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Operational risk assessment of public financial management reform in Nepal: a review of challenges and opportunities

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August 2013

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Acknowledgements

This report was drafted by an ODI team consisting of Philipp Krause, Stephanie Sweet, Edward Hedger, and Bhola Chalise. Hiramani Ghimire and Bigyan Pradhan managed the research under the guidance of Tahseen Sayed of the World Bank's Country Office in Nepal.

The team would like to express its gratitude to the government of Nepal for the hospitality and support extended during the ODI team visits to Nepal in October 2012 and February 2013. Special thanks are owed to members of the PEFA Steering Committee, chaired by Finance Secretary Krishna Hari Baskota in October 2012 and Shanta Raj Subedi in February 2013. We would also like to thank Pratap Kumar Pathak and Narendra Dahal for their guidance and support as financial comptroller general at different times. Mahesh Prasad Dahal, who led the PEFA Secretariat and was the focal point for the study on the government side, provided invaluable support to the study team. Suresh Pradhan followed him as coordinator of the PEFA Secretariat, and provided similar support and also joined the team in field visits. Rajendra Bajracharya and Baburam Subedi of the FCGO/PEFA Secretariat supported the work by coordinating the FCGO response to the draft report. The team would also like to put on record its appreciation for the DTCO chiefs and their colleagues in Kavre, Chitwan, Rupandehi, and Palpa for their very enthusiastic support, not only in collecting information but also in convening interactions with relevant interlocutors in the districts. Particular thanks are owed to Suresh Pradhan and his team at the FCGO, who were instrumental in facilitating meetings and making data and reports available. It would have been impossible for the team to cover so much ground in limited time without their help. All interviewees in Kathmandu and around the country (please see the list of interviewees in Appendix B) were very generous with their time and insights, in spite of other pressing obligations.

We would like to thank the World Bank and members of the PFM Multi-Donor Trust Fund, including DFID, AusAID, Norway, Denmark, and the EU, for funding and for engaging with the team both during the country visits and remotely. Verena Fritz of the World Bank's Washington, DC, office provided helpful comments and guidance throughout the entire process and joined both country visits. We received extensive comments and feedback on earlier drafts of this report from Hiramani Ghimire, Bigyan Pradhan, and Verena Fritz, as well as several government agencies and development partners.

Suran KC Shrestha provided invaluable logistical support while the team was in Nepal. Ruth Larbey and Roo Griffiths edited the report. All errors of fact or judgment remain with the authors.

Acronyms and abbreviations

ABBS – Any Branch Banking Services
ADB – Asian Development Bank
AG – Auditor-General
APM – All-Party Mechanism
ASB – Accounting Standards Board
AusAID – Australian Agency for International Development
AWPB – Annual Work Program Budget
CA – Constituent Assembly
CDO – Chief District Officer
CECI – Center for International Studies and Cooperation
CIAA – Commission for the Investigation of Abuse of Authority
CIDA – Canadian International Development Agency
CPN-M – Communist Party of Nepal (Maoist)
CPN-UML – Communist Party of Nepal (United Marxist-Leninist)
CSO – Civil Society Organization
Danida – Danish International Development Agency
DAP – Development Action Plan
DDC – District Development Committee
DDF – District Development Fund
DFID - Department for International Development
DHO – District Health Office
DoHS – Department of Health Services
DoLIDAR – Department of Local Infrastructure Development and Agricultural Roads
DoR – Department of Roads
DPHO – District Public Health Office
DTO – District Technical Office
DTCO – District Treasury Comptroller Office
DTMP – District Transport Master Plan
EU – European Union
FAD – Fiscal Affairs Department
FAR – Financial Act and Regulations
FCG – Financial Comptroller General
FCGO – Financial Comptroller General's Office
FNCCI – Federation of Nepalese Chambers of Commerce and Industry
GDP – Gross Domestic Product
GFSM – Government Finance Statistics Manual
GIZ – German International Cooperation
GoN – Government of Nepal
HFOMC – Health Facility Operation and Management Committee
HP – Health Post
IECCD – International Economic Cooperation Coordination Division
IFMIS – Integrated Financial Management Information System
IFRS – International Financial Reporting Standards
IMF – International Monetary Fund
INTOSAI – International Organization of Supreme Audit Institutions
IOM – International Organization for Migration
IPSAS – International Public Sector Accounting Standards
IRD – Inland Revenue Department

IT – Information Technology
JSA – Japan-Administered Accounted for Selected IMF Activities
LDO – Local Development Officer
LRN – Local Road Network
LSGA – Local Self-Governance Act
JAR – Joint Annual Review
MDTF – Multi-Donor Trust Fund
MJAFN – Madhesi Jana Adhikar Forum, Nepal
MoF – Ministry of Finance
MoFALD – Ministry of Federal Affairs and Local Development
MoHP – Ministry of Health and Population
MoPIT – Ministry of Physical Infrastructure and Transport
MP – Member of Parliament
MPPW – Ministry of Physical Planning and Works
MTBF – Medium-Term Budget Framework
MTEF – Medium-Term Expenditure framework
NC – Nepali Congress
NDC – National Development Council
NEA – Nepal Electrical Authority
NGO – Non-Governmental Organization
NHSP – Nepal Health Sector Program
NOC – Nepal Oil Corporation
NPSAS – Nepal Public Sector Accounting Standards
NPC – National Planning Commission
NRB – Nepal Rastra Bank
NVC – National Vigilance Center
OAG – Office of the Auditor General
ODA – Official Development Assistance
OECD – Organisation for Economic Co-operation and Development
OPM – Oxford Policy Management
ORA – Operational Risk Assessment
PAC – Public Accounts Committee
PEFA – Public Expenditure and Financial Accountability
PFM – Public Financial Management
PFMRP – PFM Reform Program
PIP – Priority Investment Plan
PPA – Public Procurement Act
PPMO – Public Procurement Monitoring Office
PRAN – Program for Accountability in Nepal
PRSP – Poverty Reduction Strategy Paper
RBN – Roads Board Nepal
RCC – Revenue Consultative Committee
RJP – Rastriya Janashkati Party
SHP – Sub-Health Post
SIDA – Swedish International Development Cooperation Agency
SOE – State-Owned Enterprise
SRN – Strategic Road Network
SWAp – Sector-Wide Approach
TSA – Treasury Single Account
UC – User Committee
UCPN(M) – Unified Communist Party of Nepal (Maoist)

UK – United Kingdom
UN – United Nations
UNDP – UN Development Programme
US – United States
USAID – US Agency for International Development
VDC – Village Development Committee
WBI – World Bank Institute
WBIEG – World Bank Independent Evaluation Group

Executive summary

Introduction

Since 2006, Nepal has been in transition. The conflict has ended, but political stalemate over the past several years has continued to put pressure on the country's economic development. There has been a slight improvement in GDP per capita, which stood at $717 in 2012, but high inflation and high unemployment, among other factors, have slowed overall economic development.

Though stable for the time being, Nepal is facing a political transition. A peace agreement was signed in 2006, an interim constitution was passed in 2007, and elections were held in 2008. In contrast with the years leading up to 2006, the country is at peace, and all the major political actors are working towards resolving conflicts peacefully and by formal means. Since that time, however, political party fragmentation and shifting coalitions have resulted in frequent turnovers of government. One of the main areas of contention between political parties is the restructuring of the state, including intergovernmental relations. In 2012, the Constituent Assembly (CA) was dissolved after failing to agree on a new constitution at the end of its four-year term. A new interim government was sworn in in March 2013, and elections to a new CA have been announced for November 19, 2013.

Institutional arrangements

Nepal's civil service is widely reported as being cohesive and professional. The Civil Service Act (current version from 1993) regulates professional civil service cadres, grades, the creation and filling of vacancies, and staff transfers. There seems to be a strong *esprit de corps*, especially among top civil servants, a degree of pride in membership, and a belief that civil servants can rise through the ranks only by performing well and passing objective and difficult exams. However, according to Transparency International, Nepal is the second most corrupt country in South Asia. Out of 183 countries surveyed in the Corruption Perceptions Index, Nepal was ranked 139 in 2012, 154 in 2011, and 146 in 2010.

The setup of central agencies involved in public financial management (PFM) is complex. The main actors are the Ministry of Finance (MoF), the Financial Comptroller General's Office (FCGO), the National Planning Commission (NPC), the Public Procurement Monitoring Office (PPMO), and the Office of the Auditor General (OAG). The MoF has a fairly straightforward organizational setup, but is weakened by a fragmented central finance function. The FCGO is housed as a department under the MoF and undertakes a large share of core finance functions. The financial comptroller general reports to the finance secretary, who is at the same rank, which diminishes the functional relationship between the FCGO and the MoF.

The NPC plays a significant role in financial management in Nepal but has been affected by rising politicization in recent years. The NPC is in charge of development planning and has a role in most other activities that collectively determine the government's medium-term policy stance, most notably the Medium-Term Expenditure Framework (MTEF).

The administrative configuration of sectoral and local government entities is multilayered. At the local level, District Development Committees (DDCs), Municipalities, and Village Development Committees (VDCs), introduced under the Local Self-Governance Act (LSGA), work in parallel with de-concentrated sectoral departments at the district level such as the Department of Health or the Division Road Office. While local bodies were envisaged as autonomous entities, in practice they are subordinate to the Ministry of Federal Affairs and Local Development (MoFALD). Since the expiration of locally elected representation in 2002, the national government has appointed civil servants to assume local-level functions, resulting in a decline in accountability and an increase in political influence.

Overview of PFM system and processes

Nepal has a well-established tradition and experience of economic and development planning processes. In recent years, the NPC has developed Three-Year Plans, which establish national and sector policy priorities and development targets. Spending ministries need to develop their own strategic plans, which should accord closely with relevant sector and cross-sector priorities. At the local level, DDCs should follow a 14-step participatory planning and budgetary process, which requires each district to seek input from user groups, community-based organizations, and the private sector. These sectoral and local plans are weak and lack credibility, however, as political elites and top-down authority have consistently influenced the decision-making process. Many observers noted that, in practice, political influence increasingly undermined the allocation of resources to medium-term plans.

Budget preparation is formally well governed by detailed guidelines and procedures, but these are not always adhered to in practice. The budget manual specifies a clear annual budget calendar, but there are often severe delays throughout each stage of the process, resulting in late submission of the budget to Parliament. According to a 2008 worldwide survey by the Organisation for Economic Co-operation and Development (OECD), Nepal in practice lags behind most countries surveyed on every key deadline of the budget calendar. Whereas in a country using a fairly basic budget the calendar would be organized around clearly delineated phases of a set period of budget execution (typically one year), the practice in Nepal is that phases encroach on one another and create overlapping patterns of simultaneous and disconnected activities. In practice, there is no hard deadline for inclusion of new capital projects. In addition, expenditure ceilings set by the MoF have yet to become a credible constraint, which undermines efforts to link budget allocations to policy priorities.

Budget execution in Nepal faces a number of challenges, resulting in spending that is heavily skewed towards the end of the fiscal year. The current political environment has often delayed appropriation of the annual budget, and interim authorizations are required. The authorization process, especially for capital projects, remains highly centralized and bureaucratic. Even after the budget has been approved, the project approval process usually takes an additional three to four months, owing to cumbersome procedures and complex procurement processes. Nepal's virement rules are extremely flexible, resulting in a large amount of re-budgeting throughout the year. The high level of virement during budget execution ensures flexibility but weakens the credibility of the budget preparation process.

Accounting, reporting, and audit in Nepal follow an internationally recognizable pattern in theory, with gaps apparent in practice. Although in-year budget monitoring and reporting are almost nonexistent, final consolidated financial statements are prepared annually and submitted to the OAG for review and scrutiny. For more than six years, however, there was no auditor general (AG), which substantially weakened the OAG's effectiveness. The recent appointment of an AG is expected to address this challenge. Furthermore, scrutiny of public finances by the CA and its committees has been rendered obsolete by their absence in the current political environment. Internal audit also remains weak, as there is insufficient separation of responsibilities from the treasury function with the FCGO.

Strengths and problem areas in PFM

The overall Public Expenditure and Financial Accountability (PEFA) assessment based on 2005/06 fiscal year data – that the system was "generally well designed but unevenly implemented" – remains a good summary of PFM performance. Since that assessment, there has been some clear and specific progress in terms of PFM strengthening, but this has also been challenged by the adverse political context. Based on analysis of the current PFM system, specific achievements that have been reported or observed include the following:

- Continuity of well-established ***formal*** **development planning processes** by the NPC that determine national and sector priorities over a three- to five-year period, involving bottom-up engagement by DDCs and VDCs
- Progress in maintaining **sound aggregate fiscal management** – associated with annual preparation of a medium-term macro fiscal framework – that has supported the introduction of conservative revenue forecasting and provided a framework for multiyear contracting of highest priority (P1) public investment projects
- Introduction and progressive **implementation of a Treasury Single Account** (TSA) since 2009, which by early 2013 had been rolled out to cover 60 out of 75 districts and 95 percent of government expenditure
- Introduction of a **new Chart of Accounts** in 2011/12, broadly compliant with the Government Financial Statistics Manual (GFSM) 2001 and comprising administrative, economic, and functional classifications as well as sources of financing
- Implementation of **electronic tendering for government contracts** and a correspondent reduction in the level of intimidation and anticompetitive practice in public procurement
- Creditable and consistent positioning on **fiscal transparency**, on which Nepal scored 44 and 45 out of 100 in the 2012 and 2010 Open Budget Indices, respectively
- Adoption in 2009 of the **Nepal Public Sector Accounting Standards (NPSAS)**, using the International Public Sector Accounting Standards (IPSAS) for Financial Reporting under the Cash Basis of Accounting
- Initial **adoption of external audit standards** based on the International Organization of Supreme Audit Institutions (INTOSAI) and strong coverage of conventional regularity and compliance audit approaches across government

This report documents a number of areas where public finance institutions in practice fall short of what might be called international best practice, as well as the aspirations of Nepali laws and institutional design. Next to PFM challenges it documents broader political and other contextual concerns, as well as PFM performance in terms of outcomes achieved (or not). There are different ways to interpret this substantial amount of descriptive information. In line with the approach outlined at the beginning of the report, we opted not to measure the *status quo* in Nepal against any externally defined benchmark. Instead, the focus is on problems with the public finance system as identified by Nepali officials and observers. In this sense, it can be considered an appreciative inquiry that takes the concerns of government officials as its starting point.

A problem-centric approach shifts the terms of the debate and has recently been identified as a key to successful institutional reform in development (Andrews 2013). Instead of adding up shortcomings that may or may not matter to the government, problems are areas of immediate concern. The term "problem," as distinguished from a permanent condition, also implies solvability. This is a way of focusing a large body of possibly relevant information on a limited number of relevant issues. It is necessarily selective, and does not cover anything that could be done to the contrary. The selection of issues presented here is narrower, and a more realistic reflection of what a developing country government can aim towards simultaneously than what many PFM reform plans would normally cover.

A focus on problems also ties the analysis of PFM to an assessment of risk. The report shows tangible problems that fall into the category of administrative control risks from the point of view of potential reformers. Ultimately, political and administrative risks cannot be divorced from each other, as public finances and central government institutions are inherently political. However, in our assessment, the direct political risks are in fact outweighed by administrative risks that are more easily amenable to corrective or ameliorative action by public officials.

The concern about the state of public finances is best summarized as, "public spending is compromised." This is a concern over both the quality of every unit spent and the failure to achieve quality outcomes and results through the PFM system because of shortfalls in budget execution. According to the data, Nepal has performed quite well at the aggregate level in terms of deficit and debt levels over the past few years. However, more detailed analysis of public finances within sectors, at subnational local levels, and inside spending units reveals these more serious concerns.

This main problem can be broken down into four more tangible areas: (a) ineffective oversight and scrutiny; (b) a dysfunctional budget process; (c) weak capital project implementation; and (d) flawed central finance institutions.

Ineffective oversight and scrutiny: The accountability framework of audit and oversight has been eroded by the vacuum in political governance and is constrained by outdated audit technique and skills. Most visibly, the national legislature and local councils are absent, and the posts of AG and chief commissioner of the Commission for the Investigation of Abuse of Authority (CIAA) were vacant for several years. Both positions have recently been filled. The external audit function is weighed down by a heavy burden of mandatory compliance audits. There is no internal audit cadre (or subgroup) distinct from the accounting function, with a corresponding exposure to conflicts of interest.

A dysfunctional budget process: At the moment, budgetary practice falls short of its own aspirations. The approved budget is not a predictor of actual spending. Instead, it is in some ways the beginning of a new set of budget negotiations and constant streams of reallocations and virements that continue throughout the budget year. The disarray of the budget process leads to much execution occurring in the final trimester of the year; the first and second trimesters often see a continuation of planning and negotiation, with the exception of salary expenses.

Weak capital project implementation: Under-spending of the capital budget is a problem, but the capital budget is further weakened by external interference in decision making, which diverts spending to lower-priority projects and causes fragmentation of the capital budget into multiple small projects. There are reports of loss and leakage of funds through the inflation of user costs of construction as well as over-charging by user committees, which then subcontract. Procurement and contracting are weak in terms of both competition among contractors and technical capacity for proper procurement planning.

Flawed central finance institutions: The central finance function in Nepal is quite fragmented, with few core finance functions actually under the control of the MoF itself, and the rest spread among the FCGO, the NPC, and Nepal Rastra Bank (NRB). This creates incentive problems around interagency coordination and complex reforms, because no stakeholder has a strong interest in devoting resources to reforms that cut across agencies and departments. Staff transfers are frequent, weakening the capability of core administrative units. Bureaucratic hurdles involving central finance institutions limit budget execution unnecessarily. In current budgetary practice, many decisions involve a high degree of central ministry involvement, including in relatively minor matters handled by local spending units.

Reform entry points

The following entry points are based on a combination of decision criteria: political contentiousness, institutional complexity, and technical ambition. They take into account the assessment of the current state of Nepal's public finance system, the analysis of institutional arrangements, and, most importantly, the solvable problems presented in the previous section. No action is put forward that is not linked at least indirectly to the problems that together compromise public spending at the moment.

With regard to oversight and external scrutiny, activities can be implemented to strengthen the current efforts of different government bodies. The recent appointment of an AG and a CIAA Chief Commissioner has empowered staff to pursue their work with a measure of nonpolitical legitimacy and backing that many observers felt had steadily been eroding. In the medium term, the OAG can upgrade its audit skills and carry out audits on a risk basis, rather than using its current method of comprehensive compliance audits. In the short term, the government can establish a separate sub-cadre of internal auditors to formally distinguish internal audit from treasury functions and provide for greater accountability.

The second area of reform is fixing the budget process. The budget calendar is in disarray, at least immediately, because of failure by budgetary actors to adhere to reasonable time periods for budget planning, formulation, and execution, and especially to jointly stick to deadlines, after which one phase of the budget process transitions into the next. Budget actors should work to ensure projects in the budget have a full 12 months available for execution. Specifically, the MoF could ensure the final budget is presented to Parliament two months prior to the start of the fiscal year. These efforts will improve budget credibility and budget annuality. Another "quick win" would be a joint consultative review of inter-ministerial arrangements in budget planning, formulation, and execution to establish a clear division of roles between the NPC, the MoF, the FCGO, line ministries, and local bodies regarding the procedural requirements of budget planning, formulation, and execution.

Strengthening the implementation of capital projects is a third key area in improving PFM in Nepal. First, the government should require that feasibility studies, work plans, and procurement plans be completed and approved before projects enter the budget. The realistic aim would not be to remove political input, but rather to ensure all proposals are considered in a more timely way before the start of the fiscal year. Second, loss and leakage of funds allocated to capital projects might be reduced if indirect measures are taken. Direct approaches to changing the role and responsibilities of user committees are unlikely to find traction. The main proposed entry point is technical and institutional support to local government monitoring and supervisory capacity. A proposed accompanying measure is to develop national-level norms and rates for project costing, to replace the current district-by-district regime for norm setting, which produces significant discrepancies and creates some perverse incentives. Third, the government can improve procurement practice through training of officials and pilot initiatives to strengthen competition. Fourth, establishing better minimum technical standards and enforcing them more robustly through technical monitoring can enhance contractors' service delivery.

The last entry point is to strengthen the inter-institutional coordination of the central finance function. First, it is necessary to strengthen the analytical, planning, and institutional leadership capability of the PEFA Secretariat to take forward a reform agenda across different agencies, beyond changes that mainly affect the FCGO internally. It would be highly desirable for such an organizational strengthening to include secondment of officials from different ministries and cadres to increase buy-in from across the public finance system. Furthermore, formally or informally, the key PFM actors, as well as the Ministry for General Administration, could protect the in-post tenure of key PEFA-relevant staff positions at the MoF, the FCGO, and other agencies.

The risks and entry points set out in this report have implications for the engagement of external actors. Development partners can work with the government on the different areas of PFM strengthening. They need to consider what scope there is for technical assistance and other forms of support. An important option could be for the government and development partners to agree on a set of progress indicators that could be jointly monitored by the government and development partners to assess improvements in PFM performance over time, while at the same time giving the government the flexibility to respond to a rapidly changing environment.

1. Introduction

1.1 Objectives

The purpose of this forward-looking assessment is to inform dialogue about the implementation of public financial management (PFM) improvements in Nepal, including their prioritization and sequencing in the prevailing political context. It aims to provide a "reality check" on the strengths and weaknesses of the existing PFM system and focuses on nontechnical aspects such as institutional and political factors. Such an in-depth and holistic understanding of the current challenges in the government's PFM framework is considered a critical step in identifying the available reform space, as well as the operational risks and potential mitigation measures.

The study covers not only the central budgeting and financial management functions associated with the finance ministry, but also financial management at local levels and in two sectors. Specifically, the assessment aims to promote a common understanding on how to improve PFM performance at central, sectoral, and local levels and to strengthen the framework for service delivery in the health and roads sectors. The analysis is intended to inform a better understanding of key constraints to delivering improvements in support of policy initiatives in the selected sectors.

An important distinction between this study and standard PFM assessments based on the Public Expenditure and Financial Accountability (PEFA) methodology is that this endeavor attempts to avoid a normative starting point for reviewing the PFM system. The analysis tries to achieve this objective in three ways. First, it provides an insight into how Nepal's PFM system functions in practice. Second, it identifies areas in PFM and the related public administration system where the challenges and operational risks are the greatest. Third, it points to entry points for PFM strengthening that support improvements both in state capability and effectiveness and in service delivery in the health and roads sectors.

"Operational risk" in this context is used broadly, to encompass uncertainties and other factors that may threaten initiatives to strengthen PFM and consequently hinder service delivery performance. Such risk is likely to arise from institutional features such as limited capacity to implement policies or consistent failure to follow up on audit reports. The framework for analysis agreed between the government and development partners for the study classifies operational risk in three ways: *inherent risks* arising from the scale and complexity of contract implementation; *administrative control risks* arising from weaknesses in the public administration system; and *political control risks* arising from limited political responsiveness to reported control failures. The primary focus of the study is on a combination of bureaucratic and political factors that together determine the underlying constraints to improvements in PFM.

This analysis of operational risk is tantamount to a problem-driven (or problem-centric) review of the PFM system and development of entry points for strengthening its systems and processes. It starts with a diagnosis of the main observed constraints to better PFM, then disaggregates these factors into tractable problem sets, and finally develops possible solutions that are compatible with the prevailing context and government policy objectives.

The study in Nepal was conducted as a joint initiative between the government and its development partners, involving joint analysis and fieldwork. The work involved a desk-based review of reports and assessments on public expenditure trends and on the public finance system in Nepal. Detailed analysis of budget data and expenditure outturns provided a strong empirical complement to the more qualitative review of PFM performance that was conducted through literature surveys, semi-structured interviews, and workshops.

The study involved two fieldwork trips, one in September/October 2012 and one in January/February 2013. These included meetings with a wide range of current government officials, as well as former Cabinet ministers and former senior officials. District visits made to Kavre, Chitwan, Rupandehi, and Palpa entailed meeting with officials responsible for regional, district, municipal, and village public administration and service delivery. Visits were also made to selected frontline service delivery units.

1.2 Approach and methods

In this report, we undertake a dynamic institutional review to assess the operational risk related to PFM improvements in Nepal. This section outlines each component of the approach developed for this review, and also embeds these components in the latest theoretical discussions found in the public policy literature.

Analytically, the operational risk assessment (ORA) focuses on the analysis of administrative control risks that are the most open to direct corrective measures. The centerpiece of the methodology is a dynamic institutional review covering key elements of PFM, as well as the administrative, socioeconomic, and political environment in which PFM systems operate. Technical systems are intertwined inexorably with their environment, and it is not possible to arrive at a politically feasible assessment of reform options without considering both the technical challenges and issues emerging from the nontechnical environment.

The dynamic institutional review has three dimensions, discussed in turn. First, we assess the technical PFM systems as they currently operate. Second, we wed the discussion of PFM to an analysis of institutional incentives and capability. Third, we approach both of these as problem-centric, rather than trying to measure the *status quo* in Nepal against abstract or unrealistic benchmarks.

1.2.1 PFM systems analysis

Much work has been done in recent years to standardize and formalize the measurement and assessment of PFM systems. The PEFA framework has quickly become the standard for the field. This contains 28 indicators covering the different dimensions of PFM: budget credibility, comprehensiveness and transparency, policy-based budgeting, predictability and control of budget execution, accounting, recording and reporting, and external scrutiny and audit (PEFA Secretariat 2005). As more PEFA assessments have become available, their scores have been used for cross-country comparative analysis (with an emphasis on comparing African countries). Studies have yielded useful, but ultimately inconclusive, evidence about the relationship between PFM reforms, external support, and PEFA scores (de Renzio 2009; de Renzio et al. 2011).

PEFA assessments do not automatically yield specific reform measures or plans for any given country, nor are they intended to. Twenty-eight indicator dimensions do not lead directly to an equivalent number of priorities. The question of appropriate reform priorities and sequences to fit each country's context and circumstances has been hotly debated in the PFM community since Allen Schick argued 15 years ago that developing countries should not try New Public Management reforms in the style of New Zealand (Schick 1998). In practice, advanced reforms are often implemented in very different contexts, although few authors would explicitly suggest countries "leapfrog before looking," to paraphrase Schick. The pattern of implementation, however, is mixed. Especially in Africa, many "best practice" reforms have been found either to fail or to be very limited in their success (Andrews 2010; Andrews 2013).

A very common recent solution to the problem of "basics first" versus "advanced reforms" has been to formulate a series of "platforms." These outline a long-term vision for the PFM system and a stepwise plan to reach very advanced models of budgeting after completing more basic stages first (DFID 2005). Having been applied in several countries, notably Cambodia, the platform approach has been rightly criticized as fundamentally flawed. The available evidence also suggests a notable failure of countries to get beyond the initial stages, making highly optimistic plans for future progress quickly obsolete (Allen 2009). A recent review of several post-conflict countries by the World Bank found that advanced budget reforms, particularly in budget formulation, have a poor record of succeeding, whereas some budget execution reforms can be quite advanced, even in difficult contexts (Fritz et al. 2012; Hedger et al. 2012). This suggests that formulating complex or long-term reform plans that constrain governments' ability to prioritize in future are not appropriate for countries emerging from conflict or those in transition.

The current discussion of PFM reform in Nepal is based on a PEFA assessment published in early 2008 and a comprehensive reform plan that has been in place for some years. Preparations have been underway for some time to carry out a repeat PEFA assessment and to update the reform framework based on the new information. Although they provide the overall framework, these foundations need to be specified and translated into specific steps that are feasible and politically acceptable in the short run. It is not the purpose of this report to replace or update the PEFA assessment, or to develop a new comprehensive reform plan. The analysis of the PFM system carried out here is more modest and applied: It focuses on a description of how the PFM system currently works in practice, with an emphasis on the flow of public funds on the expenditure side from the central finance agencies to frontline spending units. Special emphasis is given to spending in the health and roads sectors.

1.2.2 Incentives and capabilities

Embedding PFM systems in country contexts requires consideration of the capabilities and incentives of key actors and institutions. The next step in PFM reforms is not simply a function of a country's stage of development: It depends on numerous factors in combination. There has been a massive increase in the number of approaches and ideas that can be brought to bear since the World Bank first identified the importance of public sector institutions (World Bank 2000). The Bank's recent approach to public sector management explicitly recognizes the importance of the institutional context of reform, and emphasizes that it is more important to fit with existing institutions than to emulate international best practice (World Bank 2012a).

The number of institutional features potentially relevant for PFM reform is overwhelming. The collection and allocation of public funds is an essential element of any political system, and vice versa. As a result, much of the political landscape and a country's politics and economic setup, as well as cultural features and the social structure, can and in some way inevitably does have a bearing on the handling of public funds. This overabundance of potentially relevant factors can lead to an overly elaborate analytical structure that does not necessarily lead to much clearer conclusions and recommendations. For the purposes of this report, we limit the scope of analysis to the actors concerned with PFM, their capabilities, and their incentive environment.

There is a well-developed literature analyzing institutional incentives and capabilities, but not all of it is easily applied to developing countries. Much of what is specific to the context of Nepal still needs to be inducted carefully from the evidence available on how the PFM system operates in practice. In terms of the generic political environment, the concept of "limited access orders" is a useful point of departure (North et al. 2007). The "common pool resource problem" has been useful in looking at budgeting and fiscal institutions, and provides a helpful analytical tool to apply to Nepal's budget system (Hallerberg 2004; Poterba and von Hagen 1999; von Hagen 2004; von Hagen and Harden 1995). To study central finance institutions and their incentive environment, we use recent institutional research (Allen and Grigoli 2011; Allen and Kohnert 2010; Allen and Krause 2013; Dressel and Brumby 2009).

Nepal is not easy to categorize. It is a polity still in transition after conflict, but does not share the same legacy of shattered institutions that afflicts many fragile states. We refer to recent World Bank research on PFM reform in fragile states as one point of reference, without assuming that the findings necessarily apply to Nepal (Fritz et al. 2012; Hedger et al. 2012). Depending on the PFM dimension, the experiences of other Westminster systems, of countries with British-influenced civil service systems, or of South Asian neighbors might be just as relevant.

1.2.3 Problem-centric

The issues covered in this report are based not on a gap analysis against international best practice, but on problems identified by stakeholders in Nepal. In line with the latest international thinking on institutional change in development, this report moves away from a best practice approach and tries to base its analysis on actual problems found in the system, according to the stakeholders running it or affected by it (Andrews 2013; World Bank 2012a). This approach relies on extensive interviews with government officials, politicians, and representatives of organized civil society groups and lobbies in order to gather a solid understanding of how, empirically, systems work at the moment and of stakeholder perceptions of shortcomings and problems.

A problem-centric approach is especially appropriate in the current political environment of Nepal. Although the political transition continues, the political system runs within a complex and volatile context, and risks to implementation are high. Both international development actors and government officials are concerned with the feasibility of new initiatives, given that much can change in a short period of time. Focusing on problems identified by stakeholders themselves allows for a higher degree of ownership of any possible reform measures, as well as a more nuanced understanding of the likely contestation individual measures might face.

A focus on problems does not indicate that there is no scope for change, or indeed that problems are insurmountable. On the contrary, it is in the very definition of the term "problem" that it can potentially be solved. Many structural features of Nepal's public finance system might fall short of Organisation for Economic Co-operation and Development (OECD) practice but could be entirely appropriate and functional given Nepal's current capacity endowment. Other permanent features, such as social and geographic fragmentation, are not amenable to change or amelioration – at least in the short run. In contrast, problems can be solved. Together, the analysis of technical PFM features, incentives, and capabilities and a focus on specific problems allow for a sequence that leads from describing the *status quo* to diagnosing the main problems to proposing some inroads to support the government's efforts at tackling them.

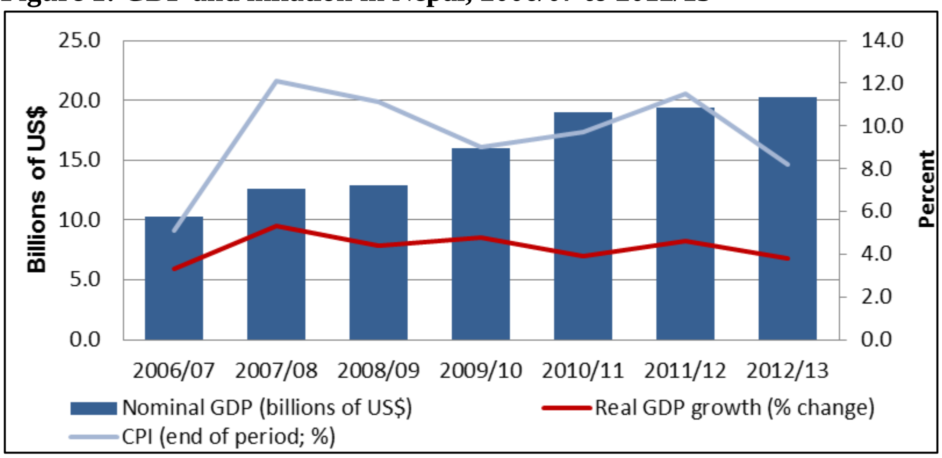
2. The environment of public finances

This section sets the stage for the analysis by providing a broad overview of the current economic and political environment, as it is relevant in reviewing the management of public finances in Nepal. First, it examines recent macroeconomic trends in growth, inflation, and public debt, also briefly discussing Nepal's public finances, including aggregate trends of revenues and expenditures as well as expenditure composition. Second, it discusses donor engagement in PFM, given the large role in Nepal's development of foreign aid, which represents a quarter of the national budget. Lastly, it provides an overview of the political context of Nepal.

2.1 Economic context

Nepal's economy remains fragile. The insurgency may have ended, but political stalemate over the past six years has added pressure to the country's already weak economic development. Although Nepal's GDP per capita has improved slightly, standing at $717 in 2012, the country remains among the poorest in the world. The 2013 UN Human Development Report ranked Nepal at 157 out of 187 countries (UNDP 2013). Nepal has maintained a steady GDP growth rate, averaging 4.2 percent over the past five years (IMF 2011). However, high inflation and unemployment have slowed overall economic development. With a total labor force of 11.8 million, the employment rate amounts to 61.8 percent (World Bank 2011b). Inflation has gradually increased, with the annual rate growing from 2.8 percent in 2004 up to 11.1 percent in 2008/09. Inflation is projected to have declined again in 2012 to around 8 percent, mostly because of expected increases in agricultural output (IMF 2011).

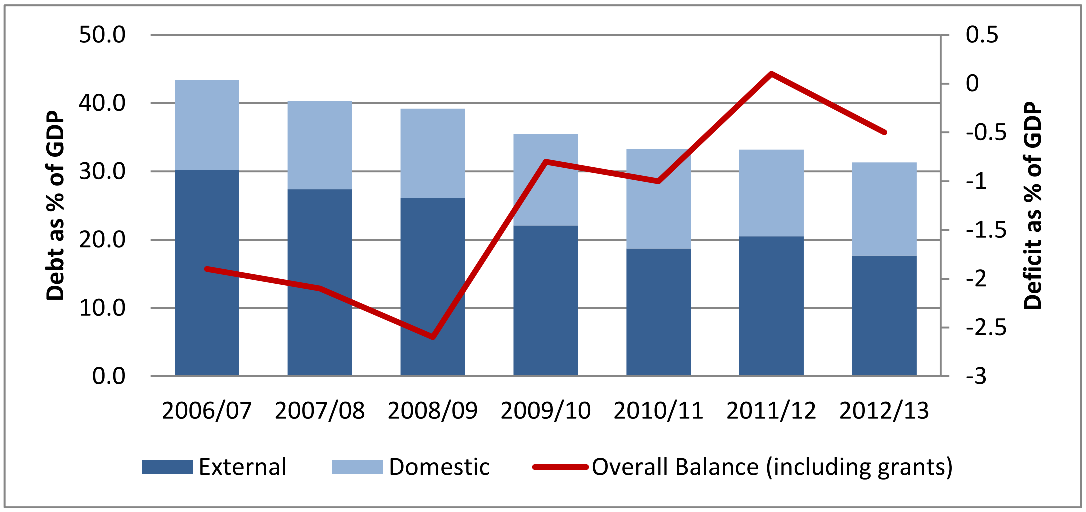
Figure 1: GDP and inflation in Nepal, 2006/07 to 2012/13



Source: IMF Article IV Reports 2008, 2010, 2011, and 2012.

Migration and remittances have contributed significantly to the reduction of poverty in the past 15 years. The World Bank ranks Nepal among the top five countries in terms of the contribution of remittances to GDP (approximately 23 percent) (World Bank 2011b). While the level slowed briefly in 2009 as a result of the global economic crisis, the share of households receiving remittances has increased from 30 to 55 percent in the past seven years and per capita average remittance levels have quadrupled (IMF 2011).

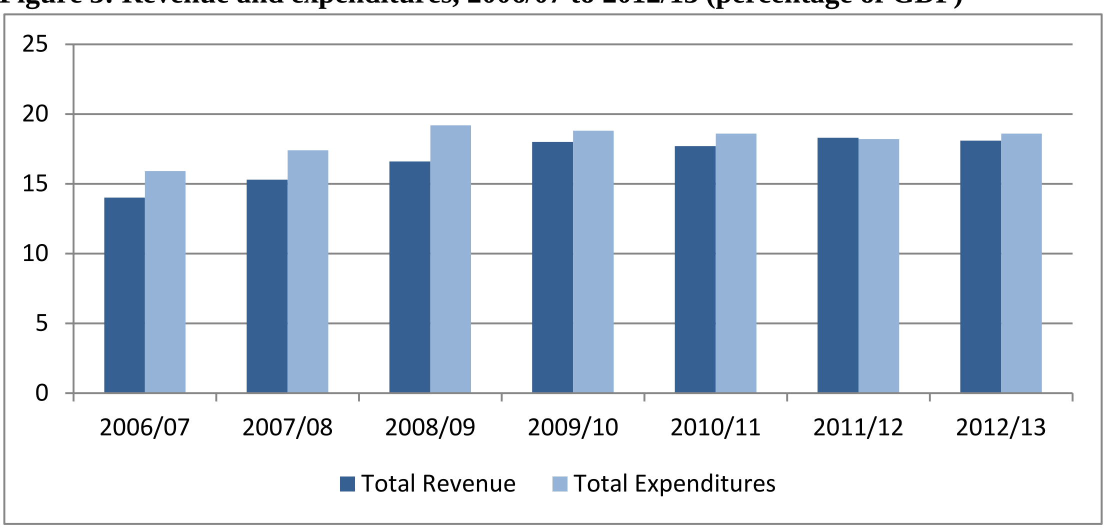
Figure 2: Public debt and deficits, 2006/07 to 2012/13 (percentage of GDP)



Source: IMF Article IV Reports 2008, 2010, 2011, and 2012.

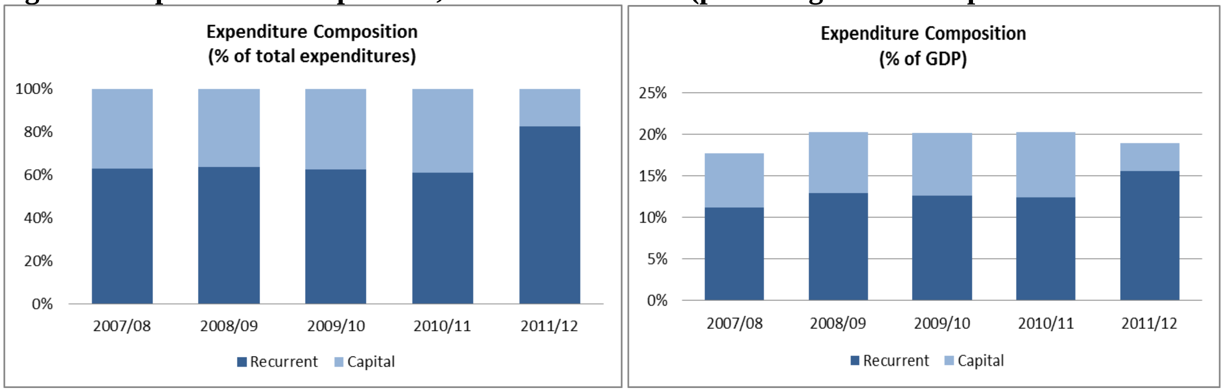
Fiscal sustainability is not a significant problem at the moment. Low budget execution rates – probably exacerbated by the political transition – may have promoted this, at least in part. Government revenue grew from 14 percent of GDP in 2006/07 to an estimated 18.4 percent in 2010/11. The debt profile has improved dramatically over the past several years, and Nepal's public debt is now well below the average of comparator countries. Public debt declined to 33 percent of GDP in 2010/11 from 64 percent in 2001/02 (IMF 2010b), and external debt to 18.7 percent. Now that external debt is within reasonable thresholds, the International Monetary Fund (IMF) and the World Bank indicate that Nepal is at only moderate risk of debt distress. This large debt reduction has created fiscal space that could be used for much-needed infrastructure and human capital, provided spending quality is ensured.

Figure 3: Revenue and expenditures, 2006/07 to 2012/13 (percentage of GDP)



Source: IMF Article IV Reports 2008, 2010, 2011, and 2012.

Figure 4: Expenditure composition, 2007/08 to 2011/12 (percentage of total expenditures and GDP)



Source: FCGO.

There are growing liabilities in the state-owned enterprise (SOE) sector. In 2011/12, the two main loss-making SOEs, the Nepal Oil Corporation (NOC) and the Nepal Electrical Authority (NEA), made losses equivalent to 1.2 percent of GDP (NRs 19 billion). The overall debt levels are NRs 27 billion for the NOC (1.7 percent of GDP) and NRs 61 billion for the NEA (3.9 percent of GDP), most of which is owed either directly to the government or to the pension funds with government guarantees. The debts are not being serviced.

Revenue and expenditure growth has not picked up much since 2008/09, despite higher levels of foreign aid (see figure 3). External funding constitutes almost a quarter of total government expenditure and over 70 percent of the capital budget. The composition of spending is increasingly tilted towards current expenditure, which averaged over 60 percent of total expenditure in 2010/11 and 83 percent in 2011/12. Current spending has increased by 4 per cent of GDP over the past five years, compared with an increase of 2 percent in capital expenditure.

2.2 Donor engagement in PFM

Foreign aid plays a large role in Nepal's socioeconomic development, representing a quarter of the national budget, but better information transparency is needed. The International Economic Cooperation Coordination Division (IECCD) of the Ministry of Finance (MoF) is mandated with the overall coordination and harmonization of foreign aid from over 40 countries, including 35 resident agencies. As a result of concern over the government's implementation and oversight capacity, however, an increasing amount of official development assistance (ODA) flows outside the budget. In fact, it is estimated that only about half of foreign aid is channeled through national systems such as the budget or procurement systems, with a large amount of external grant funding bypassing the budget process altogether.

An NGO recently conducted a survey of seven development partners and found that none of them had provided complete budgetary information. Many donors also kept beneficiaries in the dark about project budgets, many were reluctant to provide information on projects, and at least one agency did not even have a designated officer to share information (Freedom Forum 2012).

In relation to PFM, there have been multiple assessments and diagnostic exercises over the past decade (see box 1). The most significant was the joint PEFA assessment by the government and development partners, conducted in 2007 and covered FY 2005/06. This provided a basis in 2008 for the Development Action Plan (DAP), and for the formation of the PFM Steering Committee and the PEFA Secretariat on the government side. A joint PFM Reform Program (PFMRP) Strategy was produced in

2009, covering the period 2010-2013. The PFMRP was formulated based on the recommendations made under the PEFA assessment. Short-term priorities in this are strengthening the PFM system and building the capacity of the PEFA Secretariat.

Box 1: PFM assessments 2002 to 2012

Country Financial Accountability Assessment, 2002 – World Bank
Country Procurement Assessment Review, 2002 – World Bank
Nepal: Public Financial Management Assessment, 2005 – Asian Development Bank (ADB)
Gap Analysis of Public Sector Accounting and Auditing, 2007 – World Bank
Public Expenditure and Financial Accountability Report, 2007 – World Bank
Public Financial Management: Strengthening Basic Systems, 2010 – IMF
Improving Budget Execution, Fiscal Reporting and Cash Management, 2012 – IMF
Public Expenditure Review, 2010 – World Bank
Public Expenditure Review – Roads – 2011 – World Bank

Source: Authors' compilation.

To support the PFMRP strategic framework, a Multi-Donor Trust Fund (MDTF) was established in late 2011 by pooling donor resources and target priority issues. The MDTF, under the leadership of the World Bank, was designed to provide "a coordinated approach to address PFM challenges." The UK Department for International Development (DFID), the Danish International Development Agency (Danida), Norway, and Australia have already joined the Fund, and the EU and other donors are interested in joining. Total pledged contributions to date amount to over $11 million.

The MDTF has a clear results framework that links activities and outputs to planned outcomes. The value of a trust fund such as the MDTF is that it can enable donor coordination and harmonization around support to country priorities, thus reducing the transaction costs to the government arising from working with multiple donors while adding resources to the Bank's country operations and work program. According to interviews with development partners, however, the MDTF has a weak vision, and, thus far, its different strands have been rather separate. Rather than formulating a broader vision for PFM reform, the MDTF program started from specific activities.

The overall objective of the MDTF is "to strengthen the performance, transparency and accountability in public financial management" through three components:

(a) **Strengthening PFM systems and processes.** The objective is to improve expenditure control, and enhance government accountability and transparency by strengthening the treasury system, improving financial reporting, and building PFM capacity. With the Financial Comptroller General's Office (FCGO), the MDTF is supporting government reform initiatives and actions, including Treasury Single Account (TSA) implementation and rollout to ministries and local bodies, introduction of the International Public Sector Accounting Standards (IPSAS) and the rollout of training, and general PFM capacity building (including strengthening of the PEFA Secretariat). In addition, there is support to strengthen the Office of the Auditor General (OAG). This covers technical assistance on risk-based approaches to audit, performance-based audit, and IT audit. Specifically, the MDTF aims to increase the proportion of audits meeting OAG financial statement auditing standards from 35 to 60 percent and the proportion of audit observations implemented by the executive – within one year – from 35 to 50 percent.

(b) **Enhancing accountability in public financial management.** This program aims to strengthen institutions of accountability and civil society to enhance their oversight of PFM processes and performance. This demand-side engagement will not only provide grant support to community service organizations (CSOs) in 10 districts through the Program for Accountability in Nepal (PRAN), but also engage, and support strengthening in, government oversight agencies including the Public

Accounts Committee (PAC), the Commission for the Investigation of Abuse of Authority (CIAA), and the National Vigilance Center (NVC).

(c) **Deepening knowledge related to PEFA assessments.** The program will support activities to expand knowledge on current PFM practices and options for improvement.

2.3 Political context

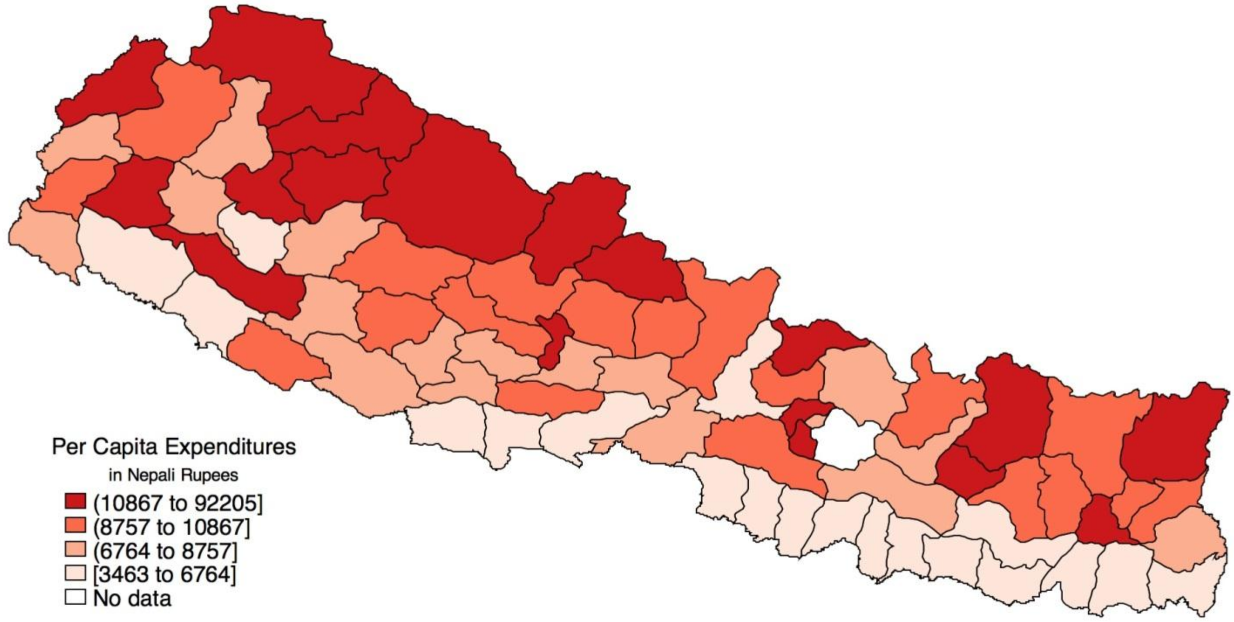
Nepal is a polity in transition. In November 2006, the signing of a comprehensive peace agreement ended a decade-long period of insurgency. An interim constitution was then passed in January 2007. Following elections in April 2008, which all major political forces contested, a Constituent Assembly (CA) took office with a brief to pass a permanent constitution by May 2010 and to serve as a temporary legislature until replaced by a permanent one elected under the new constitution. The CA failed to agree on a new constitution; with its term expired, it was dissolved in May of 2012.

Politics is still uncertain. The current "apolitical" government, formed in early March of 2013 under the chief justice of the Supreme Court, consists of former civil servants and excludes political representatives. The government's primary mandate is to hold CA elections by the end of 2013. Accordingly, elections to a second CA have been announced for November 19, 2013. There are 140 political parties registered with the Election Commission. Many of them are expected to contest the elections, but some challenge the legitimacy of this process and have already announced that they will boycott or even obstruct elections. Difficult political negotiations on a wide range of election issues will dominate Nepal's political agenda in the run-up to the elections. The new CA will, once again, be expected to deliver a new constitution.

The political system is fragmented. Only four out of 56 political parties that contested the 2008 elections won more than 5 percent of the seats in the legislature. The strongest party by some margin was the Communist Party of Nepal (Maoist; CPN-M), with 36.6 percent of seats, which had fought against the government prior to 2006. The CPN-M has since split into two parties. It was followed by the Nepali Congress (NC) with 18.3 percent and the Communist Party of Nepal (United Marxist-Leninist; CPN-UML) with 17.1 percent, then the Madhesi Jana Adhikar Forum, Nepal (MJAFN) with 8.7 percent of the seats. The MJAFN has since split into three parties. The remaining 19.7 percent was taken up by a large number of small and very small parties, as well as independent candidates. Party affiliations are not set in stone, and the formation and reordering of splinter groups is common and seems to be increasing.

The main sticking point in the negotiations over the new constitution has been the restructuring of the state, including intergovernmental relations. Specifically, actors cannot agree on the decentralization of authority, both fiscal and otherwise, currently held by the center to a new intermediate level of government between the national level and the districts. The country is currently divided into 75 districts and more than 3,900 Village Development Committees (VDCs). There are also 14 zones and five development regions, although these are not actual levels of government. The country is ethnically, socioeconomically, and especially geographically very diverse, and at times fragmented. A restructuring of the local levels of government would therefore have profound consequences for the way politics is organized, and the stakes are high for all actors involved – which explains the universal reluctance to commit to a final political settlement of the pending issues.

Figure 5: Nepal district spending per capita (NRs)



Source: FCGO; National Population Census 2011.

Distribution of spending by district varies considerably, but not necessarily in a way that indicates obvious political imbalances. In 2011/12, total government expenditure was NRs 338,804 million, or NRs 12,788 per capita. This is a large increase from average per capita expenditure of NRs 3,871 in 2004/05. Almost two-thirds of all government spending (61 percent) went to the Central region in 2011/12, compared with 6 percent in the Far-Western region, which received the lowest share. By population, the Central region has the highest per capita expenditure (NRs 21,636) and the Eastern region the lowest (NRs 6,785) (FCGO data).[1]

Although the country is divided administratively into five regions from east to west, differences in per capita expenditure are noted along a south to north transect. From south to north, Nepal can be divided into three belts: the Tarai, the Hills, and the Mountains. As figure 5 shows, some of the country's highest per capita expenditures are in the mountainous districts in the north, whereas the lowest are in the Tarai. For example, the district of Manang (Western region), located in the far north, has the highest per capita expenditure in the country (more than NRs 90,000); its low population density of fewer than 7,000 persons partly explains this. Differences between the Mountains and the Tarai can also be explained by geographical and accessibility constraints that limit investment in the north and west, which are underserved. For example, a bag of cement in Humla (Mountains) costs NRs 7,500, in Jumla (Hills) NRs 1,500, and in Banke (Tarai) NRs 650.

Nepal is a limited access order. According to this concept, limited access order societies are governed by elite groups that exercise control over the political system to create rents for themselves and their clients, in order to limit the use of violence (North et al. 2007; North et al. 2009). Limited access orders are very common, and do not necessarily have deeply negative implications for a country's stability or development potential. Powerful groups cooperate and refrain from using violence to achieve their aims, knowing that such violence would reduce the amount of rents available. They restrict, if necessary by force, other groups that are not part of the ruling group from organizing and competing for resources. This is in contrast with open access orders, where citizens of all kinds can form groups that compete for resources through nonviolent means. Nepal's recent history displays all the salient features of a limited access order.

Nepal experienced acute fragility during the conflict that went on between 1996 and 2006. During this period, the Maoists and the groups they represent fought the ruling coalition for, essentially, access to the distribution of resources in the country. The peace agreement of 2006 and the political process since then is an indication by all parties that they prefer a polity in which competition is organized nonviolently, and that resorting to organized violence in the case of fundamental disagreements is no longer an option. In this sense, the political parties are working to establish a state in Weber's sense, one that exercises a legitimate monopoly on the use of violence in all its territory (Weber 1980 [1921]). It is worth noting that, despite profound disagreements between actors and the inability of the parties to come to an agreement, large-scale violence has not recurred.

There have been some major steps towards a more open, stable, and nonviolent system. A multiparty political system seems secure for the time being. Elections were held, the results were accepted, and all major parties have engaged regularly in the political process since 2006. Shifting coalitions have destabilized matters, resulting in frequent turnovers of government, but the political process as such has continued. Handovers from government to government have been peaceful and the formal procedures of government continue to operate in spite of mounting uncertainty.

The country's deep political crisis has resulted in temporary piecemeal budgets for most of the current fiscal year (FY 2012/13). After the dissolution of the CA in May 2012, uncertainty increased dramatically. The budget year runs from July 16 to July 15. At the start of FY 2012/13, the president, endorsing an ordinance proposed by the Unified Communist Party of Nepal (Maoist) (UCPN(M)) government, promulgated a four-month budget based on the previous year's budget, to be followed by fresh elections, but agreement on those could again not be reached. A new budget decree covering an additional one-third budget was passed in November. These budgets replicated the 2011/12 spending plan, with no new policies or programs. As such, they were intended to provide the minimum necessary for the government to continue functioning. In April 2013, the new government passed a complete full-year budget adjusted to include the appropriated expenditures promulgated under the first two budgets.

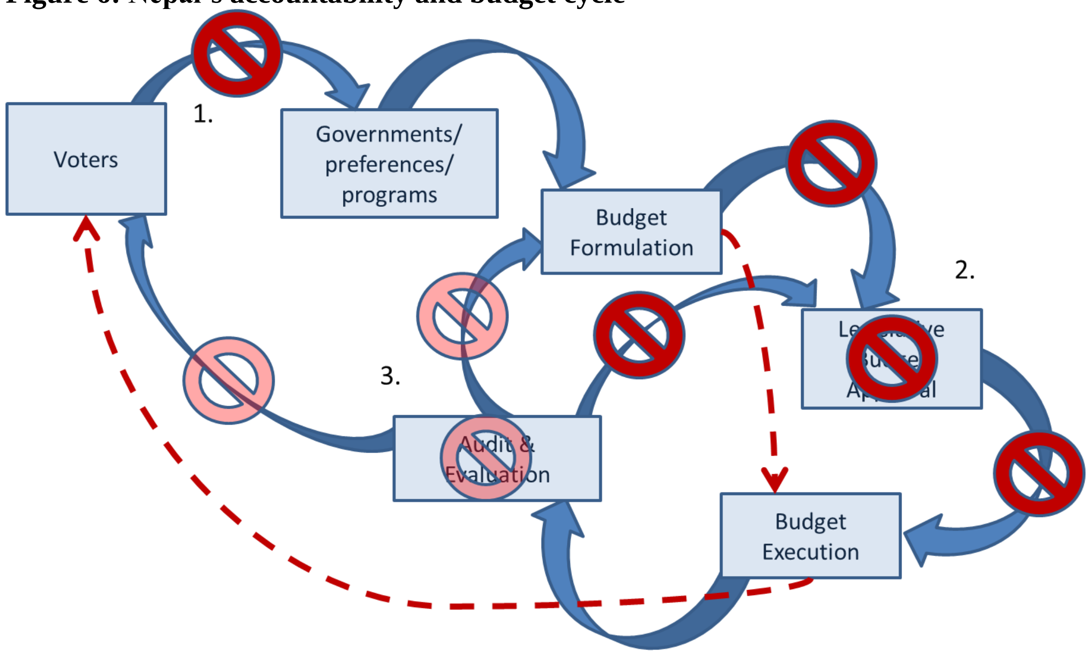
The formal institutions of the Nepali state are under increasing external pressure from multiple and increasing numbers of claimants on the common pool of public sector resources. Nepal is even more vulnerable to political disruption and external influence on the public administration because so many of the formal accountability mechanisms are currently not fully operational (as intended by the interim constitution). This ultimately represents a profound danger for the operation of the budget system, including both the formal budget process and the daily operation of PFM. Two factors in particular, described by interviewees in this study, are combining to apply pressure.

(a) **The increasing fragmentation of the party system is paralleled by the rise of party-affiliated unions that compete with one another for members.** This competition has led to more union demands and higher militancy in both the private and the public sectors. The US State Department recently indicated this as a major concern.[2] In the public sector, unions allegedly seek better conditions, employment protection for their members, and influence over appointments.

(b) **Parties are increasingly seeking influence over the public sector, more so the further one moves away from the center of government.** At the local level in particular, where administrative capacity is often low, outsiders exert influence over spending decisions and, at times, over staff matters as well. An area where this has become particularly acute is procurement. It is alleged that local party organizations influence bid awards to direct them towards affiliated contractors, who then deliver substandard outputs. Numerous instances of physical intimidation and disruptions around the submission of bids have been reported, although the recent establishment of an online submission system seems to have reduced this problem substantially. Other, more indirect, levers of influence around local procurement remain, however.

In sum, the accountability and institutional oversight mechanisms envisaged by the interim constitution are severely weakened at present. There is a risk of further institutional erosion (see figure 6). In principle, there would be a budget cycle going through the annual phases of formulation, legislative approval, budget execution, and audit and evaluation, leading to the next formulation, and so on. The budget cycle does contain strong elements of accountability through the interplay of executive, legislative, and independent bodies.

Figure 6: Nepal's accountability and budget cycle



Source: Authors' compilation.

The relationship between voters and the budget cycle is becoming more tenuous. The budget cycle is – in theory – partially nested in a wider accountability cycle that includes informing and accounting to voters, who regularly select governments based on the strategies and programs different parties propose. Thus, validated by elections, the strategies of the government of the day could be assumed to reflect the preferences of voters; the programs it funds according to its spending plans could be assumed to be in service of such preferences. It is important to underscore that all these elements are provisioned for in Nepal's laws and regulations, including the interim constitution.

In Nepal, the accountability system is severely threatened in two ways, and threatened in a third. First, the link between voters and government is currently very tenuous. Second, the dissolution of the legislature means there is no legislative oversight of public spending, and the final accounts of the government cannot be approved or checked after submission by the OAG. Third, because key accountability bodies were leaderless for several years, their effectiveness eroded. For instance, there was no permanently appointed auditor general (AG) between 2007 and 2013. The government can try to formulate and implement spending programs directly in the hope that the effects of its activities are visible and noticeable enough that citizens give their implicit and explicit approval to make up for the weakened accountability system. However, over the long term, there still seems to be cross-party consensus that the formal accountability mechanisms of the political system be restored.

In early May 2013, the government filled the long-vacant leadership positions in the OAG and the CIAA. This has been an important step towards addressing accountability challenges in the government.

The appointment of the AG and the chief commissioner of the CIAA follows consensus among major political parties on the nomination of candidates for these positions. While the OAG now runs at full capacity, the CIAA is still short of three commissioners. In addition, both institutions need organizational strengthening so they can play their roles more effectively and recover ground lost during the years of leadership vacancy.

Centralized budget authority is a central element of PEFA-inspired reforms. Political and institutional instability has the potential to affect public finances negatively in different ways. Political instability and a strong central budget authority are closely related; the literature identifies three elements as important predictors of strong budget authority (Hallerberg 2004; von Hagen 2004; von Hagen and Harden 1995).

(a) **Single-party governments or small, ideologically closely aligned coalitions are more likely to allow for strong authority,** because they find it easier to delegate to a powerful finance minister. Where coalitions are large and unstable, every party would like to deploy the finance minister and every party has strong incentives not to trust or empower another party's appointee for fear he or she might implement disagreeable policies.

(b) **Stable party systems and (c) regular, competitive elections make it more likely that the government of the day will consider the full tax burden of its spending decisions** (if it spends poorly, given a certain tax level, it might be voted out, and in the long run it might inherit the fiscal burden it created today). If a government has to consider the full burden of its taxes, it is more likely to appoint a strong finance minister to serve as counterbalance to the spending units in government.

Table 1: Conditions for strong budget authority in Nepal

Strong budget authority is enhanced by:	Why?	Nepal has:
Single-party governments or small, cohesive coalitions	*Political backing to empower MoF*	*Large, unstable coalitions*
Stable party system	*Incentive to consider full tax burden*	*Unstable party system*
Regular, competitive elections		*Irregular elections*

Source: Authors' compilation based on Hallerberg (2004).

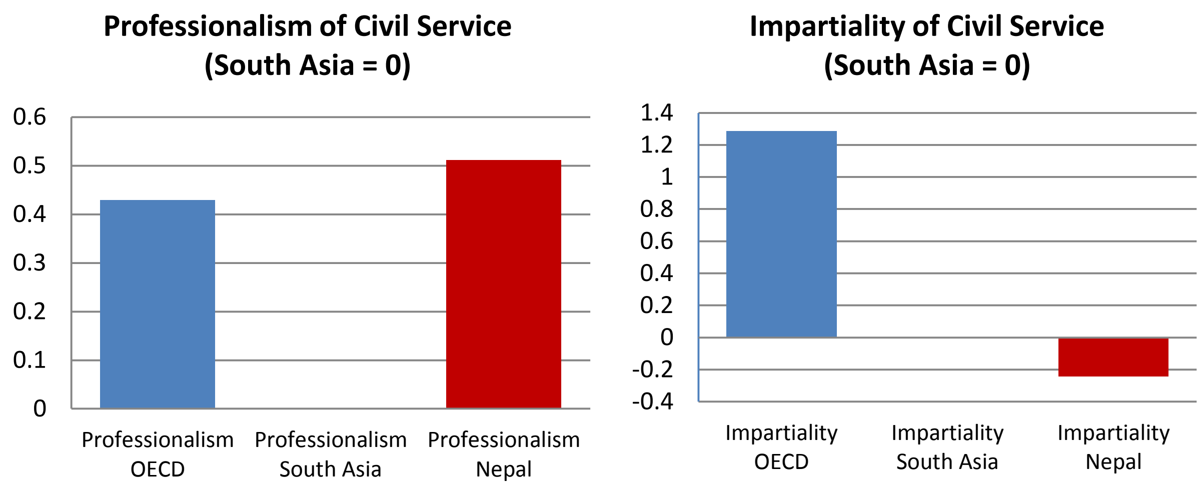
None of these three conditions is currently present in Nepal. This makes the enforcement of ceilings, especially over the medium term, structurally difficult, and complex, interlocking reforms less likely to succeed. It must be noted, however, that the recent successful rollout of the TSA shows the government is capable of forcing through the kinds of reform that strengthen central budget authority against the discretionary power of spending units. Furthermore, fiscal discipline is not (yet) a major problem for public finances. Going forward, the success of the TSA bears careful analysis to generate an understanding of the enabling factors and the precise nature of the obstacles overcome to understand what lessons could be drawn for other PFM reforms.

According to Transparency International, Nepal is the second most corrupt country in South Asia. Out of 183 countries surveyed in the Corruption Perceptions Index, Nepal was ranked 139 in 2012, 154 in 2011, and 146 in 2010. Corruption is perceived as endemic, in both the public and the private sectors. Although the Prevention of Corruption Act (2002) has established sanctions for corrupt practices, laws are weakly enforced and the political elite and high-level government bureaucrats can often act with impunity.[3]

Nepal's government institutions will play a key role in determining the future of the public finance system. Unlike the years leading up to 2006, the country is at peace, and all the major political actors are working towards resolving their interest conflicts peacefully by formal means. Unfortunately, however, the time taken on this conflict resolution means the larger political process is at a stalemate. The macro-political environment also has few favorable elements, as the administrative structure of the country is under huge pressure to deliver benefits for all parts of society, the political situation is unresolved, and some actors are willing to use informal means to gain access to rents.

Nepal's civil service has been widely reported as cohesive and professional. The Civil Service Act (current version from 1993) regulates professional civil service cadres, grades, the creation and filling of vacancies, and staff transfers. There seems to be a strong *esprit de corps*, especially among top civil servants, a degree of pride in membership, and a belief that civil servants can rise through the ranks only by performing well and passing objective and difficult exams. The top rank of secretary (what would be a permanent secretary in the British civil service) is perceived to be more political, but this is not unusual in many other countries, even those with strong civil services.

Figure 7: Professionalism and impartiality of the bureaucracy in Nepal



Note: South Asia in this case covers Bangladesh, India, Nepal, Pakistan, and Sri Lanka.
Source: Dahlström et al. (2010).

At the same time, issues around corruption and rising politicization raise questions as to the public sector's impartiality. Given that the awarding of government contracts, the provision of services, and access to the government are being taken over by outside interests (be they political or interest groups, or simply self-interested elite actors of varying backgrounds), the government cannot act impartially as prescribed by the law. One would expect the government of a limited access order to be partial.

Comparative evidence suggests Nepal's bureaucracy is indeed highly professional, but not as impartial as its peers. Figure 7 displays Nepal's 2008-2010 scores on professionalism and impartiality as recorded in the University of Gothenburg's Quality of Government dataset (Dahlström et al. 2010). The measure of professionalism includes the extent of meritocracy and the rules around tenure, and assumes that the opposite of "professional" is "politicized." The comparison shows that Nepal not only ranks as more professional than the average of South Asian countries, but also is actually above average even compared with the OECD. Impartiality is defined as the degree to which civil servants use only the stipulations of laws and regulations (and no personal or other considerations) when making individual decisions. In this regard, Nepal lags far behind the OECD average, and its South Asian peers as well.

3. Institutional arrangements for PFM

This section discusses the institutional features of the stakeholders in the public finance system: their formal role, their organizational arrangements, and how they are integrated into the larger landscape, including informal institutional dynamics. The main central finance actors discussed in the first section are the Ministry of Finance (MoF), the National Planning Commission (NPC), the Financial Comptroller General's Office (FCGO), and the Public Procurement Monitoring Office (PPMO). The next two sections discuss, respectively, the key players at the spending ministries (health and roads sectors) and local government bodies (under the direction of the Ministry of Federal Affairs and Local Development; MoFALD) involved in PFM. The final section provides an overview of the external oversight agencies, including the Office of the Auditor General (OAG), the Commission for the Investigation of Abuse of Authority (CIAA), and the National Vigilance Center (NVC).

3.1 Central ministries

The setup of central ministries involved in public finances in Nepal is complex. The main actors are the MoF and the NPC. There are several departments or agencies under the general authority of the MoF. One is the FCGO, which carries out the treasury function. On the revenue side, the Inland Revenue Department (IRD) is responsible for tax administration and collection, but is not covered further in this report.[4] Another important actor is the PPMO, which reports directly to the Prime Minister's Office.

The NPC and the MoF have evolved in parallel. Between 1963 and 1968, a Ministry of Economic Planning was in charge of all fiscal and economic affairs; in 1968, the MoF and the NPC were established as separate bodies. The MoF is now formally the lead ministry for economic, revenue, and expenditure affairs, and the NPC is the government's advisory body for planning and policy development.

The MoF has a fairly straightforward organizational setup, but seems weakened by a fragmented central finance function. Of the potential core finance functions a finance ministry could undertake (Allen and Krause 2013), only a small number (three out of 18) rest solely or overwhelmingly with the MoF itself: foreign aid coordination, tax policy, and budget preparation. In practice, the bulk of macroeconomic responsibilities are shared with the NPC and the Central Bank (five out of 18: macro-fiscal forecasting and analysis, fiscal policy formulation, the interface between monetary and fiscal policy, fiscal risk analysis, and financial sector supervision). The FCGO carries out a large share of core expenditure work (five out of 18: treasury and cash management, internal control, internal audit, accounting policy, and debt management). The other five functions (tax administration, customs administration, intergovernmental relations, public asset management, and procurement) are spread over other agencies and departments, some, but not all, of which are formally in a line management relationship with the MoF.

The MoF itself employs a total of 206 staff, of whom 71 are section officer equivalent or higher ranks. The ministry has a total of nine joint secretaries leading the different divisions. The IECCD and the Budget and Program Divisions are professionally the strongest, with 15 section officers or higher-ranked staff each. According to several interviewees, the Budget Division is not considered a prime employer: The IECCD offers more attractive work and the Revenue Management Division is often seen as more financially rewarding. The Budget Division does play a crucial role in the budget process, both towards the end of the budget preparation stage and during budget execution, where its authority carries great influence over virement decisions. Its day-to-day operations, however, are taken up by the vast workload associated with short-term budget execution decisions, a phenomenon that is very common in many other countries where a line item budget is paired with many within-year readjustments to the budget.

The FCGO is quite strong in administrative heft. The financial comptroller general (FCG) is in charge of more than 4,760 staff, the majority of whom work either in the de-concentrated District Treasury Comptroller Offices (DTCOs) (~960) or in the treasury offices of other ministries (~3,380). The head office itself, however, is comparable to the MoF in size, with a total of 66 staff of section officer equivalent or higher rank. The FCGO has received considerable donor support in recent years, and it, not the MoF, houses the PEFA Secretariat, which is the main PFM reform coordination body.

The current organizational setup between the MoF and the FCGO has left both organizations weakened. Institutionally, the FCGO is housed as a department under the MoF and the FCG reports to the finance secretary. However, they hold the same rank, which has disincentivized strong and sustainable leadership for the FCGO. This institutional barrier was cited as a factor in frequent turnover in the FCG post. Some voices suggest the FCGO operate as a ministry of expenditures, functionally independent of the MoF but still reporting to the finance minister. At the same time, limited integration between the two bodies threatens to draw external support away from the MoF itself, especially the units concerned with public spending issues. The international literature, covering a range of different countries, suggests splitting the central finance ministry into separate entities hinders the centralization of authority over the budget process, which in turn is associated with better fiscal outcomes (Alesina et al. 1999; Hallerberg 2004). How specifically this applies to Nepal is a matter for further inquiry, but the government's current challenges with fragmented institutions suggest it would benefit from more integration, not less.

The structure and configuration of the MoF is quite conventional, with the exception of some apparently arm's-length functions. The MoF presides over a quite traditional incremental budget process, with an emphasis on annual negotiations to formulate the budget, and fairly detailed line item control during budget execution. This is a common arrangement internationally, and not necessarily a sign of weakness (Krause 2009; Krause 2013b), as evidenced by Nepal's fiscal performance in recent years. The apparent detachment of several core finance functions into separate departments suggests influences of an "agency" model. In the core areas of budgeting, some elements of a more output-oriented, medium-term approach are intertwined with the traditional budget process. Across all agencies, the central finance function is not poorly endowed in terms of staff capacity. Its capability in terms of managing complex operations and steering public finances (see Dressel and Brumby 2009 for the distinction between capacity and capability) beyond the maintenance of fiscal discipline, however, is more doubtful.

As with politics in other countries, the position of minister of finance has been filled in quickly rotating succession in recent years. The average tenure of a minister has been one year and three months (see table 2). Ministers have hailed from across the political spectrum. Since the 2008 elections, ministers have been from either the CPN-M or the CPN-UML. Since 2006, all ministers of finance have belonged to the same political party as the concurrent prime minister, reflecting the core importance of the role. *De facto*, a path pursued by ministers appears to be a push to significantly expand revenue – which has also been facilitated by other trends, as discussed above. According to one interlocutor, "the MoF acts like a ministry of revenue" and "likes to announce how much revenue it has raised."

Table 2: List of ministers of finance, 2003 to 2013

Name of minister	Affiliation	Start of time in office
Prakash Chandra Lohani	Rastriya Janashkati Party (RJP)	2003
Bharat Mohan Adhikari	CPN-UML	2004
Madhukar Rana	Independent	2005
Ram Sharan Mahat	NC	2006
Baburam Bhattarai	CPN-M	August 2008
Surendra Pandey	CPN-UML	May 2009
Bharat Mohan Adhikari	CPN-UML	February 2011
Barsha Man Pun	UCPN-M	September 2011
Shankar Koirala	Former secretary to government	March 2013

Source: Authors' compilation based on interviews.

All ministers in Nepal hold the same rank formally; however, the minister of finance is considered more powerful than the other ministers. Changes to sectoral spending priorities (greater than 25 percent) must be approved by the minister of finance, which has created tensions of authority between the MoF and line ministries. In the health sector, for example, if the Ministry of Health and Population (MoHP) wants to decrease spending on family planning programming in order to increase spending on curative health (based on changes in the development of health priorities), the minister of health must obtain approval from the minister of finance. Line ministers see this as a problem for two reasons: (a) the minister of finance is at the same level as the minister of health and therefore should not need him/her to approve spending priorities; and (b) the minister of finance does not have technical expertise in the health sector and can therefore not understand what is needed for the country in this regard. Furthermore, in Nepal's current environment of coalition governments, the two ministers could belong to different parties, which makes approval more difficult, as it risks becoming a party political issue. This problem of delegation to finance ministers under coalition governments is very common in parliamentary democracies, and has caused serious concerns, for instance in Belgium and Italy (Hallerberg 2004).

Apart from the MoF, the NPC plays a significant role in financial management in Nepal. The country's prime minister is concurrently the chair of the NPC. One particular challenge with implementing capital expenditures is that the NPC assesses/reviews priority (P1) projects following approval of the annual budget. Logically, any review by a planning commission should take place *prior* to finalization of the budget. The NPC argues that its role is needed to constrain ministries from making unjustified changes to their work plans during the year.

The NPC is in charge of development planning and has a role in most other activities that collectively determine the government's medium-term policy stance. In the area of public finance, this notably includes the Medium-Term Expenditure Framework (MTEF) and translation of macroeconomic forecasts into the annual resource envelope. Many interviewees noted that the NPC's stature had suffered somewhat in recent years. This reflects a fairly common international trend over the past two decades that has seen planning agencies and ministries overshadowed by a more centralized finance function.

Institutionally, there is growing concern about the NPC's politicization. The vice chair and other members of the NPC are political appointees. The institutional proximity of the NPC to the Cabinet and the role of the prime minister as chair of the NPC both pose challenges to its apolitical role in the selection and prioritization of development projects. Insufficient attention is paid to feasibility studies and other elements of project preparation, with major repercussions for the use of domestic resources for public investments.

The PPMO was established in 2007 in accordance with the adoption of a new procurement act and regulations. Its central oversight role is limited compared with similar offices in other countries. For example, the PPMO does not have a legal mandate to ensure information related to bidding processes is made public. Its role is primarily facilitative: It is obliged to suggest further reforms in procurement policy and laws, issue technical guidelines and manuals and models for standard bidding documents, roll out training for officials at public entities involved in procurement, and collect statistics on procurement.

The PPMO is organizationally weak. Although it has a complement of about 50 staff, it has struggled to attract qualified staff, and about half of the established positions remain unfilled. The heads of the PPMO have served interim appointments relatively briefly. A recent review by the ADB and the World Bank concluded that, although in principle the PPMO reports to the Prime Minister, *de facto* it operates in isolation, and it is physically located far away from other government entities in Kathmandu (World Bank and Asian Development Bank 2012). It has not been able to carry out its function to collect and aggregate statistical information on procurement. It also has not yet been able to develop a procurement manual.

The role of the PPMO is limited in two ways that serve to reduce its effectiveness. First, as noted above, it does not have a legal mandate to ensure information related to bidding processes is made public. Second, it does not have a role in handling procurement complaints. Under a two-stage review process, complaints are submitted first to the chief of the concerned public entity and then, if necessary, to a review committee to be formed by the government. The committee comprises a judge, an engineer, and a procurement specialist not currently employed by a public entity. One power assigned to the PPMO is blacklisting of contractors for a period of one to three years, based on misconduct in the bidding process or in project execution.

3.2 Spending ministries

This section provides a brief institutional analysis of health and roads spending entities at the sector and local levels. It covers functional responsibilities, staff complements, power and authority relations, and informal institutions. Analyses of sector and local entities are necessarily overlapping because most service delivery occurs at local levels.

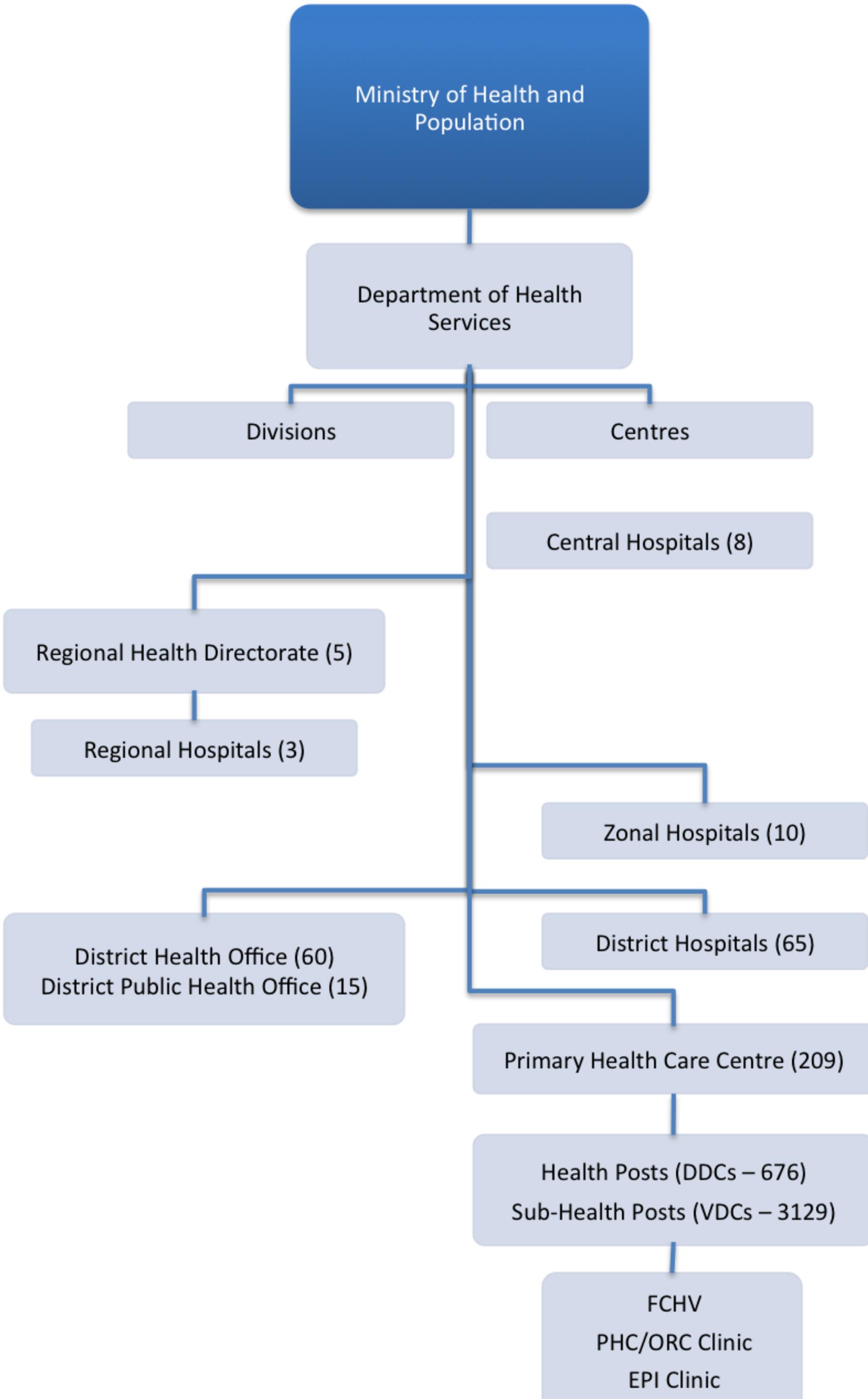
3.2.1 Health sector

The institutional configuration of the health sector is characterized by a high degree of fragmentation and administrative de-concentration. The MoHP has overall responsibility for preparing policies and budgets for the health sector and also for oversight of the delivery of health services.[5] The MoHP comprises three main departments at central government level. The main divisional unit is the Department of Health Services (DoHS), which accounts for 75 percent of the ministry budget.[6] The *de facto* hierarchy in the MoHP is determined as much by budget-holding shares within the sector as by formal organizational structures. Each department is headed by a director general; in the case of the DoHS, the director general holds an actual status equivalent to the secretary because of budgetary responsibilities.

Figure 8 displays the formal institutional structure between the central ministry and local levels that is managed by the DoHS. At the regional level are regional and zonal hospitals, which have been given decentralized authority through the formation of boards. Regional Health Directorates' main function is the supervision of a health service delivery system, but they have no financial control over the districts. Funding bypasses the regions and is allocated directly by the central level. District Development Committees (DDCs) and Village Development Committees (VDCs) are functionally responsible for the delivery of health services at the local level. Within the MoHP, the structure varies between districts. Sixty-five districts are managed by a District Health Office (DHO) with support from the District Public Health Office (DPHO), and the remaining 10 districts are managed solely by the DPHO. Throughout the country, there are 679 health posts (HPs) at the DDC or municipality level and 3,134 sub-health posts (SHPs) at the VDC level.

Lack of real decentralization in the health sector, coupled with weak local administrative capacity and adverse political incentives, has compromised reform progress. Despite the passing of the Local Self-Governance Act (LSGA),[7] the health sector remains effectively centralized. Virtually all important decisions in planning and budgeting are still made by the DoHS or the MoHP (The Asia Foundation 2012). Four main political and institutional factors further constrain improved effectiveness of health service delivery (Jones et al. 2010). First, high levels of turnover of senior staff in the MoHP undermine effective health sector management and work against a long-term focus in policy and administrative reforms. Second, interference in staffing decisions – for political patronage reasons and financial rent-seeking purposes – exacerbates weaknesses in management and supervision. Third, significant problems with the management of health sector procurement have led to inflated costs and poor quality of equipment. Fourth, effective local supervision capacity and incentives – notably through the Health Facility Operation and Management Committees (HFOMCs) – have not emerged as a material factor to compensate for weaknesses in the centralized management of health facilities. Overall, the degree of effective local control over resources and decision making is very limited. Therefore, the lack of decentralized service delivery has also acted as a buttress against the risks of local political capture of health sector expenditure.

Figure 8: Line management structure of the MoHP in Nepal



Source: DoHS (2012).

The health sector has been a major policy concern for the left-of-center parties in Nepal. These parties' programmatic efforts have focused on two dimensions: an expansion of spending on health as a share of the budget and the abolishing of user fees in the sector (see Jones et al. 2010). Some important gains have been made in health care provision and results (Nepal is on track to meet child mortality and maternal mortality reduction targets in the Millennium Development Goals).[8] The health sector has also attracted considerable aid resources, and is one of two sectors in which a sector-wide approach (SWAp) exists. The challenge appears to be where to go from here. At the day-to-day level, and similar to in other countries, the sector receives less attention from politicians than the roads sector.

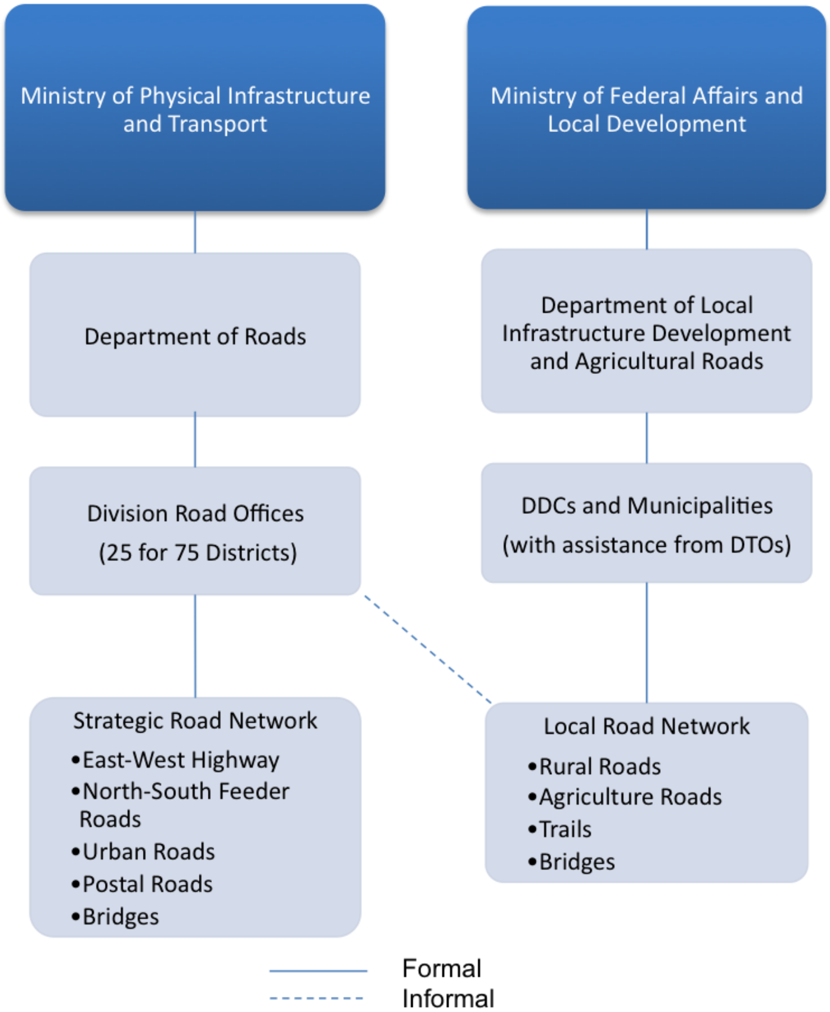
There are important constraints in terms of how the sector is managed (a large share of unfilled positions, questions over management in the hands of doctors and health care professionals), and also some concerns over fiduciary management. Addressing these systemic issues poses greater challenges and resistance than in the previous period of changes, which was characterized by sector expansion (which tends to be welcomed by a wide range of stakeholders).

3.2.2 Roads sector

The roads sector in Nepal is managed under two ministries, the Ministry of Physical Infrastructure and Transport (MoPIT) and the Ministry of Federal Affairs and Local Development (MoFALD), as well as the Roads Board Nepal (RBN) (see figure 9). At the central level, under the authority of these ministries, the Department of Roads (DoR) and the Department of Local Infrastructure Development and Agricultural Roads (DoLIDAR) share responsibilities for road network expansion; the RBN is responsible for the maintenance of existing roads (at central and local levels). Division Road Offices (DROs) fall under the DoR and are mandated to carry out the construction and maintenance of roads and bridges under the Strategic Road Network (SRN). There are 25 offices spread across the 75 districts. Most roads under the Local Road Network (LRN) are planned, implemented, and operated by the DDCs, and monitored by their respective District Technical Office (DTO), under the guidance of the DoLIDAR.[9] The MoPIT and the MoFALD provide guidance in planning, technical cooperation, and resource management.

Roads have received very strong attention from politicians. While strategic roads are mostly outside the sphere of political influence, at the local level politicians receive intense pressure to promote road projects in the national budget for their respective districts. This has led to a very long list of projects, each of which receives only a very small allocation of funds annually (currently 4,000 local-level projects are included in the Red Book). In fact, the MoPIT, though formally responsible only for strategic roads, also oversees the implementation of local roads and bridges, as politicians from around the country typically try to influence the decision making of the DoR (see figure 9).

Figure 9: Management structure of the government roads sector in Nepal



Source: Interviews with MoPIT, DoR, and MoFALD; authors' analysis.

3.3 Local government bodies

The administrative configuration of local government is complex and multilayered, and is expected to evolve further through ongoing processes of decentralization and federalism. There are currently two administrative tiers below central government: districts and, below them, municipalities and villages. The principal executive bodies at each level are the DDCs, the Municipalities, and the VDCs. There are 75 DDCs, 58 Municipalities, and about 3,915 VDCs. Further tiers of local governance exist: the *Ilaka* (which is a meso layer comprising six to seven VDCs between the VDC and the DDC) and the wards at sub-VDC level (of which there are nine per VDC and 35,235 in total). Provinces have been proposed as a new tier between central government and districts, but there is significant contention about their territorial demarcation. Different ethnic and political groups have strong vested interests in how the provinces are established geographically and thus the process has stalled, pending further political negotiation.

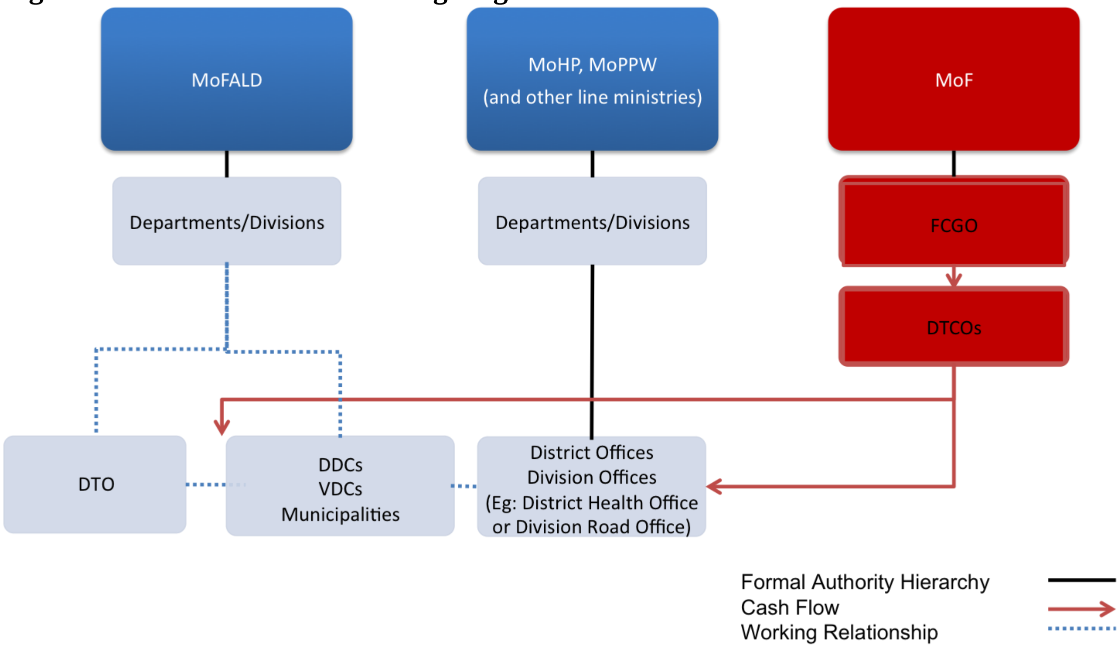
Introduction of the LSGA in 1999 aimed to enhance autonomy and expand the mandate of local bodies in Nepal. The Act expanded responsibilities and resources for specific services to DDCs, VDCs, and Municipalities. More significantly, it increased their scope by devolving authority in four vertically organized sectors – health, primary education, agriculture (includes some roads), and livestock.

The LSGA envisaged local bodies being autonomous entities, but in practice they are subordinate to the MoFALD. Only two local elections have been held in Nepal, in 1992 and 1997. The second five-year term of local elected representatives ended in 2002, at which time the government appointed civil servants to assume all functions and mandates of the Village, Municipality, and District Councils. In the past, elected officials questioned the authority of the MoFALD, but today, in the absence of elected officials, local bodies are in fact ranked lower in the hierarchy and must obey directives sent down the chain of command. On field visits, local bodies complained that they had to comply with complex planning rules mandated by the central government (i.e., the 14-step planning process) only to see everything disregarded by the central government when they received their annual budget.

Local bodies are heavily reliant on fiscal transfers from central government, which come from multiple sources. Fiscal and financial relations between central and local governments, and among the various local bodies, are complex. Local levels see a combination of sector allocations through line ministry budgets (covering all of primary education and health care), block grants, own-source revenues raised locally, and conditional grants from the MoFALD (using a formula-based allocation model). For DDCs, the central government must provide recurrent grants to cover salaries, allowances, and operational costs, as well as minimum capital grants. Additional capital grants are allocated to local bodies based on factors such as population, area, and development level. The formula applies equally to all 75 districts, regardless of local revenue collection, project costs, and geographical diversity. VDCs each receive a block grant based on a formula that takes into account population, area, and the cost index of the DDC. The amount ranges from NRs 1.5 million to NRs 3 million per VDC (70 percent capital 30 percent recurrent), with a top-up grant allocated based on concentration of disadvantaged groups. These funds are all remitted to the District Development Fund (DDF), which acts as a non-operating account.

Staffing of local bodies comprises a combination of de-concentrated civil servants from central ministries and locally appointed officials. Staffing tiers at the local level match substantive grades in the central ministries (from which the posts are de-concentrated). The senior district-level civil service representative is the chief district officer (CDO), who has responsibility for security and other territorial matters, and who reports to the Ministry of Home Affairs (and who is typically at the level of joint secretary). The coordinating official for general administrative and development matters is the local development officer (LDO), who reports to the MoFALD, and is typically equivalent to an under secretary. The parallel posts of district treasury comptroller, district health officer, and district education officer report to the FCGO, the MoHP, and the Ministry of Education, respectively. All the posts are typically at the level of under secretary, but lower-grade staff may fill them in the case of smaller districts. These de-concentrated sector ministry officials are individually responsible for their respective departmental mandates at the local level and collectively responsible for local administration of integrated programs and services. Below the senior staff, DDCs and VDCs can recruit personnel locally, but these do not form part of the de-concentrated central cadres.

Figure 10: Central to local level organogram



Source: Ministry websites and interviews.

The absence of elected local government since 2002 has permitted a fundamental decline in the integrity and accountability of public expenditure management and service delivery at the local level. Full executive authority has transferred to the senior bureaucratic cadre in the DDCs, VDCs, and Municipalities, most notably to the LDOs. These officials do not enjoy the *de facto* authority, capacity, or incentives to substitute for elected representatives. Political engagement in policymaking and budgeting processes has occurred formally and informally through "All Party Mechanisms" (APMs), comprising representatives of all the political parties active in the district. Except for a period between 2009 and early 2012, when APMs were legitimized by a Cabinet decision and then outlawed by the CIAA, the APMs have existed and operated informally and without legislative or constitutional oversight. In reality, the APMs have enabled quite a different dynamic of local governance to emerge, one that is informal, collusive, and inimical to good governance tenets. Research by The Asia Foundation (2012) found that efforts to promote consensus-based local politics had permitted collusion among political parties in the absence of a formal opposition. Similarly, the dominant role afforded to the APMs has entrenched "informal deliberative space" at local level and weakened accountability in local governance.

3.4 External control and oversight bodies

External control and oversight institutions in Nepal follow a familiar pattern in theory, but suffer from crucial gaps in practice. Nepal is formally a parliamentary democracy, with many commonalities with the Westminster type. In such a setup, the role of the legislature is elementary for accountability purposes; however, this building block is currently lacking. The OAG is a supreme audit institution that follows general international practice. The CIAA and the NVC are more peculiar. The CIAA is an investigative anticorruption agency, and the NVC is an additional anticorruption body with more of a promotional remit.

3.4.1 Office of the Auditor General

The OAG is responsible for the final annual audit of all constitutional bodies, budget entities, and spending unites of the government, down to the district level. It was established with the appointment of the first AG as per the constitution in 1959, after a predecessor of the office had been established based on the Interim Governance Statute of 1951. Article 23 of the 2007 interim constitution specifies the functions, duties, and powers of the AG. The Audit Act of 1991, the Financial Procedures Act of 1999, and the Financial Administration Rules of 1999 further stipulate the AG's audit methodology, scope, and coverage. The AG is responsible for the audits of all constitutional bodies (including the Supreme Court, the Parliament, the Public Service Commission, the CIAA, the National Human Rights Commission, and the Election Commission), all ministries and departments under them, and the Nepal Army and the Nepal Police. The AG is also responsible for the audit of autonomous bodies such as universities and colleges, funds, councils, authorities, academies, development committees, and the 75 DDCs. They also audit or nominates auditors of corporate bodies with greater than 50 percent government ownership, and, by agreement with donors, a range of donor-funded projects. The AG's mandate does not cover municipalities and VDCs, which are required to appoint their own registered auditors. As a result, the OAG typically audits over 4,000 spending units, 46 government-owned corporations, and over 700 other agencies or projects in any given year.

There was no AG in post between 2007 and 2013, owing to the country's political climate, and this vacancy weakened the effectiveness of the OAG. The AG is appointed by the president on recommendation by the Constitutional Council for a period of six years**.** The AG is assisted by four deputy auditors general and 14 assistant auditors general, who head the different audit divisions. For several years there was a succession of acting AGs, each for a short period of time, resulting in a progressively weakened institution. Although the president is in charge of appointing the AG, the process still requires a political consensus, which was not attainable for a long period in the current environment. After more than six years of vacancy, the president appointed an AG in May 2013. The lack of a permanent AG for so long has not only undermined the OAG's independence and general effectiveness but also slowed reform efforts.

The OAG's management asserts that the number of auditors (300 in total) is insufficient to meet its mandate to cover spending units, public enterprises, and other government agencies. Currently, the OAG has a total of 449 staff. This includes 300 auditors within 15 audit divisions plus one taskforce. The professional audit staff consist of civil servants within the audit cadre. The technical auditing capacity of staff is weak, even though the OAG has its own cadre of staff who are not subject to the usual civil service rules, which permit rotation every two years. The OAG also has no power over promotion or incentive payments to its staff to encourage and reward high performance.

3.4.2 Commission for the Investigation of Abuse of Authority

The CIAA has substantial formal powers, and plays the role of an ombudsperson, investigator, and prosecutor. The CIAA is a constitutional body empowered to investigate and curb corruption and improper conduct in Nepal. According to Article 120 of the interim constitution, the CIAA may conduct "inquiries into, and investigations of, improper conduct or corruption." Furthermore, the CIAA can "file cases or take any action against any person holding a public post found guilty of abusing powers" (GoN 2002). The agency's main focus is on detection and punishment of corruption, but it is also entrusted with social and institutional reform, allowing it to make recommendations on amending national policies and legal provisions in order to curb corruption and promote good governance.

The CIAA is led by the chief commissioner – a post that was vacant for more than six years. The chief commissioner and four other commissioners are appointed by the president on the recommendation of Constitutional Council for a period of six years. The CIAA Secretariat, subject to direction and control by the chief commissioner, is in charge of the administrative functions of the Commission. The secretary, who is appointed by the Cabinet, oversees the five divisions: the Investigation Division, the Police Division, the Litigation Division, the Planning Division, and the Administrative Division.

The CIAA processes all complaints and opens preliminary investigations according to its strategic plan. If, after thorough analysis, merit is established with minimum evidence obtained, a *prima facie* case is set up and an investigation officer is appointed to the case. This individual conducts inquiries, analyzes findings, and prepares a report that is submitted to the Commission, which then makes a decision.

3.4.3 National Vigilance Center

The NVC is focused on establishing good governance and controlling corruption through preventative measures. Whereas the CIAA is in charge of investigations into corruption, the NVC is focused on its prevention. Its mission is based on the proverb "prevention is better than cure." The Center's specific duties include collecting information on whether or not functions of ministries, departments, and offices are being carried out properly; monitoring property and income of persons in public office; managing the complaint boxes in all public agencies; conducting surveillance and surprise audits; and providing guidance to concerned bodies on corruption prevention.

4. Policy framework and development planning

This section describes the formal and informal planning processes of the national government, local bodies, and sectoral ministries. First, it details the national development planning frameworks, which are led by the NPC under the general guidance of the country's Three-Year Plan. Second, it discusses the planning process for DDCs, which are required to develop district plans, although these are undermined by the influence of local politicians and elites. Finally, it provides an overview of the health and road sectoral planning processes. These two sectors are guided by formal strategic plans at the national level, but suffer from severe informal practices at the local level. Decision making on allocations to health facilities, which have been devolved, is essentially still central. Public investment in local roads is still influenced by local political pressures.

4.1 National development planning frameworks

Nepal has a well-established tradition and experience of economic and development planning processes. The development planning process is led by the NPC, which acts as the advisory body for formulating development plans and policies, working under the auspices of the National Development Council (NDC). There have been nine successive Five-Year Plans since 1956, followed by a Three-Year Interim Plan (2007-2010) and a Three-Year Plan (2011-2013). These plans correspond to poverty reduction strategy papers (PRSPs). The shift from five- to three-year planning periods reflected political uncertainties following the People's Movement of 2006, and the plans have become more indicative of this context. The Interim Plan 2007-2010 gave particular emphasis to infrastructure reconstruction following the conflict.

The links between ministries, programs, and the national plan are imperfect. Three-year periodic plans establish national and sector policy priorities and development targets. The NPC issues guidelines to sectors and ministries for their detailed policy planning and programming. These plans focus on national and sector policies, with the intention that spending ministries develop their own strategic plans that accord closely with relevant sector and cross-sector priorities. In practice, most ministries do not produce strategic plans (with exceptions such as roads, health, education, and agriculture).

An unmeritocratic rating mechanism is used to prioritize programs, projects, and spending allocations against national and sector policy priorities. The NPC establishes these priorities through the preparation of the development plan. They include reconstruction, employment, growth, governance, service delivery, and infrastructure. The development plan does not identify specific projects or their costs, and does not apply a fiscal framework to the determination of priorities (IMF 2012). For capital expenditure, the NPC analyzes all proposals and spending requests from central government spending units and local government bodies. Each project is assigned points on the basis of its conformity with the strategic objectives of the development plan. Three categories are derived: P1 (17.5-25 points), P2 (10-17.5), and P3 (0-10). Externally financed projects automatically score as P1. This category also covers priority categories of recurrent expenditure, which are analyzed by the MoF. In total, government projects and programs classed as P1 cover 89.5 percent of government expenditure (GoN 2012a).

4.2 Local planning and budget preparation

The LSGA established a 14-step participatory planning and budgetary process. This requires each unit to produce annual plans covering programs and budget for the next year, with input from user groups, community-based organizations, and the private sector (box 2). For the VDCs, settlement and ward-level meetings are used as consultative processes to identify needs and priorities for village development plans. Recommendations on priority programs are also fed into the district-level planning process.

Box 2: The 14-step planning process

1. Receive budget ceiling and directives
2. Review of guidelines
3. Pre-planning preparation workshop
4. VDC/Municipality meeting
5. Community-level project planning
6. Ward Committee meeting
7. VDC/Municipality meeting
8. Village/Municipal Council meeting
9. Area (*Ilaka*)-level planning workshop
10. Sectoral planning meeting
11. Integrated plan formulation meeting
12. DDC meeting
13. District Council approval
14. Implementation of DDC plan

Source: http://www.npc.gov.np/new/staic/plansprogram.php

The influence of local politicians and is undermining the participatory planning and budget formulation process for local bodies. In most cases, local bodies follow the 14-step process, with each district developing a plan that is approved by the DDC, relevant line ministries, the NPC, and the MoF. In practice, however, local governments struggle to balance the competing demands of communities and the local elite, as well as central government directives. There is no formal mechanism for local politicians to participate in planning and policy processes, but their influence, through informal channels, remains quite strong. After the expiration of locally elected representation in 2002, the newly appointed civil servants relied on relationships with local politicians rather than rules to perform their duties. The CIAA formally dissolved APMs in 2012 based on evidence of undue political interference in local public administration by local party cadres, but the influence of party cadres persists informally today. It is common practice for local politicians to collude with the national and local governments in order to influence decision making, which results in a number of "pork barrel" projects appearing in the budget every year.

The LSGA provides for a system of intergovernmental transfers for local bodies, but very little is actually discretionary in nature, which undermines the entire decentralization framework. Budget allocation for local governments in Nepal is mostly formula-based, as discussed in section 3.3. With exception of the capital block grant through the Minimum Condition Performance Measures system, which is performance-based, the transfer system is quite restrictive, with strong directives for project spending coming from the central government. In addition, the MoFALD, and often the NPC or the MoF, sends directives to local bodies, which must relinquish needs-based projects in favor of low-priority or politically motivated projects sent by the center (Koirala 2011).

4.3 Sector planning: health and roads

4.3.1 Health

The health budget from domestic sources has increased steadily in the past five years, which illustrates strong political commitment, support, and state ownership. The current share (FY 2011/12) of government resources in the total MoHP budget is 61 percent. The health sector is highly dependent on donors, under the SWAp-I, which accounted for 48 percent of the 2009/10 budget and 39 percent of the 2011/12 budget. Donor funding in the health sector is understated, however, as a substantial amount of donor funds are off budget and channeled through NGOs.

The health sector policy framework is detailed in the Nepal Health Sector Program (NHSP 2) 2010-2015, with annual planning guided by a multi-stakeholder Joint Annual Review (JAR). The annual planning process in the health sector begins each January with a JAR meeting of government, donors, and other stakeholders. The MoHP's Policy and Planning and International Coordination Division is in charge of developing sectoral policies based on the NHSP, with assistance from development partners. These must be approved by the NPC, which produces its own set of "priority bullets" in parallel to the MoHP process. Reconciliation of the two plans is imperfect, and synchronization of national development planning with the determination of fiscal aggregates and sector budget allocations remains inadequate.

Although health is one of the four devolved sectors, the central government still heavily influences decision making about resource allocations to local-level health facilities. Although the LSGA has encouraged more local-level decision making, the planning process remains as it was before devolution. Bottom-up planning, aimed to incorporate local-level needs and demands, is yet to occur in practice. In fact, DHOs do not receive a budget ceiling but generally prepare their budget plan in a traditional bottom-up incremental fashion by adding about 10 percent to the previous year's budget.[10]

Local bodies do not prioritize spending on health, instead relying largely on the central government and de-concentrated line agencies to provide these services. According to the LSGA, local bodies should manage and supervise HPs and SHPs. In practice, this is not often the case, for two reasons.

(a) **Rules in the LSGA and in the MoHP guidelines in relation to the jurisdictions of local bodies and line agencies are contradictory, resulting in confusion and overlaps.** For example, the LSGA mandates that local bodies manage the functioning of HPs and SHPs, but the MoHP guidelines stipulate that the Health Management Committee, under the umbrella of the MoHP and the DHO, controls the resources and management of staff (Paudel n.d.).

(b) **Local bodies see less importance in providing health services in comparison with implementing infrastructure projects, which are more visible to constituents of the local elite and APM members.** It was alleged in several districts that politicians do not get involved in the health sector like they do in capital projects. Typically, 60 to 70 percent of the budget is spent on roads projects, with the remaining budget split between all other sectors, including health, education, social protection, irrigation, and other development projects.

4.3.2 Roads

The government has given priority to expansion of the country's road network. At the national level, the government has strengthened its emphasis on achieving major infrastructure improvements (roads, energy, and water), and has identified a list of 14 "national pride projects" in its Immediate Action Plan. Infrastructure development has also benefited from significant donor funding. As a result, spending on transport rose from 1 percent of GDP in 2009 to 2 percent in 2011 (World Bank 2011a). Decentralization and empowerment of local bodies for road construction is an ongoing process, but the overall roads sector investment is controlled at the center. On average, 72 percent of public sector investment in roads is carried out through the MoPIT and 28 percent through the MoFALD (ibid.).

At the national level, the Priority Investment Plan (PIP) provides a detailed strategy for the SRN, whereas the districts follow district transport master plans (DTMPs) for local roads. The 10-year PIP for 2007-2016, which was developed by the DoR, provides a list of recommendations and interventions in the form of new construction work, rehabilitation, upgrading, and maintenance. In particular, it recommends expanding the road network from 5,000 km to over 9,700 km of national highway and feeder roads by 2016. At the district level, the government has adopted a policy that each DDC should prepare a five-year DTMP and implement the development of road investments accordingly. The DTMPs provide an overview of the existing transport infrastructure situation and recommendations in relation to the resources available to the district. The preparation of the DTMP follows a series of steps that include technical mapping and grading as well as consultation meetings with stakeholders in order to advocate participation and ensure ownership. Most of the 75 districts have prepared five-year local road programs in coordination with the DoLIDAR, but a few still lack them owing to capacity constraints.

Whereas the planning process for strategic roads follows relatively transparent and proper procedures, local political pressures still heavily influence the planning process for public investment in local roads. Political influence injects itself into the local planning process via two routes:

(a) **The MoPIT, while responsible for the SRN, also oversees the implementation of local road and bridge projects.**[11] In fact, 20 percent of the MoPIT's budget covers local roads and more than 70 percent of the 400 bridge projects are locally demanded. Politicians from around the country typically try to influence DoR decision making, which has led to a skewing of the ministry's resources according to political influence. In an effort to remove itself from political influence and improve the planning mechanisms in the roads sector, the DoR began handing over local road projects to the DoLIDAR in 2012.

(b) **DTMP investment priorities are not adhered to at the district level.** The list of local roads and bridges actually included in the final budget does not typically match the DTMP. Local politicians and elites influence the local decision-making process of the DDCs and Municipalities, and are inclined to demand new road projects rather than the completion of ongoing projects. It is alleged that the central government has added new projects at the expense of projects prioritized in the DTMP. For example, the central government will often limit the amount of ongoing projects or cut projects entirely in order to stay within the aggregate threshold while meeting the demands of politicians. It is common practice to portion out the budget among many less important projects rather than gearing the budget towards a few important projects. This has resulted in local officials often saying, "projects never die in Nepal." The absence of locally elected representatives is cited as a reason for lack of community ownership and, consequently, poor governance.

5. Budget formulation

While budget formulation should proceed smoothly and finish on time to allow for timely review and debate before the start of the fiscal year, this process is in disarray in Nepal. This section details the formal guidelines and procedures that govern the budget preparation process, from revenue forecasting to submission of the final draft to Parliament. It also describes the reality of budget formulation in Nepal today. The main weaknesses highlighted include lack of clear ordering between planning and formulation, nonbinding expenditure ceilings, and severe delays in the transition from one phase to the next.

5.1 Forecasting and planning

Forecasts of fiscal aggregates are produced through a multi-institutional process led by the Resource Committee. This comprises the NPC vice chair and members, with support from Nepal Rastra Bank (NRB), the MoF, and the FCGO. The process starts in November when the Resource Committee reviews estimates of revenue and financing and sets the aggregate ceiling for the next fiscal year, commencing July 15. The Economic Affairs and Policy Analysis Division of the MoF prepares annual economic policy analysis and macroeconomic forecasts. The NRB also prepares a set of parallel forecasts, notably on growth rate estimates. The Resource Committee reviews both sets of projections and determines the parameters to include in the macro-fiscal framework.

Within this process, both the NRB Research Department and the MoF Revenue Department develop revenue estimates. A Revenue Consultative Committee (RCC) under the MoF provides recommendations on tax policy measures. These domestic revenue estimates represent trend analysis informed by specific information on sector developments, and take into account economic and monetary developments such as GDP growth, balance of payments, and inflation (IMF 2010a). They are compiled along with estimates of international grants and loans (based on commitments by development partners) and domestic borrowing forecasts to determine the resources available for the upcoming fiscal year.

Aggregate fiscal discipline is relatively sound, although the disaggregated underlying forecasts are less robust. Foreign financing has tended historically to be overestimated, despite increased conservatism in the MoF. In contrast, domestic revenue generation is typically underestimated. Reliance on the latter as a compensating mechanism for shortfalls in external financing is expected to become less feasible once the initial gains in measures to improve tax compliance have become locked in.

Formal multiyear fiscal planning was introduced in 2002 through an MTEF, prepared by the NPC in parallel with the 10th National Development Plan. The MTEF is updated annually on a rolling basis, with the first year setting the expenditure for the annual budget and with two forward years. The framework estimates the spending requirements needed to cover recurrent, development, and statutory expenditure. Resource availability to meet these expenditure needs is determined based on state revenues, foreign grants and loans, and domestic borrowing. Recently, the government agreed to transition to a Medium-Term Budget Framework (MTBF), but this has not yet been put into practice.

In moving from an MTEF to an MTBF, Nepal is following an established international trend. According to a recent study, the number of countries adopting the formal mechanisms of an MTBF increased from one to 42 between 1990 and 2008 (World Bank 2013). The same study found a relationship between fiscal discipline and more sophisticated medium-term frameworks, but no strong case for causality, as it is just as possible that governments with higher commitments to fiscal discipline are more likely to adopt these frameworks, rather than the other way around.

An MTBF by its nature (needing a strong top-down spending constraint) requires some of the institutional preconditions for centralized budget authority that Nepal currently does not have (see table 1 in section 3 above). At the same time, there is a strong and growing body of evidence that suggests the complexity of setting up an MTBF means its establishment is likely to fail in many developing countries, and to be a harmful diversion of resources better employed elsewhere. A recent World Bank study of PFM reforms in post-conflict countries found attempted MTEFs to be near-universal failures, although the sample size was quite small (Fritz et al. 2012; Hedger et al. 2012). Schiavo Campo (2009) labeled MTEFs "Potemkin villages" for producing elaborate facades at high transaction costs. MTEFs are often cited as examples of limited reforms serving form, not function, driven more by the needs of donors than by the functional requirements of governments (Andrews 2013; Krause 2013a).

MTEF implementation in Nepal has significant limitations compared with the aspirations cited by international agencies. On the positive side, the MTEF has helped ensure basic fiscal discipline and facilitated multiyear contracting. It has also supported the prioritization of investment projects (through according P1, P2, and P3 categories) and the introduction of sector ministry expenditure ceilings, at least in principle. However, four major challenges remain, according to government officials.

(a) **Lack of integration or substantial connection between the MTEF and annual budget preparation has led to a certain amount of parallel activity.** The annual budget itself remains a distinctly separate process, and the forward year estimates of the MTEF are not used as a basis for the annual estimates. In fact, the 2007/08 MTEF provided a flat 7 percent increase for the two forward years for all ministries and agencies. This shows the MTEF exercise has been formulaic, rather than building on policy decisions/priorities or matching revenue projections (see table 3).[12]
(b) **There is a consequent perception among some government officials that the MTEF requires significant work on top of, and disconnected to, the normal responsibilities for national planning or annual budgeting.**
(c) **There is no formal manual for MTEF preparation in Nepal, and no software has been developed to support the preparation process.** This makes it excessively time-consuming, and insufficiently standardized as a process.
(d) **The MTEF documents have not been produced on an annual basis since the introduction of the process in 2002/03.** There was a hiatus during the period of political uncertainty, with two further MTEFs prepared but not published, and then two years when no MTEF was prepared. The formal MTEF process was resumed again in 2011/12.

Table 3: MTEF vs. Red Book budget ceilings (for selected ministries)

	2007/08	**2008/09**	**2009/10**	**2007/08 to 2008/09**	**2008/09 to 2009/10**
	(NRs thousands)			*% change*	
MoPIT (formerly MPPW)					
Red Book budget	14,606,381	22,004,270	29,500,624	51%	34%
MTEF 2007/08	14,606,381	15,562,498	16,725,141	7%	7%
MoHP					
Red Book Budget	12,098,583	14,945,964	17,840,466	24%	19%
MTEF 2007/08	12,098,583	12,890,542	13,853,569	7%	7%

Note: MPPW = Ministry of Physical Planning and Works.
Source: GoN (2007; 2008; 2009; 2010c); FCGO.

Minimal links exist between the MTEF and planning and budgeting processes at sector level. Despite the setting of expenditure ceilings through the MTEF process, spending units reportedly routinely disregard these when they develop their budget requests (IMF 2012). In the absence of strategy or policy content in the MTEF documents, it is difficult to understand how the planning and the budget processes are integrated. The assessment of the PFM Steering Committee is that the government is not committed at a political level to a medium-term fiscal management perspective because short-term political imperatives dominate decision making and the benefits of a medium-term approach will accrue to future governments.

5.2 Budget preparation process

Budget preparation is governed by detailed formal guidelines and procedures, but the calendar is rarely adhered to in practice (table 4). The MoF is responsible for overseeing the budget process. By the end of January, it allocates total planned expenditure across line ministries and agencies. At the same time, it issues the Budget Preparation Directory and the Budget Operations Manual to line ministries, departments, divisions, and other government agencies, both of which are quite comprehensive. These documents prescribe the timetable, procedures, and forms to be completed, as well as their budget ceilings. Although these ceilings are presented as "approved," MoF staff commented that lower ceilings were often provided to the line ministries to leave room for negotiations later. The concerned ministries then send budget ceilings along with sector guidelines to the departments, district offices, and local bodies under their mandate. Subject to the ceiling and guidelines prepared by each ministry and the MoF, district-level offices prepare their budget and send it up to the concerned department. The departments then consolidate these and prepare their budget and send it to the ministry, which should then submit the request to the NPC and the MoF. According to the Budget Circular, the line ministries are required to submit their budgets to the MoF by the end of March, but this often does not occur until May. As noted above, the lack of strategic plans in most sectors renders line ministry budgets highly supply-driven.

Table 4: Budget calendar in Nepal

Activity	**Timeline**		**Institutions**
	Actual	**Proposed**	
Budget formulation			
Resource Committee estimates domestic resources, foreign aid, and loans, then proposes national budget ceiling	December-January	By end November	NPC, MoF
MoF issues Budget Manual and sectoral budget ceilings to each line ministry	February	Mid-December	MoF
Line ministries send thresholds to subordinate departments, district offices, and projects	February	End-December	Line ministries
Line ministries consolidate and submit draft budget proposals to MoF	May	February-March	Line ministries, MoF
Discussions/negotiations on policies, programs, and budget of central and district levels	May-June	March-April	MoF, line ministries
Preparation of final draft budget	July	Mid-May	MoF
Budget execution			
Approval of Appropriation Law (to authorize 1/3 budget)	Mid to late July	July 15	Parliament
Authorization letters (for 1/3 budget) sent to FCGO, line ministries, departments, divisions, and local bodies	Mid to late July	By July 30	MoF
Budget release for first trimester	Mid to late July	By July 30	Line ministries, departments, FCGO, DTCOs
Red Book approval	August to February	July 15	Parliament
Work plan approval process	3 to 4 months into FY	Not specified	Line ministries, departments, NPC
Procurement and contracting	2nd to 3rd trimester	All FY (start 1st trimester)	Line ministries, departments, PPMO
New capital project implementation	2nd to 3rd trimester	All FY (start 1st trimester)	Line ministries, departments
Progress reports	Ad hoc	By 15th of every 2nd month	Line ministries, MoF
Midterm evaluation	February-March	By end February	MoF
Final evaluation of budget	January-February	By December 15	MoF, FCGO

Source: Author's compilation based on Budget Circular and discussions with the MoF.

MoF analysis of budget submissions and negotiations with line ministries is hindered by partial computerization and excessive line item detail. The MoF Budget Division and the NPC evaluate spending requests and conduct budget negotiations up to the beginning of the fiscal year, although the Budget Circular specifies March and April. Program and sector discussions on the budget estimates are held between the MoF/NPC and the concerned ministry or agency to reconcile proposals within the constraints imposed by the aggregate ceiling for the central government. This phase is very time-consuming; one official estimated that 400 budget line items were discussed with each ministry. A further constraint is that the line ministry budgets are submitted to the Budget Division in hard copy format (based on Excel or Oracle), and must be inputted manually into the computerized Budget Management Information System used by the MoF.

Expenditure ceilings have yet to become a credible constraint, and this undermines efforts to link budget allocations to policy priorities. The bottom-up approach of budgeting creates problems when reconciling with top-down ceilings. According to the MoF, differences between request estimates and targets are usually very large. Spending units regularly ignore expenditure ceilings and submit requests two to three times in excess of their ceiling. Top-down constraints are therefore not formally binding in the budget preparation process but rather serve as the first bid. Forward expenditure estimates in prior year budget documents are not used as the starting point for new spending ceilings and allocations, so spending units develop entirely new estimates each year (IMF 2012). Expectation of flexibility and discretion during budget execution then encourages ministries to overestimate their expenditure requirements during budget formulation to create padding for subsequent virement and reallocation.

The MoF compiles the negotiated budget requests at the end of June and prepares the draft annual budget. At the same time, the Resource Committee decides the final set of macroeconomic forecasts, and corresponding adjustments are made to the overall revenue and expenditure estimates. According to the MoF, this adjustment can be as much as NRs 10 billion, which is divided among line ministries with reference to policy priorities. Once the MoF finalizes the programs and allocations, the finance minister introduces the final draft budget to Parliament through his/her annual budget speech. This typically occurs during the first or second week of July. On the same day, the draft Finance Bill and the draft Appropriation Bill are presented to the Cabinet and Parliament.

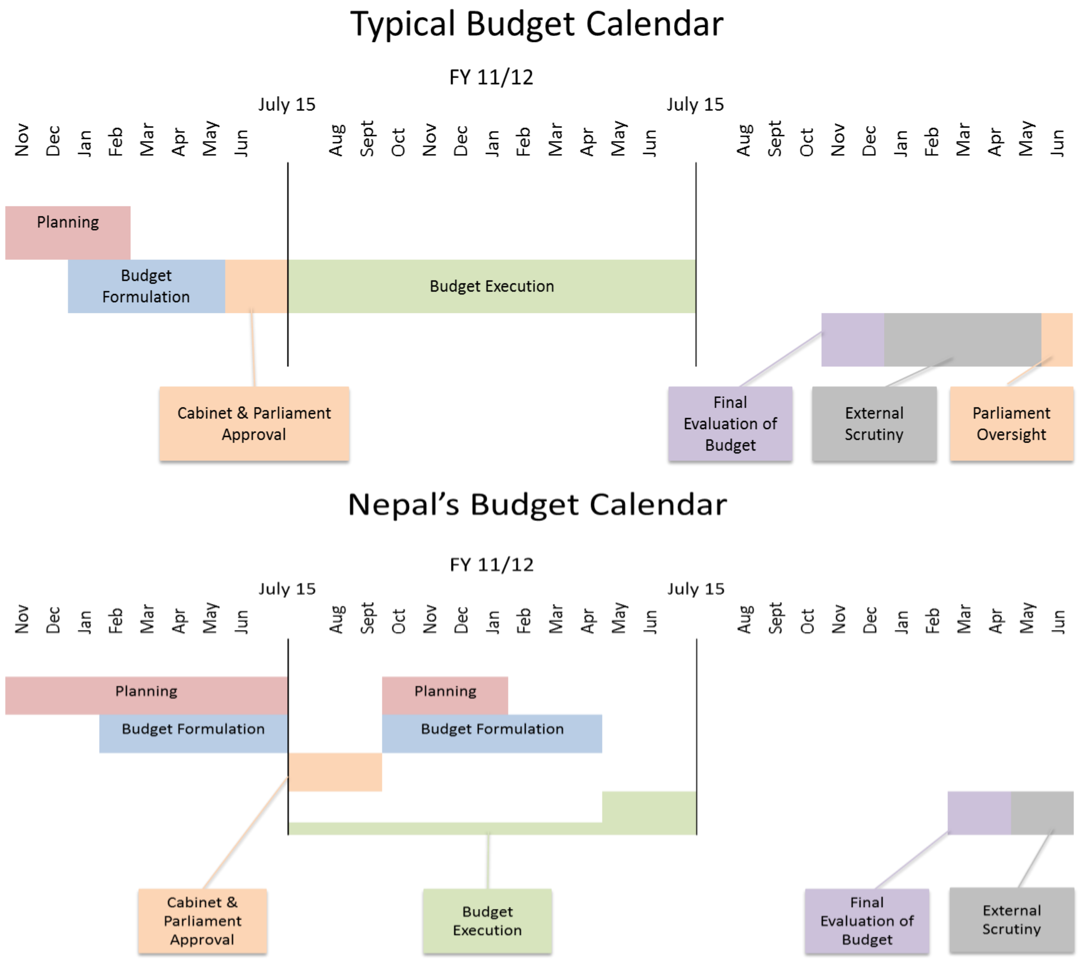
Table 5: Budget approval dates

Fiscal year	Date budget submitted to Parliament	Date budget approved by Parliament
2006/07	July 12, 2006	August 23, 2006
2007/08	July 12, 2007	August 8, 2007
2008/09	July 14, 2008	November 1, 2008
2009/10	July 13, 2009	November 10, 2009
2010/11	July 12, 2010	February 8, 2011
2011/12	July 15, 2011	September 20, 2011
2012/13	July 15, 2012	April 9, 2013

Sources: IMF (2012); World Bank interview.

While a clear annual budget calendar is specified in the manual, there are often delays. In recent years, the draft budget has been submitted to Parliament during the last weeks or days before 15 July. This is too late to allow for timely review and budgetary debate before the start of the fiscal year. Furthermore, the CA did not pass the final budget until November in both 2008 and 2009, and not until February 2011 for the 2010/11 fiscal year. These delays are apparently politically motivated, as no changes are made to the budget submitted to Parliament. In fact, the Red Book is a mirror image of the final draft budget prepared by the MoF and submitted to the CA. These delays in appropriation cause subsequent challenges for budget execution and the need to use exceptional procedures to authorize expenditure at the start of the fiscal year.

Figure 11: Comparison of Nepal with a "typical" budget calendar



Source: Authors' compilation.

Overall, the budget calendar in Nepal is in disarray (see figure 11). Whereas in a typical country the calendar would be organized around specifically delineated phases around a set period of budget execution (traditionally and most commonly for one year), the practice in Nepal is that phases encroach on one another and create overlapping patterns of simultaneous and disconnected activities that severely hamper the ability of spending units to effectively and efficiently execute the budget.

While delays in the budget calendar are common in many countries, the degree and quality in Nepal are quite unique. In other countries, for instance, there might be delays in approving the budget, so the budget year may not start with an approved budget. Many countries have contingency mechanisms for such cases. In Nepal, however, the budget is with some frequency submitted only days before the start of the fiscal year. In comparison, in a survey of 97 countries worldwide in 2008, the OECD found that, on average, central budget offices started the budget process nine months before the start of the fiscal year. Budget negotiations with spending ministries were started on average 5.5 months before the fiscal year, and were concluded 3.5 months before. More than 81 percent of countries submitted the budget to the legislature at least two months before the start of the fiscal year. The same survey also found that, in 55 percent of countries, the legislature approves the budget at least one month before the start of the fiscal year (OECD 2008). It is treacherous to compare the situation in any one country to a relatively abstract international average, but the overwhelming impression from this international comparison is that Nepal's disorganized budget calendar differs significantly from the situation elsewhere.

6. Budget execution

This section examines the various budget implementation processes that typically occur during the fiscal year. In particular, it focuses on budget execution, cash management and payment controls, aggregate expenditure patterns and execution rates, in-year budget revisions and reallocation, debt management, and procurement of goods and services. Each of these subsections addresses the strengths and weaknesses of PFM. The second part of this section describes challenges facing line ministries and local bodies during budget execution from the perspective of the health and roads sectors.

6.1 Institutions and processes

More than 4,000 spending units carry out budget execution, making it relatively complex. After the budget is approved for the fiscal year, the MoF issues letters of authorization to confirm the budget allocations to the line ministries according to the Red Book, which in turn, issue authorizations to their subsidiary spending units. These letters include the budget statement, which indicates the budget heads, subheads and amounts, and details of financing sources for projects in the development budget (GoN 1999). Copies of the budget statements and authorization letters are also sent to the OAG and the FCGO. The FCGO also issues authorizations to the DTCOs in respect of items under their control.

Appropriation of the annual budget is often delayed and interim authorizations are required. If the budget is not passed at the beginning of the fiscal year, Parliament can approve the "advanced law," which allows the spending units an advance budget of up to one-third of the preceding year's expenditure incurred (interim constitution Art. 96). As such, letters of authorization are issued for only one-third of last year's expenditures to fund ongoing projects and programs under the same budget heads according to the preceding fiscal year, but not for any new programs. Supplementary letters of authorization are then issued once Parliament approves the final budget.

Despite the formal annual budget calendar, there is no hard deadline in practice for inclusion of new capital projects. Line ministries, departments, and local bodies complain the NPC and the MoF change the budget at the last minute by including programs or projects not previously planned for in their budgets. Typically, political pressures drive new projects included after the formal budget preparation stage. In the current environment, individual political party members and parliamentarians have more room to approach the executive directly to have a road or water supply project included in the budget.

Authorization for development projects remains highly centralized and bureaucratic, causing major delays in project implementation. While execution of salary payments may start on issue of the authorization letter by the MoF, line ministries and the NPC must further assess other expenditures – notably from the development budget – before project implementation can start. After the MoF and NPC have held budget discussions with line ministries and have agreed to the spending amounts for projects and agencies, the Red Book often contains revisions. Typically, the line ministries become aware of the changes only after the budget is approved. The departments, division offices, and local bodies must then readjust their work programs, rewrite project implementation plans, and develop new procurement plans. These revised work plans are again sent to the respective line ministries and the NPC (if categorized as P1, which is over 85 percent of all projects) for approval. Work plans are often rejected and there is a need for further modifications between the NPC, line ministries, and spending units. This approval process can take an additional three to four months, but has even rolled into the last trimester, which results in severe implementation delays. Furthermore, senior officials are required to sign each of these documents as they trickle up and down the chain of command, which is highly time-inefficient.

6.1.1 Cash management and payment controls

Budget releases are tightly controlled by the FCGO to manage cash flow, and there are often delays. For government-funded expenditures, the FCGO and DTCOs control execution by releasing the initial budget allotment for two months to spending units once the budget has been approved (or the one-third appropriation bill has been passed). Subsequent releases are made on a rolling monthly or trimester basis according to authorized allotments, but only after statements of expenditure are submitted for the prior periods. Although the budget system law requires release of funds to ministries and districts within 15 days, delays are common. The main cause is the slow and convoluted authorization process for work plans, which requires NPC and MoF approval. Some officials also report delays in ministries producing the procurement plans needed to trigger budget releases, arising from lack of capacity and guidance. For development partner-funded projects, funds are released either on a reimbursement basis (for loan-financed projects and some grants and bilateral projects) or on a pre-funding basis (whereby donors make deposits in advance).

Implementation of a TSA has improved the budget execution process by enabling real-time checks for payment against expenditure transactions. The TSA system has been rolled out to 60 out of 75 districts as of September 2012. Around 95 percent of government expenditures and 98 percent of government revenue are covered. Each DTCO within TSA districts has only four main bank accounts: recurrent expenditures, capital expenditures, revenue, and deposits. There are fewer than 300 separate bank accounts in total, compared with over 14,000 spending unit accounts prior to implementation of the TSA system. For spending units located in TSA districts, payment requests are brought to the DTCO, which then enters the data in the TSA system. Given automatic controls in the District Expenditure Control System, the DTCO can process checks only for amounts within the limit of the released budget.

Box 3: Treasury Single Account introduction

Nepal began implementation of the TSA in 2009/10 with the assistance of the IMF in order to ensure transparency and accountability in spending of revenue and foreign aid. With more than 4,000 spending units and 14,000 bank accounts across the 75 districts, the central government faced weak cash management and information control. The government has been implementing the TSA with support from the MDTF. Since its introduction, the TSA has improved budget execution by facilitating real-time management and monitoring of public expenditures. Unified bank accounts ensure effective control over aggregate government cash balances, allowing the MoF and the FCGO a consolidated view of cash resources at any given time.

In the TSA system, government transactions are done through a single or limited set of (linked) bank accounts operated by the DTCOs. Each DTCO within TSA districts has only four main bank accounts: recurrent expenditures, capital expenditures, revenue, and deposits. To date, more than 12,500 of 14,000 bank accounts have been closed. The closure of spending unit accounts and the consolidation of all financial resources in a TSA controlled by the FCGO has led to significant reduction in idle balances and borrowing costs. In fact, compared with 2009/10, the government of Nepal paid approximately NRs 20 million less to the NRB in bank commission.

The new system has been rolled out in 60 of the 75 districts, covering more than 97 percent of the country's total revenue and 95 percent of public expenditures. In 2009/10, the TSA system was piloted in two districts; in 2010/11, it was rolled out in 20 more districts; and in 2011/12, it was further implemented in 38 districts. The remaining 15 districts will be covered in 2012/13, with full functionality of the TSA system expected by 2014.

Similar to other recent reform efforts, the political environment has made implementation of the TSA difficult. With four caretaker governments in the past three years, and civil servants rotating every two years, capacity to implement the TSA properly and in a timely manner has been limited. During the pilot of the TSA, there was some resistance from treasury staff and spending units, who were concerned that they would lose or see changes in authority or responsibility. Through workshops and training, the FCGO was able to clarify many issues and convince them that they would see changes only in the system process. In fact, the TSA has acted as a catalyst for change, with the central finance agencies pushing through other changes in PFM.

There are many challenges threatening the sustainability of the program that must be addressed. First is motivation of and incentives for treasury staff. The government piloted a performance-based incentive program, but this was removed shortly after its introduction. Second is poor power supply and load shedding of up to 14 hours a day. While backup generators have been provided to many DTCOs, this continues to be a large complaint across many districts. Third are weak network and Internet connections. Fourth is continued interface between the DTCOs, spending units, and banks, since e-payments are not possible owing to the lack of system and digital signatures.

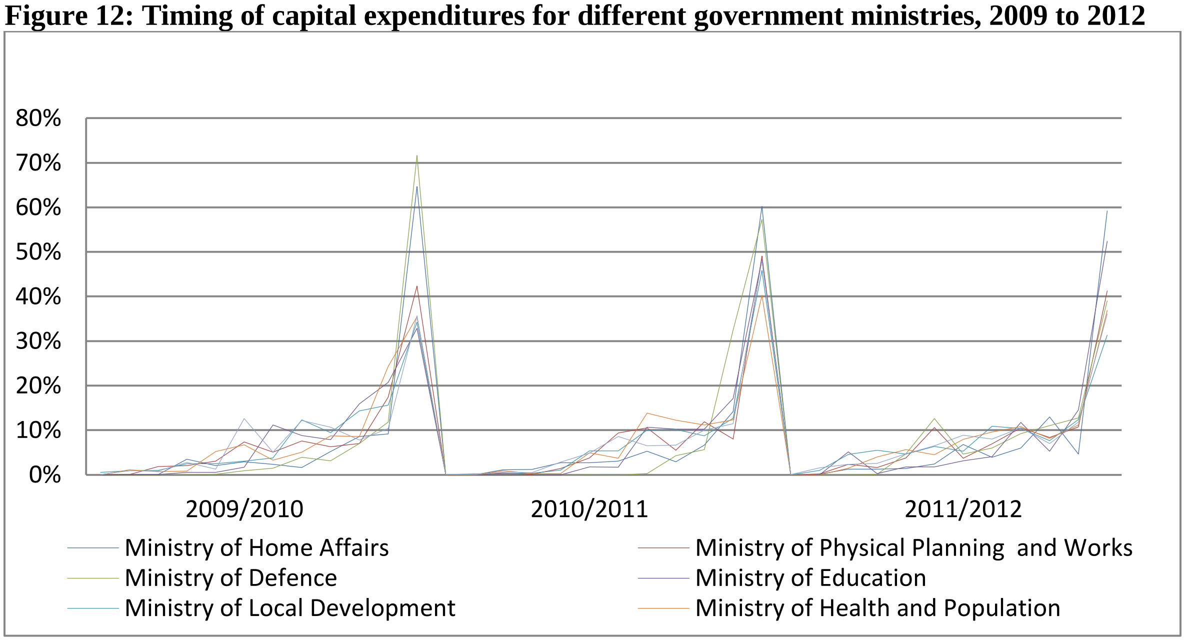
Source: Authors' compilation.

The government has also made strides in its fiscal accounting methods. Recently, it has updated its Chart of Accounts to comply with the Government Finance Statistics Manual (GFSM) classification for the 2011/12 budget. However, the budget still lacks detailed functional and programmatic coding. While care should be taken not to make the economic classification too detailed (which could lead to rigidity in budget execution), the coding should go down at least to the sub-functional level and should be linked to policy priorities. Furthermore, appropriate accounting codes for expenditures are not practiced at the district level. While central-level road expenditure is properly classified as capital expenditure and follows appropriate Chart of Accounts coding, much of district-level capital expenditure (68 percent) is accounted for as transfers, which falls under the recurrent budget.

6.1.2 Aggregate expenditure patterns and execution rates

The pattern of actual expenditure is skewed heavily towards the end of the fiscal year (figure 12). The expenditure pattern for the last three fiscal years shows more than half of total expenditures occurred in the last trimester, with more than 70 percent of the capital budget spent in the last four months. It has typically taken two trimesters before projects get off the ground, with a consequent rush to spend in the last trimester of the year, since unspent budget lapses at the end of the fiscal year. Late budget approval, cumbersome budget implementation procedures, complex procurement processes, and delays in reporting all contribute. The minister of finance announced measures in the 2010 Budget to reduce bunching by capping expenditures to 40 percent of the total in the final trimester and to 20 percent in the final month. This initiative had little impact on the timing of expenditures in the 2011/12 fiscal year, however, which also saw severe bunching in the last few months.

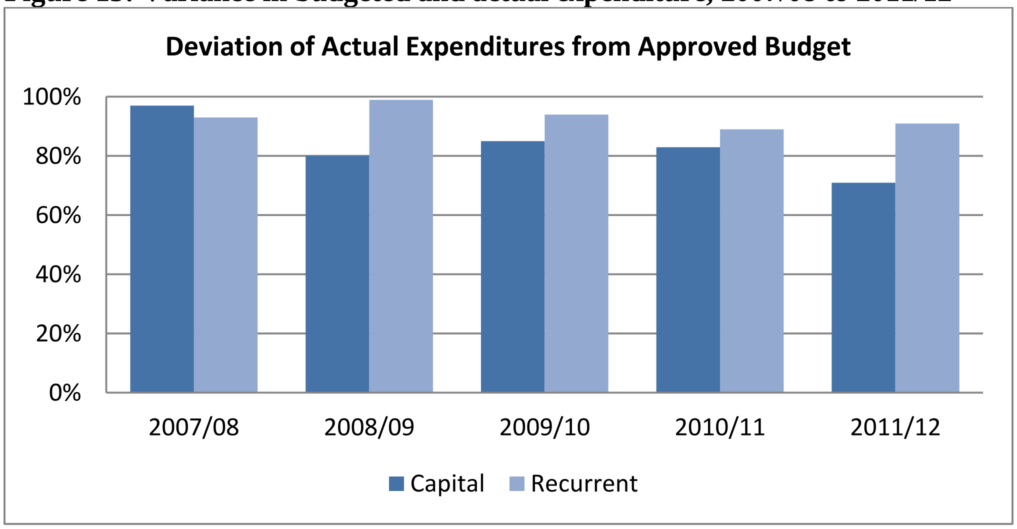
Figure 12: Timing of capital expenditures for different government ministries, 2009 to 2012



Source: FCGO data.

Under-execution of capital expenditure is a significant challenge to budget credibility and program delivery (figure 13). Domestic capital expenditure is estimated at $750 million per year (ADB and World Bank 2012), relative to total domestic revenue of approximately $2.2 billion and total public spending of $3 billion. In the past four fiscal years, actual capital expenditure has averaged only 80 percent of that planned in the budget. According to line ministries and spending units, the main reason for under-execution is late fund release owing to political interference in the budget formulation process and a complex approval process. The NPC claims there are execution problems for foreign-financed projects, which represent approximately 50 percent of the capital budget. The reasons given are complex reimbursement procedures, low absorption capacity, and the absence of counterpart funds (IMF 2010a).

Figure 13: Variance in budgeted and actual expenditure, 2007/08 to 2011/12



Source: FCGO data.

6.1.3 In-year budget revisions and reallocation

Virement rules are extremely flexible in Nepal and, as a result, a large amount of re-budgeting takes place throughout the year. There are specific restrictions, such as no reallocation between capital and current budgets and no reallocation from wages within the current budget. The MoF must approve virement from one budget heading to another, or reallocation within a budget head greater than 25 percent. However, line ministries have considerable scope to modify their originally approved budget. There is a virement cap equal to 25 percent on any particular line item for line ministries and 10 percent for subordinate spending units. In other words, line ministries may unilaterally approve transfers *within* a budget heading of up to 25 percent of the value of the budget line.

The high level of virement during budget execution ensures flexibility but weakens the credibility of the budget preparation process. Virement transactions are recorded by the FCGO and published in the annual report. However, they are reported only on the basis of volume, not with regard to frequency. Furthermore, virements within a budget head cannot be tracked electronically, as the new TSA system records expenditures only by budget head (e.g., “Bridges”). Therefore, it is assumed that more virements take place than are actually recorded in the system. The consolidated financial statement shows that total virements were equal to 26.5 percent of the 2008/09 budget, 12.3 percent of the 2009/10 budget, and 9.95 percent of the 2010/11 budget.[13] Officials interviewed noted that in-year reallocation at this volume served to undermine the entire budget preparation process. Line ministries know they have power, *ex post*, to reallocate, and thus are less concerned with getting original budget estimates correct during the budget formulation process.

Although there do seem to be elaborate rules and regulations guiding the budget execution and revision process, there is no real control or management of the budget once it has been approved. There is no central-level monitoring mechanism to track changes made to the budget, even for approved virements within budget heads for spending units and DTCOs. The team was informed that neither the Budget Division at the MoF nor the FCGO kept budget allocations updated. After the budget is approved there is no further control, and line agencies can incur spending within the budget envelope with generous powers of virement. The central agencies monitor only specific categories of spending at an aggregate level (e.g., "Bridge Construction"). For example, although the NPC has over 80 priority projects that it monitors regularly, there is no other centralized management of spending commitments entered into by the line ministries. Furthermore, actual spending levels are often not reported against revised amounts, resulting in inaccurate information on spending patterns.

6.1.4 Debt management

Although debt management is not a critical issue for a government in terms of its current debt level, there is scope to improve technical capacities and institutional arrangements. Nepal's level of public indebtedness is relatively low, at 32 percent of GDP. However, debt management is weak because it is split functionally across different agencies. Added to weaknesses in accurately forecasting revenues and projecting external development financing, this creates two notable risks. First, the fiscal planning function may not capture the fiscal sustainability of policy measures and public sector borrowing. Second, the presence of public sector borrowing and systematic under-spending of the capital budget may lead to weak allocation decisions and cash management.

6.1.5 Procurement and contracting of goods and services

The government reformed the legal and institutional setup of public procurement processes in 2007. These reforms included the adoption of a new Public Procurement Act (PPA) and associated regulations, the decentralization of procurement, and the creation of the PPMO under the Prime Minister's Office. Prior to this, procurement was regulated under the Financial Act and Regulations, with no designated central oversight apart from the general control role played by the FCGO.[14] Two further reform measures, announced in the 2010 budget, were multiyear contracting for priority projects and multi-location tender submissions (including e-tendering). These have supported improvements in budget predictability and procurement transparency.

The introduction of electronic tender submissions for government contracts has started to improve the integrity and value for money of public procurement. Since the PPA was passed in 2007, there have been improvements in the openness and fairness of the competitive tendering process, most notably through the introduction of e-bidding and a concomitant reduction in intimidation and violence. According to officials interviewed, registration now covers 146 firms, and there have been 200-300 e-tenders over the past 1.5 years. In the roads sector, procurement is required for construction projects exceeding NRs 150,000. Several DROs use the e-bidding system regardless of the size of the contract as a best practice effort to increase transparency. It is also the case that several small road projects are often packaged together to raise the value of the work to contract size. Prior to the introduction of e-bidding, reports were common of rival contractors and political parties hiring people to prevent bidders from entering government buildings to submit their tenders.

In spite of progress with tendering procedures, challenges remain in public procurement integrity. First, procurement at local levels has been subject to political "capture" within the more general distortions of public sector governance. These relate principally to the APM and the weakness or absence of formal accountability mechanisms. Local procurement is used to fund contractors connected to the dominant political parties in a particular locality, with the strong perception that financial rents flow back to provide funding for party machines. Second, collusion and intimidation in the procurement process are still seen as significant problems, even if the exact scale and prevalence are difficult to estimate.

Technical procurement challenges also hamper efforts to improve value for money. First, procurement planning and tendering processes are often delayed, exacerbating the bunching of expenditures towards the end of the fiscal year. Second, local private sector firms complain that the provisions of the 2007 PPA are too onerous. Third, there is reported to be insufficient capacity for the estimation of project costs (e.g. consulting costs) and inadequate provision for negotiation in the procurement of large-scale goods (e.g., aircraft procurement).

Related to these technical factors, the law and regulations intentionally favor domestic companies. The Public Procurement Regulations state, "In procuring goods by selecting any method as referred to in these Regulations, a Public Entity shall have to procure Nepali goods even if the price of the goods produced in Nepal is higher by up to ten percent than the foreign goods."

User committees are utilized for the implementation of small capital projects at the district level, but weak controls and political influences have resulted in fund leakages and compromised project quality. To promote local resources, the PPA gives construction authority to user committees (UCs) for up to NRs 6 million, which is reportedly a high threshold. Many local officials reported that UCs were awarded a contract for the maximum threshold before subcontracting the project for a lower amount, receiving a "kick-back" in exchange. Furthermore, several UCs can be involved in the construction of one road, with each managing the construction of the section of road that falls within its community.

6.2 Sectoral and local budget execution: roads and health

6.2.1 Health sector

The budget execution rate for the MoHP was 76 percent in 2010/11 and 81 percent in 2011/12, much lower than the national average of 87 percent in both years. Spending distribution is very uneven over the year, with more than half (55 percent) of the annual budget spent during the third trimester in 2011/12. Only 5 percent of the total budget was spent in the first trimester for the development budget, and only 28 percent was spent in the second trimester for development programs. According to spending units in the health sector, this was because most funds for the DHOs were not received until the third trimester. There are regional disparities in health spending, with the Central region receiving the majority share. More than 90 percent of drugs and three-quarters of the capital budget are spent in the Central region. Per capita budget allocations are high in the mountainous Far-Western, Mid-Western and Western regions. Tarai districts receive less than NRs 300 per capita, compared with more than NRs 1,200 per capita in Mountain districts (MoHP 2012).

Efforts to computerize district-level work planning and budgeting face some challenges. The MoHP implemented an IT-based system for the Annual Work Program Budget (AWPB) in 2009, to automate the planning and budget process down to the district level. The DHOs have been criticized for not being able to absorb funding, but, in three districts visited, field discussion indicated they were not given sufficient time to follow the necessary processes for accountable expenditure implementation. In particular, it was reported that approval of the AWPB and the accompanying letters of authorization often stretched to the second trimester of the fiscal year, resulting in the bunching-up of activities in the third trimester and inefficient spending patterns. Procurement plans are not a part of the AWPB; rather, the tenders are prepared after budget approval, which slows the process even further.

The DHOs shift resources between budget heads as a temporary measure to mitigate the effects of late budget releases on time-sensitive programs. It was alleged that programs such as leprosy were quite often conducted in accordance with seasonal deadlines, even though the budgets had not been released. In order to carry out projects without funding, the DHOs will move resources around from one program to another; once the budget is released, they move the money back again.

6.2.2 Roads sector

Budget execution in the roads sector is characterized by substantial regional irregularity. More than half of all roads sector investment (53 percent) between 2005 and 2010 went to the Central region, compared with 8 percent to the Far-Western region. In per capita terms, the Eastern region's per capita roads sector investment averages NRs 200, whereas that of the Central region averages NRs 553 (World Bank 2011a).

Weak correspondence between cost estimates and budget allocations in the roads sector compromises program implementation. During field visits, it was often stated that amounts allocated per road or bridge in the Red Book did not equate to cost estimates prepared by local bodies or departments. This is because, rather than finishing a project, the budget is spread thin to include politically motivated projects and accommodate a multitude of requests for funding each year. As a result, the DRO must negotiate the length of the road in order to stay within the budget, resulting in piecemeal construction year after year.

Weak procurement and contracting processes have compromised the quality of project implementation in the roads sector.[15] First, there are no national norms for the costing of capital projects. Unit rates for salaries, concrete, etc., are determined by each of the 75 DDCs together with private sector actors, who intentionally inflate the estimates so they can bid lower and save costs later. Second, there is limited competition during the tendering process. During field visits, it was reported that one person might own several companies and submit multiple bids to the same road construction project. The 2012/13 Audit Report also notes that the value of contracts awarded was only 6 percent higher than the estimated cost, and only 40 percent of potential bidders who purchased tender documents actually filled and returned them. Third, to reduce costs, contractors often use materials (e.g., gravel) owned by the state instead of purchasing them on the market. This compromises the integrity of the system and the quality of the construction. Fourth, it is common practice for contractors at the district level to work without payment under the assumption that they will be paid in the last trimester. As a result of delays in budget approval by the central government, local bodies have had to build a rapport with private contractors in their community to ensure continuity of projects. In some cases, the DRO or local bodies will make a contract for an entire bridge but the allocated budget is for only part of the bridge, and both the government and private contractors are unsure when the balance will be received.

There are severe delays in the construction of capital projects such as roads. In fact, the 2012/13 Audit Report notes that contracts worth NRs 25 billion out of a total amount of 38 billion were not awarded until the second and third trimesters. As a result, 87 percent of the contracts awarded were eventually provided extensions into the next fiscal year. For example, construction of small bridges should take two years, but typically takes at least three. Although the construction of bridges longer than 100 meters should take two to three years, they usually remain on the budget for more than four years.

7. Accounting, reporting, and audit

This final section of the analysis of the PFM system and processes involves accounting, reporting, and audit. It first discusses in-year budget monitoring and reporting, annual reporting and financial statements, and arrears. It focuses on the roles of the central finance agencies and line ministries, and the effectiveness of such processes. It follows this with an analysis of internal control and audit, external audit, and parliamentary scrutiny and audit follow-up. It describes the formal roles and arrangements agencies as well as the problems and weaknesses facing the government that hinder the proper performance of PFM.

7.1 In-year budget monitoring and reporting

Reporting and monitoring of financial information on budget execution is the responsibility of the MoF and the FCGO. The line ministries are responsible for maintaining the central accounts of all resources received and spent, in cash and in kind. Each line ministry should receive reports from its spending units on a monthly, trimester, and annual basis, according to regulations. However, in-year accounting and reporting are viewed as ineffective, as spending units' reports are received with delays and line ministries often do not compile them until the end of the fiscal year. The line ministries, in turn, are expected to provide progress reports every two months to the MoF and the NPC. If the budget is not passed at the beginning of the fiscal year, these progress reports are compared with the one-third budget until the final budget is approved, at which time the progress reports are then compared with the Red Book. The MoF and the NPC conduct a joint midterm and annual evaluation of the budget.

Line ministries and the Budget Division of the MoF monitor financial transactions by relying on figures provided by the FCGO. The MoF monitors spending only at the line ministry aggregate level. After the budget is approved there is weak control, and line ministries can determine spending within the budget envelope, subject to virement rules. Although the FCGO and DTCOs hold budget execution data by budget entity, line item, and functional classification, there is little central monitoring of budget execution on a monthly basis. The FCGO produces in-year budget execution reports for internal purposes only, and budget execution data are typically consolidated only for the midyear and annual budget reviews.

Budget reporting roles and processes for local bodies' flows appear well defined, but complexity and delays work against effectiveness. At the local level, financial reporting on budget execution starts at the VDC level. All VDCs should report to their DDC on a monthly, quarterly, and annual basis, according to regulations. The DDCs then consolidate information on the VDCs' expenditure of grants and submit this to the MoFALD together with a report on their own budget execution. Municipalities send their reports on municipal budget execution directly to the MoFALD. The MoFALD then prepares a consolidated report on budget execution for all local bodies and submits this to the MoF and the FCGO. In practice, reports prepared by the DDCs, VDCs, and Municipalities are neither timely nor comprehensive, and often do not follow the same expenditure classification as the central government (GoN 2008). Similarly, line offices for health (DHOs) and roads (DROs) should report to their respective department or line ministry on a regular basis, including both actual spending levels and project implementation progress.

The government reports a low level of arrears, but several international actors stated that this remained a problem. According to recent FCGO Consolidated Financial Statements, arrears have averaged around 2 to 3 percent of the total budget. However, the PEFA 2008 assessment identified arrears of payment as a problem, albeit noting that it was difficult to quantify the actual level of arrears. Published amounts incorporate only expenditures actually incurred, and do not include payment arrears –

such as reimbursements – due to the banks at the end of the fiscal year from pension payments made on behalf of the government. The IMF has also reported a lack of monitoring or control of commitments of arrears in the system.

7.2 Annual reporting and financial statements

Preparation of government accounts and financial reporting against the consolidated fund are the responsibility primarily of the FCGO. The FCGO is responsible for preparing annual financial statements of cash releases and expenditures incurred, as well as consolidated financial statements incorporating cash, direct payments, and loans and grants. By November, the FCGO collects the financial statements online for the 60 districts connected through the TSA system. Financial information from the remaining 15 DTCOs is collected manually (via floppy disks, fax, or dial-up modem transfers). All line ministries are required to submit their annual financial statements directly to the FCGO by November each year.

The FCGO prepares a consolidated annual financial statement for submission to the OAG. While there is no legal regulation stipulating a firm deadline, the FCGO has submitted consolidated annual financial statements to the OAG within six months of the end of the fiscal year (by the end of January) for the past several years. Part of the delay is attributed to the fact that the financial statements are not received from most of the ministries within the designated time period, and supporting statements are rarely attached.

7.3 Internal control and audit

The FCGO manages the government's internal audit function, but there is insufficient separation of responsibilities from the treasury function. The FCGO is responsible for coordinating and monitoring the internal audit function at the local level. Rather than being independent (e.g., a fully autonomous body or a separate division within the FCGO), the Internal Audit Section of the FCGO is located within the Monitoring and Evaluation Division. Internal audit is effectively decentralized to the districts and performed by DTCOs across the country. However, DTCO staff conduct internal audit as a secondary activity alongside their other main tasks in executing the budget of the spending units, creating a conflict of interest through their dual roles of both treasury and internal audit.

The LSGA establishes internal audit requirements for local government entities. According to the Act, DDCs are required to establish internal audit sections, headed by an internal auditor and support staff. The Internal Audit Section is tasked with overseeing the audits of the DDF and the devolved programs on a monthly basis, and those of the VDCs on an annual basis. The DDC's internal auditors carry out internal audits of the VDCs directly within four months of the fiscal year end. On occasion, the auditor(s) may conduct onsite visits to projects for the final audit.

Internal audit at district level is focused heavily on compliance. The 75 DTCOs conduct compliance-based internal audits of both expenditures and revenue of their spending units every trimester. The audits should be conducted within two months of the end of each trimester. According to DTCO staff, the process of internal audit typically involves accountants of the DTCO comparing the approved budget headings with the monthly reports submitted by the spending units and the various supporting documents (e.g., supplier invoices) held by the spending units.

The main focus of internal audit is identifying individual irregularities rather than addressing systematic issues. Any irregularities and recommendations are then submitted to the chief officer at the DTCO, who compiles and submits an internal audit report to the FCGO every trimester or year. At the same time, internal audit reports are submitted to the concerned department or ministry of each spending unit. Subsequent audits are performed to check whether irregularities are being addressed. Irregularities reported by the DTCOs each trimester should be resolved before the start of the external audit performed by the OAG. Those that are not resolved are included in the annual internal audit report submitted by the DTCO to the FCGO. The FCGO, in turn, produces a consolidated annual internal audit report that is submitted to the finance secretary and the OAG. In fiscal year 2010/11, the FCGO reported irregular expenditures totaling only 1.33 percent of total expenditures across all 75 districts in Nepal (GoN 2012b).

Discussions with the FCGO and DTCOs suggest that the internal audit system may not be effective in practice, but the FCGO recognizes the need for reform. First, DTCO staff conduct internal audits as a secondary activity alongside their other main tasks in executing the budget of the spending units. Accounting officials in the FCGO and DTCOs risk conflicts of interest through their dual roles coordinating internal audits and overseeing the accounting and treasury operations of the government. Second, transfers within the accounting cadre from spending units to the DTCOs, and vice versa, are common. An accountant currently responsible for auditing a spending unit may have previously worked in that same spending unit. Third, the internal auditors do not use professional audit methods or follow a risk-based approach. Rather, the focus of internal audits is solely compliance-based, and intended to identify irregularities of individual accounts and transactions. Fourth, both the FCGO and the OAG have noted that capacity is a major constraint, given the lack of skilled human resources and incentives for carrying out proper internal audits. According to staff interviewed in one DTCO, finance officials receive insufficient guidance and training from the FCGO. However, the FCGO has produced a concept paper on strengthening the internal audit system, which includes a proposal to separate the internal audit function from the treasury function.

7.4 External audit

The OAG is responsible for the final annual audit of all constitutional bodies and agencies of the executive arm of government, and it also covers a limited number of performance audits. The audits the OAG performs are primarily compliance-based, with a requirement to cover the transactions of more than 4,000 spending units down to the DDC level. Based on discussions with the OAG, the institution is gradually shifting towards a risk-based approach in order to improve efficiency, given its large mandate and limited number of resources. The OAG conducts performance-based audits each year on 25 selected programs or offices. These audits are reported as part of the final audit report.

Although the audit law does not specify a deadline for the audit report to be submitted to Parliament, the final audit is generally completed within nine months of the fiscal year end. The FCGO must submit a financial statement for the consolidated fund and accounts of appropriation, revenue, deposit, foreign aid, and loans and investment to the OAG within six months of the fiscal year end. The OAG then takes typically between six and nine months to perform the final audit. The external audit process involves sending auditors into the spending units and DTCOs to examine the regularity of the expenditure process. Draft audit reports are submitted to the spending units, with an opportunity given to respond to any identified irregularities. The results of these spending unit audits are summarized in the annual audit report.

The OAG recognizes its need for reform, but progress on modernization has been limited because of the current political environment. The OAG has prepared a "strategic plan" to improve the effectiveness of external audit. This plan includes capacity building through provision of greater manpower and training, as well as the introduction of international auditing standards and a greater emphasis on risk-based audit. Its reform efforts have been slowed, however, because the agency lacks the necessary leadership, independence, and capacity in modern auditing techniques. The OAG has since 2007 been led by a number of short-term acting AGs, which has hindered any sustained progress.

7.5 Parliamentary scrutiny and audit follow-up

The current political circumstances have rendered scrutiny of public finances by the CA and its committees obsolete. Formally, the final AG report is submitted to the president, who is then responsible for submitting audit reports to the CA and the prime minister. The AG report has not been formally tabled in Parliament for the past several years, most recently because of the expiry of the parliamentary term and the lack of new elections. The former PAC was active in reviewing the findings of the AG's audit report. The report is sent to all relevant government agencies and ministries, which are required to respond to irregularities within 35 days of receipt. The OAG report is also made public.

Follow-up on audit findings is generally weak, because of the country's political climate and the absence of a permanent AG for several years. According to the 2011/12 AG report, the number of irregularities amounted to NRs 48.6 billion, or 2.6 percent of the total of audited expenditures, including government offices, entities, and committees and the DDCs. Of this amount, NRs 35 billion, or 73 percent, is yet to be settled, even after informing the relevant offices and ministries. The MoPIT and the MoFALD were found to have the highest amount of reported irregularities in the 2011/12 fiscal year, amounting to almost 20 percent and 13 percent of total irregularities, respectively. According to the AG report, cumulative irregularities since 2003/04 amount to over NRs 204 billion, or 4-5 percent of the budget (GoN 2013).

8. Diagnosis: interpreting the evidence

This section traces the operational risks in the PFM system. It attempts to consider, primarily, not the fiduciary perspective of donors providing financial aid, but rather government efforts to affect development priorities in the national development plan and sector strategies and fiscal policy objectives in the Planning Approach Document. PFM ultimately cannot be separated from its context, and any assessment of reform progress and prospects needs to take a holistic view. In recent years, progress has been sustained in large part because of the institutional resilience of the civil service. However, this cadre cohesion and strength is itself threatened by atrophy of the wider political and bureaucratic governance environment.

8.1 Strengths and challenges

The overall analysis of the PEFA assessment for 2005/06 – that the system was "generally well designed but unevenly implemented" – remains a good summary of PFM performance. Since that assessment, there has been some clear and specific progress in terms of PFM strengthening, but the adverse political context has also challenged this. Progress through technical PFM reforms in all areas of the budget cycle remains closely related to the institutional, socioeconomic, and political context in which the state operates and handles public funds. The preceding sections have shown how, apart from several high-profile successes, it remains difficult to move beyond formal measures to functional improvements.

There are both strengths for future reforms to build on and areas of relative challenge and weakness. Based on the analysis of the current PFM system, specific achievements that have been reported or observed include the following:

- Continuity of well-established ***formal*** **development planning processes** by the NPC that determine national and sector priorities over a three- to five-year period, involving bottom-up engagement by DDCs and VDCs. Despite the weaknesses discussed here concerning the diminished capability of the NPC and the subjugation of formal processes to political decision making, the institutional durability of the planning process is notable.
- Progress with maintaining **sound aggregate fiscal management** – associated with annual preparation of a medium-term macro-fiscal framework – that has supported the introduction of conservative revenue forecasting and provided a framework for multiyear contracting of P1 public investment projects. Although the MTEF is subject to important critiques, and the sustainability of the current fiscal position is uncertain, aggregate fiscal discipline has held firm over the past few years. Deficits have held within tolerable limits, debt was under 35 percent of GDP in 2011/12, and recurrent expenditure was implemented at levels between 89 percent and 99 percent from 2008/09 to 2010/11.
- Introduction and progressive **implementation of a TSA** since 2009, which by early 2013 had been rolled out to cover 60 out of 75 districts and 95 percent of government expenditure. This is considered a significant achievement and a major PFM reform success. The accompanying change management process was well designed and well executed, such that resistance in line ministries and local bodies did not delay the project. More than 12,000 separate bank accounts have been closed and the payment process now involves real-time management and monitoring of public expenditures so that payments do not exceed authorized expenditure limits.
- Introduction of a **new Chart of Accounts** in 2011/12, broadly compliant with the GFSM 2001, and comprising administrative, economic, and functional classifications as well as sources of financing. Budgetary accounting does not cover full functional and programmatic classifications, and the very high level of detail in the economic classification of the budget risks working against efficient expenditure management. Nevertheless, it is a valuable starting point for strengthening the classification and reporting of expenditure.

- Implementation of **electronic tendering for government contracts** and a correspondent reduction in the level of intimidation and anticompetitive practice in public procurement. Improvements in the tendering process can be traced principally to the introduction of e-bidding following the 2007 Public Procurement Act. Other factors, such as the "least cost" selection procedure and low official norms for construction materials reportedly continue to challenge the quality of public infrastructure projects. On the other hand, the reduction in physical intimidation and violence towards bidding organizations has been dramatic.
- Adoption in 2009 of the **Nepal Public Sector Accounting Standards (NPSAS)**, using the IPSAS for Financial Reporting under the Cash Basis of Accounting. Implementation has been delayed, but the NPSAS remains a good basis.
- Initial **adoption of external audit standards** based on the International Organization of Supreme Audit Institutions (INTOSAI) and strong coverage of conventional regularity and compliance audit approaches across government. Despite the limited use of risk-based auditing techniques and a dominant focus on compliance, the underlying technical audit work by the OAG appears to be carried out thoroughly and in line with proper practice. There is also a clearly stated commitment by OAG senior staff to strengthening the capability of the OAG and the effectiveness of the external audit function. In addition, the OAG is moving towards using a risk-based approach.
- Creditable and consistent positioning on **fiscal transparency**, with Nepal scoring 44 and 45 out of 100 in the 2012 and 2010 Open Budget Indices. Although this is not a strong score, and there was no improvement over the two-year period, the avoidance of a significant slippage in the context of a challenging political environment merits some acknowledgement.
- New **strategy and capacity building program for PFM** reform through the establishment in 2009 of the PEFA Steering Committee and a PEFA Secretariat based in the FCGO. The Steering Committee comprises a wide group of stakeholders in the PFM system, including joint secretary-level officials from spending ministries. It meets periodically, albeit with some facilitation by the World Bank, and provides the strategy and motivation for efforts to improve PFM. This institutional mechanism is potentially a major driver of reform.

The context of institutional capacity frames these positive aspects of technical PFM reform progress and capacity. There are some positive underlying features of this institutional context that are likely to be supportive of reform: first, a record of political negotiations across parties; second, civil service professionalism; and finally, cross-departmental coordination. However, it is important to note that these nontechnical strengths are also vulnerable to adverse political influence, which can undermine efforts at strengthening PFM.

First, the experience of the peace process suggests that actors across the political spectrum can come together and sacrifice some of their own preferences in order to achieve a joint political outcome. It is a feature of the current political landscape in Nepal that all major political actors were present for the initial peace process and the establishment of the postwar settlement. This sets Nepal apart from many other post-conflict countries, where political rifts have never been bridged in living memory. It points to an ability of the political system to eventually resolve the structural conflicts currently preventing a permanent constitutional settlement.

Second, civil service professionalism and cadre cohesion are valuable elements of existing state capability. Nepal's civil service is highly professional but, along with other public institutions, seems to be under threat from political instability and interference. It would be of great interest to consider how targeted action could strengthen human capacity in key public finance institutions. One such action could be an effort to strengthen the career profiles of public finance civil servants and increase the stability and predictability of tenure in post for key leadership positions, and, connected to this, ways to limit disruptive transfers of key staff. Later on, these actions could lead to a broader discussion around human resource issues. The stability of the existing civil service will also have to be balanced against the necessary opening of the public sector to include previously marginalized groups of society.

Third, some important building blocks of inter-entity coordination for PFM reforms already exist. As noted, the PEFA Steering Committee and its Secretariat provide a link among central ministries, as well as between them and line ministries and local bodies. Given the high complexity of the current PFM reform program, this is a factor of great importance. However, coordination should not stop with the PEFA Steering Committee. It is undoubtedly important to have a steering body where key actors can discuss the reform agenda, and this is likely to increase buy-in from potential veto players. However, the budget process itself is not very centrally led at the moment. In order to make it so, more attention will have to be given to the role and capability of the Budget Division, which will need more assistance if it is to be able to start serving as a steering body for the annual budget process.

The detailed description of current performance in the PFM system in previous sections of this report suggests areas of relative weakness and operational risk. Before moving to a more systematic and diagnostic analysis, it is useful to summarize the main challenges in the system identified from technical assessments and from the perspectives of Nepali stakeholders.

- **There is a high level of disruption to the orderliness and timeliness of both budget preparation and budget execution.** Budgets are not appropriated in accordance with the legislative calendar, and actual expenditures deviate significantly from the plan in their timing and composition. Formally, the MTEF in Nepal provides a rolling three-year macro-fiscal framework within which to develop credible expenditure ceilings for line ministries. However, these ceilings do not provide a credible guide to spending limits, and substantial bunching of expenditure in the last trimester (and especially the final month) of the fiscal year weakens the efficiency and effectiveness of that spending. These weaknesses introduce significant operational risk into the PFM system.
- **The budget process yields limited underlying prioritization of expenditures and provides only a weak linkage to sector policies.** Budget submissions and negotiations managed formally through a bottom-up process bear limited reference to resource constraints or to adjudication among relative policy priorities. Furthermore, the provisional settlements reached through this formal process are wholly undermined by pervasive political interference, especially in the latter stages of the process after the engagement of spending units has concluded. Budget formulation itself is split between the NPC, which manages the MTEF and capital expenditure budgeting, and the MoF Budget Division, which manages annual recurrent expenditure budgeting. This bifurcated institutional arrangement weakens the budgeting process by preventing a single entity (the MoF) from having jurisdiction over total public expenditure. The designation of 89.5 percent of government expenditure as “P1” (highest priority) diminishes the usefulness of that categorization and risks distortion of the proper prioritization process (GoN 2012a).
- **The planning and implementation of the capital expenditure budget suffer serious challenges of fragmentation, delay, and under-execution.** Issues with delayed and convoluted central reauthorization procedures, public procurement and tendering, external financing arrangements, and technical capacity for project appraisal all serve to hinder the execution of capital spending. The capital budget suffers from systematic under-execution, recording levels of 85 percent to 93 percent from 2008/09 to 2010/11. High levels of external financing from development partners complicate and delay the implementation of projects because of the additional procedures concomitant with donor funding. The separate roles of the NPC and the MoF in the expenditure management processes for public investment, for example the post-appropriation approvals process by the NPC, are a source of additional delay. Lack of technical capacity to execute capital expenditure is a third challenge, especially at the lowest levels of government.

- **The formal institutional framework for public procurement has improved, but informal practices continue to present a serious challenge to underlying integrity and value for money.** The procurement oversight agency (the PPMO) has limited real power, and the full provisions of legal reforms have not been effected. At the local level, disruptive political pressure and influence over the awarding of public contracts is entrenched and rampant. Major reforms introduced in 2007 have formally established a framework consistent with good procurement practice. The positive impact is limited by the weakness of the PPMO, limited capacity in devolved units to apply procedures and resist political pressures, and insufficient checks on conflicts of interest.
- **The public finance system is characterized by a misleading sense of formal control through in-year virement rules.** Actors in the PFM system can use the formal institutional framework of rules and procedures to privilege and secure their particularistic objectives over more beneficial budget outcomes. Treasury systems are possibly the most significant element of PFM reform progress, and the TSA provides an indicator of strengthened financial control by the MoF. However, the credibility of budget execution against planned expenditure is undermined by the prevalence of adjustments and under-spending with sector ministries. Virement procedures inculcate high levels of effective discretion to reallocate the budget at the level of spending units. Political interference in budget execution is reported as widespread at local levels of government through (now informal) APMs.
- **The accountability framework for audit and parliamentary oversight has been eroded by the vacuum in political governance and is increasingly constrained by outdated technique.** Lack of separation of internal audit from internal control, a long period of vacancy in the AG position between 2007 and 2013, burdensome compliance audits, and the absence of functioning parliamentary committees have the combined effect of severely limiting meaningful accountability over the executive. Audit arrangements at the local level have proved especially prone to capacity constraints and political capture. The wider context of the absence of national legislature and local councils renders any form of elected representation difficult, and thus also any formal mechanisms of legislative, fiscal and financial oversight of the executive.

These observed strengths and challenges are not intended to create a normative perspective on the performance of the PFM system in Nepal, or to determine mechanistically the priorities for PFM reform. They are in many ways comparable to other countries facing political instability or emerging from conflict (see box 4). Instead, they provide an evidence base for how the current system functions, which may be analyzed against the development priorities and fiscal policy objectives of the government and other domestic stakeholders in Nepal. This is a necessary frame of reference to avoid the risk of *ad hoc* or arbitrary determination of reform priorities based on solely technical logic. The following section attempts to develop a more structured problem-driven analysis of these findings.

Box 4: PFM reform trends in post-conflict countries

One relevant comparison group for Nepal is countries that have recently emerged from periods of political instability and conflict. Throughout this report, references have been made to patterns in South Asia with regard to bureaucratic institutions, and systems democracies more generally. Countries emerging from conflict are relevant because political instability restricts the choice of PFM reforms and prompts government to prioritize certain reform areas over others.

A recent study compared PFM reform trajectories in eight countries. It found that substantial progress over time is possible even in the most challenging environments. Of the eight countries studied, four showed substantial progress (Afghanistan, Kosovo, Sierra Leone, West Bank and Gaza), two had made some progress (Cambodia, Liberia), and two had made only limited progress (Democratic Republic of Congo, Tajikistan). This is noteworthy, as it suggests instability and conflict do not automatically prevent the strengthening of PFM systems. It is also notable that, in all eight cases, donors had advised governments to undertake comprehensive multidimensional PFM reforms, irrespective of country size, institutional heritage, or per capita income. The success rate of different reforms varied considerably, offering lessons about the feasibility of some reforms, as well as revealing government preferences.

Two clear patterns emerged: Budget execution exhibited the most rapid and advanced performance improvement across all PFM dimensions, characterized by revised charts of accounts, centralized cash management (through establishment of a TSA), and automation of central treasury functions. In comparison, gains made on the basic elements of budget formulation were not matched by progress with more advanced reforms such as multiyear budgeting and program budgeting – despite considerable external technical support.

Substantial progress in budget formulation in fragile states was confined largely to the basic annual budget process, improving capacity for macro-fiscal analysis and forecasting, and revising budget classifications. There was less progress across all eight countries on more ambitious and complex aspects of budget preparation. In particular, attempts at multiyear expenditure planning (linked to government policy priorities) and program-based budgeting (linked to service delivery results) struggled to yield results. Despite attempts to introduce MTEFs in seven of the eight countries, only Kosovo had succeeded in sustaining the preparation of a full MTEF; in all other cases, MTEF reforms became costly failures that diverted scarce resources without delivering benefits.

Budget execution exhibited the most rapid and most advanced performance improvement of all PFM dimensions, but progress was not comprehensive. The restoration of basic fiscal control was a common downstream priority, in tandem with re-establishing a formal budget preparation process and producing an annual (or part-year) budget. The successful implementation of TSAs is noteworthy, as it requires the centralization of financial control in the finance ministry and a reduction in the discretion of sector ministries and government agencies to run their own separate accounts.

However, even where compliance with stronger execution systems was relatively good, the credibility of the originally approved budget was weakened through procurement practices and through in-year budget adjustments and supplementary appropriations. Furthermore, parliamentary scrutiny remained the weakest PFM function across the eight cases studied, partly as a result of limited reform effort and weak political incentives, both of which undermine efforts to strengthen budget accountability.

Source: Hedger et al. (2012).

8.2 Problem analysis

This report documents a number of areas where public finance institutions in practice fall short of what might be called international best practice, as well as the aspirations of Nepali laws and institutional design. Next to PFM challenges are broader political and other contextual concerns, as well as a record of PFM performance in terms of outcomes achieved (or not). There are different ways to interpret this substantial amount of descriptive information. In line with the approach outlined at the beginning of this report, we opted not to measure the *status quo* in Nepal against any externally defined benchmark. Instead, the focus is on problems with the public finance system as identified by Nepali officials and observers. In this sense, it can be considered an appreciative inquiry that takes the concerns of government officials as its starting point.

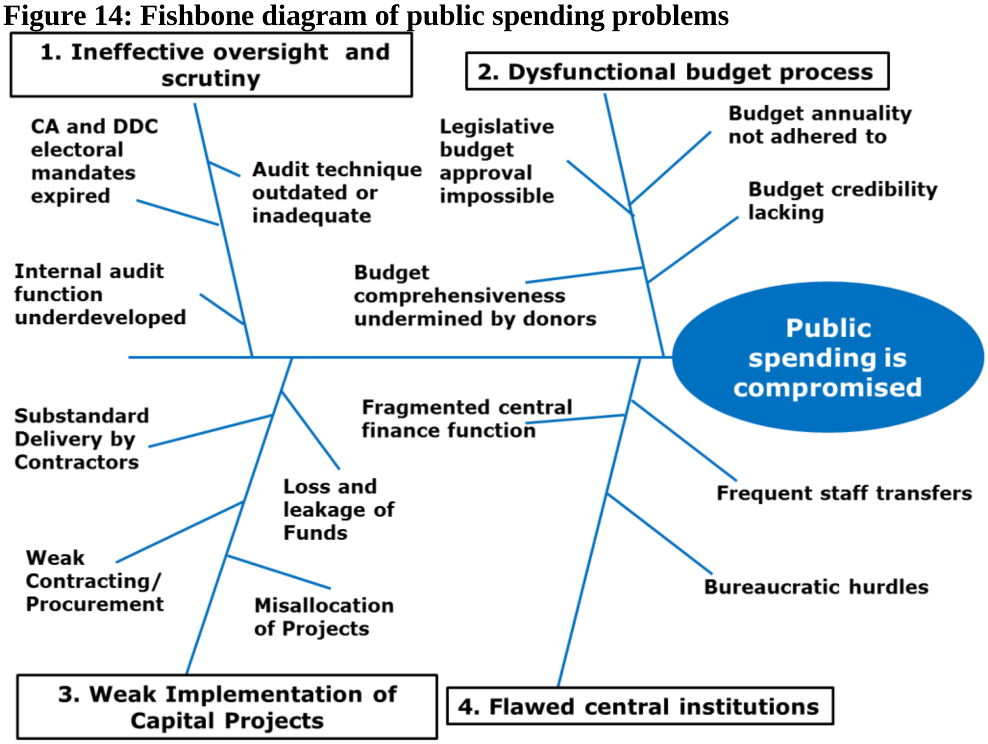
A problem-centric approach shifts the terms of the debate, and has recently been identified as a key to successful institutional reform in development (Andrews 2013). Instead of adding up shortcomings that may or may not matter to the government, problems are areas of immediate concern. The term "problem," as distinguished from a permanent condition, also implies solvability. This is a way of focusing a large body of possibly relevant information on a limited number of relevant issues. It is necessarily selective, and deliberately does not cover anything that could be done. The selection of issues presented here is narrower, and a more realistic reflection of what a developing country government can aim towards simultaneously, rather than what many PFM reform plans would normally cover.

A focus on problems also ties the analysis of PFM to an assessment of risk. The discussion in this section shows tangible problems that fall into the category of administrative control risks from the point of view of potential reformers. Ultimately, political and administrative risks cannot be divorced from each other, as public finances and central government institutions are inherently political. However, in our assessment, the direct political risks are in fact outweighed by administrative risks that are more easily amenable to corrective or ameliorative action by public officials.

The concern about the state of public finances is best summarized as "public spending is compromised." This is a concern over both the quality of every unit spent and the failure to achieve quality outcomes and results through the PFM system because of shortfalls in budget execution. According to the data, Nepal performs quite well at the aggregate level in terms of deficit and debt levels over the past few years. However, more detailed analysis of public finances within sectors, at local level, and inside spending units reveals these more serious concerns.

This is a multidimensional problem. It reveals itself through several critical symptoms well known to policymakers. Three examples are especially noteworthy. First is the "bunching" of expenditures, a problem very often mentioned first by officials describing shortcomings of PFM systems. The highly uneven execution of capital spending causes persistent under-spending against plans and budgets, which in turn limits the government's ability to improve key infrastructure bottlenecks. The bunching also makes it difficult to get the best value for money from capital funds, since so much of officials' attention is taken up with obtaining and expending funds in a very turbulent budgetary environment. Second, the disorganized budget calendar, which in some ways is the cause of the bunched spending, makes it difficult for spending units and central ministries to plan and manage spending in a reliable and predictable administrative environment. Third, the current disconnect between parts of the policy cycle, caused by the weakness of external oversight bodies and particularly the absent legislature, call into question the government's ability to ensure appropriateness and probity of the use of public funds – especially against external influences to divert funds towards narrow interests.

Figure 14: Fishbone diagram of public spending problems



Source: Authors' analysis.

"Public spending is compromised" is an aggregate problem. It is not immediately amenable to direct intervention. In order to make it more tangible and actionable, it needs to be broken down into smaller component parts. The Ishikawa, or "fishbone," diagram (see figure 14) shows a summary of the aggregate problem and its component parts. The problem is broken down into four problem branches, each consisting of several possible entry points the government could pursue. This problem-centric approach deliberately develops a logic of mutually reinforcing steps that move beyond individual indicators of the PEFA framework, or a distinction between "upstream" and "downstream" budget elements, or, indeed, between cycles of the budget process. Instead, these tangible steps – individually, and through mutual reinforcement – contribute to tackling the larger issue of compromised public spending.

8.2.1 Ineffective oversight and scrutiny

The accountability framework of audit and oversight has been eroded by the vacuum in political governance and is constrained by outdated audit technique and skills. Most visibly, the national legislature and local councils are absent. This leads to the absence of functioning parliamentary committees for legislative budget review and legislative audit scrutiny, as well as of sector-specific parliamentary committees to hold the government to account. The posts of AG and CIAA chief commissioner were both vacant for years. Civil servants in interim charge of the respective bodies are able to maintain the competent discharge of daily operations, but cannot have the same heft and authority as a constitutionally appointed head.

Both external and internal audits are not fully effective. Apart from lacking an appointed head for many years, the external audit function has been weighed down by a heavy burden of mandatory compliance audits. Concerns over misappropriation of funds, donor attention paid to corruption, and the weakness of the internal audit explain why the OAG cannot at present easily delegate or relax its compliance audits. Yet the workload this creates limits the organization's ability to pursue more risk-based and performance-oriented approaches to audit. Local government audit arrangements for VDCs and Municipalities are hamstrung by capacity constraints and prone to political capture. The internal audit function is at present not well developed. For instance, there is no internal audit cadre (or subgroup) distinct from the accounting cadre of the civil service. Internal audit at the DTCO level is not separate from the accounting function, with the corresponding exposure to conflicts of interest.

8.2.2 Dysfunctional budget process

Budgetary practice in Nepal falls considerably short of being a functional budget process. Since the early 20th century, the budget process has been commonly defined by certain characteristics, specifically that it be passed by the legislature into law; that it be a credible predictor of actual spending; that it be comprehensive, covering all spending; and that it be annual, passed on a regular basis for a set period, most commonly one year (Schick 2002). It may not be appropriate to hold Nepal to a standard without a domestic basis, but these principles are stated aspirations in Nepal as well, as expressed, for instance, by the interim constitution and the Financial Administration Rules.

In the current fiscal year (2012/13), as a result of the CA's dissolution, the formal budget was not passed by a legislature. The dissolution of the CA in May 2012 removed a functioning legislature that could pass the budget into law. Instead, the government promulgated a series of interim measures to retain current levels of spending from the previous year's budget until the budget for the fiscal year was passed in April of 2013, retroactively integrating previous short-term measures. The budget exists in the formal sense, but it cannot in the present situation be legislatively authorized. Furthermore, the approved budget is not a good predictor of actual spending. Instead, it is in some ways the beginning of a new set of budget negotiations and constant streams of reallocations and virements that continue throughout the budget year. Changes at the aggregate level may be relatively contained. Officials in many local bodies overwhelmingly reported that they did not regard the approved budget as an indicator of actual funds.

Annuality is not adhered to in practice. Although, formally, an annual budget is passed every year, in practice the budget calendar allows only a small proportion of the budget year for actual execution of most of the budget. The disarray of the budget process means much execution takes place in the final quarter of each year; the first and second quarters often see a continuation of planning and negotiation, with the exception of salary expenses.

Budget comprehensiveness under control of the government works well, but is weakened by donor practices. In the last PEFA assessment, comprehensiveness received one of the highest scores. This record does not seem to have deteriorated in recent years. However, significant donor funds are being spent in the country outside of country systems, making the budget a less than comprehensive expression of all public spending. This issue is of great concern to the government; donor scores were highly negative in the latest PEFA, and in Paris Agenda implementation reports, but progress on this front is clearly outside the government's ambit of control.

8.2.3 Weak implementation of capital projects

As well as under-execution of the capital budget, the weakness of capital spending extends to several other areas of budget execution. Observers noted that capital projects were at the moment not well allocated. Political interference in decision making diverts spending to lower-priority projects, and causes fragmentation of the capital budget into multiple small projects. Interviewees within and outside the government noted that UCs in practice allowed themselves to be overcharged for projects they tendered, and permitted the leakage of funds in other licit and illicit ways. In the districts, private contractors are involved in setting unit costs with the DDCs and inflate prices as a consequence. More generally, the selection of contractors suffers from weak competition, despite some formal improvements in the procurement process. This is combined with weak technical capacity for proper procurement planning. Finally, at least some instances were noted of contractors delivering substandard outputs, facilitated by the weak monitoring and inspection of project implementation by government units.

8.2.4 Flawed central finance institutions

Based on the international literature on fiscal institutions, the incentives for centralized authority and decision making are poor (because of informality, unstable governments, and large and shifting coalitions). According to a recent survey article, central finance agencies can between themselves carry out up to 18 different central finance functions, covering policy functions, regulatory functions, and operational functions, as well as reform management (Allen and Krause 2013). The central finance function in Nepal is quite fragmented, with only three out of 18 core finance functions within the MoF itself, five out of 18 within the FCGO, and five out of 18 shared between the NPC and the NRB; the remaining five are spread out among other agencies and departments.

Frequent staff transfers weaken the capability of core administrative units. Such units seem to be adequately staffed, but the two-year limit on transfers does not apply to secretaries and joint secretaries, which exposes crucial managers to rapid rotations out of positions where institutional memory is critical. The lack of continuity in post creates a strong disincentive for managers to invest in a longer-term reform agenda, the results of which they are not likely to see. Observers at all levels, inside and out of government, noted disruption caused by transfers, which are happening increasingly frequently under pressure from politicians or politically affiliated unions.

Turnover of staff in the PEFA Secretariat has been frequent, which has been an impediment to a strengthened PFM improvement agenda. The PEFA Secretariat coordinator was changed twice within two years; most recently, the second coordinator was transferred within four months of his placement. Other staff in the Secretariat have also been transferred. This demonstrates inadequate commitment of the government to adequately backing up PFM strengthening with resources and political support.

Bureaucratic hurdles involving central finance institutions unnecessarily limit budget execution. In current budgetary practice, many decisions involve a high degree of central ministry involvement, including in relatively minor matters handled by local spending units. For instance, according to roads officials in several districts, local officials have to re-plan small roads and bridges projects several times a year, because of the volatile funding situation (and because political interference puts projects onto the budget that spending units themselves do not request). Every time a P1 priority project is re-planned, the new program needs to be sent to the NPC for approval – usually granted without substantive engagement – which retards implementation by weeks. Such steps seem to be controls without a clear functionality, causing further complications that especially the capital budget can ill afford.

The relatively marginal role of the Budget Division in the PFM reform process creates vulnerabilities for future reforms. Fragmentation of the central finance function creates incentive problems around interagency coordination and complex reforms, because no stakeholder has a strong interest in devoting resources to reforms that cut across agencies and departments. In other countries, the budget office takes on a "challenge function," analyzing and scrutinizing new spending proposals in each round of budget negotiations. This challenge function relies on a sound analytical capability for all spending sectors coming before the sector desks in the budget office. This seems to be quite underdeveloped in Nepal's MoF at the moment. Ultimately, central budget offices like the MoF's Budget Division play a crucial role in the budget process and cannot be marginal in a structural PFM reform.

This summary of problems presents both challenges and opportunities. These are not issues brought into the policy discussion in Nepal purely by international agencies; they are issues raised frequently by Nepali officials and observers. Although quite long, the list of concerns under the four headings of oversight and scrutiny, budget process, capital spending, and central finance institutions can be addressed by specific reform actions. The following section develops an initial set of activities that could be undertaken in each of the four areas.

9. The way forward

This section provides a number of feasible entry points for both the government and the donor community going forward. It does not aim to provide a comprehensive strategy to address all weaknesses of Nepal's public finance institutions, nor would it replace existing reform frameworks or plans. It is specifically tailored towards the problem diagram in this report, and offers a way for stakeholders to immediately initiate activities to address the problems identified.

The 2013/14 fiscal year is going to be an important one for reforming Nepal's public finances. As the political uncertainty continues, it is unclear how much agenda space top-level decision makers in politics and administration will be able to devote to PFM and other institutional reforms. The analysis of the PFM system as it currently stands shows a picture of strengths and weaknesses. Both the government of Nepal and the donor community will need to decide how to prioritize reforms and see what is really feasible given the current context.

Reform efforts need to match capacity with expected benefits. The ability of the government to pursue multiple reforms at the same time is limited. This is true for any government, but in Nepal at the moment the limitation matters very much. As long as the political uncertainty persists (and in the face of a very broad reform agenda), not everything can be tackled at once. Recent experience in other post-conflict countries shows that governments would be well advised to avoid unrealistic advanced budget reforms, especially on the budget formulation side. Budget execution reforms are not advancing unchallenged, as Nepal has found, but they promise clear benefits for the probity of public funds. For instance, a reasonable approach would be to redirect efforts away from complex multiannual budget systems to focus first on an orderly and credible annual budget cycle – where quite a bit of work still remains to be done in Nepal (Fritz et al. 2012; Hedger et al. 2012).

The following entry points are based on a combination of decision criteria. They take into account the assessment of the current state of Nepal's public finance systems, the assessment of institutional arrangements, and, most importantly, the solvable problems presented in the previous section. No action is put forward that is not linked at least indirectly to the problems that together compromise public spending at the moment. The decision criteria have been used to broadly group possible actions into three clusters:

(a) Short-term: actions that can be taken right away, are within the ability of public officials to deliver, and will yield at least some returns in the short run
(b) Medium-term: actions that will take more sustained effort and investment, but that still can be taken forward by public officials – or at least steps in that direction could be taken right away
(c) Long-term: actions that rely on longer time horizons and/or on broader political engagement. These are worth keeping on the agenda, but, realistically, are not within the control of the government or civil servants as they are exposed to wider political risks

It is the nature of a volatile political situation that these clusters are not set in stone; where an issue falls could change quite rapidly with the circumstances. For this reason, this report abstains from formulating too specific a work plan or change agenda. It is, however, worth explicitly outlining the decision criteria themselves, so they may be reapplied or changed as the situation evolves. Different analysts may apply these criteria differently, and they are meant as an analytical tool, not a strict rule suggesting a certainty that does not exist in institutional change. They are as follows:

(a) **Political contentiousness.** It is important to acknowledge that there is no neat distinction between technical PFM and non-technical politics, as decisions over public resources are inherently political.

Superficially technical PFM matters can be exposed to political contention, or be underpinned by political consensus so as to make them uncontroversial. In the case of Nepal, interviews suggested that there seemed to be a broad consensus that the everyday matters of PFM would receive similar support and attention irrespective of the party that supplies the minister of finance. The only exception to this is the area of intergovernmental relations and decentralization, which is highly contentious and political.

Political contention is not so much centered on particular issue areas, but rather constrained by political agenda space. Because of the salience of the political uncertainty around the constitution, elections, and a new political settlement, actors have little time and resources to consider other issues on the political agenda. Unlike theories around veto players, where failure becomes more likely with the number of potential spoilers, this problem is more akin to a classical implementation challenge, where every decision point needed for a change to go into effect is a potential bottleneck to impede change, because the agenda space is constrained and issues are not taken up (Pressman and Wildavsky 1973; Tsebelis 2002).

As a consequence, the decision criterion of political contentiousness asks how much, and for how long, a proposed action would require the attention and commitment of political actors, how likely it is to be a controversial issue, and whether different political actors would have to work together in order to bring change about. For instance, where government officials already have a clear mandate to take action and the necessary changes are within their control, the situation is better. The more of these political factors are in play, the less attractive an action is. This specifically includes changes that require legal or even constitutional changes to become effective.

(b) **Institutional complexity.** The institutional and political assessment suggests that the preconditions for complex institutional changes in Nepal are challenging. Specifically, the relative fragmentation of the central finance function, as well as the macro-institutional volatility, cautions against any institutional changes that rely on a centralization of institutional authority, in particular those that rely on viable delegation of budget authority to a central finance minister. In the sequence of institutional change, steps to better integrate the central finance function would have to precede steps that take such integration for granted.

Institutional complexity is assumed to have a negative impact on the chances of success for change. The higher the complexity or the more an action relies on integrated institutions being able to lead complex institutional change, the lower its chances of success.

(c) **Technical ambition.** In the international literature on PFM reforms, it is now common to acknowledge that, as Schick (2012) puts it, “basics first is best practice.” PFM systems that require the growing of substantial technical capacity, especially in relatively short order, are just as prone to failure as are systems that assume considerable technical capacity already exists when starting to demand outputs from new systems. The latter problem, called “premature load bearing,” has recently been identified as a persistent “capability trap” that holds governments back, rather than strengthening them (Pritchett et al. 2010; Pritchett et al. 2012). The recent introduction of the TSA in Nepal has shown that the government is capable of handling technically quite demanding projects in the PFM sphere, and some localized capacity requirements are to some extent substitutable in the short run (Welham et al. 2013).

Judgments about the technical ambition of reforms need to be made in the context of which actor is likely to bear the main burden, as well as the corresponding political contentiousness and institutional complexity. On such a scale, for instance, further efforts to deepen and broaden electronic financial management systems seem more likely to succeed in the wake of the TSA's success than advanced medium-term budgeting measures, which would trigger all three decision criteria.

This section proceeds in three steps. First is a discussion of entry points for future reform, based on the analysis carried out in preceding sections. The second subsection discusses the link between PFM reform and service delivery as a key concern for policymakers at the moment. The final subsection outlines an initial set of issues for future donor engagement.

9.1 Entry points

9.1.1 Reinforce oversight and scrutiny

At the national level at least, it is possible to take measures to ensure the retention of the institutional memory and basic capacity of the PAC, specifically its support staff and operations to prepare the ground for the return of elected legislative bodies. This is despite the fact that whether or not there is an elected body at either the national or the local level is beyond the control of civil servants.

Official oversight agencies benefit greatly from a strong, clear mandate. The most powerful way to do so lay in appointing an AG and a CIAA chief commissioner in early May 2013. This will strengthen the organizational heft of those bodies. Both organizations benefit from the high quality and professionalism of the Nepali civil service. A strengthened OAG and CIAA will not in the short run transform the public sector, but will likely empower staff to pursue their work with a measure of nonpolitical legitimacy and backing that many observers felt had steadily been eroding in recent years. Furthermore, all oversight bodies would benefit from a greater degree of clarity over organizational roles. The OAG, the CIAA, the NVC, and the PPMO all have explicit formal mandates, but many interviewees noted many overlaps in practice, and a lack of heft of each of these bodies because of the number of other actors. One might also expect rare skillsets among staff to be unnecessarily diluted, although there was no reliable evidence to this effect. Since the appointment of new heads in the OAG and the CIAA, the main political bottleneck to a further strengthening of these accountability bodies has been removed.

The internal audit function would be strengthened by giving it greater formal salience. This could be achieved by establishing a separate sub-cadre of internal auditors. Within DTCOs, such separate cadres could then implement a formal separation between accounting and audit functions, for greater clarity of purpose and to avoid conflicts of interest. At the moment, treasury officials do not audit themselves – spending units are the account holders – but may well find themselves auditing transactions they themselves had processed before. According to some interviewees, such changes were contemplated in the past but were postponed to become part of larger organizational changes. In this instance, a quick win by pursuing them might create useful momentum for other reforms later on. At the moment, efforts to strengthen internal audit seem quite feasible in political, institutional, and technical terms.

Over time, a more capable internal audit could enable the OAG to carry out its audit work more strategically. Rather than bearing the heavy workload of a very comprehensive compliance audit mandate, the OAG could invest in upgrading its audit skills and carry out audits more selectively on a risk basis, as well as performance and value for money audits. A great area of largely uncharted territory remains how to deal with external audit at the local level, where capacity constraints can be crippling, as is the potential for conflicts of interest, especially in remote areas. There is necessarily a degree of institutional complexity and technical challenge in the relationship between internal and external audits. The OAG's willingness and ability to move beyond comprehensive compliance audit depends to a large extent on the internal audit function taking on its intended role, which, owing to capacity constraints, especially beyond central ministries, is a much more challenging task than is focusing on the OAG itself.

Interim oversight arrangements could provide confidence to the public in terms of the scrutiny of public resources. In the absence of parliamentary oversight committees, other actors should in the meantime take the lead in safeguarding a good PFM system for both the public and donors. A suggested assurance arrangement could be the establishment of a committee representing civil society and individuals with a high reputation in good governance, to play a stop-gap role until the re-establishment of the PAC.

Together, these efforts to strengthen oversight and scrutiny can create direct inroads into the problem of compromised public spending. This is especially so in a situation where all major political actors could benefit from a professional, neutral space in the public sector that is somewhat insulated from narrow capture. Many interviewees noted that, at the moment, public officials fear politicization of their technical work, and political actors fear capture of state bodies by political competitors. A technical space where core public finance functions are carried out soundly and safeguarded by competent scrutiny could be a settlement to the benefit of all.

Some of these entry points have the potential to be politically contentious. However, the recent appointment of new heads in the OAG and the CIAA, as well as the mandate of the nonpolitical government, suggests the remainder of 2013 may be a window of opportunity worth using to strengthen accountability bodies further. There are technical and institutional challenges, but some initial actions, such as investing in internal audit and capacity building at the OAG, need not be challenging at first.

To maintain the institutional presence and basic capacity of the PAC support function, reviewing qualification standards and requirements for local government auditors and work to establish the formal distinction between internal audit and treasury functions are feasible actions in the short term. Further development of the OAG's audit techniques and clearer roles of accountability bodies will require more sustained and possibly long-term engagement, and more profound changes.

9.1.2 Fix the budget

Fixing the budget process to enable it to perform the function foreseen by Nepal's laws should be a priority for the PEFA Steering Committee. The absence of a formal legal approval mechanism for the annual budget law is clearly beyond its remit, but fortunately will immediately cease to be a problem once a sitting legislature resumes its work. Similarly, the government has only limited means to elevate budget credibility by ensuring greater use of the budget system by donors. It is the responsibility of donors to improve on their commitments to the use of country systems.

Improving budget credibility and annuality is well within the ability of public officials to address in the short run. While it is hard to establish simple causes for the disarray in the budget calendar, it owes at least immediately to a failure by budgetary actors to adhere to reasonable time periods for budget planning, formulation, and execution, and especially to jointly stick to deadlines, after which one phase of the budget process transitions into another. At the moment, for instance, investment projects are still re-planned and re-approved far into the budget year, when planning ought to have come to an end for that cycle. As indicated by the institutional assessment, one reason for the disorganized budget process may be the distribution of rents to maintain stability, as is often the case in limited access orders. This suggests that efforts to strengthen order and stability of the budget process may become politically contentious. However, the disorderly budget calendar in particular is a very common basic PFM problem (albeit one that is particularly severe in Nepal). It is possible to work on this without having to get involved in fundamental political issues, and many of the practical matters are straightforwardly administrative. The more important challenge will be to overcome the inherent institutional complexity by creating and maintaining buy-in from sector ministries and allowing the finance ministry to take a leading role at the same time.

Coordinated by the PEFA Steering Committee, the MoF, the FCGO, the NPC, and line ministries could work towards a joint understanding of how to restructure the budget calendar. This restructuring would ensure a clear separation between planning, formulation, and execution of the budget. Specifically to further budget credibility, budget actors could begin budget preparation sooner to ensure that the final budget is submitted to Parliament several months prior to the start of the fiscal year, and that projects in the budget have a full 12 months available for execution.

Joint inter-ministerial work on the budget calendar and more timely submission of the budget to the legislature are both realistic actions for the short run. Inter-ministerial efforts to ensure spending units have the full budget year to execute the budget, and to eventually make the legislatively approved budget an accurate predictor of spending, will require more sustained work and probably will not yield immediate results from one budget cycle to the next. It is important to point out, however, that no one of these actions would put significant additional technical demands on the PFM system – the challenge is institutional and to some extent political.

A joint assessment of roles and responsibilities is not by itself going to change the budget calendar. The experience of TSA implementation might lead as an example here. The technical case for a better budget calendar is quite strong, and the comparison with other countries very unfavorable (and such benchmarks can be powerful arguments, even in front of nontechnical decision makers). Compared with the TSA, there are no upfront costs associated with the changes. Framed as a largely technical change to catch up with international practice, a better budget calendar could develop momentum, if led by officials who stand to gain, either in professional reputation or for operational reasons. Unlike with the TSA, leadership will not lie with the FCGO, but with the MoF itself, especially the budget department. If senior budget officials do not see the benefits to their future ability to manage the budget better, then these actions will probably not gain much traction.

9.1.3 Strengthen the implementation of capital projects

Four actions are proposed under this entry point. First, improve the technical prioritization of capital projects and expenditure allocations through earlier approval processes. Second, strengthen fiduciary controls through local monitoring and clearer norm setting for project input costs. Third, improve procurement practice through the training of officials and pilot initiatives to strengthen competition. Fourth, enhance the performance of contractors through upgraded technical monitoring capacity and the enforcement of minimum standard for materials.

Misallocation of capital expenditure to relatively low priority, piecemeal, and inefficient project activities might be reduced by a stronger requirement for work plans and procurement plans to be completed and approved before projects enter the budget. The major observed weakness is not so much an inadequacy of project appraisal methods or formal budgeting processes. Instead, it is the informal, late-stage, and inappropriate political interference in budget decision making that serves to contradict and undermine more "efficient" selection of projects and allocation of public expenditures. Both of the consequent weaknesses – first, inefficient selection of projects for priority funding; and second, fragmentation of limited budgets across multiple small projects – could be ameliorated substantially by a stronger commitment to the approval of feasibility studies and work plans prior to the inclusion of projects in the budget.

This measure would mean establishing a bulwark against external and specifically undue political pressures outside the regular planning process. A prototype of this requirement was developed under the previous administration, and senior officials interviewed for the study suggested it might indeed be feasible. The realistic aim would not be to remove political input, but rather to ensure all proposals are considered in a more timely way and evaluated more fully on their technical merits. Current practices cause severe delay in project approval and expenditure authorization during the fiscal year, which in turn delays public investment in all localities – even those prioritized by influential party activists and local politicians.

Loss and leakage of expenditure allocated to capital projects might be reduced by strengthening local government monitoring capacity and by developing national-level norms for project costing. Significant local-level discretion by UCs over contractor selection and the financial terms of contract awards has frequently been associated with leakage and inefficient use of expenditure. This decentralized arrangement for local-level public investment management is a well-established practice in Nepal, and one not readily amenable to reform because of the wider political imperative for decentralization. Analysis also suggests the cause may be influences on the UCs as much as the motivations of the UCs themselves. Direct approaches to changing the role and responsibilities of UCs are unlikely to find traction. However, indirect measures that target the oversight environment and the standardization of costing methods might reduce the discretion of UCs. The main proposed entry point is technical and institutional support to local government monitoring and supervisory capacity, allied with more integrated government–citizen social accountability initiatives. An accompanying measure proposed is to develop national-level norms and rates for project costing – to replace the current district-by-district regime for norm setting, which produces significant discrepancies and creates some perverse incentives.

Comparative international evidence on the causes of underperformance in service delivery shows that weak and ineffectual district- and local-level monitoring and inspection is a significant contributory factor to poor sector outcomes (Williamson and Dom 2010). The finding for Nepal is consistent with international experience, and it is a reasonable expectation that the same entry points will be relevant. Clarification and gradual improvement in the coherence of mandates and responsibilities across de-concentrated district administration functions could be an initial measure. Linking up existing citizen-based and social accountability initiatives to formal superintendence mechanisms has good precedent. Supervisors recruited from local communities on a daily fee basis to inspect the performance of contractors in the roads sector is a positive example that might be emulated and further developed.

Weaknesses in public sector contracting processes that hamper integrity and value for money might be addressed through pilot initiatives to strengthen competition and through further training of officials. Many reports suggest inadequate market competition for public contracts caused by anticompetitive contractor practices and excessively stringent tender requirements. Significant improvements have already been made through electronic tendering processes, and one very positive result is a substantial reduction in contractor intimidation and violence. However, it has been reported that the practice of syndication persists and the contractor market remains too thin in some sectors and districts to ensure proper competition. Pilot initiatives to boost market competition on the supply side will not be straightforward, but there is emerging evidence of demand from some business groups and contractors' associations to improve the quality and integrity of partnerships between government and contractors. Further training of officials in public procurement practices would be a useful supporting measure.

Substandard delivery of services by contractors through the use of inferior materials and inefficient project implementation might be addressed by establishing better minimum technical standards and by enforcing them more robustly through technical monitoring. Reports of inadequate output quality caused by the use of inferior materials are widespread, and the capacity to monitor multiple small-scale and remote capacity projects is severely constrained. A dual approach of technical standards and local community monitoring (see earlier proposal) may have some purchase on the issue. International experience of technology-based monitoring and accountability innovations points to the potential of this approach as a response to the challenging topography of Nepal.

In combination, these four sets of measures would attempt to circumscribe the worst excesses of current policies and practices in the contracting and implementation of capital projects. They would build on existing social accountability initiatives, avoid conspicuous and overambitious reforms likely to attract high-level resistance, lock into the residual strength and organization of the civil service, and attempt gradually to expand the existing political space for more ambitious reforms.

These measures will require sustained engagement to produce results, but they can be achieved in the medium term. The main bottleneck will be local government capacity to handle the increased technical requirements of enhanced capital budget management. However, the crucial measure of ensuring feasibility studies, work plans, and procurement plans area are completed and approved by all administrative actors before projects enter the budget could in theory be carried out by administrative fiat.

9.1.4 Join up central institutions

The PEFA Secretariat and Steering Committee represent an important building block of inter-institutional coordination at the center of government. The underlying central finance function is, however, relatively fragmented, which makes it more difficult for the government to perform central finance functions that require a high degree of central authority or joined-up action to succeed. Some elements of this fragmentation are so embedded in the central government's DNA that they will be hard to change, even in quieter political times, such as the basic set of central ministries and the separation between planning and budgeting in disjointed bodies. There are still feasible measures for the government to contemplate (as indeed they have been already) regarding the fragmentation of central authority, the disruption caused by frequent staff transfers, and bureaucratic hurdles in budget management.

There are several entry points to start ameliorating institutional fragmentation. The government could strengthen the coordination function of the PEFA Steering Committee by ensuring it holds frequent and regular meetings, including discussions of technical staff inputs about future work, where appropriate. Beyond its convening power, it will be necessary to strengthen the analytical, planning, and institutional leadership capability of the PEFA Secretariat to take forward a reform agenda across different agencies beyond changes that mainly affect the FCGO internally. It would be highly desirable if such an organizational strengthening included secondment of officials from different ministries and cadres to increase buy-in from across the public finance system. At the moment, universal buy-in and support to the Secretariat's agenda is more assumed than evident.

A key element of a future institutional structure should be a strengthened Budget Division of the MoF. For any complex type of reform that affects management of the budget, the central budget office acts as a veto player that, if not in the lead or at least on board, might well act as spoiler. In its current setup, the Budget Division seems to play a crucial budget-political role in the management of budget operations, especially around cash allocations and virements. It does not have the same analytical and strategic capacity that budget offices in many other countries have (Schick 2001). All things being equal, a more capable Budget Division with a better developed strategic budgeting capability and an analytically grounded challenge capacity would enhance the likelihood of complex reforms succeeding. This is, in other words, a crucial administrative risk control measure.

In the medium term, Nepal could explore institutional solutions to overcome limited central budget authority. The current macro-political and institutional environment of the budget process is such that the conditions for centralizing much budget authority in a powerful central finance ministry are poor. The relatively weak record of the MTEF in recent years bears this out. The successful introduction of the TSA, on the other hand, has been labeled a "stealth reform," precisely because of the difficulty surrounding reforms that reduce the discretion of de-concentrated actors. However, there are possible alternative – or complementary – solutions that could be explored. In other countries with unstable coalitions or minority governments, fiscal pacts have proven a potentially effective way to create some stability in fiscal decision making (Hallerberg 2004; Hallerberg et al. 2009). Much of this experience is from Europe, in a much more developed context, but many European countries do have a parliamentary system similar to Nepal's. All-party agreements following an election might be used to safeguard certain aggregate objectives that could survive changes in government or ministry.

Protection from frequent staff transfers can help build and retain crucial tacit knowledge and institutional memory. At the moment, the frequency of staff transfers at the crucial management levels is deeply disruptive of a PFM reform agenda and presents a constant operational risk to reform implementation. Formally or informally, the key PFM actors, as well as the Ministry for General Administration, could protect the in-post tenure of key PEFA-relevant staff positions at the MoF, the FCGO, and other agencies. Such protection could informally extend to minimum periods, even for secretaries and joint secretaries, to enable the formation of a distributed leadership group to sustain momentum. Each ministry or department should review nonfinancial performance incentives to make key PEFA-relevant staff positions more attractive to fill and retain.

Overcoming bureaucratic hurdles in budget management can free up capacity at the center and within spending units, as well as speed up budget execution. A quick-win first step in this direction would be a joint consultative review of inter-ministerial arrangements in budget planning, formulation, and execution to establish a clear division of roles between the NPC, the MoF, the FCGO, line ministries, and local government bodies regarding the procedural requirements of budget planning, formulation, and execution.

A stronger central finance function could play an important leadership role related to PFM reform and the management of public finances more generally. There are some limits to how much structural change can take place without political leadership, but this is the area with the greatest potential for short-term action, even in the face of continued political volatility. A recent study of PFM reforms in fragile states found that West Bank and Gaza was able to implement a very ambitious reform program over several years in one of the most turbulent political and administrative risks environments, carried by strong and sustained central leadership and staff continuity (Krause 2012). The contrast between West Bank and Gaza and Nepal is stark, and bears important lessons for what can be achieved even if operational risks are very high.

Actions under consideration for joining up central institutions could be initiated immediately. In the medium and long run, a stronger, more integrated, central finance function will require explicitly political (and most likely legal) adjustments, but in the short run, existing institutional mandates offer sufficient grounds to move forward. The strongest short-term obstacle to an empowered PEFA Secretariat, to more developed strategic budget capability in the MoF, and to protection of the tenure of key positions is bureaucratic inertia.

Some crucial buy-in from officials could be generated by showing that many of the changes considered here have suited the professional aspirations of senior budget officials elsewhere. In other countries at quite different levels of income (such as West Bank and Gaza, Uganda, and Chile, to name just a few cases), similar institutional changes have helped central finance officials carry out their functions better and more professionally. Some interviewees felt that the current reform pattern in Nepal may have unwittingly focused too much attention on the FCGO, given the existence of internationally recognized and attractive reforms that can gather international support, without corresponding actionable activities for other ministries or departments. If carried forward in a coordinated fashion, several actions proposed in this report would redress this balance and allow especially the finance ministry to take on a more central role. Buy-in from the finance ministry will be crucial.

There are problems in each phase of the budget cycle that are ultimately always related to the political context, but there are also quite familiar PFM issues common to many other countries as well. The experience of TSA implementation shows that seemingly technical reforms can yield structural change if carried out in a way that is not immediately threatening to political actors, that finds ways to deal with institutional complexity, and that does not overwhelm in their technical ambition. It will be essential to find senior officials and former officials to take up these actions as their own. This should be made easier because the fishbone diagram is based on a large number of interviews with Nepali officials, with many voicing at least tacit support for some expression of these problems. A framing of the entry points as ways to reinforce the professionalism of the civil service working on PFM in Nepal might be an appropriate way to foster early support.

A summary of the entry points shows that there are items where immediate action is possible, with some potential for quick wins, that others require sustained engagement with a higher threshold for results, and that a few are outside of the control of public officials (see table 6). None of these activities is risk-proof or unaffected by political or administrative control risks. However, they can be carried forward by the initiative of public officials, and can generate momentum and capability to tackle more profound and difficult changes later on. We have abstained from providing specific timelines at this stage, as many factors will have to be considered, not the least of which will be emerging leadership on these issues by the government before specific plans can be drawn up.

Table 6: Summary of entry points

Feasible 'quick-win' reforms (short term)	Sustained engagement reforms (medium term)	Reforms outside the control of public officials (longer-term)
Strengthen oversight and external scrutiny		
• Maintain institutional presence and basic capacity of PAC support function and cadre • Review qualification standards and requirements for local government auditors • Formally distinguish internal audit and treasury roles in DTCOs by establishing a separate sub-cadre of internal auditors	• Upgrade audit techniques of OAG and assist in the move towards risk-based approaches	• Simplify roles and interagency coordination arrangements for OAG, CIAA, NVC, PPMO • Institutional strengthening of oversight bodies based on long-term (and irreversible) action plans finalized through broad political consensus
Fix the budget process		
• Joint work by MoF, NPC, line ministries to reach joint understanding about restructuring the budget calendar to clearly separate planning, formulation, and execution • Ensure budget is submitted to Parliament a reasonable amount of time prior to start of fiscal year	• Joint work by MoF, FCGO, NPC, line ministries to ensure spending units have 12 months to execute budgeted spending • Make the Red Book the definitive predictor of actual spending	• Budget legality is a political issue – would disappear quickly after party agreement on elections and future of CA • Improve on donor commitments on the use of country systems (see GoN 2011b, aid on budget far below Paris targets for 2010, 56 percent in 2011)
Improve capital project implementation		
• Ensure feasibility studies, work plans, and procurement plans are completed and approved before projects enter the budget	• Strengthen local government monitoring capacity and link up social accountability initiatives • Develop national-level norms/rates for project costing • Enforce minimum standards on quality of materials • Improve technical capacity in monitoring/oversight • Train officials on public procurement	• Strengthen role of local government bodies in planning and monitoring of capital projects

Feasible ‘quick-win’ reforms (short term)	Sustained engagement reforms (medium term)	Reforms outside the control of public officials (longer-term)
	• Pursue initiatives to improve competition for public contracts	
Join up central agencies		
• Strengthen coordination function of PEFA Steering Committee to hold frequent and regular meetings, including technical staff inputs where appropriate • Strengthen analytical, planning, and institutional leadership capability of PEFA Secretariat to take forward a reform agenda across different agencies (beyond FCGO) • Strengthen budget leadership role of Budget Division in MoF, including its challenge function and strategic budgeting capability • Formally or informally, protect in-post tenure of key PEFA-relevant staff positions at MoF, FCGO, and other agencies • Each ministry or department to review non-financial performance incentives to make key PEFA-relevant staff positions attractive to fill and retain • Joint consultative review of inter-ministerial arrangements in budget planning, formulation, and execution to establish clear division of roles between NPC, MoF, FCGO, line ministries, and local government bodies		• Fundamental review of role of central finance agencies, which might involve legislative measures

9.2 PFM reform and implications for service delivery

This section discusses the relationship between PFM improvements and service delivery outcomes. There is a lively discussion internationally as well as in Nepal about how to improve the delivery of critical public services, which affects how stakeholders perceive the PFM reform agenda. It is important to consider this issue carefully, so as to have realistic expectations of what PFM reforms can and cannot be expected to achieve, especially in the short run and in a turbulent environment.

It is widely assumed that improved PFM systems will have a positive *indirect* effect on service delivery. There is a large literature on the determinants of effective public service delivery in developing country contexts (e.g., see World Bank 2004). The absence of staff wages, key commodities, operations and maintenance spending, and capital investment will certainly reduce the likelihood of effective service delivery. Therefore, improvements to PFM systems and processes that support the planning and execution of expenditure in these areas could be expected to lead to an improvement in performance. The specific PFM functions and processes that contribute to effective service delivery will vary across different public service sectors, depending on variables such as the emphasis on public investment management processes, payroll management and control, and budgeting for operations and maintenance spending.

Even if all relevant budget allocations are remitted fully and reliably to spending units, service delivery may be ineffective for other reasons. The wider literature on public service delivery does not identify PFM-related issues as a particular or significant challenge. Much of the recent discussion on service delivery in developing countries focuses instead on higher-level institutional, incentive, and political failings that undermine effective service delivery (World Bank 2004). Although the absence of PFM systems capable of providing basic financial inputs will likely have a negative effect on service delivery, the presence of effective PFM systems does not guarantee effective service delivery (Welham et al. 2013).

There appear to be few specific PFM processes that are strongly associated with improvements in service delivery outcomes. The absence of adequate PFM capability linked to service delivery inputs may have a *negative* impact. However, it is difficult to trace specific *positive* effects from strengthened PFM performance. This may lead to a conclusion that a large number of PFM processes need to be strengthened for the PFM system to have an impact on service delivery. The level of overall PFM performance, rather than specific elements, may be more important for service delivery. Realism about the scope and scale of potential reforms is a necessary caveat to the conclusion that broad-based PFM capability is more relevant for service delivery. A reform program attempting improvement to a wide-ranging list of PFM functions may not be appropriate or feasible in all contexts. Other considerations are important for the prioritization of measures to strengthen the PFM system.

For governments, the absence of a strong or direct link between PFM improvement and service delivery performance is not necessarily a problem. Governments have legitimate reasons to pursue PFM reforms that are not in the first instance connected to improving public service delivery. It is much more common for concerns over fiscal discipline to be the principal driver for reforms, but control over the executive as an element of state building can be a strong rationale as well (Welham et al. 2013). It is important not to assume that service delivery will automatically improve, or that it ought to be a priority in all instances. Evidence of successful PFM reforms in post-conflict countries shows there are different viable reform trajectories, depending on the priorities of the reformers in charge (Hedger et al. 2012).

A stated objective of the government of Nepal and its development partners is ensuring strengthened PFM systems contribute to improved service delivery. Alongside the feasibility of potential reform measures and their potential contribution to objectives such as enhanced state effectiveness and sustained macroeconomic stability, this effect is a high priority. This report has proposed four "entry points" concerning PFM reform: (a) reinforce oversight and scrutiny; (b) fix the budget; (c) strengthen the implementation of capital projects; and (d) join up central institutions. It is therefore instructive to assess the possible links between these sets of measures and effects on service delivery in the roads and health sectors.

PFM affects service delivery outcomes only indirectly, so none of the proposed actions should be expected to raise service delivery performance directly or in isolation. Nonetheless, the framing of this study makes a substantial improvement in the quantity and quality of public expenditure the central objective of the measures proposed. A focus on how the budget is prepared and executed is therefore highly relevant to the expenditure inputs required for service delivery in the two sectors. Positive indirect effects of the proposed actions in terms of service delivery should follow, all other factors outside the PFM system being equal. The expected contribution of all four sets of PFM measures to the *overall* performance of the PFM system would also be expected to have a corresponding overall influence on services provided by government and funded through public expenditures.

Reinforcing oversight and scrutiny is more likely to strengthen the enabling environment for improved service delivery gradually than to produce a strong, immediate, or specific effect in either sector. Clearer mandates for the official oversight bodies and formal appointment of agency heads will support more effective scrutiny of service delivery expenditure and of public investment management processes. Strengthening of internal audit through reorganization of the function and establishment of a separate sub-cadre, together with upgrading of the approaches and techniques used for external audit through a greater focus on risk and performance, will ensure closer attention to regularity and purposes of spending on service delivery. Linking up these formal PFM measures to existing citizen accountability initiatives such as social audits and service delivery scorecards would serve to develop a stronger institutional fabric of demand-side pressure for service delivery performance.

"Fixing the budget" by improving its credibility and annuality would support increased predictability and greater smoothing of public expenditures, especially for capital investment, operations and maintenance, and commodities. Although public salary payments in Nepal have been made reliably and with only minimal delay, most other expenditures have suffered sizable adjustments and severe time lags. The disarray in the budget calendar is a major factor facilitating problems of limited credibility. Improvements in capital expenditure budgeting, through compliance with a more feasible budget preparation schedule, would make a large positive contribution to public investment management in the roads sector. Corresponding enhancements in expenditure planning and budget approval for operations and maintenance and commodities would be beneficial for performance in the health and roads sectors.

Strengthening the implementation of capital investment projects is high priority for improving the timeliness and quality of construction of new roads, bridges, and health care facilities. Earlier project approvals during budget preparation, national-level norm setting for input costs, pilot initiatives to boost contractor competition, and better local monitoring of implementation would all make small positive contributions either to implementation timeframes or to the quality of delivery. None of these is claimed as a major or wholesale solution to the significant current weaknesses in public investment management. However, they would serve to promote some shifts in incentives by contractors, would increase the level of performance information available to government officials, and would establish a more rational and realistic annual implementation schedule.

Joining up the central institutions to ameliorate the situation of institutional fragmentation and strengthen the functions of the MoF would provide a clearer line of sight for central government on service delivery performance. Institutional mechanisms such as the PEFA Steering Committee (comprising joint secretaries from major spending ministries) provide opportunities to support better service delivery. These mechanisms for decision making and financial management offer a valuable precedent for further technical and institutional measures. The proposal to strengthen the Budget Division in the MoF and to build more strategic budgeting capability would have positive benefits in relation to the analysis of spending ministries' proposals for service delivery programs.

This brief discussion outlines how some of the proposed PFM reform actions might be expected to contribute to improvements in service delivery, albeit indirectly. It is important to remember that public expenditure and PFM is only one set of contributory factors here. However, it is argued that the measures proposed would have a beneficial effect on health and roads sector service delivery.

9.3 Options for external engagement and joint monitoring of progress

The risks and entry points set out in this report have implications for the engagement of external actors. Development partners can work with the government on the different reform areas. They need to consider what scope there is for technical assistance and other forms of support. This section concludes by presenting a short list of indicators that the government and development partners could monitor jointly to assess improvements in PFM performance over time.

The current situation requires external actors to allow space as the government continues to develop its reform agenda. The experience of TSA implementation shows that, even in a situation of considerable uncertainty and potential opposition, the government is capable of implementing technically ambitious and politically challenging reforms. Success in this area suggests there are areas of reform that can find strong backing among technical officials without threatening political stakeholders into instant opposition. While external actors may not always know the best opportunities, the problem areas identified in this report could at least facilitate productive dialogue between development partners and the government based on the acknowledgement that these are shared problems often noted by the government as well as development partners.

Development partners should consider how best to support government-led initiatives. Table 7 offers a list of potential activities involving external support but led by the government. The list is deliberately short and does not include prescriptions. This list could form part of a broader conversation about reform trajectories and directions between government and development partners. A dialogue will inevitably result in items being added or dropped, and the agenda will change as it becomes evident where good matches between external support and domestic leadership lie. Support does not have to be financial in the first instance.

Table 7: Donor engagement options on immediate PFM actions

Immediate action possible	Donor engagement options
Strengthen oversight and external scrutiny	
(a) Maintain institutional presence and basic capacity of PAC support function and cadre (b) Review qualification standards and requirements for auditors at local level (DTCOs, DDCs, VDCs, municipalities) (c) Formally distinguish internal audit from treasury roles in DTCOs (d) Establish a separate sub-cadre of internal auditors	(a) Facilitate the reconvening of the PAC support cadre and provide training in principles and approaches (b) Provide technical backstopping support to accredited local accountancy bodies to carry out review (c) Offer information on potential models and associated guidance to support development of a proposal and decision by the relevant authority (e.g., PEFA Steering Committee) (d) Provide mentoring options for newly appointed/recruited internal audit staff
Fix the budget	
(a) Joint work by MoF, NPC, line ministries to reach joint understanding about restructuring budget calendar to clearly separate planning, formulation, and execution	(a) Share comparative budget calendars and guidance from other countries; then convene workshop to discuss different formulations and their benefits/disadvantages
Improve capital project implementation	
(a) Ensure work plans and procurement plans are completed and approved before projects enter the budget	(a) Support government-led functional review of authorization and approvals process for capital projects; then support identified streamlining actions through pilot exercises
Join up central agencies	
(a) Strengthen coordination function of PFM Steering Committee to hold regular meetings, including technical staff inputs where appropriate (b) Strengthen analytical, planning, and institutional leadership capability of PEFA Secretariat to take forward a reform agenda across different agencies (beyond FCGO) (c) Strengthen budget leadership role of Budget Division in MoF, including its challenge function and strategic budgeting capability (d) Formally or informally, protect in-post tenure of key PEFA-relevant staff positions at MoF, FCGO, and other agencies (e) Review non-financial performance incentives of each ministry or department to make key PFM-relevant staff positions attractive to fill and retain (f) Joint consultative review of inter-ministerial arrangements in budget planning, formulation, and execution to establish clear division of roles between NPC, MoF, FCGO, line ministries, and local bodies	(a) Provide temporary co-secretariat role for the Steering Committee and offer guidance on terms of reference, agenda setting, and conduct of the meetings (b) Consider options for adding capacity to the PEFA Secretariat to support with planning and analysis (c) Provide targeted technical assistance on a demand-driven basis to support planning and implementation of changes (d) Work with PFM Steering Committee to develop new proposals to Ministry of General Administration on transfers (e) Produce international comparative analysis of similar schemes for PFM coordination mechanisms to use as basis for developing proposals for strengthening coordination function in Nepal (f) Provide technical support to the review

In parallel with direct engagement on reform initiatives, development partners and the government should develop a set of indicators to monitor progress on PFM. A joint monitoring process has the potential to focus dialogue with the government on a set of priorities without committing to a rigid set of activities that restrict the ability of stakeholders to adjust to a rapidly changing political environment. In a context where structural changes to the architecture of the state are exposed to multiple operational risks, it might not be feasible for detailed implementation plans to remain fit for purpose for extended periods of time. A recent comparative study of post-conflict reforms in eight countries found there was no apparent relation between detailed upfront plans and eventual reform success (Fritz et al. 2012).

There are downsides to structuring engagement on PFM around a set of indicators. As with every other target-based mechanism, there is a significant risk of moral hazard that needs to be mitigated. This is a problem common in both developed and developing countries. For instance, problems around the target-setting public sector management approach in the UK have seen ample study (Hood 2006; Hood 2007). Similarly, there is now a growing body of evidence suggesting that a focus on targeting formal institutional change has had a negative effect on developing countries. This point has been made forcefully by Matt Andrews, Lant Pritchett, and Michael Woolcock, among others. They argue that, instead of creating better institutions, poorly designed reforms aimed at reaching objectives measured against institutional indicators create the shells of institutional form without strengthening government functionality. At the same time, these reforms divert capacity from more important priorities (Andrews 2009; Andrews 2013; Pritchett et al. 2010; Pritchett et al. 2012).

Box 5: Potential PFM improvement monitoring indicators

1. To capture aggregate fiscal discipline:
   - *Public sector debt and deficit (as a percentage of GDP)*
2. To capture basic PFM functionality to ensure budget execution:
   - *Percentage variance between budgeted and actual expenditures (aggregate and by ministry)*
   - *Virements as a percentage of total annual expenditures (aggregate and by ministry)*
   - *Percentage of current, capital, and total expenditure spent in last trimester*
3. To capture the government's ability to adhere to a structured budget calendar:
   - *Number of activities in the budget calendar adhered to according to proposed timeline*
   - *Number of months prior to July 15 expenditure ceilings were provided to line ministries*
   - *Number of weeks/months prior to July 15 the budget was submitted to Parliament*
   - *Number of weeks after July 15 the budget was passed by Parliament*
   - *The FCGO submits financial statements to AG by December 15*
4. To capture the ability of the MoF to operate a top-down budget:
   - *Percentage of capital projects in the approved budget with fully detailed plans proposed by ministries*
   - *Number of ministries that adhere to expenditure ceilings provided by the MoF*
   - *Percentage variances between MTEF ceilings, Resource Committee ceilings, and Red Book ceilings*
5. To capture the ability of central institutions to carry out their functions free from undue political interference:
   - *Percentage variances between MTEF ceilings, Resource Committee ceilings, and Red Book ceilings*
   - *Length of tenure of:*
     - *Finance secretary, finance comptroller general, AG, CIAA chief commissioner, NVC director, PPMO director*
     - *Joint secretaries at MoF, FCGO, OAG, CIAA, NVC, PPMO*
   - *Percentage of civil servants at MoF, FCGO, OAG, CIAA, NVC, PPMO subject to the two-year requirement who complete their posting before moving to another position*
   - *Size of contingency line to total expenditures; and percentage of expenditure actually charged to contingency line*
6. To capture effective external scrutiny of the budget to ensure probity of public funds:
   - *Percentage of arrears in total expenditures*
   - *Percentage of irregularities in total expenditures*
   - *Percentage of settled irregularities*

Source: Authors' compilation.

Several steps can be taken to mitigate moral hazard around monitoring indicators. First, the risk is much lower if there is agreement among a viable coalition of stakeholders about the purpose of reform. Given the political nature of PFM and its importance for the management of public resources, there are always going to be losers of change. Having a supporting coalition is not a trivial requirement, since part of the moral hazard is precisely to declare superficial "ownership" without a process of debating and negotiating a set of objectives within government as much as between government and other actors. Second, the pitfalls of targets are reduced the closer the indicator is to measuring function instead of form. Unfortunately, measuring function is a very difficult process, and in some ways this challenge is at the cutting edge of the international policy debate on development.

The list of potential monitoring indicators can be only a starting point for a process of debate and negotiation. To provide a degree of flexibility over focus, scope, and ambition, the suggestions listed below cover PFM at different levels. It is important to underscore that this is not meant to be final or definitive. The list also does not set targets for any of the potential indicators, which would be premature. Any firm set of indicators and targets can be the result only of dialogue between stakeholders, and some indicators may be best used for a qualitative assessment on a regular basis without setting any firm target at all.

Appendix A: Mapping of donor support to national and local PFM reforms

Donor support	Project title	Amount and implementation modality	Activities	Implementation period	Responsible government agency
MDTF funding: AusAID, Denmark, DFID, and Norway	Strengthening PFM Systems	$4.3 million MDTF (recipient-executed and bank-executed)	Upgrading IFMIS for TSA Function; Enhancement of Information System; TSA Rollout Support; Training/Study Tour, Convergence to IFRS; Commitment Accounting; IPSAS Training/Study Tour; PFM Capacity Building	October 13, 2011-June 30, 2015	FCGO, ASB, and PEFA Secretariat
World Bank MDTF funding: AusAID, Denmark, DFID, and Norway	Strengthening the OAG Project	$2.3 million MDTF (recipient-executed and bank-executed)	Enhance the Quality of Financial Statement Audits (1.2); Upgrade the Capacity to Conduct Performance Audit (0.6); Enhance the Impact of Audit	January 2012-June 30, 2015	OAG
World Bank MDTF funding: AusAID, Denmark, DFID, and Norway	Strengthening Demand-Side PFM Capacity	$ 1.5 million MDTF (recipient-executed and bank-executed)	Grant Making to CSOs for Action Learning, Training, Monitoring, and Awareness Raising; Knowledge Sharing; Monitoring Impact Evaluation, and Research		CECI
ADB, DFID, CIDA, Embassy of Denmark, Embassy of Norway, and SDC (pool funds) supported by UN agencies and GIZ	Local Governance and Community Development Program	Program implemented by DDCs, Municipalities, and VDCs supported and supervised by Ministry of Local Development	PFM support at subnational level to improve accounting system; Minimum Conditions and Performance Measures to enhance overall management at local level; improve planning and budgeting system; capacity-building activities	July 2008-June 2012	Ministry of Local Development

Donor support	Project title	Amount and implementation modality	Activities	Implementation period	Responsible government agency
ADB	Strengthening Public Management	Program grant	Enhance linkages between central and local budgets and fiscal management (in coordination with other development partners; address gaps and disconnects between central and local levels, including development of three-year rolling MTBF); strengthen PFM and reduce fiduciary risks at local level (largely supports implementation of Ministry of Local Development PFM and fiduciary risk action plan); institutionalize procurement reforms at national and local level (work with PPMO to implement its strategic plan); strengthen capacity of oversight and accountability institutions (CIAA, OAG, NVC)	Mid 2012-2015	MoF, Ministry of Local Development, local bodies (DDCs, VDCs and Municipalities), CIAA, OAG, NVC
DFID	Nepal Health Sector Support Program	Implementation subject to funding	Review of scope for Transaction Accounting and Budgeting Control System	Implementation subject to funding	MoHP
DFID	Nepal Health Sector Support Program	Technical assistance support aligned behind national health plan NHSP 2	Annual support to budget preparation and analysis process	Ongoing until 2015	MoHP
DFID	Rural Access Program	Implementation pending approval	Support to implement MoFALD's fiduciary risk reduction action plan in program districts; trial results-based payment system in program districts	3 years	DoLIDAR/ MoFALD
USAID	Nepal Economic Growth, Agriculture, and Trade	$1 million Program implemented by Nepal Economic Growth, Agriculture, and Trade, a US contractor	(a) Enhancing tax payments – ABBS (payment of taxes through e-payment system); (b) support IRD in data links with 2 more government agencies for increased tax revenue; (c) training to IRD staff	(a) June 2010-July 2012; (b) June 2012-June 2013; (c) June 2012-June 2013; (d) June 2012-June 2013	IRD/MoF

Donor support	**Project title**	**Amount and implementation modality**	**Activities**	**Implementation period**	**Responsible government agency**
			on 3 of the specialized tax areas; (d) establish and help operate a Revenue and Policy Analysis Unit at IRD		
GIZ	Subnational Governance Program	Consultancy, training, policy development	Accrual accounting implementation (training, software use, asset valuation, opening balance); revenue administration capacity building (own-source revenues, tax administration); fiscal decentralization (grant formula, fund flows, channeling of funds); Minimum Conditions and Performance Measures; municipal solvability assessment	Ongoing up to June 2014	Municipal Management Division/ Ministry of Local Development, Local Fiscal Bodies Commission
ADB	Local Governance and Community Development Program				
IMF	Article IV Missions from Asia-Pacific Department			Regular periodic missions	MoF
IMF	Diagnostic support on PFM from Fiscal Affairs Department	Occasional and regular short missions from IMF headquarters	Regular Fiscal Affairs Department PFM diagnostic review missions and PFM evaluation missions; regular Fiscal Affairs Department Revenue Administration Division diagnostic review missions covering all aspects of revenue administration		MoF, NRB
IMF	Selected Asia-Pacific Division countries: Effective and Efficient Public Financial Management (JSA Program)	Resident advisor at IRD since August 2010 (50 percent of time); peripatetic advisor assisting Department of Customs since 2008; short-term technical assistance supporting Large Taxpayers Office (2008-2010); short-term	Advisory support to IRD to improve compliance levels (registration, return filing, audit, arrears); short term support to IRD's Large Taxpayers Office to improve audit function performance; advisory support to Department of Customs on reform planning, organization structure, risk	2008-2013	IRD/MoF, Department of Customs

Donor support	Project title	Amount and implementation modality	Activities	Implementation period	Responsible government agency
		technical assistance supporting Department of Customs (2011)	management, etc.; short-term support for Department of Customs post-clearance audit function and to develop an IT strategy		
IMF	Resident PFM advisor (funded by JSA)	Resident advisor	Advising on TSA, budget execution, accounting and financial reporting, capacity building, PEFA, internal audit, donor coordination, PFM reforms, etc.	August 2009-November 2011; June 2012-December 2013	MoF, FCGO
EU	To support future priorities of the World Bank, MDTF and ADB program	€10 million		2012-2015	
EU	Support to Ministry of Peace and Reconstruction	€210,000 technical assistance	Supporting Ministry of Peace and Reconstruction in finalizing a Financial Management Action Plan and its implementation; carrying out a PFM diagnostic; ensuring improved reporting	2011-2015	Ministry of Peace and Reconstruction

Note: Includes training/capacity building, technical assistance projects, and PFM-related analytical work (PEFA, public expenditure reviews, etc.). Includes projected budget figures.

Appendix B: List of people interviewed

ADB

Sid Vikram	Senior Governance Specialist
Rachana Shrestha	Public Management Officer
Sishir Bhattarai	Consultant

AusAID

Tara Gurung	Country Manager
Ben Reese	Head of Post

DFID

Bandhu Ranjan	Program Manager
Matt Gordon	Team Leader for Service Delivery

Embassy of Denmark

Kirsten Schack	Counselor Finance

Embassy of Germany

Omar Kassab	Researcher

Embassy of Norway

Asbjorn Lovbraek	Counselor

Embassy of Switzerland

Pramesh Shrestha	Head, Finance and Controlling

EU

Lluis Navarro	Head of Cooperation
Gerrard Van Driesschf	Head of Finance

Former government of Nepal officials

Khem Raj Nepal	Former Local Development Secretary
Dilli Raj Khanal	Former MP, UCPN(M)
Madhab P. Ghimire	Former FCG
Keshav Acharya	Former Advisor to MoF
Prithvi Raj Ligal	Former NPC Vice Chair
Minendra Rijal	Former Minister
Ram Sharan Mahat	Former Finance Minister
Surendra Pandey	Former Finance Minister
Rameshwor Khanal	Former Finance Secretary
Avanindra Shrestha	Former PPMO Secretary

Government of Nepal officials

PFM Project Team	
PEFA Steering Committee	
Baikuntha Aryal	Joint Secretary, Economic Policy Analysis Division, MoF
Durgesh Kumar Pradhan	Under Secretary, Budget and Programme Division, MoF
Lok Darshan Regmi	Joint Secretary, Budget and Programme Division, MoF
Suresh Pradhan	PEFA Coordinator, FCGO

Madhav Karki	Deputy Director General, Department of Roads
Krishna Hari Baskota	Secretary, Office of Prime Minister and Council of Ministers
Ganesh Joshi	Secretary, CIAA
Yuba Raj Khatiwada	Governor, NRB
Mahesh Prasad Dahal	Financial Sector Management Division, MoF
Hari Bhakta Shrestha	Joint Secretary, MoPIT
Babu Ram Marasini	Program Coordinator, MoHP
Rajendra Nepal	Joint Secretary, Accounts and Administration, MoPIT
Sri Ram Poudel	Adviser to Finance Minister
Padam Bahadur Chand	Joint Secretary, MoHP
Prabin Mishra	Secretary, MoHP
Ramesh Nath Bastola	Executive Director, RBN
Bir Bahadur Rai	Joint Secretary, Ministry of General Administration
Dinesh Thapaliya	Joint Secretary, MoFALD
Madhav Regmi	Secretary, NVC
Pushpa Lal Shakya	Joint Secretary, NPC
Suresh Tiwari	PFM Adviser, MoHP
Dhan Bahadur Tamang	Secretary, PPMO
Bimala Subedi	Acting Auditor General
Som B Thapa	Secretary, Public Accounts Committee
Tulsi Sitaula	Secretary, MoPIT
Bodh Raj Niraula	Joint Secretary, MoFALD
Teertha Dhakal	Joint Secretary, NPC
Yub Raj Bhusal	Secretary, NPC
Begendra Paudyal	Joint Secretary, Ministry of General Administration
Deependra Bahadur Kshetry	Vice Chair, NPC
Mingmar Gyalgen Sherpa	Director General, DoHS

IOM

Tom Sinkovits	Chief of Mission

Other

Madan Dahal	Economics Professor, Tribhuvan University
Kedar Khadka	Director, Pro-Public
Parashu Ram Upadhyay	Executive Director, National Association of VDCs in Nepal
Bishnu B KC	Chair, Transparency International Nepal
Hem Raj Parajuli	Executive Director, Association of DDCs in Nepal
Krishna P Sapkota	Former Chair, ADDCN, former CA Member
Sagar Prasai	Deputy Country Director, The Asia Foundation
Udaya Pant	IMF Adviser (at FCGO)
Suresh Basnet	President, Chamber of Commerce
Suraj Vaidya	President, FNCCI
Jayaram Lamichhane	President, Federation of Contractors' Association of Nepal

UNDP

Binod Lamsal	Financial Analyst

USAID

Rave Aulakh	Senior Economist
Amy Fawcett	Financial Controller

Kristin Ray	Deputy Director, Program Office
Rajeeb Shakya	Financial Analyst

World Bank

Tahseen Sayed	Country Manager
Aurelien Kruse	Country Economist
Hiramani Ghimire	Senior Governance Specialist
Roshan D Bajracharya	Senior Economist
Farhad Ahmed	Senior Transport Specialist
Deepak Shreshtha	Senior Transport Specialist
Bigyan Pradhan	Senior Financial Management Specialist
Rajib Upadhyay	Senior External Affairs Officer
Manoj Jain	Lead Financial Management Specialist
Rama Krishnan Venkateswaran	Senior Financial Management Specialist
Richard Holloway	Coordinator, Program for Accountability in Nepal
Mohan Aryal	Education Specialist, World Bank

Appendix C: Summary matrix of challenges, entry points, and recommendations

Core problem	Specific PFM challenges	Entry points	Recommendations for donors
Public spending is compromised	Ineffective oversight and scrutiny	(a) Maintain institutional presence and basic capacity of PAC support function and cadre (b) Review qualification standards and requirements for local government auditors (c) Formally distinguish internal audit and treasury roles in DTCOs by establishing a separate sub-cadre of internal auditors	(a) Facilitate reconvening of PAC support cadre and provide training in principles and approaches (b) Provide technical backstopping support to accredited local accountancy bodies to carry out review (c) Offer information on potential models and associated guidance to support development of a proposal and decision by the relevant authority (e.g., PEFA Steering Committee) (d) Provide mentoring options for newly appointed/recruited internal audit staff
	Dysfunctional budget process	(a) Joint work by MoF, NPC, line ministries to reach joint understanding about restructuring budget calendar to clearly separate planning, formulation, and execution (b) Ensure budget is submitted to Parliament a reasonable amount of time prior to start of fiscal year	(a) Share comparative budget calendars and guidance from other countries; then convene workshop to discuss different formulations and their benefits/disadvantages
	Weak implementation of capital projects	(a) Ensure feasibility studies, work plans, and procurement plans are completed and approved before projects enter the budget	(a) Support government-led functional review of authorization and approvals process for capital projects; then support identified streamlining actions through pilot exercises
	Flawed central institutions	(a) Strengthen coordination function of PEFA Steering Committee to hold frequent and regular meetings, including technical staff inputs where appropriate (b) Strengthen analytical, planning, and institutional leadership capability of PEFA Secretariat to take forward reform agenda across different agencies (beyond FCGO) (c) Strengthen budget leadership role of Budget Division in MoF, including its challenge function and strategic budgeting capability (d) Formally or informally, protect in-post tenure of key PEFA-relevant staff positions at MoF, FCGO, and other agencies (e) Each ministry or department to review non-financial performance incentives to make key PEFA-relevant staff positions attractive to fill and retain (f) Joint consultative review of inter-ministerial arrangements in budget planning, formulation, and execution to establish clear division of roles between NPC, MoF, FCGO, line ministries, and local government bodies	(a) Provide temporary co-secretariat role for Steering Committee and offer guidance on terms of reference, agenda setting, and conduct of the meetings (b) Consider options for adding capacity to PEFA Secretariat to support with planning and analysis (c) Provide targeted technical assistance on demand-driven basis to support planning and implementation of changes (d) Work with PFM Steering Committee to develop new proposals to Ministry of General Administration on transfers (e) Produce international comparative analysis of similar schemes for PFM coordination mechanisms to use as basis for developing proposals for strengthening coordination function in Nepal (f) Provide technical support to review

Notes

[1] Capital expenditures for the district of Kathmandu, which is included in the Central region, include direct payments and commodity grants from development partners. Several districts make expenditures using such sources, but the FCGO adds most of them to Kathmandu because of difficulties in tracing district expenditure. As a result, total expenditure of Kathmandu appears unreasonably high.

[2] http://www.state.gov/e/eb/rls/othr/ics/2012/191206.htm

[3] In addition to the 2002 Anti-Corruption Act, there is also a CIAA Act, of 1991 and 2002, as well as the CIAA Regulations of 2002.

[4] Altogether there are six departments: the FCGO; the Department of Customs; the IRD; the Department of Revenue Investigation; the Revenue Administration Training Center; and the Department of Money Laundering Investigation. The PPMO is in a category of its own.

[5] The MoHP covers over 91 percent of the total budget for the health sector, and is the primary focus of the discussion in this report, especially given data constraints. We do recognize that the health sector in Nepal spans the MoHP, MoF, the Ministry of Defence, the Ministry of Home Affairs, and the Ministry of Commerce and Supply.

[6] Within the MoHP there are additional divisions and departments that manage other aspects of the health sector besides service delivery, including, for example, drug procurement, curative programs, AIDS, and population management. The two main divisions other than the DoHS are the Drugs Administration, which holds only 1 percent of the budget, and the Department of Ayurveda.

[7] Local Self-Governance Act, 1999, and Local Self-Governance Regulation, 2002.

[8] The maternal mortality rate has been reduced despite the fact that still only 29 percent of births are attended by skilled health personnel, against a goal of 60 percent.

[9] The National Transport Policy (2001) classifies "strategic roads" as national highways and feeder roads, whereas "local roads" are rural roads, agriculture roads, and main trails. Urban roads, postal roads, and bridges are in separate categories under the authority of DoR.

[10] This figure was quoted to the team during a meeting with officials in Chitwan.

[11] Budgets for the LRN under the DRO are typically less than NRs 1 million, but the DRO manages 40 of these with a small number of staff, who spend 80 percent of their time dealing with politicians and user committees and traveling across the district.

[12] The authors were able to obtain only two MTEFs: 2007/08 through 2009/10 and 2011/12 through 2013/14. The 2011/12 MTEF shows some improvement, as it does not provide for the same flat rate across ministries and agencies. However, proper analysis cannot be made to compare with the Red Books since they are future years.

[13] The IMF (2012) reports 26.5 percent in 2008/09 and 9.5 percent in 2009/10. Our calculation is 12.3 percent for 2009/10 and 9.95 percent for 2010/11 based on the Red Book (Virement Out/Final Budget).

[14] See also http://www.oecd.org/site/anti-corruptioninitiative/policyanalysis/35110064.pdf

[15] The procurement process for the roads sector is the same for the SRN, the LRN, and bridges.

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