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Reforms under Fiscal Stress

A Policy Note on the Priorities for Fiscal and Budget Reform in Nepal

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Executive Summary

i. While political events have dominated the headlines on Nepal, a significant subtext is the effort by senior technocrats over the past few years to keep the ship of state afloat. Through efforts to craft and implement the PRSP and to strengthen the budget system, a small group of senior technocrats have sought to sustain and lay the foundations for improved public sector performance through a set of pragmatic reforms.

ii. Yet unfolding political events threaten economic prospects and fiscal stability in the country. With security expenditure to combat a violent insurgency claiming a growing share of resources, Nepal faces the risk that declining economic performance will reduce domestic revenue intake as well as donor support. The consequence of such a trend would be to crowd out expenditure critical for sustaining development and thereby continue a vicious circle of economic decline.

iii. The PRSP provides, in part, a basis for stemming this tide, by articulating the government's intention to revive growth, improve service delivery, promote social inclusion and improve governance. Over the past few years government policy in the PRS has emphasized a transfer of resources to support rural and human capital development, including in areas where the insurgency poses a threat to livelihoods. However, implementation of this vision will depend critically on extraordinary political leadership and effective management of public resources. Private sector confidence and, therefore, economic recovery will depend on evidence of the government's ability to link PRS objectives and resource allocation to the creation of public infrastructure and improved delivery of key public services. Both domestic revenue and foreign assistance trends must be stabilized and strengthened by resolute actions that demonstrate strategic policy making, budgeting and implementation. This is a difficult challenge in the midst of an insurgency that constrains and threatens government operations in many parts of the country. A number of steps will have to be taken to confront these challenges.

iv. **Fiscal Management:** Nepal does not presently have a large fiscal deficit but preliminary simulations of potential economic shocks suggest that in the medium term Nepal could face debt servicing difficulties. The budget system has demonstrated its ability to maintain fiscal discipline. But, given the demand for greater expenditure on security functions and uncertainty regarding revenue and aid, maintaining fiscal balance and an appropriate composition of expenditure is becoming a more problematic issue. The government is faced with the possibility of either a growing *fiscal deficit* or a public *service deficit*. This raises questions about the appropriate fiscal strategy under the circumstances. Should the government accommodate to the fiscal deficit through additional borrowing or should it seek to contain it, and if so how? Should the adjustment be on the revenue side or through expenditure rationalization? Can the government make more efficient use of existing donor commitments? Can access to predictable external grant resources be increased to sustain productive expenditure? How can efficiency of public spending be improved?

v. A clearly articulated medium term fiscal strategy would be helpful both in building domestic understanding and reinforcing political commitment to realistic fiscal limits. It would also provide a useful basis to engage donors and the international financial institutions (IFIs) on their support for the strategy. A fiscal strategy that banks on raising substantial sustainable domestic revenues would be difficult under current circumstances of low economic growth in a conflict environment. Therefore, the strategy must rely on a three-pronged effort based on *expenditure rationalization, enhanced external assistance and some limited domestic borrowing*. While every effort should be made to enhance predictable donor support for the budget, it would make sense for the government to consider a significant expenditure rationalization both to ensure that priority activities are adequately financed and to demonstrate the political resolve to cut wasteful, low value programs and projects. If this political will is demonstrated, it would also increase the prospects for attracting external grant support, and thus allow some fiscal stimulus to the economy. Although current debt levels are above 50 percent of GDP and Nepal falls under the Highly Indebted Poor Country category, it may be appropriate to consider the scope to increase domestic borrowing to ensure counterpart funding for high value investments, although this should be undertaken on a limited basis and with full consideration of the macroeconomic and solvency implications of such borrowing. It would be clearly preferable for the government to use grant aid rather than domestic borrowing, but should grant aid fall short, it may be rational to undertake limited borrowing in cases where the returns to raising such counterpart funding would result in high economic and financial returns, if this is macro-economically viable.

vi. **Political Engagement in the PRSP and MTEF**: From the perspective of institutional development, one remaining area of weakness in the PRSP and MTEF is real political engagement in making strategic decisions on policy and the budget. While the unsettled political conditions that have prevailed over the past few years may explain both the lack of political engagement and the extraordinary compensating efforts of the technocrats, it is a weakness that must be addressed. The need to develop a fiscal strategy offers the opportunity to address this weakness. Appropriate adaptations would need to be made to the budget process to allow for the political leadership to be informed and make judgment on the fiscal strategy.

vii. **Linking the PRSP to the MTEF/Budget**: Most countries find it difficult to ensure allocation of resources and implementation of budgets according to plan or policy priorities. Weak links in the information and accountability chain can cause a divergence between plans and actual allocations. Since 2002 the Nepal government has undertaken a series of creditable and pragmatic actions to link the PRSP to the budget and to ensure allocations related to priorities. Notably, the MTEF has been used to improve the realism of development budget allocations and better alignment and funding of the highest PRSP priorities for ministries However, the additional fact is that actual development budget expenditure has fallen considerably short of even this more realistic appropriation. It is not clear if this underperformance reflects a problem of external financing shortfalls relative to what is anticipated in the budget, or whether security conditions in the country are preventing the execution of the development budget, or whether both factors are at play. But the ultimate impact on development spending is clear: the development budget has declined sharply as a share of GDP from 9 percent in 2000 to 6.3 percent in 2004 and estimated at 6.6 percent in 2005.

viii. **Executing the PRSP Budget Priorities**: Under these somewhat unpredictable and deteriorating financial circumstances, the government has sought to ensure that a subset of development projects (priority one projects) are effectively executed. Specifically, the government has ensured: (a) full funding of all priority one projects; (b) preferential fund release to priority one projects early in the fiscal year; (c) performance based fund release for subsequent trimester release, and (d) discontinuing virement of funds among priority categories. These measures have seen an improvement in implementation of priority one projects. It must be presumed that the costs of development budget cuts have been largely borne by lower priority projects.

ix. The government is in the process of expanding the focus of the MTEF to the full budget. This is important to avoid the risk of an excessive emphasis on the development budget and a lack of focus on recurrent activities. It is notable that whereas the PRSP is cast in terms of improving service delivery and social inclusion, the government has largely cast the implementation of the MTEF in terms of execution of priority development projects. While this was justified as a sequencing decision to initiate the MTEF, it does create a lopsided emphasis on ensuring resource flows to investments only, rather than to ensure flows to major government programs and their delivery. The sooner this distortion, which is anyway present in the dual budget, is corrected, the better it would be for effective implementation of the PRSP. However, the integration of the regular budget in the MTEF should be implemented with caution with respect to the capacity of the line ministries to handle an increased workload associated with medium-term planning of recurrent expenditures. This involves such issues as the adequacy of staffing levels and skills in macroeconomic forecasting and identifying spending priorities.

x. **Efficiency in Government:** The third area of the performance of the budget system, the technical efficiency of resource use, remains for all countries the most difficult area to assess and improve because of the dependence of performance on multiple factors – on incentives, skills and capabilities of staff, quality of management and supervision and the availability of complementary inputs. Issues of political uncertainty, civil service management, limits on political interference in day-to-day operations, adherence to financial and operational regulations, and accountability to service recipients all have a significant impact on the behavior and efficiency of government departments. A pragmatic approach to public sector reform will be necessary to achieve efficiency gains. For the near term, the challenge is to initiate a process of executing budgets to improve completion and operation of priority investment projects and delivery of key public services. With regard to efficiency of public investment, improving the timing and quality of work planning would allow a better use of existing project funding during the fiscal year. This is an achievable goal that does not depend on the broader challenge of improving the predictability and volume of external aid flows. A second area of focus is the integration of the development and regular budgets into the MTEF approach so that these are seen as two aspects of a unified strategy to improve government services and management of assets.

xi. **Summary of Recommendations**: Given the rapidly evolving economic situation and its adverse implications for the fiscal situation, Nepal confronts challenges both of appropriate fiscal policy design and reforms to expenditure management that requires urgent strategic decisions. Reforms to budget management via the MTEF should be adapted to ensure application of such a strategy while continuing reforms that enlarge the impact of better budget management.

- Clearly, the development of a draft of the **medium term fiscal strategy** to underpin the "top down" fiscal management framework is the major challenge confronting Nepal in the near term. This would enable the central agencies to anticipate major economic and fiscal trends over the medium term and adapt fiscal management accordingly. It would serve to focus cabinet attention on fiscal strategy ahead of budget preparation, force cabinet members them to recognize the need for hard choices and engage international partners. That would, in turn, provide the basis for a credible MTEF to be prepared. Under current fiscal circumstances, this would appear to be the most urgent challenge.

- The preparation and implementation of sector strategies is also helpful to the MTEF and in conveying progress to development partners. In primary education and in the health sectors, such strategies have enabled donors to confirm financial support in the form of sector wide adjustment programs. Thus sector strategies could complement the fiscal strategy and provide a potentially virtuous circle that could improve government performance and credibility.

- **High level political engagement in the PRSP and MTEF process** could be strengthened. While senior technocrats have played a role in compensating for this lack of engagement, it is an issue that will need to be addressed if political understanding is to guide the policy choices in the PRSP and MTEF. It would also be important for credibility vis-à-vis external partners.

- The PRSP in Nepal was viewed as a distillation of broad principles of the Tenth Five Year Plan. As such, it facilitates the integration of the plan/PRSP and the MTEF/budget. The government might consider further ways to ensure that strategic economic planning is effectively reflected in future versions of the PRSP and the budget. This will require consideration of how policies will be generated in the future and how planning may be adapted to provide the best strategic guidance as the country faces difficult fiscal and development challenges. Other PRSP countries such as Tanzania and Uganda have used sector working groups to strengthen policy formulation capability in the sector ministries which is then linked to the PRSP/MTEF. Nepal might consider a similar approach.

- The **budget preparation process** could be adapted to more clearly distinguish the resource implications of new policy and project initiatives from those due to ongoing commitments. Along with an overall fiscal strategy that defines the limits to revenue, deficit financing and spending, this would facilitate Cabinet engagement in prioritization of new initiatives within agreed fiscal limits.

- At the central level, it would be advisable to **consolidate the formulation and management of both the current and capital budgets** at the Ministry of Finance while strengthening the role of the National Planning Council in robust development of the macroeconomic framework, in identifying development priorities, in evaluating and screening investment projects and in monitoring and evaluation of government programs and investments.

- The government should continue its pragmatic approach to the MTEF. One of the tasks facing the government is with regard to expanding the MTEF approach to the full budget while deepening the processes and disciplines in the main ministries where service delivery outcomes are most critical. Identifying major programs that contribute to priority PRSP service delivery goals would help integrate the recurrent and capital budget preparation and execution. On the other hand, ongoing initiatives such as activity costing and performance budgeting which are very capacity intensive should be deferred until the circumstances are more appropriate for such high level reforms. Pragmatic goals such as improved work planning for public investment projects would deliver more tangible results in terms of effective use of available resources, including existing donor commitments, and completion of priority projects. Ensuring appropriate funding of operations for key public services would also be an appropriate goal that would be achievable. Monitoring and reporting on progress in implementing the budget would be important to sustain such progress and to restore the confidence of the public and development partners in the effective use of resources.

Reforms Under Fiscal Stress

A Policy Note on the Priorities for Budget Reform in Nepal

This note, first of the several on fiscal management and policy option notes planned, provides a concise assessment of the achievements to date of the ongoing reforms to budget management in Nepal and concludes with some guidance on the key focus areas of fiscal policy and expenditure management over the near and medium term. It is a selective assessment that looks at major aspects of the policy and budget process with a view to identifying areas for strategic focus, rather than a detailed rendering of the reforms. The note highlights the fiscal challenges that are assuming increasing prominence and which must be addressed by policy decisions and medium term reforms. While recognizing the uniqueness of Nepal's initial conditions, capacities and current security related challenges, the note takes account of international experience in implementing such reforms. The note starts with the economic and political background. The second section reviews fiscal trends and outlines issues to be considered by a fiscal strategy. The third section discusses institutional issues to strengthen the budget process.

1. Background

1.1 With a population of 24 million, per capita GDP of around $250 and 31 percent of the population below the poverty line, Nepal faces significant challenges to reducing poverty through growth and improved equity. Per capita income growth was 2.45 percent between **1985 and 1999** compared to 0.8 percent in the earlier two decades[1]. A number of social indicators improved over this period, including the literacy rate, rates of child immunization, and percent of the population with access to safe drinking water and electricity.

1.2 **Economic growth in Nepal during 2000-2005 has had to contend with a difficult political environment.** Over the past five years, a fractious mainstream political process and deteriorating governance environment have allowed the gradual emergence of a Maoists insurgency that now poses a challenge to the nation state. Political neglect and poor governance has sparked a violent Maoist uprising nationwide that has claimed more than 13,000 lives to date. This political turmoil has had a predictable impact on economic performance, with 2001-02 marking a significant low point with an actual decline in output.

[1] WDI data

Table 1.
Selected Economic Indicators: Growth Rate
(In Percent)

	FY 1990-2000 (average)	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05 (estimates)
GDP	5	5.5	-0.6	3.1	3.5	2.5
Inflation	8.5	2.7	2.9	4.7	4	5.7
Forex reserves	22.7	25.1	0.8	2.2	14	3.1

1.3 **Despite considerable political uncertainty, and perhaps because of it, important reforms have taken place.** The past few years have witnessed major political upheavals, including the death of the king and the dismissal of democratically elected governments. In this context, the main response to the economic crisis has been from the technocratic leadership in government where key officials have rallied to propose policies in the Tenth plan/PRSP to make growth and public services more inclusive to address conflict and poverty. The government effectively merged Nepal's Tenth Plan with the PRSP thereby avoiding potential conflict in objectives and instruments. The PRS's four broad pillars are: (i) generating equitable and broad based growth; (ii) improving service delivery; (iii) promoting social inclusion, and (iv) improving governance.

1.4 To support the implementation of the PRS, the government introduced: (i) the Medium Term Expenditure Framework (MTEF) which links the PRS to the budget; (ii) reforms in education, health, financial sector, and anti-corruption/governance programs; (iii) Immediate Action Plan (IAP) – a list of must complete actions in fiscal year, and (iv) devolved selected centrally controlled activities to local bodies under Local Self Governance Act, among others.

1.5 Implementation of the PRSP has had to content with continued disruptions in the political/security environment and related strains on public financing. Given the current political circumstances, the strategy has had to contend with restraining the pressure of security expenditure on aggregate spending, while simultaneously seeking to improve the allocation of resources to areas identified as priority by the PRS.

2. Public Finance Trends and Challenges

2.1 **Nepal's expenditure and revenue effort is similar to some other low income economies.** As a share of GDP, Nepal's average expenditure and revenue in recent years have averaged about 19 percent and 12 percent, respectively, compared to Guatemala's 13 and 11 percent, Tanzania's 15 and 11 percent, and Uganda's 21 percent and 11 percent. While Uganda raises about the same share of GDP in revenue as Nepal, it has been able to maintain a higher share of expenditure and fiscal deficits because of the larger share of aid it receives in grants. Net of grants, Uganda has a deficit comparable to Nepal. Sri Lanka and Pakistan have significantly higher revenue and expenditure, although the level of these countries' foreign financing is comparable with Nepal's (Table 2).

Table 2.
Comparative Fiscal Indicators for Selected Countries
(In Percent of GDP)

	Nepal				Pakistan				Uganda			
	Period (1990-2000)	2001	2002	2003	Period (1990-2000)	2001	2002	2003	Period (1990-2000)	2001	2002	2003
Revenue	10.0	11.9	11.9	12.3	16.9	15.6	17.1	17.5	9.3	10.6	11.5	11.2
Domestic Borrowing	1.5	3.0	3.6	2.6	4.9	2.5	3.9	2.3	0.4	0.6	0.2	0.1
Foreign Financing	4.7	4.6	3.4	3.5	2.4	3.6	3.5	2.6	7.5	9.3	11.1	10.0
Expenditure	16.6	19.4	19.1	18.4	22.9	21.6	23.1	22.4	16.3	20.8	22.8	21.4
Per Capita Income ($)/1	212.2	245.8	238.9	240.9	503.4	528.0	532.0	546.1	211.5	261.2	271.4	276.5

	Guatemala				Tanzania				Sri Lanka			
	Period (1990-2000)	2001	2002	2003	Period (1990-2000)	2001	2002		Period (1990-2000)	2001	2002	2003
Revenue	9.6	10.7	11.3	11.1	11.2	11.2	11.4		19.09	16.6	16.5	15.7
Domestic Borrowing			0.1	0.6	0.5	0.0	0.0		5.6	8.8	8	4.5
Foreign Financing		1.9	0.7	1.2	3.2	4.5	4.2		1.9	1.03	0.6	2.9
Expenditure	10.9	12.9	12.2	13.1	13.7	15.8	15.4		26.9	26.1	25.4	23.7
Per Capita Income ($)/1	1584.1	1689.7	1683.1	1674.7	258.7	280.0	294.0		737.3	858.4	879.5	920.6

/1 Constant 2000 US $

2.2 **While aggregate revenue and expenditure have been relatively stable, the composition of expenditure has changed significantly**. The share of security expenditure in Nepal has doubled since 2000, from 1.7 percent of GDP to over 3.4 percent of GDP. This trend has clearly caused a crowding out of other productive expenditure and is a major factor in the current fiscal situation. It is useful to review how other countries have dealt with the fiscal consequences of the need to allocate greater resources to security. Uganda also faces an internal insurgency as do other countries such as Colombia and Sri Lanka.

2.3 **Fiscal Policy Issues.** In the second half of the 1990s, Nepal financed total expenditure of 18 percent of GDP through revenues of 11 percent, foreign financing of about 5 percent of GDP and the rest through domestic borrowing which averaged 1.8 percent of GDP. Regular expenditure was successfully limited to 9 percent of GDP, allowing development expenditure of 9 percent.

2.4 Since FY2000, today, the insurgency has doubled expenditure on security to over 3.5 percent of GDP and correspondingly increased regular expenditure to 13.5 percent of GDP. Faced with a weak economy, declining aid resources and increasing security expenditure, Nepal has managed competing claims on resources to avoid large fiscal deficits largely by sacrificing development expenditure. In FY01-02, the government was able to limit the growth of total expenditure to 19 percent of GDP by cutting back development expenditure to 7.5 percent of GDP. Despite an increase in revenue intake to 12 percent of GDP, domestic borrowing increased to 3.6 percent of GDP to fund the deficit net of grants in FY02 (Table 3).

Table 3.
Government Operation 2001-2005
(In Percent of GDP)

	Pre - PRS			PRS					
	FY96-00 (Average)	FY00/01 Actual	FY01/02 Actual	FY02/03 Actual	FY03/04 Actual	FY04/05 Budget	FY04/05 Budget Mid-Year Amendment	FY04/05 Estimated Outcome	FY05/06 Budget
Revenue	11.0	11.9	11.9	12.3	12.6	13.1	13.7	13.5	14.1
Expenditure	18.0	19.4	19.1	18.4	18.0	20.8	21.4	19.1	21.9
Current	9.2	11.1	11.5	11.4	11.2	12.6	13.0	12.1	13.1
Consumption expenditure	4.2	5.1	5.3	5.0	4.9	4.7	5.1	5.2	5.3
Capital	7.5	6.9	6.1	4.9	4.7	5.9	6.1	4.7	6.4
Investment	2.4	2.0	1.5	1.4	1.2	1.2	1.2	1.0	1.4
Repayments	1.4	1.4	1.5	2.1	2.2	2.3	2.3	2.2	2.4
Current Account Surplus/Deficit (-)	1.9	0.7	0.4	0.9	1.4	0.5	0.7	1.4	1.0
Overall Deficit (before grants)	-7.0	-7.5	-7.2	-6.1	-5.5	-7.7	-7.7	-5.6	-7.8
Overall Deficit (after grants)	-5.3	-5.9	-5.6	-3.6	-3.2	-4.8	-4.8	-3.5	-4.6
Financing	7.0	7.5	7.0	6.1	5.5	7.7	7.7	5.6	7.8
Foreign Financing	5.1	4.6	3.4	3.5	3.8	6.0	6.0	3.8	5.7
Grants	1.7	1.6	1.6	2.5	2.3	2.9	2.9	2.1	3.2
Loans	3.4	2.9	1.8	1.0	1.5	3.2	3.2	1.7	2.5
Domestic Borrowing	1.8	3.0	3.6	2.6	1.7	1.7	1.7	1.8	2.0
Memo Items:									
Total Expenditure	18.0	19.4	19.0	18.5	18.2	20.8	21.4	19.1	21.9
Regular expenditure	8.9	10.4	11.5	12.1	11.9	12.0	12.7	12.5	12.9
o/w security	1.7	2.4	3.2	3.3	3.2	2.9	3.3	3.5	3.4
Development expenditure	9.1	9.0	7.5	6.4	6.3	8.8	8.8	6.6	9.0
Aid (% of Development expenditure)	56.5	50.7	45.7	54.7	61.0	68.5	68.5	57.7	63.8
Pro-poor Spending (% of Total)		30.3	29.7	28.4	30.6	34.0	34.0	31.1	34.3

2.5 Since FY03, the government adopted a two-pronged approach of rationalization of public spending and increased tax effort to arrest the rise in fiscal deficit. Revenue as percent of GDP has increased further to an estimated 13.5 percentage point of GDP. The government has been less successful in restoring donor finance to the late 1990s level, although it could be claimed that a sharper decline has been averted. The expenditure adjustment took place largely through the cutback in development expenditure that the government has been able to achieve.

2.6 **Reforms revived external financing, temporarily.** Given the dependence of Nepal on external assistance, the government's fiscal options are considerably influenced by trends and fluctuations in aid inflows. The government was relatively successful for a period in restoring donor confidence by its reform actions, as indicated by the increase in concessional foreign financing from 3.4 percent of GDP in 2002 to 4 percent in 2005. This, in part, allowed the government to reduce domestic borrowing as a source of deficit financing, which declined from 3.6 percent of GDP in 2002 to 1.8 percent in 2005. However, while initial expectations were that aid as a share of GDP would be further enhanced in FY2005 to 6 percent, in actual fact it is projected to decline to an estimated 3.8 percent of GDP.

2.7 **Nepal needs to maintain and deepen the public expenditure reforms necessary to restore confidence in government and its public services**. One of the key reforms that is important to government credibility is further development of the budget system to enable public policy priorities to be effectively financed and to be reflected in improved public sector performance and development outcomes. In Nepal, this budget reform is articulated as the implementation of the MTEF

2.8 **Despite the success in curtailing the deficit, the signs point to a weakening fiscal situation.** Domestic revenue growth has been offset by an equivalent growth of regular expenditure. With the continuation of the insurgency, security expenditures continue to rise. External aid has been unstable, in part reflecting domestic political instability. The government has used the development budget as the cushion to absorb the fiscal shocks because of the growth of expenditure due to security and salary increases and lower than anticipated foreign financing. Fiscal adjustment to these shocks will cause development expenditure to fall to 6.6 percent of GDP in FY05, 30 percent lower than budgeted.

2.9 **Ironically, the development budget is shrinking even as its effectiveness as a development tool is being improved.** While maintaining fiscal discipline at the aggregate level, the budget pathologies of the past – unrealistic budgets, absence of links between annual plan and the budget or outputs to sectoral strategy – have been partly corrected with the implementation of PRS anchored by application of MTEF principles to the development budget. Despite these improvements, it must be acknowledged that there continues to be a problem of under-spending relative to planned development expenditure – averaging 29 percent from FY01 to FY05. The shortfall of actual versus the budget is increasing for the social sectors and reflects, in part, the shortfalls in external aid inflows relative to budget projections.

2. 10 **As domestic financing of development declines, the government has become more dependent on (unpredictable) foreign financing**. Aid dependence of the development budget has increased from 46 percent in FY02 to 58 percent in FY05 and projected to be 64 percent in FY 06. On average 38 percent of budgeted aid does not materialize. Non-availability of aid funds reduces the level of development expenditure in general and capital expenditure in particular. In the absence of large savings through further rationalization of development budget activities,[2] development expenditure outcomes has been lowered by an equivalent of foreign financing shortfalls. While there is a need to restrain the growth of current expenditure and increase domestically generated financing (revenue plus domestic borrowing), the prospects for doing so are limited under current circumstances. The only recourse to stem further fall of donor finance availability is through strengthening of the PRSP and the specific spending plans associated with it through demonstration of money being well spent. To reach this point, concerted efforts need to be made by the government to efficiently use committed funds[3] through budgeting of more implementable components of an activity, while development partners need to focus on strengthening predictability of aid focusing on efficiency of budget expenditure.

2. 11 **The problem of declining "fiscal space" for development is manifested in a number of ways**. The most direct impact at present is on development expenditure which has been cut repeatedly. In the current conflict environment, further increases in security expenditures will require further cuts in investments and is likely to spill over into cuts on maintenance and operations, if it has not already. Thus, the lack of fiscal space is likely to have both short and long term adverse consequences for the ability of government to provide public services. It is also clear that it is difficult to sustain a medium term approach to public expenditure management with a high degree of unpredictability in resource levels and ad hoc adjustments at the budget execution stage. Given the conflict-influenced difficult implementation situation, both the government and its development partners could help

[2] After rationalization, development budget lines increased from 434 in FY 03 to 454 in FY 05.
[3] Approximate undisbursed IFI's aid is 8 percent of GDP.

matters by making efficient use of available commitments, removing inordinate delays in decision-making and relaxing the requirement for counterpart funds.

2.12 **The government needs to develop a fiscal strategy**: There are a number of costs to not responding aggressively and strategically to the growing fiscal risks. First, if the financial environment is deteriorating in terms of resource levels and degree of unpredictability, it will make the financing of key government operations more problematic. Already it is clear that ad hoc adjustments during budget execution are reducing the effectiveness and completion rates of public investment projects. This is likely to worsen. Second, failure to improve government performance in key areas will undermine the government's ability to retain support for its policies, embolden the insurgency and set up a vicious cycle of increased need for security expenditures with further adverse implications for other government services.

2.13 **There a number of conventional options to addressing this declining fiscal situation, some of which are more desirable than others**.[4] First, the government could seek to raise domestic revenues.[5]. Second, the government could try to generate a larger amount of external assistance. This should certainly be a major part of the fiscal strategy, both because of the need to boost grant support as well as to improve the predictability of flows. However, it would not be advisable to formulate a fiscal strategy that relies solely on this element, given the uncertain political environment and some reluctance of donors to commit resources. At any rate, donors will be looking for a number of indicators of commitment to improved governance before they are likely to scale up support to previous levels.

2.14 **A third option is a significant rationalization of government expenditure which eliminates waste and low priority programs and improves efficiency**. This should deserve serious consideration both as an efficiency enhancing and commitment signaling measure. Beyond the rationalization of development projects undertaken in 2002 (which may have been, at least in part, a consolidation of project line items rather than real elimination of low priority projects), it is not clear that this avenue has been adequately explored – certainly not in the recurrent budget where losses of public enterprises continue to be a potential call on the budget. A recent ADB report (Nepal Public Finance Assessment) made the observation that the political leadership, perhaps distracted by other considerations, appears not to fully recognize the true difficulty of the fiscal situation. A proposal for radical rationalization of government spending on both recurrent and development programs would be one way to both make the reality of this most evident to the political leadership and to address the fiscal situation by generating fiscal savings and improving the efficiency of the budget. Furthermore, by demonstrating its political resolve to make the necessary decisions to address the growing fiscal strain, the government might also favorably influence its development partners to continue and enhance aid flows.

2.15 **Finally, a fourth element of the fiscal strategy would be to consider the scope to run a larger deficit through domestic borrowing**. This will have to be undertaken with careful consideration of the implications for crowding out private sector borrowing, as well as the potential implications for public debt levels. At present the scope for additional borrowing is limited by the PRGF agreement. In principle, borrowing should be part of a fiscal strategy if

[4] The remainder of this section outlines the four key parameters of such a strategy. More detailed analysis is required to discuss and finalize such a strategy.

[5] The FY 06 Mid Year Fiscal Ordinance has sharply reduced customs duties and shifted emphasis to VAT , as main source of revenue collection.

it can be used to stimulate the economy or to complete high priority public investments. While some fiscal expansion may be necessary given the economic situation, it can only be justified if there is a high degree of confidence that such spending will have an economic stimulus and development impact.

2.16 **Taken together, the government could adopt a fiscal strategy that could show the way forward.** A fiscal strategy that is based initially on a significant housecleaning of government programs and projects and supplemented by a modest increase in the fiscal deficit might create the necessary basis to strengthen government performance and impact on the economy. If this is done with the intention to provide a strong signal of government resolve, it would also serve to strengthen the confidence of development partners and create a virtuous effect by attracting a larger volume of grant support. A number of alternative scenarios could be developed based on projections of the security environment and donor support to enable budget management to minimize the disruptions to government services.

3. Policy and Budget Formulation (PRSP and MTEF)

3.1 The deteriorating economic and political environment created the conditions and necessity for new initiatives in Nepal in 2000-05. The PRSP initiative supported by external partners provided Nepal with the opportunity to better articulate its policies in support of poverty reduction both to confront the insurgency and to revitalize its economy. And, as discussed above, an MTEF process has been introduced.

3.2 In principle, the MTEF argues for attention to all three levels of budget performance – aggregate fiscal discipline, allocation to politically defined (and economically sound) priorities, and operational efficiency in delivering public services. While the conceptual argument for the MTEF reform is compelling, implementation in each country is a difficult and unique challenge since the design and sequencing of the reform must take account of initial conditions, including government capacity and quality of leadership of a relatively complex institutional change, and management of donor support, to name some of the complicating factors. Nepal has shown remarkable pragmatism in adopting an approach to this reform that addresses issues that are seen to be important and achievable. The approach that Nepal has taken, a departure from aiming to strengthen all three levels of budget performance, is internalization of reform, that too on an incremental basis, staying in line with existing implementation capacity focusing first in strengthening first two levels of budget performance. This reform assumes greater significance because it is also critical to a strategy that requires enlarging donor assistance in the form of budget support.

Political Engagement in the PRSP and MTEF

3.3 **The presumption in most countries is that the political leadership is empowered to make resource allocation decisions**. Where these decisions are guided by a policy making process we might expect to see allocations according to policy choices made by the leadership regarding the role of the state and the priorities for public policy. However, in many countries the political leadership may make ad hoc resource allocation decisions that are either not grounded in prior policy analysis or which conflict with stated policy. Both the PRSP and the MTEF serve as mechanisms to discipline the political leadership so that policy can be responsive to needs but prioritized by the requirement to abide by a budget constraint. In South Africa, Uganda and Albania, the explicit engagement of the political leadership in setting strategic priorities for policy and the budget have served to strengthen the credibility of policies and the budget. In particular, it facilitated effective cooperation between the Cabinet and a legislative body, which restrained opportunistic behavior of the members of parliament and allowed the adoption of realistic budgets. .

3.4 **In Nepal, the political leadership appears to have largely neglected its responsibility for decisions on policies and priorities**. Technocrats have tended to make decisions on the budget framework and priorities with only cursory involvement of the Cabinet. While this has limited the risks due to populist policies, it does suggest a potentially serious weakness in institutional arrangements because the political leadership does not have ownership of the fiscal framework and the PRSP priorities.

Merging Planning and Policy

3.5 **Nepal appears to have succeeded in reviving a moribund planning process to support the PRSP.** As in many other countries, development plans in Nepal displayed the standard pathology – ambitious goals and targets were set without factoring in resource availability so that many sectoral activities were launched but inadequately funded. The result was that projects and programs were poorly implemented and the economic benefits of investments were not captured. Overall, credibility of the plans was gradually diminished. It is, therefore, all the more remarkable that the reforms introduced in the last 2-3 years, guided by a highly participatory PRS document has served to revive and make more useful the planning process.

3.6 **Medium term planning has been linked to the needs of the PRSP**. Unlike some countries, Nepal has explicitly recognized the need to reconcile and adapt existing processes for policy and plan formulation with the PRSP approach. By explicitly integrating the PRSP with the Tenth Five Year Plan Nepal ensured that the five year plan was made more operationally relevant and poverty focused. By merging the Poverty Reduction Strategy Paper (PRSP) with the Tenth Plan, the government has effectively used the economic planning capacity to articulate an operational economic strategy.

3.7 At the same time, the PRSP itself avoided the risk of creating a policy process that was unconnected to real decision making, or in conflict with policy objectives generated by a different process. Additionally, by adopting the PRSP consultation process, the Plan/PRSP has taken a meaningful approach to the poverty reduction goal through appropriately defined sector strategies. Implementation has been given a boost by the adoption of the Immediate Action Plan (IAP) of the Government, a "must-complete" list of priority activities that strengthens and focuses efforts towards early completion of activities. By adopting this approach, Nepal has avoided the dilemma, faced by a number of countries, which have chosen to launch a separate PRSP process and have had to subsequently confront the questions of consistency and credibility of two apparently unconnected policy processes. In effect, the integration of the planning process and the PRSP has helped improve the allocative efficiency of declining donor funding, which has happened in most countries that have introduced the PRSP as a parallel process to planning. Given the importance of aid financing, this has been a critical step for alleviating fiscal deterioration.

3.8 The PRSP articulates a four pillar strategy consisting of: (i) broad based pro-poor growth ; (ii) improved service delivery to rural populations to accelerate social and human development; (iii) targeted programs to mainstream inclusive development of marginalized groups/communities, women, and backward regions; and (iv) good governance, to promote accountability, transparency, and reduce corruption, and to increase effectiveness of public expenditure.

Linking Policy and the Budget

3.9 The integration of the plan and the PRSP has allowed Nepal to also address a key challenge for all governments, i.e. to make policy realistic and affordable by forging it with the budget through the MTEF (see below). While the unpredictable shifts in the overall resource environment discussed above has limited the impact of reforms in this respect, it is, nevertheless, true that a coordinated effort by the Ministry of Finance (MoF) and the National Planning Commission (NPC) has allowed greater realism in policy making.

3.10 In this context, it is worthwhile reiterating that the budget reforms in Nepal are best understood as pragmatic and necessary adaptations to a deteriorating fiscal and economic situation. The initial impetus of budget reform in 2001 was a growing fiscal deficit. In a context where development expenditures had to be curtailed, the reforms sought to ensure that high priority development projects linked to the PRSP were completed expeditiously. But broader shifts in allocation in line with PRSP priorities have also been accomplished.

3.11 **The MTEF has facilitated significant changes in intra-sectoral allocation in favor of human development line with the PRSP.** The development budget is better aligned with programs that support human development. The share of social sector – education, health, drinking water and local development – has risen from about 35 percent of actual development expenditure in FY02 to 47 percent in FY05. Within the social sector, the share of the education sector has risen from 6 to 13 percent, health from 7 to 9.6 percent, drinking water from 6.7 to 7.6 percent and local development from 11.4 to13 percent over the period. These four sectors are particularly important for achieving the PRS human development and social inclusion goals and emphasize decentralization and community-managed approaches to improve delivery and efficiency of public services in rural areas. The prospect of donor harmonization has provided a major incentive for the adoption of sector-wide programs in education and health. The projected increase in sector budget due to pooling donor funds is 25 percent for education and 33 percent for health for FY05 (Table 4) .

3.12 **Correspondingly, the share of the economic sector including infrastructure has been reduced.** Allocation for economic sector has been cut from 26 to 22 percent, while the infrastructure sector has been cut from 33 to 28 percent. Within the economic sector, the decline in the share of infrastructure sector, transport and power, is of concern because of its impact on medium term growth. Investment in transport and power sectors have declined from 35 percent of development expenditure in FY 99 to 26 percent in FY 05, largely due to completion of large projects, shift in donor emphasis from infrastructure to human development, and, in on-going projects, the impact of insurgency. While the PRSP has put emphasis on rural access and rural electrification, insurgency and donor fund unavailability, will dampen large resource shift efforts of the government[6] in these two sectors.

[6] A 195 million US dollar hydro power project, in final leg of construction, is facing financial constraints resulting into 17 hours per week per household of load shedding .

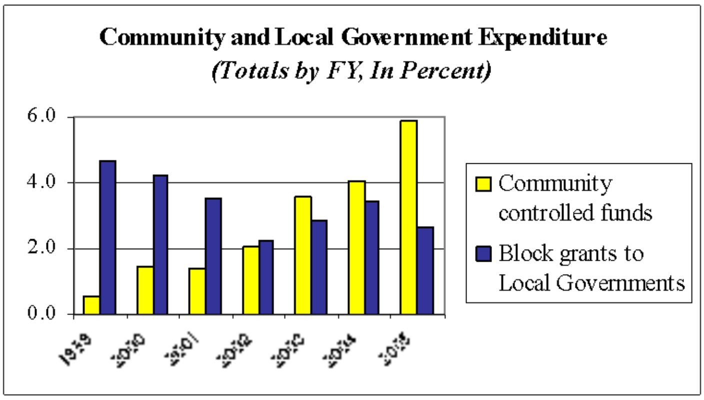
Table 4.
Composition of Development Expenditure, FY 2000 - FY 2005
(In Percent of Total)

	Pre-PRS				PRS		
	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
Social Services	**36.0**	**39.1**	**34.7**	**34.7**	**43.9**	**42.0**	**47.4**
Education	5.8	8.1	7.5	6.2	8.1	10.4	13.3
Health	5.9	6.7	5.3	6.7	7.0	7.2	9.6
Drinking Water	6.5	7.6	6.5	6.7	8.6	8.3	7.6
Local Development	13.9	13.0	12.5	11.4	17.5	12.9	13.0
Other Social Services	3.9	3.6	2.9	3.8	2.8	3.3	4.0
Economic Services	**24.3**	**25.6**	**23.5**	**25.7**	**23.0**	**24.3**	**22.1**
Agriculture	6.8	6.6	6.3	8.1	6.5	5.2	5.4
Irrigation	10.3	9.6	10.7	10.0	8.1	6.4	6.6
Forestry	1.7	1.6	1.3	1.8	2.0	1.5	1.4
Industry	1.0	2.6	1.0	1.6	1.9	1.2	1.0
Other Econimic Services	4.6	5.2	4.2	4.2	4.5	9.9	7.8
Infrastructure	**36.4**	**33.1**	**33.5**	**33.3**	**29.9**	**31.4**	**28.3**
Transportation	17.9	14.8	14.4	12.9	13.0	12.9	12.0
Communication	1.6	0.9	0.7	1.1	1.9	2.0	2.8
Power	16.9	17.4	18.4	19.3	15.0	16.5	13.4
Others	**3.3**	**2.2**	**8.3**	**6.3**	**3.3**	**2.2**	**2.2**
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Memo Item:							
Pro-poor Spending (% of Total)			**30.3**	**29.7**	**28.4**	**30.6**	**31.1**

3.13 The PRSP has also supported a pro-poor focus. The pro-poor focus is defined by rural sector activities, including rural development (cash crop, livestock, small irrigation, and community forest activities), small and micro hydro power, and rural road construction. Actual pro-poor expenditure has risen from 30 percent of total expenditure in FY01 to a projected 34 percent of total expenditure for FY06. Box 1 illustrates the growing reliance on communities to channel and manage resources, intended for development initiatives as part of an explicit strategy to strengthen ownership and impact. This increasing involvement of communities in resource management should be balanced with the ability of the central government to run a national PRSP agenda. In Ghana and Uganda, the emphasis on bottom-up budgeting has resulted in “projectization” that has undermined the implementation of comprehensive development programs.

Box 1.
Development Space: Community Control

The increased efforts of HMG/N to develop activities and funds to communities have resulted as response to the threats of the insurgency on development. The government strongly believes that service delivery be enhanced only if communities are empowered to control development activities that affect their lives. Prior to the implementation of the PRS, communities controlled less than 1.5 percent of the total expenditure. It increased to 4 percent in 2003/04, and the allocation for 2004/05 has been further increased to 6 percent of total budget. The amount of money controlled and spent by the communities has not only grown, but from 2003/03 it has actually surpassed the central grant amounts spent by the local governments.



The experience so far, therefore, suggests that truly community-owned development initiatives are more likely to be protected by the people compared with projects where the ownership levels and participation are lower than the ideal. In many of the truly community-owned and managed programs, the people have managed to negotiate the 'development space' needed to continue activities (Poverty Alleviation Fund; schools under School Management Committees; drinking water schemes under Rural Drinking Water Fund Board; and road maintenance under Road Board Fund) suggesting that the approach ahs greater resilience and could, therefore, be useful to duplicate for giving continuity to development despite the insurgency.

3.14 **Despite the unpredictable resource environment, the implementation of the MTEF protected funds for PRS priorities.** The institutional capacity limitation and the need to pace budgetary reform led to the MTEF confining its coverage to five major ministries initially. But, with evidence of fiscal pressures in FY02, the MTEF was extended to all ministries and sectors and adopted as basis for the implementation of PRSP in FY02/03. In the fourth year of the MTEF implementation, the achievements of this budgetary reform are several (Table 5), namely: a) to attempt a realistic definition of the medium term budget constraint through the MTEF forecasts; b) to link plan to a realistic budget by dropping non-performing activities (which were reduced from 633 budget lines in FY02 to 434 budget lines in FY03) ensuring increased allocations to priority one activities (which were increased from 122 million to 143 million between FY03 and FY05); c) to allocate the assured cash budget to priority projects; d) introduction of performance based release system to facilitate better implementation, which improved from low of 62 percent in FY01 to 73 percent in FY05. Excluding the two large projects, Malamchee Drinking Water and Marshyangdhi Hydroelectric, which have security and implementation-related problems, the completion rate[7] increased to 80 percent. Despite these improvements, other exogenous changes have limited improved execution of the development budget. The projected low expenditure for this fiscal year (FY05), in addition to implementation difficulties, is the result of major

[7] Actual expenditure out-turn compared to original approved budget.

political disruptions (two changes in government within a year) and the non-availability of donor funds.

Table 5.
Development Budget Performance in Successive MTEF FY 2002-2005

	FY 01/02	FY 02/03	FY 03/04	FY 04/05	FY 05/06
A: Budget realism (Rs. Billion)					
	51				
MTEF 1		39 (Budget)	43	49	
MTEF 2			42(Budget)	45	51
MTEF 3				47 (Budget)	52.9
MTEF 4					52 (Budget)
Budget Predictability					
I. Increase in Budget					
Budget lines - Development Budget	633	434	443	454	411
Allocation per project (Rs. Million)	80	89	95	104	126
Priority one allocation per project (Rs. million)		123	147	144	163
II. Tied to Cash Budget (Rs. Billion)					
Cash Budget - Development		25.0	30.0	34.0	38
Priority One Budget		23.0	30.0	36.0	41
III. Performance (in percent)					
A: Development Budget	62.0	75.0	74.0	73.0	
B: Development Budget without Melamchi and Marshyangdi		82.0	80.00	76 (Estimate)	
C: Priority One projects		69	76	76	

3.15 **Budget Framework: Over the past decade, Nepal has overhauled the legal framework for the budget.** The Constitution provides a framework for estimates of government revenue, expenditures, financial allocations, management, and monitoring and financial procedures. The 1996 "Budget Preparation Directive" issued by the MoF, marked the beginning of a concerted effort by the Government to institutionalize the process of making the budget transparent and accountable. Since then two amendments to the Budget Preparation Directive have overhauled or introduced: (i) policy and legal frameworks related to the budget formulation process; (ii) medium term outlook and classification of income and expenditures; (iii) budget formulation tables, explanations and responsibilities; (iv) guidelines for prioritization of expenditures; and (v) guidelines for estimation of income and expenditure. These directives provide the basis for line ministries to prepare the annual plans and budget for the next fiscal year and two forward years of the MTEF.

3.16 **Budget Process: At the outset, an explicit fiscal framework sets the basis for budget preparation.** The fiscal framework is agreed by the Resource Committee[8] and commences the annual budgetary process. The technical leadership of the NPC/MoF sends out the sectoral ceiling along with budget directives to the line ministries to prepare the annual plans for budget discussion**.** *As noted earlier, it appears that at this initial stage of the budget process, there is no effort to garner explicit political endorsement by the Cabinet of the budget framework.* Second, at the line ministry level, although the Budget Directive provides comprehensive guidance including budget formulation tables and forms and with regard to expenditure prioritization, the line ministries find it difficult to collate all district level demands within the timetable.[9] An additional problem for line ministries is the inability to confirm donor commitments at the budget

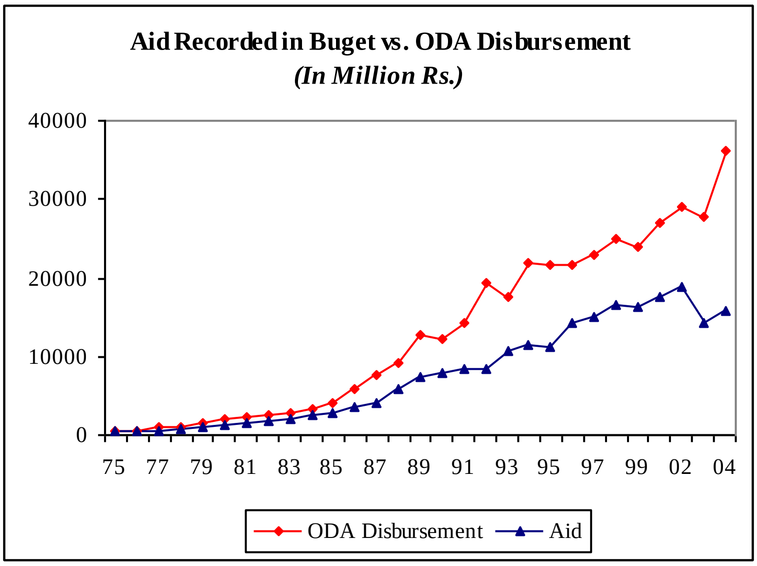
[8] Institutions represented at the Resource Committee are: National Planning Commission, Ministry of Finance and Nepal Rastra Bank (Central Bank). Fiscal framework is guided by PRGF.
[9] All funds in contingency budget line are appropriated to designated budget line upon commitment of funds and annual plans agreed with NPC/MoF. To this extent, budget is very transparent and –currently- subsequent budgets have lower contingency budget.

preparation stage. As noted earlier, the unpredictability of donor funds is a major contributor to downstream problems in budget implementation.

3.17 **Budget coverage must be improved to support budget formulation**. A lack of comprehensive coverage of public resources and expenditures is often a handicap to budget formulation and effective application of the MTEF. In Nepal, the existence of a number of extra-budgetary revolving funds, as well as a significant amount of external technical assistance not channeled through the budget implies inadequate coverage that weakens resource allocation and budget discipline (Box 2). Poor management of off-budget activities can create fiscal risks for the budget. At a minimum, such funds can soften budget constraints and cause agencies to continue with activities that are contrary to the objectives of public policy. The prevalence of domestic off-budget arrangements is often a reason for poor coverage. Another reason may be that donor financing is poorly reported and factored into the budget framework because reliable information is not provided by donors. A review of the MTEF experiences in several African countries noted that most countries had only partially integrated donor resources into the MTEF because donor disbursements retained an element of unpredictability. While Ghana, Tanzania, and Uganda appeared to have had greater success in integrating donor financing into the budget framework, Benin, Burkina Faso and Cameroon have achieved partial coverage of external financing.[10]

Box 2.
Extra-Budgetary Channel Aid

It is difficult to gauge just exactly how much of foreign assistance that is disbursed in Nepal is spent through mechanisms outside the budget. But the difference between ODA disbursements recorded in OECD's Development Assistance Committee (DAC) databases and the aid disbursements shown in HMGN's official budgetary data provide us with a crude proxy to measure off-budget aid. The DAC definition of ODA includes grants or loans which are undertaken by the official sector, with promotion of economic development and welfare as the main objective, and on concessional financial terms (in the case of a loan, it should have a grant element of at least 25 percent) ODA data are provided in current US dollars and the annual average of the exchange rates reported in official HMGN sources were used to convert disbursed amounts into current rupees. As evident from Figure 1, ODA disbursements have been consistently higher than the aid disbursements accounted for in the government budgetary data. In 2003, for example, for every dollar of aid was spent through the budget, $1.3 was spent through extra-budgetary channels. Considered over the 29-year period between 1975 and 2003, ODA disbursements have been higher than aid disbursements through the budget by 60 percent.



Source: Sailesh Tiwari, Bank staff.

[10] Holmes and Evans (2003).

3.18 **Several activities are currently underway to improve coverage and reporting of donor financing**. The introduction of imprest accounts for some donors for withdrawal of funds to carry out agreed activities and require reporting of such expenditure during the fiscal year is expected to improve the coverage and reporting of such off-budget line items. It, nevertheless, would be helpful for Nepal to undertake a concerted effort to improve the coverage of external financing in the budget framework[11] that will also allow subjecting donor-funded activities to the greater scrutiny of the sectoral priorities. The experience of a number of countries suggests that there has been a limited questioning of existing policies by the governments, and donors have only compounded this "add-on" mentality. Overall, this effort will help more effectively engage donors in the country's policy and budget formulation cycles, as well as ensure an on-going dialogue between the Government and donor community to avoid discrete interventions and to move to a more strategic approach in the selection of donor projects.

3.19 **Unpredictable aid flows weaken budget formulation and disrupt budget execution**. Given the large unpredictability due to donor finance, which translates into significant unpredictability in delivering a prepared budget, the problems affecting budget performance are often perceived as downstream problems of management of uncertain cash flows. External project aid is typically earmarked to designated activities and any delay in disbursement potentially affects funding of those activities as well as adversely affects overall budget implementation. In the short run, the impact of such delays can be cushioned through an effective treasury system that uses short term borrowing to moderate cash flow problems. However, it is clear that Nepal faces not just problems in the timing of aid flows but broader shocks to levels and sharp year-to-year decline and cash management is inadequate to address problems of that magnitude. A strategy to improve the predictability of aid would be critical to improving upstream budget formulation and to minimize the problems of downstream budget execution. The fact that donor-financed projects often tie up resources for a number of years upfront reinforces the importance of integrating such projects in the MTEF planning.

3.20 **Project implementation could be improved through timely work planning.** Not all problems of budget execution are due to cash flow problems. A considerable part of the fiscal year is lost because of delays in reviewing and approving work plans for projects. As a result, only a part of the year is available to disburse funds and the attempt to squeeze expenditure into the last trimester of the fiscal year often leads to poor quality spending as well as underperformance relative to the budget. Annual work plans should be prepared shortly after budget negotiations and should be finalized soon after the budget is approved by Parliament. An earlier approval of the work plan in the fiscal year would allow ministries to strengthen project implementation and make more effective use of available funds over the fiscal year. Work plans should reflect the feasibility and implementability of activities each of the trimester, taking into account the geography of project site, seasonality, security, and other factors, as well as a realistic schedule for tendering and contracting of activities.

3.21 **Nepal should continue to be pragmatic in its approach to reforms**. References to undertake activity based costing may be problematic as a high cost reform that may divert the government from other more effective, less capacity-intensive interventions. Given the experience of the city of Bogota (see box 3) a less sophisticated approach may be more

[11] In 2002, Tanzania reported a significant increase in reported revenue after launching an effort to more comprehensively record aid flows.

realistic for Nepal, as swamping the departments with the cost information would be counterproductive given technical capacity constraints.

Box 3 Performance Based Budget Reforms

Within Latin America, the Municipal Government of Bogota (capital of Colombia) attempted to introduce systematic program costing as a basis for an MTEF. An official who was intimately involved in the MTEF development process admitted in a seminar that adoption of the activity-based costing was the most technically challenging aspect of the MTEF development and noted that the lack of trained staff and integrated financial management systems proved to be big obstacles to reform. He cautioned the seminar participants against facile adoption of such a technique.

Rather than adopting sophisticated methods which face implementation problems, more rough and ready methods may serve the purpose of projecting future costs. The Chilean approach of "competitive bidding fund" builds on somewhat simpler projection of blocks of expenditure items (medium-term financial programming), and estimation of total revenue capacities over the medium term. The system then focuses on strategic prioritization by providing the political decision-makers systematically screened project/program proposals.

Source: Yasuhiko Matsuda, Bank staff.

3.22 **Pragmatism would be particularly important in considering performance based reforms**. Introduction and development of performance budgeting is a problematic area. The experience of both developing and OECD countries indicates that it requires a substantial technical capacity and a long time to design a balanced system that links classification structures, performance information and budgetary outcomes. Linking performance and resource information, although important, needs to be taken with a caution. Without viable monitoring mechanisms and reliable financial and non-financial information, the allocation of scarce budget resources may, in effect, discriminate against high-value projects while favoring those that have a low value.