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EXECUTIVE SUMMARY

1. This report reviews the trends in expenditure patterns in public financial management (PFM) in Nigeria since 2001, and assesses the impact thus far of the ongoing government reform efforts. The PEMFAR covers areas that have been traditionally undertaken by separate Bank reports such as the Public Expenditure Reviews (PER), the Country Financial Accountability Assessment (CFAA), and the Country Procurement Assessment Review (CPAR). The analysis covers fiscal policies and performance at both federal and state government levels.

Fiscal trends

2. In recent years, Nigeria has made noticeable progress in macroeconomic stabilization, structural reforms, and the strengthening of mechanisms and institutions for accountability. Since 2001 the Federal Government of Nigeria (FGN) pursued an expenditure policy that has been much more prudent than during earlier episodes of high oil prices. Fiscal restraint has become a major component of improved macroeconomic management. In 2004 the government introduced oil price rule based budgeting, which limits the annual utilization of oil revenues to the level associated with a pre-determined oil price. This innovation resulted in significant budget surpluses and rapid accumulation of foreign currency reserves. In 2004-05 consolidated government budget surpluses averaged 10 percent of GDP a year.

3. While consolidated government expenditures in 2005 were about twice as high (in real terms) as in 1999, almost the entire growth occurred early in the period of 2000-01. Between 2001 and 2005 the real level of consolidated government spending remained largely unchanged. Moreover, in 2003-05 consolidated expenditures increased by only 13 percent despite the fact that the oil price practically doubled. The relative size of government expenditures measured as a share of GDP has declined considerably, from about 45 percent of GDP in 2001 to below 33 percent in 2005, a level that is more in line with other developing countries. This is evidence of a radical shift towards a much more responsible fiscal policy.

4. Other indications of strengthened fiscal discipline include improved budget predictability (i.e. much small deviations between approved budgets and actual spending), albeit from a low level, better administration of oil taxes, and increased transparency in the allocation of the Federation Account (FA) revenues.

5. However, overall fiscal restraint was accompanied by noticeable growth in the non-oil budget deficit – by almost 3 percentage points of non-oil GDP in 2001-05. This was primarily a result of relative deterioration in the collection of non-oil taxes (from 17.5 percent of non-oil GDP in 2002 to 14.5 percent in 2005), while consolidated non-oil non-interest government expenditures have been growing broadly in line with the growth in non-oil GDP. Collection of import and export duties declined by more than 20 percent in real terms in 2001-05, notwithstanding the fact that the dollar value of imported goods more than doubled during the

period. The latter indicates substantial remaining challenges within the customs administration and highlights a need to accelerate customs reforms.

6. While the reform challenges on the expenditure side by far exceed those related to revenue mobilization, the FGN has to continue its recent efforts to raise efficiency of tax administration. Measures to change the structure of government revenues towards a higher share of domestic taxation are of particular importance to help reduce economic volatility. There is also a critical link between quality of tax administration and improvements in the environment for private sector growth.

7. The aggregate expenditure trends mask serious differences between federal and sub-national spending. The Nigerian fiscal system has gone through rapid decentralization. The share of sub-national budget spending in the consolidated budget doubled, increasing from 23 percent in 1999 to 46 percent in 2005. Sub-national budget expenditure in 2005 was almost four times higher in real terms than the 1999 level. Moreover, spending by local government authorities (LGAs) has been growing even faster than state government spending, which means that sub-national budget systems have in turn become increasingly decentralized. This decentralization was driven primarily by changes in the revenue sharing arrangements from the FA allocation introduced between 1999 and 2002, including the decline in the share of first line charges, and by stricter implementation of the revenue sharing formula than was the case in the 90s.

8. Rapid expenditure decentralization has created both new opportunities and challenges for public service delivery in Nigeria. Given that Nigerian sub-national governments are mainly responsible for financing basic public services such as primary health and education, decentralization creates the potential for further improvements in the financing of these priority sectors. At the same time, due to well-known capacity constraints at the sub-national level, this expansion in financing creates a substantial risk of a decline in spending efficiency. It also increases the risk of misuse of funds due to slower pace of PFM reforms in states. So far, fiscal decentralization in Nigeria has not been accompanied by strengthened inter-governmental coordination in the areas of fiscal and sector policies. This complicates progress in service delivery.

9. Moreover, the benefits of fiscal decentralization were distributed rather unevenly across sub-national governments. This is because, in keeping with the constitutional requirements, about a third of all FA allocations to states reflect derivation oil payments and, which are heavily concentrated. The four main oil-producing states (Rivers, Bayelsa, Delta, and Akwa Ibom) jointly received about 90 percent of all derivation oil payments, or about N265 billion (US$2 billion) in 2005. The fact that despite all these additional revenues, the oil producing states of Nigeria did not perform much better than the rest of the country in terms of service delivery and human development indicators[1] suggests that major efficiency gains still remain available through improvements in the expenditure management and accountability systems of these states. Overall, rapid expenditure decentralization poses a risk of growing inequality across-the-states, especially with respect to the quality and availability of social

[1] The UNDP Niger Delta Human Development Report (2006) presents a picture of pervasive poverty, environmental degradation, and longstanding exclusion of local communities in Niger Delta. It claims that the preeminent underlying cause of this situation has been a failure of governance at all levels.

services. To be able to achieve its national development targets, in particular with respect to MDGs, the federal government will need to develop its capacity for monitoring cross-state differences in access to core social services and strengthen federal equalization programs to provide additional opportunities to citizens in less developed states. The FGN has made efforts recently to improve its capacity to monitor state expenditure patterns, but these efforts are constrained by the lack of constitutional authority to request proper budget reporting and disclosure by states.

10. At the same time, it would be important for the government to make further progress on several aggregate fiscal management fronts:

- By conservative estimates, at the end of 2005 federal budget and pension arrears exceeded N300 billion (US$ 2.3 billion), which is about 20 percent of the total 2005 federal budget expenditures.[2] In 2006, the FGN made a commitment to resolve this problem, and it is expected that by the end of 2007 the stock of federal arrears would decline to a small fraction of its 2005 level. The FMF completed intensive audit of contractor claims that helped to eliminate a large portion of fraudulent claims. The Government also raised N75 billion through domestic borrowing to repay pensions owed to about 280,000 pensioners. It has been implementing a plan to repay all debts to small contractors and securitize the debts to larger contractors. This important initiative needs to be accompanied by additional actions to strengthen the system of commitment control and ensure that budget arrears, once cleared, do not re-emerge in the future.

- About 40 percent of non-interest spending, administered by the federal government, remains outside the regular budget (see Table E1). This includes critical public investments in the oil (NNPC cash calls) and power (projects funded from the excess crude account) sectors, which are funded jointly by all tiers of the government. While these are legitimate government spending, it is important to further formalize the planning, approval and oversight of these specific expenditures[3] that cut across all government levels. Overall, the government should move more aggressively towards budget consolidation to ensure efficient prioritization in resource allocation as well as to make further progress in budget transparency. A possible solution could be the introduction of a special section in the annual budget documentation to cover all the expenditures, administered by the FGN on behalf of the entire federation. There is also a need for proper incorporation of external borrowing and grant funding in the federal budget.

- Subsidization of major parastatals declined but remains significant. As estimated by recent analysis of Adam Smith Institute and the World Bank, the combined budget support to the three large state-owned companies in power, railways, and port sectors amounted to about 0.9 percent of GDP in 2004. As the FGN continues its privatization

[2] Most of outstanding budget arrears are debts to contractors that were accumulated before 2004. Pension arrears reflect the fact that the pension system in place before the reform of 2005 was too generous and was poorly managed.

[3] Under the current arrangements, there is some oversight of these expenditures by National Assembly, Auditor General Office, BPMIU, etc. However, the existing oversight rules are less clear than in the case of regular budget spending.

program, it is important that an integrated monitoring system is put in place to track the financial performance of parastatals, including non-commercial parastatals in health and education that remain under government control.

- The new fully funded pension system has been operational since July 1, 2004. It replaced the system that had been highly segmented, poorly managed and broadly unaffordable. In the long run, this would help to put the pensions on a sustainable footing and avoid the pension arrears problem. However, the government is not fully prepared yet to address the full costs of transition to the new pension system. The FGN should accelerate the development of proper fiscal projections for expected pension liabilities and set up realistic plans to finance the gaps in the system during the earlier years of pension reform implementation.

Quality of budget spending

11. The FGN has made impressive progress in establishing and maintaining aggregate fiscal discipline, however the pace of improvements in the quality of budget expenditure has been slower. This is because budget management improvements at the sector level (planning and implementation of specific programs and projects) have been generally less advanced than progress in macroeconomic management (see Box E1). The evidence from sector and state level studies points to major opportunities to improve cost efficiency of expenditures through stronger transparency and accountability arrangements at the project/activity level[4]. The challenge of improvements in quality of budget expenditure is even more acute at the state level due to additional capacity constraints and much slower pace of the ongoing PFM reforms. This limits visible public benefits from high oil prices and recent improvements in macroeconomic discipline and creates additional pressures for fiscal expansion.

[4] In particular, the PEMFAR-sponsored budget monitoring of projects financed with money repatriated from Switzerland ("Abacha Loot") pointed to some weaknesses in internal budget accounting and reporting processes in the participating MDAs.

Table E1: A large share of federal spending remains outside of the regular budget, N billion

	2004	2005	2006, est
Total non-interest expenditures undertaken by the federal authorities	**1,463**	**1,926**	**2,538**
as % GDP	15.28	14.83	17.34
1. Federal budget non-interest expenditures	**846**	**1,123**	**1,555**
as % GDP	8.83	8.65	10.62
2. Off-budget investments managed by federal entities	**481**	**618**	**783**
as % GDP	5.02	4.76	5.35
Funding for JV Cash Calls	455	532	542
National Power Project	0	50	196
Donor funded projects	26	35	45
3. Expenditure by other federal level entities	**137**	**185**	**200**
as % GDP	1.43	1.42	1.37
Federal extrabudgetary funds and FCT, 1/	78	97	124
Education Fund	17	33	39
Customs (Special Levies)	40	32	37
Others	2	22	0
Memo: share of non-budgeted spending in the total non-interest expenditure, %	42.2	41.7	38.7

1/ includes Stabilization Fund, Ecological Fund, Natural Resource Development Fund, and allocations for the Federal Capital Territory (FCT). Allocations to the FCT are covered by a separate budget, voted by the NASS independently from the federal budget. FCT allocations amount to less than 0.2% of GDP a year.
Source: Staff estimates.

Box E1: Significant budget expenditures in the past did not always bring improvement in service delivery

Health: It is estimated that total annual spending in the sector (public and private) exceeds 6 percent of GDP, which is rather high by international standards. However, the health outcomes remain extremely low and have not improved over the years. Infant and maternal mortality rates remain high at 110 and 8 per 1,000 births in 2005, respectively. Moreover, infant mortality increased by 20 percent between 1990 and 2005. Communicable diseases (particularly malaria and diarrhea) are the main causes of mortality, which can be easily prevented or treated at relatively low cost.

Education: This sector has been attracting a substantial amount of funding over the last 4-5 years from all tiers of the government. This helped to improve significantly net primary enrollment. Also, the share of the primary school students that reach grade 5 increased from 71 percent in 2000 to 78 percent in 2005. But the quality of nation's teaching and schooling remains of concern, and this is reflected in poor literacy outcomes. Adult literacy rate was only 64 percent in 2004.

Roads: Inadequate funding for maintenance, rehabilitation and asset renewal during the previous decades is the major reason for high transportation costs and poor safety conditions. It is estimated that between 50 and 70 percent of road network is in poor condition. The FGN recently has increased funding for the sector to address the problem.

Power: In 2001-05, the Federal government spent in the sector, about N270 billion (more than US$2 billion), while frequent power shortages remain the major development constraint for the private sector and a critical social problem. A partial explanation for this low impact of budget spending relates to the low completion rate of initiated investment projects in the sector. The value of unfinished construction has increased by N82 billion since 2000.

12. The review of sectoral composition of the federal budget expenditure suggests modest changes between 2001 and 2005. Most of the changes that took place reflected the broader and fully justifiable shift in the expenditure structure from capital to recurrent spending (including salary increases) that happened in the federal budget since 2002. As a result, the expenditure shares of Ministries, Departments and Agencies (MDAs) that are responsible for social and administrative functions increased slightly, while the shares of MDAs in infrastructure declined. The data also suggest that despite additional N100 billion of debt relief funds that were earmarked for MDG sectors in 2006, the proposed 2006 shares of social and infrastructure sectors in the budget[5] (17 percent and 18 percent of total MDA spending respectively), while somewhat higher than in 2005, were still lower than in 2004.

13. Does this mean that the FGN has been missing some major opportunities to improve financing of core MDG sectors and is not aggressive enough in reallocating expenditures towards policy priorities that were identified in the NEEDS? The conclusion of this report is that the aggregate expenditure composition does not represent a major fiscal policy problem. Within the current set of institutional and policy constraints, the FGN has made a good effort so far to increase the real level of MDGs financing. A relatively high growth in the real size of the overall federal budget spending in 2005 and 2006 suggests, notwithstanding a broad stability of respective expenditure shares, a considerable increase in total spending on MDGs.

[5] This excludes large off-budget investments in power, which in 2006 were expected to exceed 20 percent of the total MDA budget spending.

The current limitations of MDGs financing reflect largely the difficult reform environment in Nigeria, where the government has been trying to expand its pro-poor spending against other competing priorities (e.g. increasing infrastructure investments and addressing major structural problems, such as pension reform, that hamper the country's longer-term development prospects), while staying within the sustainable overall expenditure envelope.

14. Moreover, the broad conclusion of this report is that, despite recent improvements, the core problem within Nigeria's budget system at the moment, which is common to all levels of the government, is more one of low efficiency of budget spending, than of inadequate amount of funding. Further improvement in expenditure efficiency should be seen as a key priority for the next stage of fiscal reforms and has to be considered as a central element in the reform agenda of the next federal administration.

15. As already mentioned, the FGN has launched several major reform steps that aim at reducing inefficiency and waste in budget spending and ensuring a steady improvement in the quality of public expenditures. The most noticeable initiatives include: (i) procurement reform that helped to reduce costs of government contracts and improve accountability of contractors; (ii) preparation of Medium Term Sector Strategies (MTSS) to improve prioritization of project spending; (iii) efforts by the MDGs office to channel a considerable portion of new investments, including in water and rural electrification, to completion of the existing projects; (iv) payroll verification undertaken by the BOF that helped to remove from the public payroll about 65,000 ghost workers; etc. These efforts will need to be continued and scaled up.

16. The recent improvements in the efficiency of public investments can be statistically illustrated using the Incremental Capital Output Ratio (ICOR), which is estimated as a ratio between annual national investments and annual increase in GDP. Nigeria's historical 30-year average ICOR of 12.7 was very high, more than double that of a better managed oil economy such as Indonesia, reflecting fiscal mismanagement under the military rule. However, average 10 year ICOR for Nigeria for a more recent period of 1994-2004 declined considerably to the level of 10.4 that is much closer to the performance of other oil producing economies (Indonesia – 9.2, Mexico – 7.9). Moreover, the most recent data for 2003-05 show further improvement in ICOR to about 8. It should be a priority of the next administration to support further reforms required to continue this positive trend.

17. While achieving MDGs in Nigeria will ultimately require an expansion in budget financing in core social and infrastructure sectors, future scaling up has to be managed carefully. The major improvements in service delivery in the core sectors in the short to medium term should come as much from further expenditure growth as from much better utilization of the existing allocations. In other words, there is the need to synchronize government scaling up efforts with those to advance PFM reforms. Expenditure expansion will be more successful in areas where the drivers of spending inefficiency are well identified and there is a genuine determination to do things differently, in particular on the basis of a well-designed and costed MTSS. Future increases in sector allocations should also reflect variations in expenditure efficiency across different sectors.

18. Moreover, given remaining weaknesses in the PFM system, the risk of mismanaging efforts to scale up spending in core sectors remains in Nigeria. Due to the oil wealth, there is currently a fiscal space for rapid increase in expenditures that may exceed the government's

capacity to manage this properly. Excessive relaxation of fiscal policy has to be avoided. As recognized in the latest government programs, saving a portion of the windfall gains and their utilization over the longer time period (i.e. spreading their use over the oil price cycle) would help to get more gains from the same amount of resources.

19. The entire agenda of the PFM reform is in one way or another related to the issue of spending efficiency. Several key dimensions of the matter, many of which are already being pursued by the government, could be summarized as follows:

- Further strengthening of MTSS to reinforce the link between sectoral spending programs and longer term development objectives.
- Operating a Virtual Poverty Fund (VPF) to improve both the budgeting and monitoring of poverty-reducing spending under the debt relief gain program. This is a critically important pilot program with a strong potential for scaling up.
- Increasing the predictability of funding for implementing agencies as another key pre-condition for efficient service delivery and project implementation.
- Improving the quality of budget reporting and monitoring, and the disclosure of budget outcomes and their evaluation. The objective should be the creation of a data-rich environment with respect to budget spending, which would support the identification of inefficiencies on the basis of better analysis and broader participation in the budget process by various stakeholders.
- Moving ahead more determinedly with public service reform to strengthen implementation discipline and improve incentives for effective budget utilization.
- Increasing personal accountability of accounting officers for the utilization of funds in line with the approved budget.
- Encouraging states to reform their expenditure patterns, including through undertaking joint federal-state projects financing and matching grant schemes.

20. The government should also continue to place greater emphasis on sector-specific steps to improve spending efficiency, by concentrating on areas such as the following:

- Improvements in efficiency of sector expenditure by increasing financing of operations and maintenance costs, while rationalizing both payroll costs and other recurrent expenditures;
- Restructuring of public service delivery – for example, in health the governments at all levels should pay more attention to financing of primary health and prevention compared with tertiary services (hospitals);
- Improvements in the quality of the government's capital project portfolio by focusing on fewer projects, which are adequately funded and executed, to ensure a decline in their completion periods, as well as in the numbers of unfinished projects; and
- Strengthening of the quality of project planning and implementation, including instituting improvements in economic and financial analysis of project proposals, project costing, and monitoring of physical construction.

Assessment of the current PFM practices at the federal level

21. The government reform team that came to office in 2003 inherited an extremely weak budget management system. The legacy of military regime included open disrespect for existing fiscal regulations, massive informality and a lack of transparency in budget practices, outdated concepts of budgeting, weak capacity and heavily distorted incentives for civil servants.

22. Since 2003, the Federal government has made a significant effort to advance reforms of the PFM system. It has undertaken steps to increase the transparency of the budget process, ensure more efficient cash management, reform the procurement process, update the legal framework for PFM, strengthen monitoring and evaluation (M&E), and introduce a more strategic longer-term focus in budget management. Recent surveys, including those done by the World Bank Institute, suggest that, while corruption remains high, since 2002 there has been a considerable reduction in bribery, in particular in the area of public procurement, and tax and permit administration. Nigeria has been a global leader in implementing the Extractive Industry Transparency Initiative (EITI). This has clearly helped to reduce waste in public resources, particularly on the capital budget and payroll sides. There is still a long way to go, given the original low base from which the reforms were launched, but the trend thus far has been clearly positive.

23. This report assesses Nigeria's current PFM practices against two types of benchmarks. First, the current fiscal management systems are reviewed against recommendations made by earlier World Bank reports such as the PER (2001), CPAR (2001) and CFAA (2000). Second, an assessment is undertaken against the benchmarks of the best international practices suggested within the PEFA performance management framework (PEFA, 2005).

24. With respect to improvements made against the earlier recommendations proposed by the World Bank, this review finds that the FGN made advances in macroeconomic and debt management, budget formulation, accounting, and procurement reform. However, less progress was made with respect to capacity building, including in the Budget Office, and in such areas of financial accountability as reporting, monitoring, and disclosure.

25. The key findings of this report with respect to financial accountability systems could be summarized as follows:

- Political commitment to the reform process is strong within the top level of the government, although in some areas this has yet to translate into a fully articulated development plan.
- The reform program is still in its initial stages, but its impact has already been significant on particular aspects of the PFM operations.
- Most of the PFM areas that show weaknesses have been recognized by the government, and appropriate reform efforts are either ongoing or planned.
- Overall, despite recent progress, the fiduciary assurance environment in the FGN remains weak compared with existing practices in some comparator countries.

26. The trends in the Nigerian PFM system were also reviewed against 28 PEFA performance indicators. This diagnostic has confirmed a trend toward system-wide improvements, which reflects strong government commitment for reform. In more than half of 28 PEFA individual areas, both performance and underlying systems have improved noticeably over the last few years. However, because the initial pre-reform level was low, even after several years of reforms Nigeria's PFM system remains fragile.

27. Thus, a peculiar feature of the current PFM situation in Nigeria is that for a number of indicators/areas performance is improving but is still quite weak. Such indicators include budget classification, public access to budget information, the transparency of taxpayer obligations, the effectiveness of taxpayer registration, the management of cash balances and debts, and the quality of in-year budget reporting.

28. At the same time, for a number of indicators, performance remains weak, and little progress has been made recently. These include the incidence of government spending that remains off budget; the consolidation of fiscal data for enlarged government; the oversight of fiscal risk related to the operations of state enterprises; the control and collection of tax arrears; the predictability of government funding; the availability of information on funds received by service providers; and the timeliness and quality of annual accounts.

29. Moreover, the reforms that promise to advance budget transparency and expenditure efficiency, including those in procurement, have been much slower at the subnational level, where more than half of consolidated budget expenditures are administered.

Priority directions for further PFM reform at the federal level

30. Thus, there is a large unfinished PFM agenda, and the expenditure management reforms will need to remain a key part of future government development program to ensure sustainability. Maintaining momentum with budget reforms is critical to whether the FGN can establish a better budgeting system, one that provides for sound fiscal policy over the oil price cycle, allocates resources according to government priorities, and improves the efficiency and effectiveness of MDAs' spending.

31. The immediate challenge is to secure the passage of legislation that the government has prepared to support stable budgeting and adequate consultation during budget preparation, strike a functional balance between the roles of the executive and the legislature, and provide for an active debate on strategic budget priorities and needs ahead of the preparation of detailed budget estimates. The Government fully recognizes the need to underpin the reforms through legislative mechanisms and has submitted several key bills to National Assembly that are currently at different stages of passage. These include Bills for the Audit, Fiscal Responsibility, EITI, and Procurement.

32. At the same time, it is worth noting that gains from the ongoing legislative improvements will be achieved only if the capacity exists to significantly improve the enforcement of both laws and financial regulations. The current weaknesses in the Nigerian PFM system derive less from deficiencies in the legal framework and more from under-utilization of the accountability and control mechanisms that have been in place for many decades. The 1958 Finance (C&M) Act and the various financial regulations issued since then,

while requiring modernization, are fundamentally sound. They provide the Minister of Finance with considerable powers to hold accounting officers to account, including through withholding budget releases to MDAs, disallowing expenditures and imposing disciplinary actions on individual officers. These powers have to be exercised. Updating the legal framework for public financial management therefore needs to be accompanied by a greater determination to ensure that the rules are applied and necessary actions implemented. The potential for doing this has been admirably demonstrated in the area of procurement reform.

33. As the government defines priorities for the next round of PFM reform, the following two key issues require immediate attention:

- **Sustainability of reforms**. The immediate risk for the government's reform strategy relates to slow progress in capacity building within both the Ministry of Finance and the relevant departments in the ministries. Critical capacity building needs should be identified and a plan to address these needs outlined and implemented to ensure that budget, financial management and procurement staff, including those in Budget Office and the Accountant General's Office, are fully engaged and can carry forward the PFM reform effort.
- **Sequencing of further reform steps**. It is important to separate the immediate reform agenda from the medium-to-longer-term agenda. The practical reform strategy should reflect the paramount capacity constraints within the government, which impedes the needed transition to a new budget model, built around a programmatic budget structure within the MTEF.

34. While the scope of the government reform program would remain unavoidably broad, some re-balancing of priorities seems justifiable. Recently the reform team invested most of its effort and made the greatest progress in such areas as macroeconomic and debt management, budget formulation, the upgrading of the PFM legal framework, and the launching of the high profile anti-corruption drive. For the immediate future, the most pressing priorities relate to (i) improvements in the quality of budget spending at sector and project level on the basis of stronger accountability for the utilization of public funds, and (ii) capacity building within the budget system, in particular in the BOF. Accelerating the GIFMIS implementation could be seen as a platform for many other required improvements on the budget execution and reporting side. This will help to address the existing gap between much improved fiscal discipline at the macro level and less reformed procedures for project planning and implementation at the sector level. In the short term, the government may consider conducting 2-3 specific sectoral pilots (e.g. in health, education, and power), which could help the government concentrate its expenditure rationalization efforts and receive coordinated donor support in these areas.

35. In practical terms, this would require a stronger emphasis on enforcement relative to new policymaking. The key element of the proposed strategy relates to <u>improvements in the quality and availability of the information</u> on how the government actually spends its money. The budget expenditure reports need more detail, greater accuracy, better timing, and higher frequency. The direct responsibility of the federal Ministry of Finance is to design and enforce new reporting and disclosure requirements on other stakeholders, in particular line MDAs. The ultimate goal is to ensure (i) that every recipient of public funds produces a regular report on how much money is received and how these funds are spent, and (ii) that these reports are publicly available. Particular steps in this direction could include the following:

- Reporting and disclosure. Introduce monthly reporting on budget releases, commitments, actual expenditure by MDAs, arrears and revenues. Institutionalize practice of regular within-the-year budget execution reports, which should make a special focus on analysis of budget performance relative to the approved annual budget. Monthly expenditure reports from MDAs to the OAGF should be a basis of government in-year and end-year reporting. Ensure that the reports of the Auditor-General and other main fiscal reports are publicly available.
- Accountability. Strengthen responsibility for regular budget reporting to the OAGF. Continue to use the power of withholding budget allocations to MDAs and parastatals that either report late or do not comply with the established reporting standards. Request MDAs to produce their annual accounts that would reflect utilization of their entire financial envelopes (budget allocations, external grants, and own revenues). Introduce changes to the reporting regime for parastatals, including non-commercial parastatals, aimed at setting up arrangements that support the regular submission of their accounts to the dedicated government unit, which could monitor their financial performance and generate a consolidated performance and risk report.
- Coverage. Introduce regular reporting on government operations which currently remain outside of the budget process (oil savings, cash call spending, federal extrabudgetary funds, external grants and loans).
- Timing. Establish firm deadlines for the submission of financial statements to the Auditor-General, the submission of Audit Reports to the PAC[6], the PAC discussion and National Assembly approval, and the FMF response to audit findings.
- Presentation. Improve the transparency and quality of the annual budget documents by providing better-structured information on the macroeconomic framework, fiscal risks, and the overall composition of expenditure in institutional and functional terms, as well on the structure of financing sources. These improvements should lead to a transition towards the international standards of budget classification. Review the format of annual statements and agree on amendments to the formats to bring these closer to the cash-based International Public Sector Accounting Standards.
- Computerization. Give the highest possible priority to the full implementation and proper maintenance of the ATRRS as an interim means of ensuring prompt and complete in-year financial reporting from the MDAs. GIFMIS implementation should receive priority.
- Capacity. Expand strategic use of external advisors – spend more money to buy expertise that is not currently available within the government (e.g. on independent project evaluation, project audit, etc.), while simultaneously building up local capacity for the medium to long-term.

36. With respect to other components of budget process priority reform measures for short to medium term would include:

- Adopting, based on a successful experience with the 2007 budget preparation, a more realistic and respected budget timetable, either by law or by administrative commitment, for preparing and approving the budget before the beginning of the fiscal

[6] Despite the recent efforts to address the backlog, the latest audited annual accounts that were submitted to the National Assembly are 2001 accounts.

year. This should include reaching an understanding with the National Assembly on how it could become a party to a more orderly process. Discontinue the practice of extending the end of the budget year.

- Strengthening the multi-year perspective in the budget. The immediate emphasis should be on (i) ensuring stability of multi-year global and sectoral expenditure envelopes, and (ii) strengthening the MTSS. Redefine the role of National Planning Commission (NPC) in the budget process and policy coordination generally.
- Strengthening the budget monitoring and evaluation system through (i) better funding of the M&E function, (ii) improved disclosure of monitoring results, (iii) better coordination among different agencies involved in M&E, (iv) the expanded participation of civil society, and (v) the incorporation of M&E outcomes in the MTSS development process. The recently launched MDGs expenditure monitoring system could serve as a model for upgrading M&E standards across the board.
- Ensuring the Ministry of Finance has an adequate mandate for efficient day-to-day budget implementation. This includes well defined powers for virement within the budget heads. Given the existing legal limitations, this may require either (i) a joint search for a new definition of powers for virement within the budget heads that is acceptable to both branches of power, or (ii) the development of a new procedure for legislative scrutiny of virement requests by the government that would provide for a speedy review and approval of such requests.
- Improving budget predictability by reviewing the mechanisms for transferring oil revenue to the Federation Account to ensure a steadier revenue inflow. If and when necessary, complementing such efforts to stabilize the revenue flow with an improved capacity to meet short-term liquidity requirements through domestic capital market borrowing.
- Developing options for increased government co-financing of IDA, AfDB, EU, and other donor projects as a quick way to raise efficiency of budget investment spending and accelerate capacity building in project preparation and implementation.

37. Strengthening focus on budget accountability may also require some rebalancing of government anti-corruption efforts. In recent years, the FGN has emphasized the strengthening of special anti-corruption units such as the Independent Corrupt Practices and Related Offences Commission (ICPC) and the Economic and Financial Crimes Commission (EFCC), the amendment of relevant laws and regulations, and vigorous implementation of anti-corruption policies. Going forward, to put the anti-corruption effort in the area of public finance on a sustainable footing, the FGN could complement its current program with significant investments in capacity building of the offices of the Accountant General and the Auditor General. Reduction in the scope of off-budget public spending may also be considered a priority for the government anti-corruption strategy because, despite all its remaining weaknesses, the accountability framework for utilization of budget money is much stronger than for spending within other components of the public finance system.

38. In the medium-term (three to five years), the above reform measures will need to be complemented by the following steps that are much more demanding in terms of institutional capacity:

- Completely overhauling cash management, including establishing a Single Treasury Account to replace all individual MDA accounts in commercial banks.
- Deepening sector policies by remaking the content of sector envelopes through the improved orientation of sectoral spending on service delivery, the better costing of policies and other tools available within the MTEF paradigm.
- Restructuring of the budget along programmatic lines.
- Incorporating a modern chart of accounts based on international best practice.
- Complete implementation of a modern budgeting, financial control, accounting, financial reporting, and management information system (GIFMIS).

39. It is also important to emphasize a need for the stronger coordination of PFM reforms with parallel reforms in the civil service. There are several reasons why this is critical:

- Public service reform, with its potentially heavy severance pay costs, needs to continue to be fitted into the aggregate fiscal envelope for spending over the medium term.
- The reviews of ministerial mandates, organizational structures and staffing levels need to be made consistent with the MTSS.
- The incentive structure confronting ordinary civil servants – pay, working conditions, discipline, and accountability mechanisms – needs to be transformed in order to turn the tide on informal PFM practices and ensure compliance with the new formal rules of PFM.

PFM reforms at the state level

40. The report's analysis reveals a number of positive recent developments in fiscal management at the state level. Although budget deviations are still high, they show a declining trend. States are clearing the backlog of their annual accounts. Public access to fiscal information has improved, with some states (such as Kaduna) beginning to publish their budget reports in newspapers. Participation in the budget process is opening up – MDAs, civil society groups and members of the public have more opportunities to make inputs, though still limited, into the process. Payroll controls have improved in a number of states, with governments using various forms of computerization to improve payroll management and minimize the incidence of ghost workers. Increasingly, states are using banks to improve the efficiency of tax collections.

41. However, these improvements in PFM do not go far enough to influence significantly the overall quality of fiscal management in states. Despite recent progress, states are lagging behind the Federal Government in almost every area of PFM reforms, in particular in budget formulation, procurement, debt management, and computerization. In other words, state governments are not adequately complementing the FGN's efforts to build a modern national PFM system that will ensure effective public service delivery.

42. In many states the budget policy shows much deviation between announced goals of social and economic development (which according to most SEEDS are MDG-related) and actual priorities of the budget spending. The budget process is excessively focused on financing of individual projects, not on improvements in service delivery. State capital budgets are often unrealistic: the review of actual budgets in a sample of states reveals that actual

execution of capital budgets commonly does not exceed 40 percent. In some states, a limited number of large and politically motivated projects attract most of capital spending. Budget execution functions are excessively centralized in the governor's office, while powers of line MDAs are limited. State fiscal relations with local governments remain non-transparent. State governments withhold and centralize a significant portion of federation account transfers to LGAs, but accountability for these centralized funds is weak. Quality and availability of budget execution reports in states remains poor.

43. Moreover, the states face major common constraints to deepening their PFM reform efforts. The most critical is inadequate political commitment to carry out a serious reform of budget management. Different vested interest groups resist attempts to introduce reforms that threaten the status quo. Several state governments that sought to implement necessary reforms have had to roll them back. In addition, states face an acute shortage of technical and human capacity to design and implement reforms. This is aggravated by the inability of the public service to compete for qualified and experienced professionals because of the low wage.

44. At the same time, there is a high degree of variability among states in their reform efforts. The individual state's progress reflects primarily the degree of commitment accorded to PFM reforms by local political leadership. There is also variability in the state reform agendas. The emerging picture is that of a lack of compulsion for states to reform. They choose to reform, decide what to emphasize, and reform at their own pace. However, that pace is generally slow. There is need to imbue the reform process with a sense of urgency both to hasten the process and to widen its scope.

45. Since states do not have sufficient incentives to carry out these reforms on their own, how can the Federal Government facilitate the process? Given the autonomy of state governments in fiscal and financial management matters, the FGN can do little by way of direct intervention. Instead, the FGN should look for an alternative, more cooperative approach for engaging the states that could include the following elements:

- The FGN should continue to provide good reform examples for states to follow.
- It should develop model financial regulations and laws for states and encourage states to adopt them.
- It should offer technical assistance (TA), including training, to states willing to follow its examples.
- It could support the offer of TA with the creation of a States PFM Reform Assistance Fund to provide matching grants to assist states with implementation of PFM reforms. Such a Fund could utilize the mechanism of cash transfers to states, which the FGN is currently contemplating.
- Simultaneously, the FGN has to build its own capacity to monitor subnational fiscal performance at both levels – individual states and in aggregate. The recent SEEDS benchmarking exercise represents a promising framework that could strengthen inter-state competitive pressures and improve longer term incentives for reform at the state level.

46. In the medium-term, the FGN could start sponsoring joint projects with states under the conditions of the acceptance of the prescribed minimum PFM reforms. Such a minimum

degree of reform might include state equivalents of key federal laws, including the Fiscal Responsibility Law. Finally, the FGN should create a well-staffed unit in the Federal Ministry of Finance to monitor and coordinate the reform efforts of states, disseminate best PFM practices, and administer the Reform Assistance Fund suggested above.

47. Initially, in its dialogue with the states the FGN may emphasize increased transparency, accountability, and disclosure. Accounting and reporting reforms should therefore receive top priority as well as making more budget information available to the public. Integrating the accounting, budget, and payroll systems will facilitate the production of better budget reports.

48. Reforms in budget planning and execution may then both complement and deepen the state reforms in accounting and reporting. Eventually, states will need to move towards a multi-year budget framework (based on medium term fiscal forecasts and sector strategies), and integrating the capital and recurrent budgets. Budget reform should also include a new budget classification system that will facilitate accounting and expenditure tracking and analysis. To encourage value for money in public spending, procurement reforms are essential and should also form a part of the state budget reform package.

49. More strategically, the FGN should encourage further discussion on the directions for reforming fiscal federalism arrangements in Nigeria. The existing model of federalism presents challenges for both governance reforms and improvement in service delivery. A solution for its gradual transformation could be found on the basis of the best international practice and lessons from Nigeria's own experience.

Progress with the reforms in public procurement

50. Public procurement, a long recognized area of high fiduciary risk in Nigeria, is an area where recent reforms have significantly contributed to fostering transparent and accountable processes. The new federal procurement system, with the Budget Monitoring and Price Intelligence Unit (BMPIU) on the top and based on the best practice principles of open competitive procurement, was introduced in 2001, and since then there have been significant budget savings.

51. However, the current system remains excessively centralized, which poses a risk of overstretching the limited BPMIU capacity and slowing down the procurement process. Because BPMIU staff has largely focused on exercising its prior review and other control functions, they have fewer opportunities to work on policy reforms to facilitate building a robust national procurement system. There is also no independent mechanism in place yet to handle complaints from bidders or contractors; however, this will be set up after the Procurement Law is enacted.

52. To make recent success sustainable, it is important that the Procurement Bill, which would institutionalize the work of BMPIU, is passed without additional delay. The Bill would be the basis for establishing the Bureau of Public Procurement (BPP), a modern procurement regulator and reform facilitator. Transferring staff from the BMPIU to the BPP in a way that ensures its unique esprit and dedication to the public interest is maintained will require addressing pay, incentive and workplace issues.

53. There are several other challenges that must be met once the new law is passed and institutionalized:

- A cadre of procurement specialists will need to be created, and investment made in training and capacity building for public procurement.
- Ensure that in addition to capital contracts, contracts within the recurrent part of the budget are also subject to open and competitive procurement.
- Improve the transparency of the procurement process by continuing to advertising all tenders, publishing contract awards, and producing a regular annual report that provides quantitative data on federal Government contract tendering and awards.
- Move towards system decentralization under efficient BPP's oversight. The prior review role of the BPP should be considerably compressed.
- Step up efforts to ensure proper alignment between the public procurement and the broader financial management system, including mandatory requirements for procurement planning as part of the multi-year budgeting process.
- Establish a collaborative, strategic approach for the monitoring, audit and oversight of public procurement between the Office of Auditor General and the BPP.
- Introduce a system of periodic surveys of private sector perceptions of public procurement.
- Develop an E-Government Procurement Strategy and action plan with clearly defined benchmarks.
- Support the efforts of reform-minded state governments to reform state procurement systems along the same lines.

Challenges of budget financing of the power sector's expansion

54. The power sector's performance has improved recently, but it still falls short of customers' expectations. Recent progress must be viewed in the context that the FGN spent more than N200 billion (about US$2 billion) in the sector from 1999 to 2005, and electricity is still delivered to less than half the population, while electricity supply meets less than a third of the existing demand. A disproportionally high share of sector investments went into an increase in the value of unfinished projects, instead of expanding the pool of usable assets. The number of incomplete rural electrification projects under the Ministry of Power and Steel had grown from 340 prior to 1999 to 1,500 projects by the end of 2005.

55. Weaknesses in the budgeting arrangements, governance problems in the sector, and an inadequate tariff policy have been major factors that limited significantly the benefits from the previous public investments in the sector.

56. The latest emphasis in the government's power reform program has been on rapid increase in generation capacity based on major additional public investments in the sector. The noticeable effort was also made in the sector to improve collection discipline, to improve budget planning on the basis of the MTSS, strengthen regulatory capacity, and prepare various sector entities for privatization. However, urgent attention needs to be paid to strengthening institutional arrangements and clarifying responsibilities for efficient coordination, monitoring and supervision of the new investment program. New public investments in the sector should be made as part of the regular budget process to strengthen accountability for effective use of

funds. The government also needs to clarify reporting, monitoring, and auditing arrangements to track expenditures under both National Integrated Power Project (NIPP) and the rural electrification program.

57. At present, no institutional arrangements exist to succeed Power Holding Company of Nigeria (PHCN) that ceased to operate on June 30, 2006. The technical and managerial challenge of coordinating and tracking engineering progress of the overall power mega-project must be confronted at the earliest opportunity. An inter-agency task force should be established to develop main options on how the technical coordination can be implemented in the unbundled sector.

58. Within the government reform strategy visible and politically rewarding commitments to new investments continue to prevail over attention to the less visible, but equally important objective of upgrading the quality of sector management and strengthening the commercial focus of its operations. The government should establish a set of performance benchmarks to monitor improvements in commercial performance of companies in the sector.

59. The current sector strategy relies on a large increase in the share of electricity generated by private power plants. An expansion in privately generated power could be financially sustainable only if it is backed by improvements in payment discipline in the sector and is accompanied by tariff adjustments to achieve cost recovery in tariffs. Without this, additional power generation would result in a higher subsidy burden for the government budget. The government should launch a communication campaign to prepare grounds for tariff adjustment to be phased in as soon as additional generation capacity becomes operational.

60. The government should build a consensus with respect to a desirable future sector configuration. Evidence from elsewhere suggests that this is most likely to succeed if it is done in a transparent way, based on informed discussion and consultation with core stakeholders, and the decisions are clearly communicated to the private sector.

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