously outside the budget. Planning the allocation of scarce resources was not given due priority³.

The pattern of government expenditure followed more or less the uniform course till the 1990's. Public expenditure and revenue both increased; but the expenditure increase trend was greater than the revenue. The inadequate mobilization of domestic resources through government revenue resulted in a serious problem of widening resource gap in Nepal. Foreign aid was the main source of development financing and deficit financing continued to increase. Planning, budgeting, and implementation had inherent problems such as lack of capacity, co-ordination and monitoring. In spite of a number of initiatives taken, one of the main problems of Nepal has been the lack of proper domestic resource mobilization⁴.

Several factors have contributed in varying degrees to the lack of effectiveness of public spending in Nepal. The institutional factors played major role in the over-programming (having too many programs in scarce resources) of the budget, its lack of focus and prioritization and implementation problems⁵. The lacks of ownership of projects/ programs at various levels and the absence of accountability, also undermined the quality and effectiveness of public spending. Managing the national budget became increasingly difficult for Nepal Government to further their objectives of poverty alleviation and attaining the MDG's⁶.

³ Beyer, Johan C., 1973.

⁴ Pathak, Rita (1999), Pp 34-35

⁵ World Bank (2000)

⁶ Adhikari, Deepak (2004)

Nepal Budgeting System

The first annual budget of Nepal was presented in 1952. Prior to being overthrown in 1951 the country was ruled by Rana's Oligarchy. The state treasury belonged to the Rana Prime Ministers. The government mechanism was geared towards maintenance of law and order. The country practiced self-isolation from the outside world. The ruling elites had little or no concern about balanced growth and development of the country. During the period, the treasury offices in different district headquarters were responsible for collection of revenue and disbursement of expenditure. The central level state treasury control office was Kumari Chowk. The concept of systematic planning, budgeting; and economic development through budget were absent at that time. The major sources of revenue consisted of traditional items like land revenue, customs, excise duties, royalties on contracts for felling trees and for supplying of porters, vehicles, liquor licensing fees and so on. The major expenditure items included salaries of army, police and administrative personnel.

In 1952, the first annual national budget was presented in the form of an annual plan by the then Finance Minister Subarna Shamser with the estimation of expenditure of Rs. 52.5 million. The revenue estimation was amount of Rs. 30.5 million. According to Interim Government Act 1952, it was mandatory to prepare income and expenditure estimate for coming year and obtain assent from the King. Budget was made public only after obtaining the assent from King.

In 1957, the budget was classified into regular budget and development budget. The first development plan was introduced in 1958 with economic and social objectives; and laid down priorities for development of economy. With a view to achieving a set objectives and investment in priority sector, the government began to increase the budget size and customary budgeting process was changed. Ever since, Nepal's annual budget is brought out with the classification into Regular Budget and Development Budget. The regular budget to deal with the administrative and ordinary expenditure of the government where as the development budget deal with the expenditure as provided for the development plans.

In 1959, a new accounting system was devised for facilitating the preparation and execution of budget. In the fiscal 1962-63 (this was the year when Nepal Government implemented its second three year plan) functional classification was introduced organized the budget items in terms of functions of government, *viz.* Economic Administration and Planning, Social Services, Economic Services, and Miscellaneous (on the development budget side), and similarly Constitutional Bodies, General Administration and Planning, Judicial Administration, Foreign Services, Social Services, Economic Services, Defense and Miscellaneous (on the regular expenditure side). The functional classification of budget facilitated allocating the resources according to the policies of the government and the consolidated accounting information became available. Economic classification was attempted by the Ministry of Finance in the fiscal year 1969/70 to identify the impact of the budgets transactions on the economy by Distinguishing allocations between current and capital expenditure.

Planning for the development also came into focus in the late 50's and 60's. First five year plan started in 1956 and a party-less Panchayat System was established in 1962 by King Mahendra. Major

reorganization was done in economic planning, with the high-powered planning board under the previous government dissolved in 1961 and the **National Planning Council (NPC)** was established. The King had direct control over economic policies for some time as Chairman of the Council of Ministers; and headed the NPC also. The king also appointed royal commission on taxation and land reform.

The government budgets remained in deficit. During the seventies and eighties, most of the development expenditure was met from Foreign aid. For financing budget deficit, government adopted policy of borrowing from internal and external sources.

After the political revolution of 1990, multi-party democracy came with the King, as nominal executive head of the state. The liberalization of Nepalese economy also started from the year 1991-92; and it was realized that the government's role in the industrial and other enterprises should gradually be decreased with corresponding increase of the private sector initiatives. Several reform measures in the fiscal sector were introduced and initiated; on both the revenue and the expenditure side.

The first budget (1997-98) of the Ninth Plan envisaged to pursue the objective of poverty alleviation in a more co-coordinated, integrated and effective manner. The budget was committed in such a way that "NPC will be made more active in project selection, monitoring and evaluation. MOF will require preparing budget on the basis of three year rolling expenditure plan. The mid-term evaluation of the budget will be conducted on time and budget will be managed accordingly." ⁷ The 2000-01 budget gave special emphasis on reform in public expenditure management, revenue administration; and improvement in the effectiveness of foreign aid.

Structural Adjustment Program (SAP) and Enhanced Structural Adjustment Facility (ESAF)

The government adopted a stability program supported by the IMF Standby Arrangement and a Structural Adjustment program in 1987 and in 1989 financed by the World Bank Structural Adjustment Credits and by an IMF Structural Adjustment Facility. The specific objectives of the adjustment program in Nepal were:

- Macroeconomic Stabilization,
- Increased resource mobilization,
- Enhanced investment efficiency,
- Improvement in financial management of public enterprises,
- Increased productivity and employment in the agriculture sector, and
- Encouraging private sector involvement in agriculture, forestry, trade and industry.

Nepal entered into another agreement with IMF under the Enhanced Structural Adjustment Facility in 1992 after second SAP expired in 1990. The objectives were:

⁷ Nepal Finance Minister's Budget Speech, 1997

- Raising GDP growth to about 5 percent per annum in the next three years,
- Reducing annual inflation to 5 percent and limiting current account deficit to 9.6 percent of GDP,
- Reducing fiscal deficit to 7.8 percent of the (before grant) with domestic borrowing limited to 0.2 percent of GDP by the end of the program period (1994-95).

Immediate Action Plan (IAP) and Medium Term Expenditure Framework (MTEF)

In June 2002, Nepal Government adopted the IAP that was designed to expedite reforms in three critical areas-prioritizing public expenditures, improving service delivery and strengthening anti-corruption and accountability measures. Main IAP action points for public expenditure included:

- Setting a realistic budget ceiling and eliminating a number of low priority projects.
- Assuring funding for high priority projects, but tying funds release to performance.
- Implementing public procurement and financial accountability reforms.
- Public posting of budget information and tracking of expenditures.

On the recommendation of the 2000 Public Expenditure Review and the work of the Public Expenditure Review Commission in 2001, and prompted by the worsening fiscal situation, Nepal Government decided to introduce MTEF Starting in FY 2002/03. Overcoming the entrenched tendency to seek increased foreign aid to cope with fiscal stress, the reform minded NPC and MOF used the fiscal pressure to motivate serious adjustment in budget allocations. The MTEF was a good beginning but was not sustained later.

Three Years Interim Plan (2007/08 to 2009/10) and Budget Policy

After coming to an end of Tenth Five Year plan, NPC formulated and implemented the Three years interim plan (2007/08 to 2009/10); echoing the sentiments and expectations of the *Jan-Andolan* (people's revolution). This interim plan was prepared to address issues specific to the transition period, in a post-conflict situation. This Plan put special emphasis on increasing public expenditure to assist relief and generate employment as well as on peace building, reconstruction, rehabilitation, reintegration, inclusion, and revitalization of the economy.

A. Expenditure Policies

The following policies were adopted in order to improve public expenditure management:

- Additional efforts to be made to increase efficiency in public expenditure to strengthening fiscal system, and maintaining fiscal discipline in order to help maintain macroeconomic stability.
- Additional measures to be adopted to reduce the imbalance between current and capital expenditure.

- Medium Term Expenditure Framework to be reviewed and input/outcome/impact system to be adopted in a concrete manner for new methods of Sectoral prioritization and investment effectiveness.
- Budget release and control system to be reviewed and improved.
- Unproductive expenditure to be gradually reduced, and auditing enforced to maintain fiscal discipline.
- Feasibility study to be carried out to implement a zero-based budgeting system.
- Gender accountable budget system will be institutionalized.

Tax Policies

- The system of collecting and mobilizing taxes to be made transparent and simple by reviewing existing tax system and acts.
- Revenue leakage will be controlled by strengthening revenue administration capacity.
- Value added tax system to be made more effective
- The tax base to be gradually broadened.
- Customs rate and other tax systems to be adopted in line accordance with Nepal's commitment to international and regional organizations like World Trade Organization, and SAFTA.
- Domestic revenue mobilization to be strengthened by broadening reintegration and inclusive development.

The Formulation Process

Budgeting in Nepal used to be categorized into a regular budget and development budget. This was adjusted to meet international nomenclature of current budget and capital budget from 2004-05. The current budget is prepared at the Ministry of Finance under major headings of expenditures on consumption expenses, office operation, grants and subsidies, service and production expenses, contingency expenses, principal and interest payments on domestic and foreign loans. The items under capital expenditure are on capital transfers, capital formation, investment in share and loan, and capital grants.

The NPC determines the size of capital/development expenditure conformity with the policies, programs and priorities envisaged in the national plan also by considering the extent of external borrowing (both bilateral and multilateral grants) and loans; and the domestic borrowing. The magnitude of current/regular expenditure is estimated on financial ceiling provided by the Ministry of Finance and the NPC.

Budget formulation starts with resource estimation. The budget division of the Finance Ministry is responsible for preparing budgets. The NPC plays major role in preparing development budget. A **Resource Committee (RC)** is chaired by the Vice Chairperson of National Planning Commission

(NPC), comprising of Member of NPC – Macro Sector, Governor of Nepal Rastra Bank (NRB), Financial Comptroller General and Secretary of Ministry of Finance. The RC determines the size of the budget by analyzing overall economic situation of the country with the help of macroeconomic indicators.

Resources estimates comprise estimates of revenue, foreign loan, foreign grant and domestic borrowing. Upon accomplishing resource estimation, the Resource Committee sets the ceiling for budget for the next fiscal year. Revenue Consultative Committee (RCC) set up at the national level under MOF provides recommendations for designing policies, determining tax base and tax rates, setting the level of exemptions, and personal and business deductions. The budget ceiling is fixed considering availability of both internal and external resources.

The NPC sets out the priority and policy goals with respect to plans and programs for forthcoming FY and provide necessary guidelines to the concerned ministry and the MOF, prior to sending of circular for preparation of budget. In the course of preparing the budget documents, Finance Ministry issues guidelines, identifying the priorities consistent with economic planning and fiscal policy and sends the circulars to all ministries and departments to prepare the budget with following information:

- Ceiling of funds including external assistance available for each Ministry for various budget funds.
- Formats to be used for various estimates and instruction to be followed in preparing the estimates.
- Policy guidelines to be followed in prioritizing activities
- Prescribed chart of accounts to be used for resource allocation under various budget headings

Each line Ministry submits the budget proposal and the annual program through one copy each to NPC and MOF in the beginning of the third trimester of the fiscal year. In the case of capital budget, the first round of discussion takes place at the NPC. The proposed program is critically examined in the prospective of policy guidelines and the circular. The MOF staff assesses the foreign aid involving projects in the context of the confirmed and commitments in the pipeline of the donors. The final round of discussion takes place at MOF, represented by the concerned ministries/ departments and NPC staff. MOF prepares a statement of expenditure containing description of all estimated expenditure for each sector Ministry, which would generally be ready by June.

Thereafter the approval of the legislature for the Budget is obtained through the Parliamentary process and the Finance Act and Appropriation Act is passed after approval by the President.

Budget Execution

The fund release process begins with the approval of the budget by the Parliament:

One sixth of the previous year's expenditure can be released as Advance to each spending unit by the DTCO's, without waiting for the Presidential assent. Subsequent releases are possible only after the Appropriation Bill gets President's assent.

Release of budget is made by the DTCO on a monthly basis by adjusting the expenditure incurred against the previous releases.

For donor funded projects, budget is released on a pre–funding (donors have to put deposit to GON Treasury in advance) and reimbursement basis (generally applied for loan-financed projects; and to some extent for grants and bilateral donor–financed projects depending upon the agreement).

The Financial Comptroller general Office (FCGO) and District Treasury Control Offices (DTCO's) play key role in the budget execution process. DTCO's release the fund upon the receipt of the following main documents and exercise the internal control through release of funds:

- a) Authority letter from the concerned Ministry
- b) Release order to DTCO by FCGO
- c) Project/Program duly approved by NPC and documented in the budget
- d) Statement of expenditure of the previous month from the requesting agency
- e) Progress report (80% progress) on the development projects
- f) Taking cognizance of any budget cuts or stop payment orders by the Ministry/MOF

Auditing

The Office of the Auditor General (OAG) is the Supreme Audit Institution in Nepal. OAG prepares the annual report after accomplishing auditing of all Government transactions. Within six months of the close of financial year, OAG has to complete the audit of all (about 4000) spending units across the country and present their annual report thereafter. The OAG presents its annual report to the Parliament. The Report is examined by the Public Accounts Committee (PAC) and taken up for further scrutiny, discussion and implementation. The irregularities are also pursued by the PAC. The irregularities (*beruju*) pursuance is coordinated by the FCGO for the entire government.

Weaknesses of Budget Formulation in Nepal

Estimation Issues

The resource estimation in Nepal is mostly based on accounting information and expenditure trends. Variation of up to 25 percent in the estimated and the realized revenue is common. The budget is also not based on the 'resource envelope'. The donor funded projects funding gets delayed during the year; and there is always a gap between the estimated spending therein and the availability of resources.

Political Intervention

Budget in Nepal is driven more by political objectives rather than social and economic objective of the government. The Nepal Public Expenditure Report (PER), 2000⁸ pointed out that the development budget is heavily over programmed. Because of the political pressures, the size of the budget is set at

⁸ Nepal Public Expenditure Report (2000)

levels, which are not consistent with the actual availability of resources and institutional capacity. The limited resources thus get spread too thinly among too many projects. The budget cycle is often delayed.⁹

Poor Performance Review

Performance based budgeting system is intended but it is not effective on ground. There are Minimum Conditions Performance Management (MCPM) introduced in the ministries like Local Development; but the performance reviews are done more as a matter of compliance of the provisions and are grossly ineffective and perfunctory.

Donor's Agenda

In spite of the Paris Declaration principles and Accra Action Agenda, some donors and the line ministries continue to prefer going through the route of projects being funded and managed outside the national budget and the national procurement systems. The aid effectiveness has several underlying problems and issues in Nepal. All donor funded projects in the Budget are also kept under the Priority –I category¹⁰. The Nepal's new procurement reforms and internal audit rejuvenation will help donor rely more and more on the national systems of PFM and expenditure effectiveness. In spite of this being the issues, several donors increasingly prefer to contribute funding directly through the national agenda and national systems.

During several past reviews by the multilateral organizations and other donors, weak Public Financial Management (PFM) practices were recognized throughout the Government of Nepal (GON). The Public Expenditure and Financial Accountability (PEFA) assessment carried out in 2007 found a high risk environment in financial management. Consequently, a PFM Reform Program (PFMRP) has been envisioned and is being developed in two stages. The Government of Nepal (GON) is committed to improving public financial management with view to establishing and sustaining peace in Nepal. This has been stated in the government's Three Year Interim Plan (2007-10) and in the recent budget speeches.

An IMF Report on Basic Systems of the PFM (2010)¹¹ observed that despite a well conceived PFM system, with a detailed legislation and regulation, there is increasing evidence that this is not working well in Nepal. It is threatened by lack of monitoring of fiscal risks, poor capital budget preparation and implementation and weak reconciliation of revenue accounts. Despite advanced set of laws, regulation and processes, there are gaps in the framework and implementation and large fiscal activities remain outside the scope of the government budget. The Report highlighted the following key deficiencies (reiterated and supplemented by 2011 FAD Mission Report¹²) in Nepal PFM system:

⁹ IMF, FAD Report (2011)

¹⁰ Funding is assured for this category projects

¹¹ Tej Prakash and others, (2010) Report of IMF, FAD on Strengthening Basic PFM Systems in Nepal

¹² Blondy Guilhem and others (2011), IMF, FAD follow up PFM Mission Report,

- Significant problems exist in the present **budget planning system** arising from a number of factors, among the most important of which are: the approach to setting overall budget ceilings; incomplete coverage of government operations; the high level of in-year re-budgeting and the persistent and increasingly significant under-performance of the capital budget.
- The **effectiveness of MTEF is minimal** to have a connection between planning and budgeting.
- **Budget execution** in Nepal follows elaborate and complex processes and monitoring of the budget implementation process is weak. The pace of expenditure is uneven, with 60 percent of spending taking place in the last two months of the Fiscal Year, especially in the capital budget.
- There is **no FMIS at the ministries level**. While the web based FMIS of the FCGO is accessible to the Budget division of the MOF; the same is not accessible to the line ministries and departments.

The SU's of the line ministries keep the accounts of their transactions. The line ministries need to have the current information available about the progress of expenditure of the programs and projects.

- There are number of constraints in **accounting system**. Its coverage of the general government transaction is incomplete. Some key data, especially on liabilities, are not captured adequately. There is no comprehensive Chart of Accounts, (COA) which hinders standardized capturing and classification of all transactions. There are also some methodological issues for quality data.
- General government data is available at scattered locations and no bird's eye view is available.
- The budget is virement-friendly and gives powers to line ministries and spending units to enter into large scale virement.
- **Internal audit system** falls far below international standards as a part of effective compliance and control. The **Office of the Auditor General** has been weakened considerably.
- The final annual accounts are not prepared timely, since these are prepared nearly one year after the end of the Fiscal Year which causes delay in final auditing.
- There is significant insufficiency in **training and education** in accounting and financial management which is critical for sustaining accounting reforms.
- **Claiming reimbursement** is being slowed which has created deficit in government treasury.

The PEFA Assessment 2007¹³

The Public Expenditure and Financial Accountability (PEFA) Assessment based on FY2005/06 data was initiated by the government with the support of the World Bank to provide a basis for objectively assessing the country's Public Financial Management (PFM) systems. The assessment covered 31 indicators including three donor-related indicators that were assessed and benchmarked covering six core dimensions of an open and orderly PFM system. The next PEFA assessment is due now.

The PEFA Assessment indicated a **high fiduciary risk environment** in Nepal. It showed that the system is generally well designed but unevenly implemented. The budget has become a policy tool that is largely credible. It is clearly linked to policies in some sectors with solid control of aggregates and has a reasonable control framework at the transaction level (notably for payroll). However, despite advanced set of laws, regulations and processes, there are gaps in the control framework and implementation, and large fiscal activities remain outside the scope of the Government budget. These

¹³ PEFA Report, Nepal (2008)

weaknesses reflect the weak demand (from both Government and external stakeholders) for better budget information (financial and physical) and management.

The performance in fiscal discipline is generally positive but remains threatened by four main weaknesses: (i) lack of monitoring fiscal risks (including those related to donor funding) that create significant uncertainties; (ii) poor capital budget preparation and implementation that weaken the Government's capacity to make the best use of existing fiscal space; (iii) weak sector strategies that prevent Government from managing medium-term fiscal space; and (iv) weak reconciliation of revenue accounts that reduces available resources.

The efficiency of delivering services has improved, notably through more predictable cash releases and some devolution of resources. However, it is hampered by several factors, including lack of procurement plans and non-observance of competitive tendering; focus of internal audit on transactions and external audit only on "irregularities" as opposed to systemic improvements; and major gaps in the monitoring systems. These factors result in rush of expenditures toward the end of the fiscal year.

Approach to Strengthening the PFM Systems

Section III of the PEFA Assessment envisaged the development of a programmatic approach to PFMRP using the platform approach through a well-sequenced sector strategy. While the platform approach may be a useful guide to the structure of the reform process, given the transition phase in the political system, the GON aims to focus on a few realistic actions that are achievable and can demonstrate results over the next three years (Stage 1). During this time the new Constitution of Nepal is expected to be adopted and the country would be in the process of defining the federal arrangements for the provincial states and local governments. The approach facilitates a change management process to enable genuine leadership of the PFMRP through achieving gradual and manageable steps. It supports a holistic government-wide approach encompassing both the institutional and technical aspects of reform.

This approach calls for greater coordination amongst the Public Accounts Committee (PAC), the Ministry of Finance (MOF), the Financial Comptroller General Office (FCGO), the Office of the Auditor General (OAG), the National Planning Commission (NPC), the Ministry of Local Development (MOLD), the Ministry of General Administration (MOGA), Local Government Bodies, and concerned departments. It also calls for effective donor coordination and harmonization to address fragment support, and build partnership and trust with the government. The GON will review the results in three years' time and will then propose another stage of the program which will either cover other aspects of a PEFA Development Action Plan (DAP) which have a more medium-term outlook or build upon ongoing initiatives or both.

The basic principles adopted to formulate PFMRP Strategy in the short-term are:

1. To deliver a few simple actions that could yield effective results which would demonstrate progress in strengthening the PFM system in the next three years while the focus of the country is on the development of the new Constitution and restructuring of the State; and
2. Building up the capacity of the PEFA Secretariat to lead the PFM agenda and institutionalize the reform process.

This Strategy emphasized the importance of clearly identified activities with an orientation towards results which are realistic and achievable within a given timeframe. Similarly, the need for the PEFA

Secretariat to develop project management and reporting skills to manage the PFMRP over 7-10 years is recognized; a realistic time frame for the comprehensive change to legislation, systems and capacity needed in Nepal.

GON Agenda

The 2009-10 Budget Speech of the Finance Minister announced following priority areas:

- Implementation of the MTEF (introduced in 2002 but not sustained) to allow multi-year contracts and ensure funds for construction works and supply of goods;
- Mandatory arrangement of e-tendering for big infrastructure projects;
- Performance based incentive systems in selected big infrastructure projects for timely completion of projects;
- Establish a budget monitoring mechanism including periodic review under the chairmanship of the Prime Minister;
- Constitute a Budget Management and Expenditure Review Commission under the chairmanship of a Member of the PAC;
- Implement public sector cash accounting system in line with IPSAS;
- Upgrade the Financial Management information System (FMIS) in line with new accounting standards;
- Financial arrangements for the implementation of the Strategy;
- A budget provision was made in the government's budget for 2009-10; and 2010-11 under a separate budget head for Public Financial Management Reform. Some donors have agreed to supplement this with funds from to achieve the development outcome ;
- To implement the above, each activity will be a module on the basis of the program and projects. The Steering Committee will direct and coordinate action to meet the financial requirements through internal or external assistance; and
- A designated agency will initiate action to channelize the external assistance through potential development partners and meet the financial gap to the concerning programs/projects with the consent of the PEFA Steering Committee.

Ongoing Reforms and New Areas

GON have taken several initiatives with the donor support and national budget in this area. Some of the examples are the Budget Management System, IT based Financial Management Information System, Districts Expenditure Control System, computerized Revenue Accounting System, Computerized Government Accounting System to map various transactions through the FMIS, centrally in the FCGO, Procurement System and e-tendering, Health Sector monitoring and financial information system etc.

IFMIS can be the single source information MIS for the government authorities, Budget, Budget Execution, public debt and investment, Financial Reporting, donors, researchers, media and public,

development projects, international organizations; and so on. It will help GON achieve several of the outcomes envisaged in the PFMRP.

The ongoing and planned reforms in Nepal are as follows:

Treasury Single Account (TSA)

FCGO have also decided to work for the Treasury reforms by way of a Treasury Single Account system recommended by the IMF. TSA is being implemented in the country progressively. As a beginning, the pilot run was done in the districts of Lalitpur and Bhaktapur; and it has now been rolled out in 36 more districts, already. The FCGO intend to cover 25 districts in the current fiscal and all 75 by end of next fiscal. TSA prima facie looks at the treasury reforms; but it is more like an 'iceberg reform', that will have strong linkages with budget, cash and debt management etc.

Once the TSA regime is fully operationalized, most of the responsibilities related to payment services, management of bank accounts and government accounting and reporting will be shifted from the Nepal Rastra Bank (NRB), banks and the spending units to the DTCOs. The available accurate real-time or prompt information will be useful for cash forecasting, cash management, working on the better debt management; and just in time release of funds for the budget execution. Besides, the DTCO's will have the accurate and authentic information on the expenditure, revenue and deposit accounts of the spending units on a day to day basis. This will pave way for a comprehensive IFMIS availability.

Nepal Public Sector Accounting Standard (NPSAS)

GON is committed to implement Nepal Public Sector Accounting Standard (NPSAS), in line with cash based International Public Sector Accounting Standard (IPSAS). On 5th September 2009, the government also approved NPSAS to be used for use in public entities; as recommended and pronounced by the Accounting Standards Board of Nepal. It is expected that the Financial Comptroller General Office is gearing to start its financial statements in NPSAS format from financial year 2012-2013. The actual implementation will have to be seen on ground.

Sustained Reform Effort to improve Public Financial Management

PEFA secretariat capacity to institutionalize the PFM reform process is being strengthened. PEFA secretariat is likely to be institutionalized in a broad based system, by way of PEFA units in line ministries; and development of capacity building to support technical outcome will be enhanced to achieve the objective defined in PFMRP strategy.

Integrated Financial Management Information System (IFMIS)

The gap in the IT area is still under the donor funds exploration. A comprehensive vision and strategic plan on the Integrated Financial Management System (IFMIS) is of utmost importance. The IFMIS will provide the convergence of the fiscal data from various Spending Units (4000); DTCO's (75), Ministries and Departments, public Institutions holding stand alone welfare or development funds, Central Bank, Commercial Banks engaged in carrying out government business, public debt and investment data, fiscal operations carried out on behalf of the government by agencies and authorities; etc.

By upgrading and joining up the existing FMIS and IT systems incrementally, Integrated Financial Management Information System (IFMIS) will be available in the FCGO. Through the robust IT applications, the convergence of data in the full TSA regime will include nearly all financial transactions of the government. This will give accurate information on cash position, treasury position, budget execution, funds utilization, MIS for taking management decisions at all levels. This will also cover the gap of non-availability of accounting and financial information system at the departments and ministries levels of the government.

Budgeting Reforms

There are a number of reform measures that are meant to improve deficiency on current budgeting system. There is a need to improve in setting overall budget ceilings, to enhance coverage of government operations, average under- performance of capital budget, despite some improvement seen in the current FY. In order to overcome various anomalies seen in the current budget planning and execution, the Government constituted a Government Budget Management and Expenditure Review Commission (PERC) set up to improve the government budget and expenditure system has submitted its interim report to the government. The final report and its implementation are expected to help bring efficiency and effectiveness in public expenditure management.

A practice has been initiated from FY 2009/10 (first introduced in 2002-03) to submit Three-year Expenditure Projection based on the Mid-term Expenditure Framework (MTEF) before the Parliament. However, there is a need to improve the quality of MTEF process. From the current fiscal, the practice 12 remote districts spending from the annual budget up to four extra months beyond the end of the budget year has also been stopped and their spending cycle has been recognized by front-loading the allocations in the budget. Also, to avoid the last quarter rush of expenditure, the annual budget spending in the last quarter has been capped at 40% of the allocation; and 20% in the last month.

The government has brought out the Budget for the Fiscal Year 2011-12 based on IMF's Government Finance Statistics, 2001. New coding in chart of account has also been introduced to incorporate corresponding changes. The previous expenditure classification of three categories (recurrent, capital and principal payment) has been classified as recurrent, capital and financing (investment). Revenue classification has also undergone suitable revisions.

Internal Audit

In Nepal the FCGO is also in charge of conducting the internal audit of the spending units though it's DTCOs. The internal audit, carried out by the staff of the DTCOs, is rather cursory and the approach is limited. The staff handling internal audit are ill-equipped in terms of skills as well as methods. They somehow perform this task in a traditional environment and without any skills developed. Generally the DTCO staff conduct internal audit as a part time activity alongside their other work in executing the budget of spending units. As a consequence, there is a potential conflict of interests and no structure of independence for the internal auditors.

Donor agencies and the Auditor General have recommended strengthening of internal audit in line with the best practices. Following weaknesses revealed in the PEFA report, an element of the PEFA reform strategy is dedicated to strengthening internal audit.

Audit

The main oversight institution on public finance in Nepal is the Office of Auditor General (OAG) and it is often viewed that this institution is considerably weak. The institutional and systemic issues need to be addressed on priority and new role to be adopted in line with the best practices in the developing and developed countries. To improve compliance in financial system, the most important challenge is to strengthen the institutions of the OAG. As a part of the overall PFM reform agenda, OAG has prepared a 'strategic plan' to improve the effectiveness of audit. This plan includes capacity building through provision of greater manpower and training. The discussion is also undergoing whether concurrence audit is possible with further enhancing the capacity of Office of Auditor's General. The OAG has plans to introduce the contemporary auditing practices and Risk-Based audit.

Reforms in Public Procurement

As a part of this reform agenda, GON promulgated Public Procurement Act (PPA); and Public Procurement Regulation (PPR) in 2007, to make the procurement system transparent, fair, competitive and efficient. These two legislations had aimed at maximizing returns of public expenditures in an effective and efficient manner by promoting competition, fairness, accountability and reliability in public procurement processes.

Public Procurement Monitoring Office (PPMO) implements Public Procurement Law provisions, through the development of operational guidelines and monitoring the enforcement of legal provisions. Besides, PPMO recommends the procurement policy to the government along with the measures for reforming the procurement laws and initiating actions to implement the public procurement law so as to enhance the quality of procurement outcomes.

PPMO has brought out a Result Based Strategic Framework (2010-2013) by summarising the public procurement activities in three major pillars:

- improve the institutional capacity in public procurement
- establish embedded learning process
- improve public procurement operations and market practice

Reforms in Result based Monitoring and Evaluation (RBME)

The present system suffers from the following institutional weaknesses:

- Traditional input output based M&E system is still in place; that loses focus on results.
- Regular monitoring is absent by the committees in place.
- Poor functional and operational mechanism of Monitoring and Evaluation.
- Poor coordination among the line ministries, Finance Ministry; and National Planning Commission.
- Most M&E units established in the ministries are ineffective.
- Lack of capacity and skilled manpower puts M&E in low priority.

- Limited use of IT in Monitoring and Evaluation.

Government of Nepal has initiated several reform measures to strengthen monitoring and evaluation system. Result Based Monitoring & Evaluation (RBME) Guideline 2010 has been approved by National Planning Commission (NPC) in July, 2010. This Guideline was prepared with wide consultation of sectoral ministries and other stakeholders including donor partners. The guideline will be implemented for donor funded projects /programs and other priority one (P1) projects/programs. RBME Guideline has focused on result based M&E instead of traditional input-output based M&E. Similarly, this guideline has suggested computer based monitoring and evaluation system at different levels. A software District Poverty Monitoring and Evaluation Analysis System (DPMAS) has been prepared, to link with two other software (under development), Poverty Monitoring and Evaluation System (PMAS); and Project Performance Information System (PPIS) software. Once the link is established, online monitoring will be easy.

NPC has issued policy guidelines to prepare sectoral Monitoring and Evaluation plan to all sectoral ministries; and made it mandatory from 2010-11. NPC has also advised all line agencies to include enough resources for M&E. Ministry of Finance has created a separate budget head in some sectors like health, education and physical Planning and Works. NPC is also preparing a National level Monitoring and Evaluation Plan. M&E training has been provided to more than 60 officers working in M&E in different line ministries and projects. Independent or third party evaluation mechanism will be implemented in selected development projects and programs. Special and regular monitoring mechanism has been developed for large, high priority and public concern projects.

Improving Projects' Performance

There is significant and persistent underperformance of the capital budget, due to poor and often delayed preparation of capital projects; lags in reimbursement of foreign-financed project spending; lack of skilled personnel; and a lack of compliance with set rules and procedures issued centrally. However, underlying all such problems is the general perception by donors of a deterioration of financial compliance in the Nepalese PFM system.

The performance of most development projects in Nepal is far below the expected one. Following the NPPR-2009, meetings were held at the Ministry of Finance with the representatives of the four development partners (ADB, DFID, JICA and the World Bank). As a follow up, project readiness filter has been revised and circulated to all concerned agencies and development partners for implementation.

The need for budget provision for project preparatory work has been accepted and opening of a separate budget code in which line agencies can access the fund for this has been facilitated. Also, start up budget provision will be made for projects where project agreement is the pipeline; but fund is assured by donors to be disbursed during that Fiscal Year.

Agreed Actions under the Nepal Portfolio Performance Review (NPPR)¹⁴ Action Plan 2010

1. Develop and adopt effective selection criteria for deploying accounting staff in development projects.
2. Develop transparent placement and transfer criteria of accounts staff in development projects.
3. Provide connectivity to FCGO's FMIS system for selected development projects (selected programs/projects Education SWAp, Health SWAp, Road Sector Development Project, LGCDP, Nepal Peace Trust, RRRSDP, Melamchi, PAF, Rural Water Supply, Irrigation Water Resources Management Project) to implement computerized government accounting system (CGAS) which facilitates effective monitoring and reporting of financial information.
4. Provide basic financial management training (mainly dealing with foreign assisted development projects) to all accounts staff, and then a refresher training program in an interval of six months.
5. Monitor the accounts staff position in all foreign assisted development projects and ensure that there are no vacant positions.
6. Develop Performance Based Reward System for Finance Staff working in foreign aided development projects based on certain result indicators to recognize the contribution of Finance Staff.
7. Discontinue the system of allowing four months grace period to fiscal year for 12 remote districts which is having serious impacts in the financial management system.
8. Make an arrangement to involve FCGO in making decisions on accounts staff related to creating new positions, upgrading or canceling the positions.
9. FCGO representative to be mandatorily included in discussions during project preparation, appraisal and negotiations.
10. Issue the revised guidelines regarding Conditional Grants in line with the budget spirit.
11. Form a working group in each line ministry headed by the Planning Chief to internalize the MTEF into the line ministry.
12. All line ministries to be mandated to prepare sectoral MTEF prior to preparation of annual budget.
13. Develop MTEF software and Manual.
14. Provide basic financial management and auditing training (mainly dealing with foreign assisted development projects) to all audit staff, and then a refresher training programs.
15. Develop Risk-based Financial Audit Manual, and pilot in selected foreign aided development projects, and then finalize the Manual.
16. Review and update the existing Performance Audit Guidelines.

Other Problem Areas that Need Further Attention:

Having seen PFM systems at work in Nepal, I have also flagged some practical issues that need attention of the Nepal authorities, to make the functional efficiency in the systems. They are listed below:

- There are questions over three-year rolling MTEF introduced to strengthen the connection between planning and budgeting and its effectiveness in practice. The approach to setting overall aggregate ceilings starts by setting expenditure targets and then finding the resources to finance

¹⁴ Nepal Portfolio Performance Review (NPPR) (2010 and 2011)

them. The MTEF projections are reviewed and revised annually; makes it superfluous.

- *The nikassa* (Release) system needs to be replaced by a lump sum ‘assignment amount’ for a quarter (until TSA is not implemented in all districts); with joint responsibility of the SU and Bank for not exceeding this threshold limit fixed by the DTCO.
- Liabilities like Pensions payment have inefficient systems; and it keeps the reimbursement of pension’s payment, to the banks, pending for almost one year or even more. GON should make the system efficient and user friendly; to the satisfaction of all stakeholders.
- Accounting of the transactions is done by the banks in the system for both expenditure and revenue. As a result, there are large scale problems of reconciliation; and of reliable information systems.
- The TDS on salaries etc are remitted through checks to the tax office, which in turn deposits the same in the bank and monitors credits and accounting. It is much more simpler and easy way to credit the amount direct to the tax head and intimate tax office about the collection through letter statements/email. It saves the efforts of all and minimizes unnecessary long path for this activity.
- Salaries are generally not drawn through the bank accounts by the employees; it is much simpler and effective way of efficient payments and reduction of work for the SU/DTCO/Banks; and to eliminate possibility of any ghost payments.
- It is also important to start looking at the systems from the point of fiscal federalism; that is contemplated in Nepal. Many of the systems and procedures will require intensive discussions and make operational the new federalism based systems and procedures. This will include budgeting, financing, accounting, borrowing, taxation, manpower and administrative arrangements; and the Centre-sub-National relationships.
- Training and capacity building is a core issue. In the present arrangements, there is hardly any systematic and effective training available for the operational and lower level staffs. It would be worthwhile to have a captive training centre; to provide training and capacity building support to all districts and offices in PFM areas. Low capacity and inappropriate manpower selections create problems of implementation of the reforms in systematic and proper way.
- There has been rather slow and a bit indifferent involvement of the NRB and accredited banks in walking the extra mile for the implementation of reform and new system/practices. Regular monthly monitoring meetings may be organized by the MOF.
- It is difficult for the OAG to audit more than 4000 units every year within six months time prescribed. It would be much efficient to consider varied periodicity for auditing the smaller units that have routine operations only. This will also give more time to the audit the more important and larger units/programs.
- Internal Audit’s new role has been appreciated but the institutional and operational arrangements are not in place. The internal audit will become more important in the federal scenario when bulk of the development programs and projects will be implemented by the sub-national tiers of the government, through the central financial assistance.
- It would be time and cost saving and more efficient to have central procurement/tendering arrangements (by signing the ‘Rate-Contracts’ with suppliers) for the routine items like computers and peripherals, office equipments, stationery, vehicles etc.; instead of each unit going through the tender process for the same purpose.
- A comprehensive PFM reform planning is required to cater to the federal arrangements¹⁵.

¹⁵ Udaya Pant (2012) PEFA Journal Nepal

The list of problem areas above is not exhaustive. There are more cross-cutting issues that need to be attended to on priority.

Lessons to Learn and Conclusion

In spite of conflicts and political turmoil, Nepal politicians have unanimity on reforms. The initiatives to improve the PFM systems and budgeting in recent years have been good starting points. However, the intended reforms did not bring the expected outcomes due to capacity and implementation issues. Nepal scored poorly in the PEFA assessment, on indicators relating to policy based budget and most other parameters. In areas like cash forecasting, commitments control, debt management and a borrowing calendar, treasury management, outcomes budgeting, gender budgeting, aid-effectiveness, investment of surplus, supply side of reforms etc. there is a lot to be initiated. There are national and donor assisted reforms that have paved way for the introduction of global standard systems and reforms. The people and the politicians now have a better appreciation of budgeting and PFM reforms and issues like the economy efficiency and effectiveness. Capacity constraints are there and they can be overcome by handholding and also 'learning by doing'. The sequencing of reforms need to be done, in order to institutionalize the basic reforms first; instead of going all out for all reforms at the same time. The intent should not be to 'push reforms' to please the donors. Rather, the simple systems may be tried first, to internalize the skills and spirit of reforms. The recognition of the need for reforms and efforts of the government so far, need to be institutionalized and monitored regularly.

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