I. Project Context

Country Context

1. Lesotho is a lower middle-income country with per capita gross national income of US$1,380. It is a small country, mostly mountainous and largely rural with about 2 million people and completely surrounded by South Africa. Lesotho has an open economy traditionally centered on trade. Its main exports are textiles, water, and diamonds. Lesotho’s main trading partners are the United States and South Africa. It is a member of the Southern African Customs Union (SACU) and the Southern African Development Community (SADC) and, as a member of the Common Monetary Area (CMA); its currency is pegged to the South African rand.

2. Lesotho has undergone political and economic changes over the last two decades. The political system has evolved towards open and competitive elections. The economy has grown at an annual rate of 3 percent in per capita terms, which, though modest for its income level, compares well with the rest of the SACU region and the African continent as well as other small states. The economy has been able to adapt itself to new realities and has taken advantage of new growth opportunities. The changes have involved shifts from subsistence agriculture and remittances toward mining, water exports, manufacturing exports, and services.
3. The country now finds itself at a crossroads, requiring new growth engines, a more streamlined role for the state, and the need for a dynamic private sector to seize opportunities in the Southern African market. Public spending grew from 45 percent of GDP in FY2004/05 to about 62 percent in FY2011/12, one of the highest ratios in the world. This level is unsustainable, and public spending can no longer be relied upon to drive growth. The effectiveness of public spending has also been low, weakening its effect on growth and social outcomes. The fiscal consolidation needed to strengthen fiscal and external sustainability would weigh on future growth, especially if not matched by greater effectiveness of spending and service delivery institutions.

4. Economic growth has not been adequately inclusive, resulting in high concentration of poverty in rural areas, persistent high levels of inequality, and widespread unemployment. Unemployment stood at 24 percent in 2008, among the highest in the world. Only 230,000 of the 608,000 employed people engage in formal wage employment. The rest are in informal activities, and they are often paid in-kind. Preliminary Government's estimates based on the 2010/11 Household Budget survey show that the national poverty head count rate stood at 57.1 percent and the Gini Coefficient based on consumption stood at about 0.53 (Table 1). Both these figures are virtually the same as those obtained in the 2002/2003 Household Budget survey. However, in comparison with the 2010/11 figures, poverty decreased in urban areas while increasing in rural areas (see Table 1). Given that about three quarters of the population live in the rural areas, addressing this poverty incidence will require greater inclusiveness of growth, a sustainable and effective public sector, and access to quality service delivery. At the heart of this development agenda, is job creation, particularly in low-skilled sectors.

5. Much of the expansion of Government spending over the past decade has been directed toward the social sectors, but social outcomes have not improved significantly. Lesotho spends close to 30 percent of GDP, or more than half the Government's budget, in three social sectors: education, health, and social protection. The country's health systems have been overwhelmed by HIV/AIDS, with the adult prevalence rate climbing to the world's third highest at 23.6 percent. However, overall coverage of key HIV/AIDS interventions has improved, including Prevention of Mother to Child Transmission (PMTCT) and Anti-Retroviral Treatment (ART). Maternal mortality is among the highest in Sub-Saharan Africa. In the education sector, learning outcomes and coverage have improved, but quality remains low at the primary level. In terms of social protection, Lesotho spends close to 9 percent of GDP on social transfers and most of them do not target the poor. Despite these challenges, deep-rooted inefficiencies have minimized the effectiveness in social spending.

6. Lesotho’s National Strategic Development Plan (NSDP) FY2012/13-FY2016/17 serves as the Poverty Reduction Strategy Paper (PRSP) and is the second PRSP that the Government has produced. With the central objective of faster growth and poverty elimination, the Government has set out its approach towards a stable democracy, a united and prosperous nation at peace with itself and its neighbours by 2020. The strategy is based on the (i) pursuit of shared and job-creating economic growth; (ii) development of priority infrastructure; (iii) enhancement of the country’s skills base, technology adoption, and foundations for innovation; (iv) improvement in health outcomes including combating HIV/AIDS and reducing (social) vulnerability; (v) reversal in environmental degradation and adaptation to climate change; and (vi) promotion of peace and democratic governance and build effective institutions. This governance pillar includes a focus on enhancing the public sector’s effectiveness and efficiency in delivering services, improving public financial management, and maintaining the rule of law. In view of the importance of PFM to the...
effective implementation of the NSDP, to minimize inefficiencies in government spending; and provide a platform for budget support assistance from development partners (DPs), the effective functioning of PFM institutions and systems at central and local levels of government in Lesotho has been identified as a high priority.

**Sectoral and institutional Context**

7. Lesotho’s initiated a Public Service Improvement and Reform Program (PSIRP) in 2003/04 of which the first (of three) component was aimed at improving government financial management (the other two addressed decentralization and government management). Under the auspices of this program DFID undertook research into the state of government financial management and determined that it was heavily dysfunctional, concluding that it operated to a ‘cultural norm of fiscal indiscipline’. Due in part to these findings, DFID was nominated by development partners to lead the assistance to the Government of Lesotho (GoL) in addressing the challenges in the sector. As a consequence, the ‘DFID Foundation Programme’ was launched in 2004.

8. The DFID Foundation Programme and the two CBEP projects were intended to address a wide range of PFM reforms covering the following main areas -

(a) planning and budgeting – including MTEF, improved macroeconomic forecasting, data collection and tax policy;
(b) accounting and reporting – including implementing a new integrated financial management information system (IFMIS), strengthening internal and financial controls and internal audit, improved technical and professional training;
(c) audit and oversight – including addressing the backlog of financial reports, strengthening the capacity of the Office of the Auditor General;
(d) administration – restructuring the MFDP, improving pension administration.

9. Another relevant (and ongoing) reform is related to the development of human resource capacity in accounting, auditing and procurement. At an early stage in the DFID Foundation Program, DFID and the GoL agreed that a major brake on raising standards in PFM was the lack of human resource capacity in accounting, audit and procurement. A study carried out by the UK Chartered Institute of Public Finance and Accountancy (CIPFA) in 2006 recommended the introduction of professional training programs aimed at government employees in these disciplines. This recommendation was accepted and the programs commenced in early 2007 with the accountancy and audit courses operated at the Lesotho Centre for Accounting Studies (with examinations for the CIPFA International Certificate and Diploma qualifications conducted joint by CIPFA and the Lesotho Institute of Accountants), and in procurement at the Institute for Development Management with students sitting for the external qualifications of the UK Chartered Institute of Purchasing and Supply (CIPS). Funding for this program from 2007 to 2012 was provided by MFDP using a grant from Irish Aid specifically for this purpose, though Irish Aid has recently indicated that this funding will no longer be available from 2013. Therefore, the CIPFA scheme for professional training in government will be replaced from 2014 by the new professional accountancy qualification scheme recently developed with the support of the Bank, through an IDF grant to the Lesotho Institute of Accountants, with different funding arrangements – currently the European Union (EU) is providing financial support of about EUR 1.2m for the implementation of the new arrangements. The CIPS scheme will be reviewed as part of this initiative.
10. Mixed results of this first phase of the reform program are evidenced in two PEFA PFM Performance Reports conducted in Lesotho in 2009 and 2012. Progress has been made on some fronts - most notably in budgeting and macroeconomic forecasting, the introduction of a new legal framework for PFM, the introduction of a new IFMIS on 1 April 2009 and completion of public accounts from 2005 to 2010 (which was just completed up to FY 2013 and submitted for auditing on 30 September 2013). But several long standing problems are yet to be resolved - a sufficient strategic overview of the allocation of resources is currently lacking, inadequate planning of services, insufficiently competitive procurement, weak cash management, the IFMIS is not yet effective in supporting good financial management and timely and reliable in-year and annual reporting, weak accounting processes and disciplines, weak payroll controls, ineffective internal and external auditing systems.

11. Most notably the IFMIS platform has been partially utilized to support key budget execution functions of the Central Government since its introduction in April 2009. Due to a number of technical and adaptive challenges, the system does not support daily operations effectively, and the timely production of reliable in-year and annual financial information is not possible. Some of the core PFM functions (requisitions, orders, commitment control and payments) were initially not performed through the IFMIS - budgets that were not loaded, users that were not properly trained and system unavailability are all contributing factors. Frequent system unavailability still continues (up to two days a week) and causes bypassing of the IFMIS in order to continue operations with no controls to ensure timely capture of transactions created outside of the IFMIS. Other PFM functions (e.g. budget preparation & asset management) are still performed manually or through parallel systems in line ministries and district sub-accountancies. Good practice accounting disciplines, such as month-end closures and bank reconciliations, are also not yet fully functional. These deficiencies severely limit revenue and expenditure control, budget execution, reliable and timely reporting, and ultimately financial accountability.

12. At an early stage in the history of PSIRP the stakeholders in the PFM component established - within the framework of PSIRP – a steering committee under the title of the PFM Improvement and Reform Steering Committee (PFM IRSC) with membership drawn from across all stakeholders (government, development partners and others) and chaired by the Principal Secretary of the then MFDP. This Committee continues in existence and provides a regular opportunity for interface between Government and other stakeholders, having met roughly every six weeks over the last year. Whilst the existence of IRSC has provided some stability to the management of the reform process, it has yet to deliver the level of program planning and coordination expected of it and, to a degree, since the end of the DFID Foundation Program has lost its sense of direction with no central program driving the reforms.

13. The Government and development partners have however committed to move to a new phase of the reforms founded on greater implementation of the new rules and regulations, tighter internal controls and greater attention to the benefits of PFM reforms for Ministries, Departments, Agencies (MDAs) and sectors. In preparation for this new phase, Government and development partners have been working together since late 2011, through the IRSC, on creating a future reform program. An initial program was approved in principle by the IRSC in May 2012, and then further refined and finalized with technical assistance from the International Monetary Fund (IMF) during the last quarter of calendar 2012. A final version of the Government Public Financial Management Reform Action Plan (PFMRAP) 2012-2017/18, with a foreword by the Minister of Finance, was
approved by the IRSC in March 2013. A High Level PFM Workshop was also hosted by the Minister of Finance on 11 November, 2013 with representation from Parliament (specifically the chairperson of the Public Accounts Committee); several Ministers (including Finance, Development Planning, Health, Education and Social Development); Development Partners (DPs, including the IMF, EU, AfDB and UNDP); several Principal Secretaries, Component Leaders for the PFM Reform Action Plan (PFMRAP), and other key staff involved in its implementation. The GoL provided an overview of the PFMRAP, and the associated implementation arrangements, and the workshop concluded with overwhelming support for its implementation and appreciation to the DPs for their support.

14. The approved PFMRAP covers a number of strategic actions, that have been structured into 8 components and linked to key results (with reference to the associated PEFA performance indicators where possible). Key outputs have been defined for each of the components as follows:

(i). Modern PFM regulatory framework implemented: (a) Regulatory framework updated to underpin PFM reforms; (b) Capacity developed to implement and sustain the PFM regulatory framework

(ii). Transparency and effectiveness of policy orientation of the budget assured: (a) Demonstrable links between development plans, fiscal strategy and budget appropriations; (b) Budget process redesigned to provide space for enhanced engagement by policymakers; (c) Effectiveness of macro-fiscal management enhanced; (d) Comprehensiveness and quality of information included in budget documentation progressively improved

(iii) Cash flow forecasts a major determinant of internal debt and financial investment: (a) Cash Management Unit and Liquidity Committee established; (b) Access to consolidated information on government cash balances; (c) Cash forecasts accurate to 90%

(iv) Internal Controls ensure strengthened operational efficiency and effectiveness: (a) Ex-ante controls on non-salary expenditures compliant with contextually relevant components of the COSO framework; (b) Compensation of employees and pension payments consistent with employee/pensioner number and entitlements; (c) Internal audit compliant with COSO and IIA controls and standards

(v) Accounting and fiscal reporting fully compliant with the regulatory framework and accounting standards: (a) Government accounting cadre reform implemented; (b) Accounting systems and application software upgraded to comply with regulations and standards; (c) In-year and annual fiscal reports published in accordance with regulations and standards

(vi) Public Procurement aligns with international best practice in efficiency and transparency: (a) Legislative and regulatory framework revised and upgraded; (b) Management and operations of the public procurement system re-engineered and reconfigured; (c) Public procurement achieves transparency through outreach to public and suppliers; (d) Human resource capacity within public procurement is significantly increased

(vii) External audit and oversight compliant with INTOSAI standards (ISSAI): (a) Legal and regulatory framework updated to comply progressively with international standards; (b) HR capacity to deliver on prescribed external audit mandate established; (c) Legislature empowered to perform oversight functions

(viii) Governance and institutional management of PFM reforms improved to facilitate ownership, monitoring and evaluation of progress: (a) Management of PFM reform institutionalised

15. This operation will support the GoL with the implementation of key result (b) of component 5 of its PFMRAP. Essentially this will entail stabilization and improving the effectiveness of the IFMIS platform.
16. Other components / activities of the PFMRAP will be supported by the EU, African Development Bank (AfDB) and IMF, under oversight and coordination from the IRSC. AFDB will be providing financial support approximating USD 4.2m primarily for activities related to procurement, internal audit and external audit. IMF will be providing technical assistance on cash management and PFMRAP coordination. The EU will be supporting the remainder of the components with financial support and technical assistance in total approximating EUR 10m.

17. Since the IFMIS has already been in operation since 1 April 2009, the planned interventions are quite distinct from other PFMRAP activities. However, IFMIS dependencies on and links to the regulatory framework, processes, controls, standards and data requirements will be coordinated through the PFM Reform Technical Committee (RTC), a sub-committee of the IRSC. This will be focused in particular on the activities related to the following key outputs – (i) Regulatory framework updated to underpin PFM reforms; (ii) Cash Management Unit; (iii) Access to consolidated information on government cash balances; (iv) Ex-ante controls on non-salary expenditures compliant with contextually relevant components of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework; (v) In-year and annual fiscal reports published in accordance with regulations and standards; and (vi) Management and operations of the public procurement system re-engineered and reconfigured.

18. This project’s deliverables are directly complementary to the PFM policy actions of the current series of World Bank development policy operations. The Development Policy Operation (DPO) series have a focus on the following key areas of reform embedded in the PFMRAP – (i) introducing a medium term budget policy statement and a medium term fiscal framework approved by Cabinet; (ii) eliminating the backlog of audited public accounts; (iii) improving the quality and timeliness of public financial management information, to support better budget execution and financial accountability (to which this project directly links); (iv) strengthening the transparency in public procurement; (v) further strengthening of the legal framework through the finalization of new PFM regulations; and (vi) improving responsiveness of key ministries to audit findings, in order to help improve the control environment. A General Budget Support Group (GBS – currently chaired by the EU) is in operation, which has joint annual reviews and an agreed Common Performance Assessment Framework (CPAF). The last joint review was in February 2013.

19. The rationale for the proposed PFM reform support project is consistent with, and aligned with Pillar 6 of the NSDP (2012-2016). The emphasis under this Pillar on PFM related interventions is primarily focused on efficient delivery of quality, timely services in an accountable and transparent manner; and political governance, including decentralization and local government transformation. This pillar also recognizes the fact that a sound PFM is crucial to achieve the nation development goals of promotion of peace, democratic governance and building effective institutions.

20. In this phase of the PFM reform agenda, the government seeks to improve its capacity to utilise public resources towards meeting the NSDP targets and ultimately those of Vision 2020 through the strengthening of human resource capacity; development of systems and procedures for effective financial management and reporting, strengthening an institutional framework that is transparent and ensures accountability in the public sector. To this end, the Project will support the Government’s efforts towards ensuring aggregate fiscal discipline, more strategic allocation of resources, and greater financial accountability. The achievement of these broader goals will not
only be critical to a more efficient delivery of basic services but also serve as a major step towards the achievement of the NSDP goals of poverty reduction and shared prosperity through broad-based economic growth.

21. Strengthening of PFM systems to support the development of the public sector capacity and efficient service delivery is consistent with the foundational pillar of the World Bank’s Strategy for Africa: governance and public sector and aligned with the Bank’s twin objectives of poverty reduction and shared prosperity. The relevance of strengthening the PFM system cannot be overemphasized in a country like Lesotho if more 50 percent of the budget currently being spent in three social sectors - education, health, and social protection - is to be translated into greater human development and economic transformational outcomes. This project serves as a platform for resolving these challenges as it will support the rebuilding of institutions and the PFM systems and practices that provide timely and reliable financial information. Without such information the ability of GoL to improve service delivery in support of the goals for poverty reduction and shared prosperity will continue to be greatly impeded.

II. Proposed Development Objectives
The project development objective (PDO) is to improve the quality and timeliness of public financial management information.

III. Project Description
Component Name
Support for improving the stability and reliability of existing IFMIS
Comments (optional)

Component Name
Support for expansion and modernization of IFMIS platform
Comments (optional)

Component Name
Support for change management, training and project management
Comments (optional)

IV. Financing (in USD Million)
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V. Implementation
22. The GoL implementation arrangements for the PFMRAP consist of two tiers, as follows - (i) an oversight/steering committee as the top tier (the IRSC); (ii) a reform technical committee (RTC) as the second tier, consisting of Component Leaders (CLs) and their support teams who will be involved in delivering the necessary outputs. A central PFM Reform Secretariat will provide overall monitoring, coordination and support for the implementation of the PFMRAP by the CLs.

23. The IRSC has been reconstituted under authority of the Minister of Finance as the oversight/steering committee for the implementation of the PFMRAP. Its membership include - PFM Development Partners; Chairperson of the Parliamentary Public Accounts Committee and Economic Cluster; Ministry of Public Service; Representatives from key Line Ministries, Departments and Agencies (Education, Health, Agriculture, Local Government, etc.); Component Leaders; and a PFM Reform Coordinator, who will serve as the IRSC Secretariat. It will meet under chairmanship of the Minister of Finance at least three times a year with the purpose to drive the reform process; inform the relevant partners and raise support for the reform; and decide on critical conceptual issues and recommendations related to the reform.

24. The day-to-day PFMRAP activities will be supported / coordinated by a PFM Reform Technical Committee (RTC), which will comprise of all Component and Sub-component leaders. It will be chaired by the Principal Secretary, Ministry of Finance, with the support of the PFM Reform Secretariat.

25. The MoF, through the Accountant-general as Component Leader, and the Deputy Accountant-general (Cash Management) as Sub-component leader, will be the executing agency for this operation. A new Accountant-general has been announced at the High Level PFM Workshop hosted by the Minister of Finance on 11 November, 2013. He is expected to assume position on 2 December 2013. The core IFMIS team, under the leadership of the Deputy Accountant-general (Cash Management), will be responsible for implementation and coordinating of all project activities.

VI. Safeguard Policies (including public consultation)

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Comments (optional)

VII. Contact point
World Bank
Contact: Gert Johannes Alwyn Van D
Title: Lead Financial Management Specialist
Tel: 5369+3141
Email: gvanderlinde@worldbank.org

Borrower/Client/Recipient
Name: Ministry of Finance and Development Planning
Contact: mkhethisa
Title: Permanent Secretary
Tel: 266-2232-3703
Email: mkhethisa@finance.gov.ls

Implementing Agencies
Name: Ministry of Finance and Development Planning
Contact:
Title:
Tel: (266) 2232-3703
Email: mkhethisa@finance.gov.ls

VIII. For more information contact:
The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop