



Nepal - Public Financial Management Multi Donor Trust Fund - Strategy for Phase II (2017-2022)

June 2017

Nepal Public Financial Management Multi-Donor Trust Fund

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1. Introduction and Context

In March 2016, the Public Financial Management Reform Program, Phase II (PFMRP II) which builds on the progress of the first phase of PFM reform (PFMRP-I), findings of the second PEFA assessment and the priority PFM areas identified by the Government of Nepal (GoN), has received endorsement from the PFM Steering Committee chaired by the Finance Secretary. Building on this, the PEFA Secretariat has prepared an implementation program, detailing the various activities and their costing, stakeholders, governance mechanisms and an integrated results matrix. This plan is meant to be approved by PFM Steering committee soon. The 2017/18 Budget proposal allocates around \$M 1.1 to the implementation of PFMRP2.

This paper aims to present a strategy and objectives for the phase II of the Nepal Multi-Donor Trust Fund (MDTF) for Public Financial Management (PFM) in support of the GoN's PFM reform program, which would provide a framework for engagement until 31 January 2022, its extended closing date. Several partners have communicated that in order to program financing for the next phase, such a strategy would be necessary and that the MDTF partners and the GoN's engagement in PFM reform have reached a level of maturity that would allow for a structured approach around a shared vision and clear strategic orientations.

The Nepal PFM MDTF was activated in December 2010. It is administered by the World Bank and jointly funded by the following donors: UK Department for International Development (DFID), the Government of Norway Australia DFAT, USAID (United States Agency for International Development), the European Union and the Government of the Swiss Confederation.

The objective of the MDTF for PFM is to support Government of Nepal's strategy to strengthen governance, optimize outputs from public resources and for ensuring inclusive and broad-based development. In particular, the MDTF aims to support the Nepal's Public Financial Management Strategy/ Program (PFMRP) Phase II (2016/17-2025/26)¹, which articulates the objectives of the government in terms of PFM reform for the next decade around 14 sub-projects. Phase II of the PFM reform program is more comprehensive in its scope and encompasses most of the government's stakeholders and systems inside and outside the ministry of finance (budget preparation and execution, accounting, cash and debt management, revenue policy and collection, service delivery and accountability mechanisms). It also sets a longer time horizon.

¹ Ref. <http://www.pefa.gov.np/wp-content/uploads/Second-Phase-PFM-Reform-Actionplan.pdf>

2. Results and Lessons Learned during Phase I (2010-2015)

During Phase 1, the MDTF has funded several sub-projects, analytical activities and technical assistance that have helped modernize various PFM sub-systems of the budget cycle and accountability framework and also strengthened the institutional capacity of the institutions performing these functions. It has also contributed to increased PFM awareness among stakeholders and a better coordination among development partners around PFM reform support. The second PEFA assessment report conducted in 2015 (the 2008 assessment laid the basis for the setup of the MDTF) notes upgrades in 19 indicators (61%), downgrades in 2 indicators (7%) with 10 (32%) indicators remaining constant. Notably, improvements have been made during the two PEFA assessments (i.e. phase 1, 2010-2015) in the areas of budget credibility, comprehensiveness, budget formulation process, accounting, reporting, and audits – most of which were funded under the phase I. The use of Information Technology has been a core area that has assisted in this improvement.

Lessons have been learned during phase 1. First the fact that successes can be achieved, like with the TSA implementation and deployment, when there is a common view among stakeholders, internal and external, on the direction to be taken and a strong leadership and necessary skills within government (in this case FCGO). Also, the role of the GoN's PEFA Secretariat has been crucial during phase 1 in the inter-institutional coordination of the central finance function. When the Secretariat did not sufficiently succeed in this coordination effort, successes have been more elusive. More needs to be done to enhance the institutional positioning and capacity of the PEFA Secretariat to strengthen this leadership and coordination role across all PFM stakeholders. Phase 1 has also shown the benefits of a strong coordination between external development partners. The MDTF

has contributed to this necessary coherence by being increasingly inclusive with the participation of new partners but also by providing a priority setting platform around which PFM initiatives managed outside of the MDTF could benefit. Phase 1 has also shown how fragile this coherence is and this will be a priority for the MDTF moving forward to strengthen coordination in PFM support. One other major lesson of phase 1 is that PFM reforms need to be at the same time given impulse and lead by the MOF but also adhered to and owned by a much wider constituency, which includes key central agencies (NPC, NRA, CIAA, and OAG etc.), line ministries and their autonomous agencies, Parliament and citizens. Otherwise there will be limitations in the achievements that can be envisaged and a disconnect between PFM reform and the wider policy objectives in terms of poverty reduction, economic development, reconstruction that the country is assigning to itself. Well performing PFM systems are a prerequisite for achieving policy goals, whichever they are. Therefore, there is a need for the PFM MDTF to be more in sync with the current challenges and ambition of the new republic of Nepal in this challenging time.

Finally, one of the lessons of the first phase is that more coherence has to be sought between the central and the sub-national PFM agendas. Both agendas have been fairly separated during phase 1 which resulted in inefficiencies, overlap and sometimes incoherence. In particular, with the devolution program established by the 2015 Constitution, both aspects (national and sub-national) of the PFM reform agenda have to be brought together. Most intended outcomes identified for the second phase of the PFM MDTF support would have to consider at the same time the national and the sub-national dimension and activities would have to be defined through this double prism.

3. The Evolving Context of PFM Reform

Nepal is under a political transition since 2006, which has not completely stabilized after the adoption of the 2015 Constitution. 2015 and 2016 have been quite traumatic for Nepal as a consequence of the April 2015 earthquakes and the economic blockade that started in September 2015. 2017 will be an electoral year with elections to be held at central and local levels. Local elections are taking place in June 2017. The implementation of the new Constitution will provoke a redefinition of the structure of the State, with far ranging consequences, notably in terms of PFM at the central and the local level. The scope of these changes and their impact on economic growth, the political transition and administrative processes is still quite unclear as this process is still in flux. Nevertheless, it has to be noted that the 2017/18 Budget proposal (Red Book) already organizes substantial resource transfers to local governments and, to a lesser extent, to provinces. This fluid

situation bears two consequences: the first one is that the MDTF needs to be quite flexible in its support of the PFM reform agenda in order to be able to adapt to the rapidly evolving context. In particular, this strategy will focus on a limited set of objectives and commit to a limited set of outcomes covering only the first 3 to 4 years of the GoN's PFM action plan (PFMRP2) which covers the 2016-2026 period. The second consequence is that MDTF partners recognize that the fiscal federalism and decentralization process, based on a devolution of powers to local governments and provinces will need a strong leadership and capacity at the MoF level and a cross-governmental approach and that any meaningful PFM reform action plan would have to address this in one way or another. It has to be noted that while the GoN's National PFM strategy does not include this local PFM dimension, it was drafted at a time when the actuality of this process was particularly elusive and unpredictable.

4. Comparative Advantage of the PFM MDTF

The Nepal PFM MDTF has obvious comparative advantages on which phase II can build and expand.

First, the MDTF has been supporting PFM reform in Nepal in the last five years and can benefit from demonstrable results as well as lessons learned from specific shortcomings and challenges that have been faced. It has also expanded the knowledge pool on PFM in Nepal through studies and reports of high quality standard. Several projects are ongoing which have created a momentum for reform in a number of sub-systems (treasury, cash management, revenue management and budget execution, public sector accounting, private sector accounting, PFM training, citizen participation, external audit and others).

Second, the primary mode of execution has been recipient execution especially for modernization of systems, processes and procedures which have enhanced the ownership and incentivized the government to lead (like for the implementation of the Treasury Single Account). This has been very well complemented by World Bank execution for specialist and expertise support in niche areas through technical assistance (Cash Management, Commitment Control, TSA expertise, budgeting, medium term frameworks). In addition, several discrete studies have been carried out which have helped enhance understanding of the PFM issues in sector (PETS in Education Sector) and political risk in PFM (Operations Risk). As is evidenced from above, most of the areas

where PEFA upgrades have been reported were receiving technical and financial assistance from PFM MDTF which establishes its value add in GoN's overall/PFM environment and makes a strong case for not only continuing but broadening/elevating the engagement to the next level. This will help GoN accelerate the PFM reform process in sectors and reap benefits by improving the service delivery and deal with financial aftermath (post-quake) effectively.

The MDTF has been the active platform for PFM dialogue during this period and has played a major role in fostering coordination around PFM issues among the various stakeholders. The expanding membership of the MDTF has also increased the inclusiveness of the platform.

The MDTF, as well as the individual projects are managed by the World Bank which can tap into a global pool of expertise and bring to Nepal some of the best experts in their fields. Besides, the World Bank in Nepal is very active in a wide spectrum of sectors relevant to poverty alleviation and economic development, which creates synergies and cross-fertilization opportunities. Besides, fiduciary risks related to the management of the MDTF as well as for individual projects are dealt with in conformity with World Bank standards and practices and rely on the support of Nepal-based staff members in the financial management and procurement areas.

5. Vision and Strategic Focus (2017-2022)

The Nepal PFM MDTF envisions a country where solid foundations for credible and performing PFM systems at federal, provincial and local levels support economic development and service delivery for citizens.

This will be achieved through the pursuit of 5 strategic objectives, which are convergent, support each other, and underpin GoN's strategy:

1. **A credible and efficient budget process for central government** that allows for strong fiscal discipline, an allocation of resources that reflects policy priorities, a solid internal control framework (including the creation of an internal audit function), an increased performance orientation and adequate accountability, notably through monitoring, supervision and external audit mechanisms.
2. **An enhanced internal and external public resource mobilization framework** that would provide sufficient resources for economic development and service delivery needs through better debt management, tax policy formulation and tax administration.
3. **Solid foundations for decentralization and increased public spending at federal, provincial and local levels.** The decentralization process, substantially impacted by the federal status of the Republic, could lead to enhanced service delivery if it is managed well and if solid foundations for funding, accountability and reporting are established from the onset.
4. **A more efficient public investment management system,** encompassing central and local levels as well as the various sources for investment (internal and external), and with a specific focus on procurement.
5. **A PFM system supporting service delivery,** notably in sectors where the impact on poverty is greater like Health, Education, rural transport for instance as well as in the cross-cutting area of post-earthquake reconstruction. This would involve an adequate social accountability framework, closing the feedback loop and supporting citizens' voice. This would also imply a greater attention to the impact of PFM reforms and systems at sector level and a greater harmonization under the leadership of the MoF of the various sector level PFM systems.

The modalities through which the MDTF would support these strategic objectives are varied:

1. **Individual sub-projects funded by the MDTF**, which would either build on results obtained during phase 1 and directly following up on phase 1 projects or would be new projects.
2. **A programmatic knowledge services window that would fund studies and discrete technical assistance on-demand.** These services could provide analytic underpinnings to ongoing or new projects.
3. **Coordinating and finding synergies with other PFM initiatives when they provide unique value or complement work undertaken under the MDTF**, building on the convening role around PFM that the MDTF has played in phase 1. This implies recognizing that other stakeholders may be better positioned than the MDTF to lead in support of some of the strategic objectives.
4. **Supporting the PEFA Secretariat and other relevant key stakeholders to play a leadership role in PFM reform** and liaise with the political level and other key elements of the enabling environment.
5. **Providing an informed platform for dialogue on PFM**, including aspects of the political economy of PFM reform and its relations to public sector management and economic development.

The MDTF comes in support of the GoN PFM strategy (2016/17-2024/25) which aims at 8 outcomes: 1. Improved budget credibility; 2. Improved comprehensiveness and transparency; 3. Improved policy-based budgeting; 4. Predictability and control in budget execution; 5. Improved accounting, recording and reporting; 6. External scrutiny and audit; 7. Improved human resource management and capacity development for PFM; 8. Improved donor practices. The following table shows the relationship between these outcomes and the proposed strategic objectives of the MDTF (from elusive match: yellow, to strong match: dark green).

	Credible budget process	Public resource mobilization	Fiscal decentralization and federalism	Public investment management	PFM for service delivery
Budget credibility	Dark Green	Light Green	Light Green	Dark Green	Light Green
Comprehensiveness and transparency	Dark Green	Yellow	Dark Green	Light Green	Light Green
Policy-based budgeting	Dark Green	Yellow	Yellow	Dark Green	Dark Green
Predictability and control in budget execution	Dark Green	Dark Green	Yellow	Dark Green	Dark Green
Accounting, recording and reporting	Dark Green	Light Green	Yellow	Light Green	Light Green
External scrutiny and audit	Dark Green	Light Green	Light Green	Light Green	Dark Green
HR management and PFM capacity	Light Green	Light Green	Light Green	Light Green	Light Green
Donor practices	Light Green	Yellow	Yellow	Dark Green	Light Green

6. Outcomes Expected from MDTF support

As mentioned previously, in view of the fluidity of the political process, the lack of predictability of the impact of the implementation of the Constitution, in particular in terms of the institutional and organizational features of the State as well as in view of the predictable resources of the PFM MDTF, at least on the short term, the Program developed in this document would like to be focused on 4 high-level outcomes to be achieved at the end of a 4-year period 2017-2020. While the strategic objectives defined above will remain valid over the life of the MDTF, it is very difficult at this stage to commit to specific outcomes over the longer period and it might be useful to embed a sufficient level of flexibility to define a second set of outcome when the context has stabilized. This also recognizes the fact that this MDTF will have to prioritize among the sub-projects and activities that constitute the PFM RP2 to select outcomes that are strategically meaningful, yet reasonably achievable within the current predictable funding and the perceived absorptive capacity of the government's stakeholders. The PFM RP2 implementation paper presented in June actually identifies areas where the MDTF is expected to play a key role and this has been taken into account in formulating this MDTF results framework. The MDTF matrix supports the higher-level objectives defined in the PFM RP2 but focuses on what is achievable in the shorter term and on selected areas where the MDTF can have more impact. The Program is expected to target three high level outcomes to be achieved towards end 2020. These high-level outcomes will be broken down into specific outcomes and then further into project/activity level objectives according to the following framework and results matrix:

OUTCOMES AND OUTCOME INDICATORS

1. Strengthened efficiency and results orientation of the budget cycle at national and sub-national level
 - 1.1. Execution rate of the capital budget reaches 50% at the end of the second trimester and 90% at the end of the year.
 - 1.2. Enhanced efficiency and integration of core financial IT systems is evidenced
 - 1.3. Revenue collection and tax administration improved resulted in improved scores in PI-20
2. Increased professional capacity of key PFM Stakeholders
 - 2.1. Increased capacity of PEFA Secretariat to design, manage and coordinate PFM reform
 - 2.2. Capacity building institutions in Nepal have strengthened capacity to deliver high quality professional development and training
 - 2.3. A critical number of staff received internationally accredited diploma in PFM (30 per year over 5 years)
3. Enhanced accountability in Public Financial Management
 - 3.1. Strengthened OAG capacity to deliver on its mandate in compliance with ISSAI
 - 3.2. Increased transparency and citizen participation in the budget process
 - 3.3. Increased involvement of relevant Parliamentary committees and oversight bodies in the budget process in acting on OAG report and assessing public expenditure quality and impact

PFM MDTF Result Matrix		
Result Indicators	Baseline	Measurement
Outcome 1: Strengthened efficiency and results orientation of the budget cycle at national and sub-national level		
Intermediate result 1.1: Execution rate of the capital budget reaches 50% at the end of the second trimester and 90% at the end of the year.	Baseline 2016: execution rate is around 10% at the end of second trimester and around 70% at the end of the year.	Data available through FCGO's budget execution reports
Intermediate result 1.2 : Enhanced efficiency and integration of core financial IT systems is evidenced	Baseline 2016: IT systems work in silos across government and within MoF (see mapping in annex)	Results are evidenced through: existence of a single dashboard for budget execution fed by LMBIS, TSA, CGAS or equivalent systems.
Intermediate result 1.3: Revenue collection and tax administration improved resulted in improved scores in PI-20	Baseline 2016: TBC. Provisionally, PI-20 is (CCD)	PEFA assessment to be conducted in 2020.
Outcome 2: Increased professional capacity of key PFM Stakeholders		
Intermediate result 2.1: Increased capacity of PEFA Secretariat to design, manage and coordinate PFM reform	Baseline 2016: PEFA Sec understaffed and no adequate skill development for PFM program design, monitoring and evaluation.	Results will be difficult to quantify but will be measured through quality of M&E information produced on PFM reform program implementation and concrete coordination initiatives among internal and external stakeholders.
Intermediate result 2.2: Capacity building institutions in Nepal have strengthened capacity to deliver high quality professional development and training	Baseline 2016: Training needs assessment for PFM staff (March 2015) ²	. FCGO adopts a PFM training strategy based on HRM policy and line ministries' needs as well as partnership with existing training institutes. . Knowledge management system is developed.
Intermediate result 2.3 A critical number of staff received internationally accredited diploma in PFM (30 per year over 5 years)	Baseline 2016: A cohort of 30 staff has prepared international accreditation over one year but passing rate around 20%	Number of PFM accreditation per year. Gender will be considered in designing activity objectives and monitoring.
Outcome 3: Enhanced accountability in Public Financial Management		
Intermediate result 3.1: Strengthened OAG capacity to deliver on its mandate in compliance with ISSAI	Baseline 2016: The closest baseline is the 2014 SAI PMF report.	SAI PMF study in 2020 with at least 6 indicators out of 24 showing improvement and less than 2 showing deterioration in performance.
Intermediate result 3.2: Increased transparency and citizen participation in the budget process	Baseline 2016: Difficult to measure. CPA guidelines and pilot have been adopted by OAG. Very little citizen participation in budget process at central level, experimental at local level (through PRAN and LGCDP mainly).	CPA guidelines mainstreamed in OAG practices with evidenced impact. Citizen participation evidenced at central and sub-national level (to be confirmed and detailed later).
Intermediate result 3.3: Increased involvement of relevant Parliamentary committees and oversight bodies in the budget process in acting on OAG report and assessing public expenditure quality and impact	Baseline 2016: PI-27 legislative scrutiny of the annual budget law is D (dim1) or not applicable. PI-28 Legislative scrutiny of external audit report is D (dim 1) or not applicable.	Expected results would be an overall score higher than D for PI-18 Legislative scrutiny of budgets and PI-31 Legislative scrutiny of audit reports (2016 PEFA Framework)

² <http://www.pefa.gov.np/wp-content/uploads/Training-Needs-Assessment-Final-Report.pdf>

Annex 1 :

Overall Risk Rating and Explanation of Key Risks

Table 1: Summary of Key Risks

Risk Category	Rating
Political and Governance	● High
Macroeconomic	● Substantial
Sector Strategies and Policies	● Moderate
Technical Design of Project or Program	● Moderate
Institutional Capacity for Implementation and Sustainability	● Moderate
Fiduciary	● Moderate
Environment and Social	● Low
Stakeholders	● Moderate
Other	--
Overall	● Moderate

The overall risk is “Moderate” as a result of the growing engagement with stakeholders on PFM reform issues and growing engagement of PFM steering committee. The PFM MDTF, has a track record of achieving results in several areas. There is a willingness to strengthen capacity of the PEFA Secretariat, with critical hiring recently completed or about to be.

Risks related to sector strategy and policies are mitigated by the implementation of the following measures: (a) high-level PFM Steering Committee to provide strategic guidance and overall monitoring of the project (in place); (b) PFM Working Committee comprising heads of all governmental stakeholder units to implement the PFM reform program in a coordinated manner (in place); (c) Effective project implementation and monitoring in progress and supported by PFM MDTF.

The stakeholders risk has been mitigated due to the regular meetings held by the working committee to discuss project progress and cross cutting issues.

PEFA Secretariat has recently agreed to participate in a GoN/DPs platform to exchange feedback on PFM reform as well as technical inputs. The PFM steering committee composition has strengthened with the inclusion of key external stakeholders. The practice of having periodic steering committee meetings has recommenced after a long lapse.

GoN has recently allocated around USD 1.1 M in the Budget proposal to fund the “PFM reform program” which is a substantial step towards increased commitment as well as sustainability.

Political and governance risks remain high since the institutional framework of the country is still in flux. It is hoped that during the lifespan of the second phase the institutional arrangements will stabilize. The PFM MDTF is also keeping its focus on the more technical issues and the building blocks of good public financial governance and will avoid supporting initiatives which are not anchored solidly in government agreed priorities and analytical underpinnings.

Annex 2 :

Short Note on Financial Situation as at 1st of June 2017

As shown in the table below, MDTF's available resources are to date around M\$ 10 (balance plus unpaid contributions minus commitments). In June the Procurement and the OAG2 projects as well as the IFMIS study will be processed, which will in total take up around M\$ 8.7 of these resources, which were contributed initially for phase 1 (except for \$2M additional contribution from DFAT) but will be supporting phase 2. This will leave around M\$ 1.3 of uncommitted resources.

Trustee	Fund Balance	Contribution Total	Contribution Unpaid	Contribution Paid	Grant Amount	Disbursements	Commitments
TF071617	4,078,836.53	20,935,013.54	1,530,365.61	19,404,647.93	16,702,874.86	15,144,193.63	846,350.49
TF072582	3,641,400.14	5,290,185.00	1,677,675.00	3,612,510.00	0.00	0.00	0.00
Total	7,720,236.67	26,225,198.54	3,208,040.61	23,017,157.93	16,702,874.86	15,144,193.63	846,350.49

PEFA Secretariat has presented an implementation plan for the National PFM strategy (PFMP2) which will involve the preparation of a comprehensive PFM project that will cover key components of the strategy and will require resources. Indicatively, the PFMP2 implementation plan is costed at around M\$ 18 over 4 years (2.75M of which will be contributed by GoN). The MDTF has started with the preparation of a project that will fund a large share of the PFMP2 in an integrated fashion. Approval of the project is scheduled to happen before end of the calendar year 2017.

The tables below, based on the best estimates of DPs early June 2017, provide an estimation of resources and their use during phase2. Additional resources, if they were made available, could cover i) increased results orientation in the disbursement modalities of MDTF-funded operations ; ii) increased engagement in the fiscal federalism agenda; iii) the acquisition of more ambitious and comprehensive IT packages as a result of the IFMIS study or iv) contribute to a flexibility window to respond to emerging needs during the transition to federalism.

Type of Resources	Amount (USD)	Remark
Balance from phase 1	10M	This includes \$M2 from Australian DFAT, made available in 2016 for phase2 and €M3 of additional resources (top up) provided by EU in December 2016 for phase 1.
EU pledge	4.5M	€M8 has been programmed for the period 2019-2022 and will be used towards MDTF and other PFM/fiscal decentralization programs. \$4.5 is just a broad estimate of the share that will fund PFM MDTF.
DFID's pledge	5.6M	Business case allocates £4.5M to MDTF with £1.5M to be made available only after evaluation. Disbursement after need is demonstrated.
Norway's pledge	4M	Only if need is demonstrated. 1.2M can be disbursed in calendar year 2017.
Swiss Embassy's pledge	3M	3M CHF. 1MCHF disbursed per year.
USAID's pledge	TBC	
Australian DFAT's pledge	TBC	The pledge in addition to the \$2M already disbursed will be known around September/October
Provisional TOTAL :	27.1M	

These resources are expected to be used in the following fashion:

Activities/projects	Amount (USD)	Remarks
SOAG2 project	4.4 M	Effectiveness in CY17
Procurement Reform project	4M	Effectiveness in CY17
IFMIS study	0.2M	Finalization Q1 CY2018
Integrated PFM project	10M	This is highly indicative and based on the costing conducted by GoN in the PFMRP2 implementation paper. This project is scheduled to be approved by December 2017.
Flexibility Window	8.5M	These resources can be used to bridge any emerging needs as indicated in the strategy.