

# Understanding low Public expenditure in Nepal

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Learning from the trends and problems

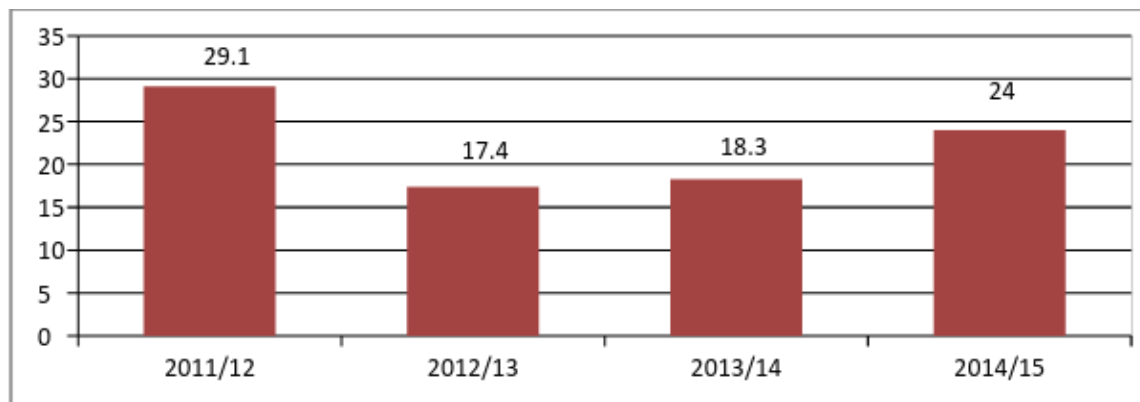
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## I. Introduction

Capital expenditure has been limited to 3.3% of GDP for the past four years in Nepal. According to a research by the World Bank, capital expenditure of at least 8-11% is required to overcome the infrastructure gap in Nepal. ADB claims that low capital spending has had an adverse impact on transport, energy, water and irrigation. For any developing country, investing in infrastructure projects is crucial to get rid of the structural bottlenecks for development. Especially in the case of Nepal, graduating from a LDC has been a focus for the past eight years. Capital expenditure gap then becomes instrumental in the development of the nation.



**Fig 1 : Capital expenditure gap in Nepal (Source: Budget Speech, Finance Ministry)**

To get a better picture of trends in capital expenditure in Nepal, it is essential to have a good idea of our economic structure. Nepal is primarily an agrarian nation heavily dependent on agronomy, horticulture and animal husbandry for income. In spite of agriculture contributing to only 30% of the GDP, more than 65% of the Nepali population is dependent on it for income. Further, increasingly the nation is heavily dependent on remittances. Remittances have probably contributed more than foreign aid in reducing poverty is what Thomas Bell claims as stated by setopati. The continuous focus on revenue extraction has made production a secondary issue. The flourishing sectors that are banking, finance and upscale housing do not have a productive asset base. Importance of informal networks cannot be undermined when searching for a job or promotion.

Looking into the history of planning of capital expenditure in Nepal, the first few development plans failed the nation in terms of economic development. But with limited knowledge and experience on planning this could have been predicted. The most prominent leap was the 8<sup>th</sup> five year plan with the onset of Multi Party Democracy in 1990 A.D. But due to structural bottlenecks the results have been inequitable access, distributional conflict and shortfall of the government. The productive asset base remains static. This trend is to a large extent continued on to planning in Nepal today. Political turmoil seems to persist and in the absence of a stable government, much improvement has not been made in terms of development projects.

In terms of resources to fund development project around 40 % of capital expenditure in projects were estimated to be funded by donor grants and loans according to budget 2015/16. Is the problem behind capital expenditure gap then a political system which believes more in planning and less on developing the nation? These are few of the questions my research would try to answer. In particular the outline would understand existing problems, where we have gone wrong in the past and what has become better. This has helped come up with a policy implication for NPC and partner agencies for the long term.

The second section is a brief literature review about the importance of capital expenditure and the reasons behind low capital expenditure in Nepal. Section III outlines the methodology that has been used in the process of writing this paper. In Section IV I discuss the current trends to get a good picture of the capital expenditure gap. The next section pins point the problem areas that need to be addressed. This is followed by two case studies of capital expenditure programs in Nepal. The paper then goes on to specify by some recommendations which is followed by Conclusion in section VII.

## **II. Literature Review**

The importance of capital expenditure for a developing country is pretty evident given that it helps in productivity growth and infrastructure which in terms helps in employment generation. In accord with the existing literature on government expenditure, a paper by Anuja et al conclude that spending on agriculture and infrastructure leads to economic growth and poverty reduction in developing countries. Along the same lines, Liandes concludes that an increase in capital spending helps foster the growth of the country. The result seems to be applicable for all developing countries and intuitively in the absence of such spending, pre requisites for development are not met.

The country lags behind in productive investment such as irrigation, infrastructure and electric plants with the failure of capital expenditure. Various donor agencies have been pressurizing Nepal to beef up its capital expenditure. In order to understand why Nepal still has a low absorption capacity with increasing capital expenditure gap, few papers in the literature have addressed this issue. According to a 1972 paper by Aaron Wildavsky, the problem lies within the administrative bottlenecks and coordination failure between planning and implementation of projects. With a tug of war between planning and finance, advice remains just theoretical. In addition to that he mentions that the constant need for an authority to look into the functioning of the project might be problematic.

In spite of the paper being written before nearly 50 years the reasons continue to obstruct implementation of plans in Nepal till date. Another paper by Lal Shankar et al look into the causes of low capital expenditure. This paper is in agreement with the authors and tries to contribute towards the same direction. This paper is qualitative and helps one understand the current trends and reasons explaining possible trends.

## **III. Methodology**

In order to understand the existing gap between estimated capital expenditure and actual capital expenditure, the first step undertaken was to understand the trends. Using the budget speeches, data was collected on the gap. The ministry wise gap is specifically interesting and something that had not

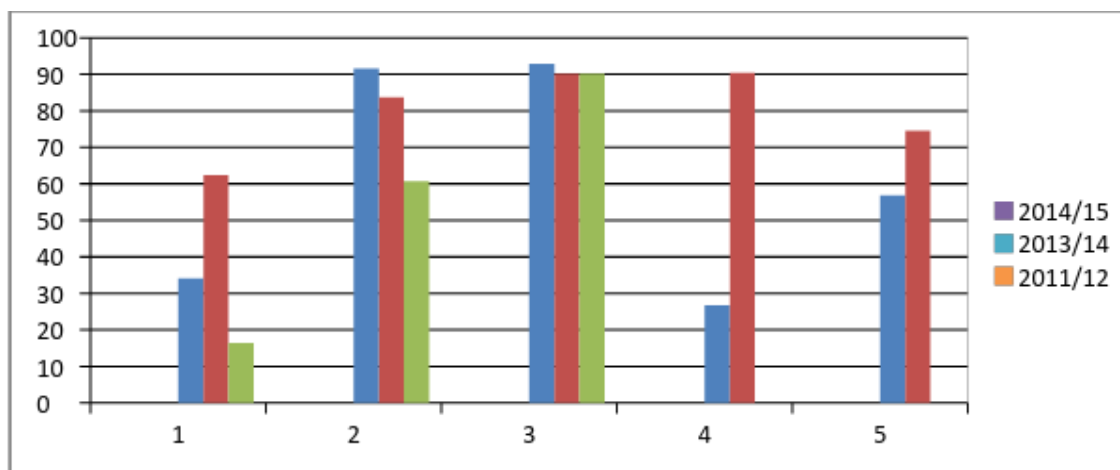
been analyzed before. In addition to that sub categories of capital expenditure namely Vehicles, Machineries, Capital Research, Land acquisition were studied to find the loopholes.

In order to have a good idea of the current status of capital expenditure in Nepal, papers and newspaper articles were referred to. In addition to emphasize on the importance of capital expenditure, few papers were reviewed. For the public expenditure definitional part of the budget, '*Budget Tarju ma Digdarshan 2072*' by the Finance Ministry was used. In order to understand the problems with the procurement system which repeatedly came up as one of the possible reason for low absorption capacity, Public Procurement Act and its amendment were studied.

NDAC data set regarding the percentage of capital expenditure achieved under each project was used. However the data availability was slightly limited due to which I have relied on mostly reports and interviews. Meeting with respective counterpart for additional information proved immensely useful. For the specific case studies, project appraisal document for each were carefully studied for further policy recommendation.

#### IV. Existing trends:

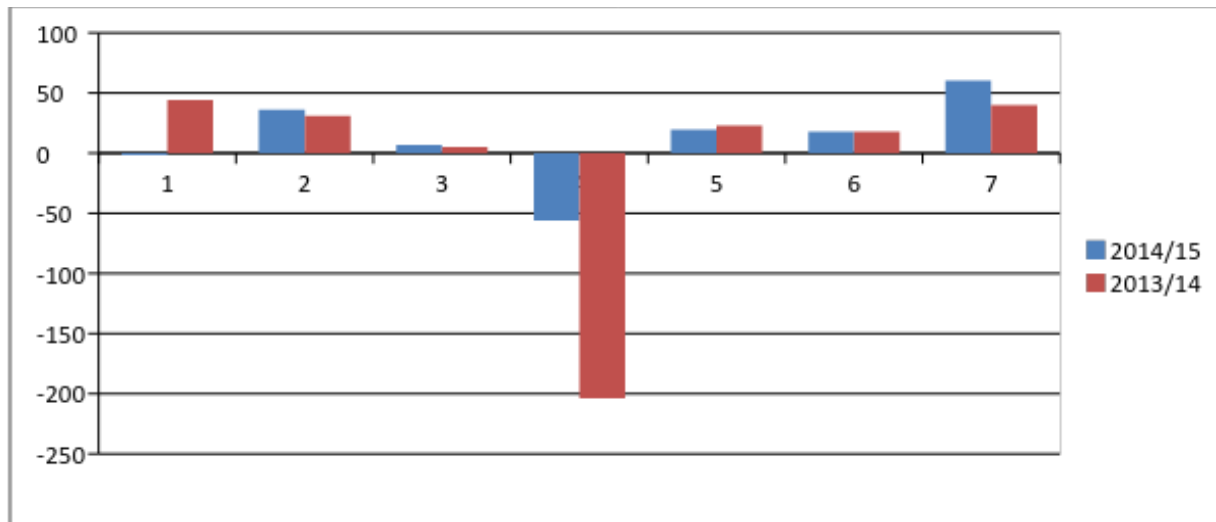
In terms of analyzing the capital expenditure gap, it is interesting to divide the percentage of actual expenditure v/s the estimated one for different ministries. The Ministry of Physical Infrastructure and planning receives most of the capital budget followed by the Irrigation Ministry. It seems in terms of performance, the **2- Ministry of Infrastructure and Physical Planning** has been improving from 60% spending in 2011/12 to 90% in 2014/15. The **3- Irrigation ministry** has been the best with fairly around 90% of the capital funds spent in all three years.



**Fig 2 : Percentage of the actual amount spent on Capital Expenditure with respect to the estimated one in different ministries. 1-Energy 2-Infrastructure 3-Irrigation 4- Urban 5- Agriculture. Since these ministries were formed later, we do not have data on the estimated amount for 2011/12. (Source: Budget Speech, Finance Ministry)**

With respect to **1-Ministry of Energy**, there seems to be no particular trend. Both ministry of **5-Agriculture** and **4-Urban Development** seem to have a decline in the percentage of capital expenditure spent. This could be since these ministries were fairly recent compared to the others. Note that data for 2012/13 is missing since the budget brought forward that year was not a complete one. Looking at the graph we can identify the trouble areas and can focus on those particular ministries.

Now to look at breakups within the capital expenditure section, Capital Research seems to be fairly under spent down the years. If we look at *Fig 3* below we realize that the trend has been to over spend on **4-Vehicles**. In order to interpret the graph a  $-50 = 50\%$  more has been spent on the particular component compared to the estimated amount in the budget. A  $+50 = 50\%$  less has been spent on the particular component than the estimated amount in the budget.



**Fig 3 : Capital Expenditure gap in different classification within Capital. 1-Land 2- Buildings 3- Furniture 4- Vehicles 5- Machines 6- Civil Works 7-Capital Research. (Source: Budget Speech, Finance Ministry)**

We can observe that there has been an under spending on **7- Capital research** and overspending on vehicles. The trend seems unusual but the rationale behind this is fairly clear. It is due to the structure of the economic policies. Purchasing a vehicle requires less effort than purchasing services. At the same time it takes lesser time too. A project X needs to show some signs of progress in the first two halves of the fiscal year. The optimal strategy is to then order vehicles while the tender for civil works and capital research are being undertaken. By the time X evaluates the tender and chooses a lowest bidder, 6 months have passed. All this while, the money assigned in the project is not used. Till then X has succeeded in spending the money in vehicles just because it's less time consuming.

This shows a burning importance to simplify the procurement law. This shifting within budget headings is possible after the allocation due to virement transfer. Under this the allocated resource can be transferred from one budget heading to the other. This needs to be rectified, probably by assigning a threshold until which the transfer can be undertaken.

## **V. Problems observed:**

Using the methodology as mentioned above, I have enlisted a list of problems that have been responsible for the capital expenditure gap. I have categorized the problems as definitional, planning, procurement and implementation to make it simpler for the purpose of understanding. The major loophole seems to be in procurement due to which most of capital spending seems to peak up in the third trimester. This trend has been persisting over a long period in time.

### Definitional

According to GFS accounting system, some capital expenditure are included in recurrent and financing due to which capital expenditure ratio has declined since FY2011/12 which is a concern for the government. It does not help solve the capital expenditure gap per say but in terms of correctly accounting for capital expenditure undertaken by the government, correcting this seems to be crucial.

### Planning

Around 85% of the projects are P1 projects which sort of violates the meaning of giving priority. Often when prior feasibility study and review is missing, the absorption capacity is low. The NPC comes up with a five year plan with detailed project proposals. Often in including projects, the ones with insufficient background work are also included.

### Procurement

There seems to be major loopholes when it comes to procuring services or work. Often a major chunk of the time is spent on procurement due to which the capital money remains unspent. There is no time limit to evaluate the bidding and this seems to be a lengthy process. Further the lowest bidder is awarded the contract which might lead to timely delivery issues. In order to hire a firm/contractor, there is a two step process which can lengthen the evaluation to atleast 5 months. This implies most of the development projects commence only in the end of the fiscal year.

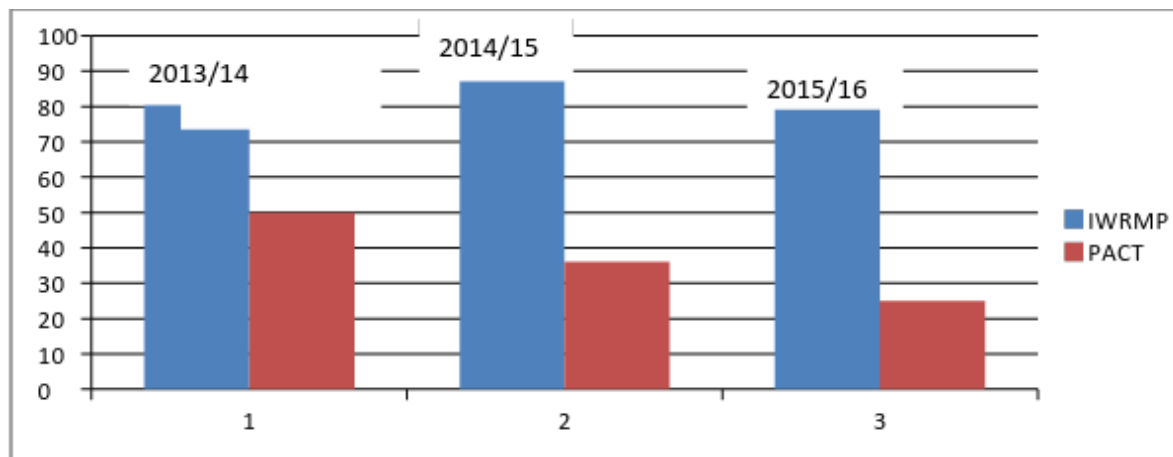
The procurement problem can be modeled as a principal agent problem. The government is the principal and the contractors that bid are the agents. The government is responsible to then pick the lowest bidder. The government faces both moral hazard (do not know the actual cost for the bidders) and adverse selection (cannot make sure that the bidders effort to keep the cost low). Under such a circumstance, the government is then should design an effective procurement method and contract.

### Implementation

Often a project is stalled because the contractors that lost file a case against the winning ones. The money then remains unused. Some contractors may not carry out the project as planned. This paper focuses more on planning and procurement. The Finance Comptroller General Office (FCGO) oversees the government expenditure and consolidates annual financial statement. It tracks the revenue, computes the income collection and releases fund through District Treasury Comptroller's Office. This layered approach of getting approval might make the process a bit more tedious and can be an avenue for coordination failure.

## VI. Case Studies

In the course of the research, case study of two projects: Integrated Water Resource Management Project (IWRMP) and Project for Agriculture Commercialization and Trade ( PACT) have been carefully studied. Both these projects are in the agriculture sector and have been funded by the World Bank. Another commonality is that both the projects received what we call Additional funding (AF) from the World Bank. The differences in terms of performance is however huge. IWRMP has a utilization rate of more than 80% whereas PACT has less than 30%. Agreed that the functioning mechanism for the two are different but such vast difference in capital utilization could not be solely justified by that reason. In the paragraphs below I try to compare and contrast the success and failure story of the two projects.



**Fig 4 : Progress in Capital Expenditure for the two projects studied**

### *i) Integrated Water Resource Management Project ( IWRMP)*

This project started in 2008 with an aim to improve the participation of the Water User Associations (WUA) and enhance the status of selected irrigation projects around Western Nepal. It received additional funding by the World Bank in the form of both grant and loan in 2013. The project is supposed to end in June 2018 but looking at the speed by which the deliverables are achieved, it is estimated to be done by 2017 thus allowing for additional canals to be built. The project had four components.

- a. Irrigation Infrastructure Transfer
- b. Irrigation Management Transfer
- c. Institutional and Policy Support for improved water management
- d. Integrated Crop and Water Management, Water Resource information system.

Out of the four components, the first two are handled by the ministry of Irrigation, the later by Agriculture development ministry and the last bit by a unit in the Energy ministry. Now recalling the capital expenditure trend in Fig2 with the current project, the irrigation part seemed to be doing extremely well which is justified by the graph above in Fig4. The agriculture part of the project is a

complement to the irrigation thus the performance is good. They have managed to improve the irrigation canals and have successfully transferred selected state managed irrigation to WUAs. The agriculture component is responsible for providing seed storage and other complementary activities along the irrigation projects.

This project does not entail heavy procurement but only small contracts to improve the canals. In discussion with the senior engineer, he mentioned that only around 3 projects out of the 140 faced a problem in terms of procurement. This could be because there is very less margin to make huge gains from the contractor side. Now talking about component d. , 4 million \$ were assigned to research along four river beds in a span of 2 years. This money till date remains untouched. The problem lied in procurement of a consultancy service.

The project hired a consultancy based on a rigorous selection process but another consultancy that did not manage to bag the contract filed a lawsuit that the process was unfair. Once the lawsuit was launched, the money to be used stayed frozen. Efforts were made to solve the Supreme Court issues but to no use. There was then a disagreement between WB and Govt of Nepal with respect to the consultancy chosen. This emphasizes on one of the problems I mentioned earlier, Procurement. The process needs to be simplified so that it reduces the time taken and secondly is more transparent. Note here that since it was a foreign donor funded project, the procurement rules of the foreign donor were placed into use.

*ii) Project for Agriculture Commercialization and Trade( PACT)*

This is the largest donor funded project in Agriculture Development ministry. Sadly enough it is the least well performing program too. It aims at using the concept of Matching funds to promote agricultural initiatives. It began in 2009 with a World Bank fund of 20 million \$ covering 25 districts. In 2013 when the program managed to spend 25% of the allocated money, WB provided additional financing in the form of loan and grant again. It also decided to extend the coverage of the program from 25 to all 75 districts. As seen in the graph above, the performance of the program terrible fell after this change. There are three components to the project where component a. tends to cover a major chunk of the money.

- a. Agriculture and Rural Business Development
- b. Sanitary and phyto sanitary facilities
- c. Project management, monitoring and Evaluation

Procurement is not a major issue in this project for underperformance so what is it that is preventing the program from doing well? In this case lack of prior planning seemed to be the case. The modality of this project is completely different from that of the other one. The program hands out matching grants to farmer groups and cooperatives. In the 1<sup>st</sup> and 2<sup>nd</sup> call, the donors provided the farmers with 25% managing cost and the rest of the amount was rewarded once sufficient progress had been made. For call 3 however, the modality of the payment was changed and no managing cost was paid. Due to this, the farmers found it very difficult to bear the cost of the project and ask for reimbursement later on. This sort of beats the purpose of trying to help farmers commercialize agriculture.

This implies sufficient planning is needed in order to make the program work. Before changing the modality of payment, checks could be run on the outcome. Speaking to the program coordinator from the Agriculture ministry, the expansion of the project to more than 25 districts with additional funding when the first grant had not been completely used can be blamed for the meek performance of the program. Similarly another issue with the project is the time take to screen the applicants. We need to keep in mind that we are dealing with rural farmers here. The 4<sup>th</sup> call took 2 years to be reviewed. This implies the cost estimations provided a few years ago might be different for the year when they actually need to spend.

## **VII. Recommendations**

Now that we have been able to get an idea of the reasons behind low capital expenditure by focusing on the existing problems, I have listed down possible policy changes that could be undertaken. In the process of gathering information it seemed that it was fairly common knowledge between various counterparts as to where the problem was, however very little had been done to solve the issue. These recommendations should be seen as a first step towards further research and design of new policies.

- *The current Budget Digdarshan needs to be challenged* with respect to the classification of Capital expenditure: Currently some of the loans that government is giving out to corporations like NEA and CANN for capital expenditure appear within financing subheading. Further even in the current account some grants that are ultimately used for capital expenditure are placed. Thus capital expenditure needs to be a sum of the current missing pieces. This is the first step and a quick fix to show that the absolute level of capital expenditure has been comparatively higher.
- *Prior to seeking funds, a feasibility study and a sufficient background study*: This needs to be undertaken for the projects that are to be considered for funding by the government. Allocating funds before having a detailed study should be stopped. In many of the cases such unpreparedness leads to delays in procurement and implementation of the project.
- *Gradually decrease the number of priority one P1 projects to say 30% of the budget*: This way funds will be concentrated only on specific programs which may facilitate it's implementation. Prioritizing too many projects may cause the government resources to be scattered in all direction. There are pre existing conditions (which exist in paper not in practice) that need to be strictly followed to categorize a project as priority 1.
- *Simplify the procurement process*, in particular depending on the work under consideration max time period limit should be specified to analyze the Request for Proposal and intent of interest. Currently a lot of time, mostly the 6-7months has been occupied by fulfilling procurement law and finding a suitable consultant/contactor.
- *Lowest bidder winning may not be optimal with respect to the quality of service available*: Either set a limit beyond which the contractors cannot bid depending on the estimate rate or try an alternative bidding mechanism. Average bidding mechanism has been suggested by Santosh Shrestha in his paper.

- *Have a system of rewarding the contractors who perform well:* An evaluation score criteria could be used as one of the supporting condition besides only looking for the lowest bidder in choosing a bid. A system of feedback will put in checks on the quality of work performed. This should indeed be discussed with the Nepal Contractor's Association. Such a grading criteria would incentivize the contractors to perform better.

### **VIII. Conclusion**

Low capital expenditure in Nepal is a problem due to failures at different level. However policy changes in the right direction takes us a step closer to increase the absorption capacity of the nation. As shown by the paper in *Fig 1*, capital expenditure gap has been fairly constant at around 30% of the estimated budget amount. The trend seems to be spending most of the allocated money in the third trimester of the fiscal year. Within the Capital expenditure column of the budget, projects tend to overspend on Vehicles and under spend on Capital research as seen in *Fig 2*. In terms of ministry wise performance, Irrigation ministry seems to be performing well. The Urban development, Agriculture development and Energy ministries have a lot to catch up on as seen in *Fig 3*.

Given the current trends, the problems seem to lie on lack of sufficient planning before inclusion of a project, lengthy procurement process, lack of prioritization of the projects, lowest bidding and lack of rewards for well performing contractors. In terms of the recommendation, the government should try to tackle these problems by policy change. Specifically, a change in the procurement system would make the implementation of the projects much easier. At the same time, projects that are termed as P1 should have completed all the background checks.

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