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Kingdom of Lesotho
Managing Government Finances for Growth and Poverty Reduction

Public Expenditure Management and Financial Accountability Review

June 13, 2007

Poverty Reduction Economic Management 1
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CURRENCY EQUIVALENTS

(as of June 13, 2007)

Currency unit	=	Maloti (M)
Maloti 1	=	US$0.14
US$1	=	M7.25

FISCAL YEAR

(April 1-March 31)

ABBREVIATIONS AND ACRONYMS

AGO	Auditor General's Office
APCBP	Agricultural Policy and Capacity Building Project
BLNS	Botswana, Lesotho, Namibia and Swaziland
BoS	Bureau of Statistics
BTL	Below The Line
CMA	Common Monetary Area
CPIA	Country Policy and Institutional Assessment
CTB	Central Tender Board
CWIQ	Core Welfare Indicator Questionnaire
DCI	Development Cooperation Ireland
DFID	Department for International Development
ECCD	Early Childhood Care and Development
EFA	Education For All
ESSP	Education Sector Strategic Plan
EU	European Union
FAPU	Fiscal Analysis and Policy Unit
FDI	Foreign Direct Investment
FPE	Free Primary Education
GDP	Gross Domestic Product
GER	Gross Enrollment Ratio
GFS	Government Financial Statistics
GNP	Gross National Product
GoL	Government of Lesotho
GOLFIS	Government of Lesotho Financial Information System
HIV/AIDS	Human Immunodeficiency Virus and Acquired immunodeficiency
IECCD	Integrated Early Childhood Care and Development
IFMIS	Integrated Financial Management and Information System
IMF	International Monetary Fund
LCE	Lesotho College of Education
LEC	Lesotho Electricity Corporation
LFCD	Lesotho Fund for Community Development
LHDA	Lesotho Highlands Development Authority
LHWC	Lesotho Highlands Water Commission
LHWP	Lesotho Highlands Water Project
LNDC	Lesotho National Development Corporation
LRA	Lesotho Revenue Authority
LTI	Lerotholi Technical Institute
MDG	Millennium Development Goal
MAFS	Ministry of Agriculture and Food Security
MET	Ministry of Education and Training
MFDP	Ministry of Finance and Development Planning

MPS	Ministry of Public Service
MPWT	Ministry of Public Works and Transport
MTEF	Medium-term Expenditure Framework
NFE	Non Formal Education
NMDS	National Manpower Development Secretariat
NMTIP	National Medium-term Investment Program
NUL	National University of Lesotho
PAC	Public Accounts Committee
PEFA	Public Expenditure and Financial Accountability
PEM	Public Expenditure Management
PER	Public Expenditure Review
PERTT	Public Expenditure Review Task Team
PFM	Public Financial Management
PRS	Poverty Reduction Strategy
PS	Principal Secretary
PSIRP	Public Sector Improvement Reform Program
PTR	Pupil Teacher Ratio
PWC	Price Waterhouse Coopers
RF	Road Fund
RSA	Republic of South Africa
RSF	Revenue Sharing Formula
SACU	Southern Africa Customs Union
SADC	Southern African Development Community
TVET	Technical and Vocational Education and Training
VAT	Value Added Tax
WFP	World Food Program

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This report is prepared by the World Bank in close collaboration with the Government of the Kingdom of Lesotho. The Government established a Public Expenditure Review Task Team (PERTT) to work closely with the Bank team. The PERTT was led by Mr. Moepi Sematlane, Acting Director, Fiscal Affairs and Policy Unit (FAPU), Ministry of Finance and Development Planning (MFDP) and included: Ms. Puseletso Molato – FAPU, MFDP; Mr. Tom Mpeta – Budget Office, MFDP; Mr. Habofanoe Makopela – DEC, MFDP; Ms. Lindiwe – Cash Management, AGD; Mr. Phatela – DSP, MFDP; Ms. Motselisi Matsela – Lesotho Revenue Authority; Ms. Nthoateng Lebona – DEP, MFDP; Mrs. M. Molumeli – Ministry of Agriculture; Mr. T. Masoabi – Ministry of Education; Mrs. Nkholise, Former Director, FAPU; and Mr. Geoffrey West – Economic Advisor, MFDP. Mr. Nyeptsi, Budget Director and Dr. M. Majoro, Principal Secretary provided critical leadership and guidance throughout. The government team provided useful contributions as well as comments on the Concept Paper and draft Report.

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EXECUTIVE SUMMARY

i. **Government plays a substantial role in the economy of Lesotho, with public expenditures accounting for about 45-50 percent of gross domestic product (GDP).** Many of the key macroeconomic determinants in Lesotho are strongly influenced by the monetary union and the pegged exchange rate with South Africa under the Common Monetary Area (CMA), membership in the Southern African Development Community (SADC) and the Southern Africa Customs Union (SACU). Fiscal policy is the government's only independent instrument. The Government pursues an active fiscal strategy at the *aggregate level* by managing total expenditures and revenues in order to ensure the sustainability of public deficits and debt and to contain aggregate demand to prevent inflationary pressures from threatening the currency peg. In practice, the Government meets these requirements by pursuing revenue and expenditure strategies which limit the annual budget deficit. Given the nature of its revenues, whereby the SACU revenue sharing formula (RSF) generates about fifty percent of the revenues, macroeconomic discipline is largely determined by its expenditure policy. *Effective planning and execution of the budget* and managing the use of budgeted resources are essential to achieving poverty reduction and other development goals set by the government.

ii. **The high level of overall public spending made possible by high SACU revenues has not resulted in significant poverty reduction.** There are growing concerns in Lesotho regarding the effectiveness and efficiency of public expenditures. Strengthening fiscal policy needs to be accompanied by an adequate and sustainable level and a productive composition of public expenditures that reflects government priorities. In order to narrow the gap between sound policy objectives and the actual economic and social outcomes envisioned in its Poverty Reduction Strategy, sound public expenditure management and control mechanisms are essential.

MACROECONOMIC PERFORMANCE AND PROSPECTS

iii. **The strong reliance on SACU revenues makes Lesotho vulnerable to developments in the region, particularly South Africa's imports.** Notwithstanding its comfortable fiscal position in the last few years, Lesotho's medium-term fiscal prospects are shadowed with revenue uncertainties and mounting expenditure pressures. The large SACU windfalls in the past two years are transitory, largely attributed to a strong South African economy and are not expected to last beyond a couple of years. The impact of Human Immunodeficiency Virus and Acquired Immune Deficiency Syndrome (HIV/AIDS) on the working population and the lower tax regime introduced in 2006 are also expected to lower revenues. While the government's response in the last two years has been appropriate – saving part of the windfall and repaying high interest domestic and external debts – there are increasing pressures to spend more to address the HIV/AIDS pandemic, raise infrastructure investment, increase human capital, and implement its decentralization program to achieve its poverty reduction strategy (PRS) objectives. Expenditures are also susceptible to external shocks like droughts and currency depreciation.

iv. **Given the temporary nature of revenue windfalls, expenditure pressures, and external vulnerabilities affecting its growth prospects, current high levels of expenditure may not be sustainable in the long run**. Nevertheless, a fiscal sustainability analysis demonstrates that current levels of expenditure do not pose a serious threat to debt sustainability in the medium-term. Given its limited domestic income generating capacity, government should use this opportunity to raise the economy's production potential. However, raising the level of expenditures or shifting them into productive sectors will not automatically lead to a higher impact on growth and poverty reduction. Effectiveness and efficiency of public expenditures will have to be raised and public expenditure management reforms will need to be consolidated and further strengthened.

PUBLIC EXPENDITURE MANAGEMENT AND FINANCIAL ACCOUNTABILITY

v. **Lesotho's Public Financial Management (PFM) system suffers from major deficiencies in budget execution, internal control, accounting delays, audit backlogs and poor fiscal reporting**. These weaknesses are now being addressed. The Public Expenditure and Financial Accountability (PEFA) assessment confirms that some progress has been made in the planning and formulation aspects of budgeting. The PEFA assessment also confirms the persistent problems relating to the long-standing weaknesses in budget execution, internal controls and fiscal reporting. Reliable information to monitor budget execution is not available. Financial rules and regulations are often not observed, sometimes due to the lack of adequate numbers of trained accounting staff.

vi. **Lesotho has an orderly and participative budget process, involving central agencies, spending agencies and the political leadership in accordance with a pre-determined budget calendar, which is broadly adhered to.** Ministries have their own internal arrangements for developing their bids. Cabinet discussion of the budget has been enhanced by the establishment of a Cabinet Budget Committee, chaired by the Deputy Prime Minister and comprising the Minister of Finance and eight other ministers. The budget has been approved by the legislature in a timely manner.

vii. **Nevertheless, lack of an effective and credible budget has been a serious weakness in Lesotho's PFM system.** While revenue outcomes are not significantly different from budget estimates, expenditures vary significantly across ministries. Under-spending in many line ministries reflects poor planning and lack of capacity, while spending of under-budgeted or unbudgeted expenditures is relatively easy under the current outdated legal framework. Also, the budget is comprehensive to the extent that it includes donor activities in the form of loans. However, donor grants and activities of parastatals are not fully included in the government budgeting system.

viii. **The absence of a comprehensive legal framework for PFM has resulted in a lack of clearly defined financial responsibilities and reporting requirements in budget development and execution**. The framework is not adequate for decentralization of budget execution, preparation of a medium-term expenditure framework and measuring performance of the ministries for use of public funds. The government should complete the review of the legislative basis for PFM and revise the Finance Act to streamline and clarify roles and responsibilities in the budget process and also explicitly recognize the medium-term nature of budgeting introduced through the Medium Term Expenditure Framework (MTEF).

ix. **Lesotho needs to strengthen the internal control environment in government agencies.** The internal audit functions in the government should be strengthened. The internal audit unit, currently in MFDP, is being gradually decentralized in line ministries and government agencies for greater effectiveness. The methodology of audit should be revisited, and the government should consider introducing a risk-based audit approach, which would facilitate strategic use of limited audit resources in high-risk areas.

x. **Public accounting in Lesotho is weak.** Public accounting in Lesotho is carried out on a cash basis and does not meet international standards. Because of the heavy reliance on manual accounting and the weaknesses of the Government of Lesotho Financial Information System (GOLFIS), the accounting system in Lesotho is susceptible to inaccuracies and delays in financial accounting and reporting which prevents verification of opening balances and has led to qualified audit reports in subsequent years for which audits have been prepared. The issue of opening balances and the timely preparation and audit of public accounts should be addressed as a matter of urgency.

xi. **Introduction of a new Integrated Financial Management Information System (IFMIS) to replace GOLFIS will not solve the accounting problems by itself.** IFMIS is expected to facilitate timely preparation of budget reports and the annual financial statements for audit by the Auditor General and submission to the Parliament. However, the following actions have to be taken for a successful implementation of IFMIS:

- training for chief accounting officers (the principal secretaries) on the importance of sound financial management;
- resolving the issue of the lack of opening balances information, due to the absence of financial statements for the five years 1996/97 to 2000/01;
- ensuring that reconciliations between GOLFIS and subsidiary systems is undertaken (bank reconciliations, reconciliation of Vote books to GOLFIS);
- establishing a working group on irregularity and internal control; and
- revamping the internal audit function.

xii. **Currently, there is no formal system of cash forecasting and management.** As a result, there are significant deficiencies in the management of government cash flows and bank accounts. A central cash management unit should be established to manage government cash flows efficiently, minimizing the costs to the Treasury. Significant delays in depositing revenues into the government's bank accounts are reported and arrangements between the Central Bank and the Treasury need to be streamlined.

xiii. **Public sector auditing in Lesotho is carried out in accordance with international standards.** However, the operation of the Office of the Auditor General is hampered by various factors, including delays in account preparation, lack of financial resources and skilled staff. A new Audit Act to strengthen the independence of the Office of the Auditor General should be submitted to Parliament for enactment without delay. At the same time the capacity of the Public Accounts Committee (PAC) should be strengthened to review reports issued by the Auditor General and ensure adequate follow-up of its reports by the Executive. The PAC should also consider having its meetings open to the public on a regular basis to foster greater transparency and accountability.

xiv. **Public access to key fiscal information is limited.** Information at the aggregate level is available publicly, in principle. But availability is limited by lack of copies and the bulky size of the Estimates document. One critical way to promote transparency is by bolstering public access to financial and other information through freedom of information legislation. Experience from other countries shows that this allows for improved accountability but also allow citizens to request information, thus providing a powerful deterrent to malfeasance in government.

xv. **To address the weaknesses in critical PFM issues, the government is implementing a wide ranging Public Sector Improvement Reform Program (PSIRP).** It is expected to be implemented over the next 3-5 years with support from Lesotho's key development partners. This includes a significant component on PFM with an emphasis on modernization, resource efficiency, transparency, and accountability. It seeks to improve public financial management through: (a) a shift to MTEF performance budgeting approach starting from the 2005/06 financial year, supported by the development of a macroeconomic model, to facilitate the achievement of the government's poverty reduction and other development goals; (b) the phased replacement of GOLFIS through the introduction of IFMIS; and (c) public procurement reform. In addition, the reform program will strengthen the operation of the Auditor General's Office and assist the Public Accounts Committee to execute its oversight role effectively. It will also support a review of the legislative basis for PFM leading to the revision of the Finance Act (along with the budget, planning, procurement legislations etc.) and the Audit Act. This would clarify roles and responsibilities in the budget process and also explicitly recognize the medium-term nature of budgeting introduced through the MTEF. The PEMFAR launches a multi-year exercise comprising successive expenditure reviews to help the government focus on core functions. The rolling public expenditure review (PER) agenda will be guided by the priorities identified by the government which will be implemented under the PSIRP over the next three to five years.

STRATEGIC ALLOCATIONS AND BUDGETARY OUTCOMES

xvi. **Some re-prioritization of expenditures is necessary to address critical shortfalls that exist for clearly defined activities, particularly for economic infrastructure**. Until recently, the budget allocations in Lesotho have largely been made on an incremental basis, focused on inputs rather than the purpose of public expenditure. Social sectors account for the largest share of public expenditures at about 40 percent. However, the share of the economic sectors, particularly infrastructure, has suffered somewhat over the past several years. Government bureaucracy, on the other hand, accounts for about 30 percent of public expenditures. Spending on defense and national security at about seven percent of total recurrent expenditures exceeds the allocations for public works and transport and is about the same as that for health and social welfare. Given the stated government priority to improve agriculture and food security and develop infrastructure, current allocation suggests the need for some re-prioritization.

xvii. **The alignment of the budget with the activities identified in the PRS is generally weak**. Only about half of the activities identified in the PRS are included in the budget, providing for less than half of the estimated incremental costs of planned Year 1 PRS activities. On the other hand, just about one half of all sub-programs in the recurrent budget accounting for about 34 percent of the total value of recurrent sub-program level allocations were deemed to be directly poverty-related. With regard to the 2004/5 development budget, it is found that nearly two-thirds of projects, accounting for three-quarters of the total value of development budget allocations were deemed to be directly poverty related. As the PRS evolves further, with greater focus on key priorities, it is essential to strengthen the link between budget allocations and the activities identified in the PRS. Without strengthening these links, the PRS will not be successfully implemented. To deepen these links and to strengthen implementation of the priority programs, government has initiated a phased introduction of the MTEF, starting with the 2005/06 budget.

xviii. **Adoption of a medium-term expenditure framework will strengthen the link between policies, planning, budgeting and reporting**. Government's commitment to the adoption of the MTEF is clearly evident. As an integral part of MTEF development, a medium-term fiscal framework has been prepared. This includes 3-year macroeconomic, revenue, expenditure and debt projections at an aggregate level. Three year expenditure ceilings have been given at the ministry-level. In addition to all ministries preparing three year budget estimates, six pilot ministries have deepened the process through developing detailed Budget Framework Papers as an input into setting of the Ministry ceilings. However, significant capacity constraints in some of the line ministries and unrealistic expectations limited the achievements on the MTEF. The very detailed costing requirement at the activity level has been difficult to implement. The budget format has remained unchanged for the 2006/07 budget cycle. Budget estimates are provided for one year only and there is no integration of recurrent and development budget.

xix. **It is important to pace these budgetary reforms in tandem with building capacity in the MFDP as well as other line ministries, both at the central and decentralized levels.** While steady progress is made on changing the planning and budgeting processes, some actions can be taken in the short term. A fiscal policy paper should be prepared for discussion and approval by the Cabinet. The paper should include the estimates, identify risk factors (revenue and spending), and propose some broad policy options on revenues and expenditures. The administrative classifications should be reviewed in order to better adapt them to the MTEF process. Moreover, a more refined functional classification should be developed in order to better identify programs. The budget format should be changed immediately in order to provide a consistent display of information to promote analysis of spending on a program basis.

SECTOR EXPERIENCES

xx. **A planning process that is increasingly linked to the budget process and the MTEF is evolving in the Ministry of Education and Training (MET)**. Key ministerial objectives are in line with the PRS goals and the Millennium Development Goals (MDGs). The policy framework is guided by the Education Sector Strategic Plan (ESSP). However, the intra-sectoral distribution is skewed towards post-secondary levels. The analysis suggests that the share of primary education needs to be raised to achieve the Education For All (EFA) goals embraced by the government. Moreover, quality of education, reflected in learning outcomes, is poor and the education system is inequitable, with relatively high expenditure serving the richest sections of society.

xxi. **At the secondary level, the major challenge relates to expansion as the first cohort of children that benefited from Free Primary Education (FPE) enter secondary schools in January 2007**. A thorough review of the implications of expansion of the secondary education system and the proposed introduction of free junior secondary education are needed. This should include a realistic strategy for school construction, provision of teachers, and replacement of the discretionary income of secondary schools. The Government will need to review teacher utilization, working hours and class sizes to design an affordable solution as well as explore cost sharing through public-private partnership.

xxii. **Reform of the post school sub-sectors (technical and vocational education and training (TVET), non formal education (NFE), higher education), particularly with regard to bursaries, is needed** to redirect funds to primary and secondary sectors to achieve EFA objectives and accommodate secondary level expansion. Post-school sub-sectors receive a greater share of the resources than either primary or secondary education and the share has been rising in the past few years. When National Manpower Development Secretariat (NMDS) expenditure is included, the post-secondary sub-sectors account for 42 percent of education spending. The variety of bursary schemes financed through NMDS need to be rationalized to increase both transparency and efficiency. The bursary loan schemes for higher education have very low recovery rates, and are effectively grants for most students. The structures of post-secondary education, including higher education funding and the NMDS, need to be reviewed. Higher education funding should be structured to encourage improvements in quality of education and appropriate targeting of courses. The NMDS system should ideally be located within the MET, and should be targeted in line with a national strategy for education and skills.

xxiii. **Implementation of MTEF in the Ministry of Agriculture has been limited by weak capacity**. The government has prepared its Agricultural Sector Strategic Plan to provide the Ministry with an effective planning instrument to achieve, in collaboration with all stakeholders, food security, sustainability, conservation of natural resources and growth. However, the PRS objectives for the sector need to be matched by a better structure and alignment of expenditures. Further, the budget system of Ministry of Agriculture and Food Security (MAFS) is highly centralized and a bulk of district expenditures is concentrated in the Maseru district for the past several years. With a large share of the population residing in rural areas, the MAFS needs to shift its resources and service delivery towards the rural areas. With the PRS focus on decentralization and service delivery, there is a need to increase capital investment in the rural areas, including for feeder roads, crop diversification which will require irrigation, multi-purpose water harvesting and storage schemes and rural soil and water conservation public works program.

List of Key Actions	
Focus Area: Credibility of Budget	**Time frame**
Key Actions	
• Establish baseline based on 2005/06 allocations and identify ministries with largest variance between budget estimates and actual outcomes.	0-12 months
• Identify causes and develop a framework to address the cost-drivers leading to the variance.	12-24 months
Focus Area: Budget Comprehensiveness	
Key Actions	
• Account for recurrent cost implications of capital budgets.	0-12 months
• Provide information on fiscal risks, including contingent liabilities and operations of parastatals.	0-12 months
• Establish a system to improve coverage of donor executed projects and grants.	12-24 months
• Fully reflect operations of parastatals in the government budgeting system.	12-24 months
Focus Area: Budget and Accounting Classification	
Key Actions	
• Develop an economic and functional classification system consistent with Government Financial Statistics (GFS).	0-24 months
• Develop an appropriate program classification.	0-24 months
Focus Area: Budget Execution	
Key Actions	
• Provide adequate training on financial management requirements and responsibilities.	0-36 months
• Improve the accuracy of information to allow implementation of disciplinary actions for non-compliance.	24-36 months
• Complete outstanding reconciliations.	0-12 months
• Transfer costs of audits for non-decentralized internal audit units to MFDP.	12-24 months
• Implement new arrangements for locating internal audit staff in line ministries, reporting to the PS of line ministry.	12-24 months
• Resolve the issue of opening balances of public accounts.	0-3 months
• Prepare 2005/06 public accounts in line with international standards.	0-6 months
• Develop a transparent fee for service arrangement between the Treasury and the Central Bank.	12-24 months
• Undertake an inventory of accounts held in commercial banks to consolidate accounts.	12-24 months
• Develop a cash forecasting and planning system under a cash management unit in MFDP.	12-24 months
• Implement the public sector procurement reform.	0-12 months

List of Key Actions *(continued)*	
Focus Area: External Accountability, Audits, Legislature Oversight	**Time frame**
Key Actions	
• Take necessary steps to enact the Draft Audit Act.	0-6 months
• Strengthen the capacity of the Public Accounts Committee.	0-36 months
• Expand the role of the PAC to include review of financial statements of parastatals.	24-36 months
• Make the PAC meetings open to the public on a regular basis.	12-24 months
• Prepare Freedom of Information legislation to strengthen transparency and accountability to the public.	24-36 months
• Provide detailed Estimates document on the MFDP website.	12-24 months
• Provide budget execution reports on the MFDP website.	24-36 months
• Code all sub-programs and projects in the budget to reflect PRS priorities.	0-12 months
• Introduce coding of sub-programs by district and/or by spatial zone.	12-24 months
Focus Area: Medium-Term Expenditure Framework	
Key Actions	
• Prepare a comprehensive fiscal policy paper.	0-12 months
• Pursue fuller integration of recurrent and capital budget.	0-36 months
• Change budget format to provide consistent display of information to promote analysis of spending on program basis.	0-12 months
• Extend the format to include two additional years in the Estimates document.	0-12 months
• Build capacity in line ministries to implement MTEF.	0-36 months
Focus Area: Education	
Key Actions	
• Develop an education financing model to provide a useful basis for preparing annual work programs linked to the annual budget within the MTEF	0-12 months
• Achieve efficiency gains by reducing the administrative burden of the school feeding program, improving modality o support through direct capitation grants and reviewing construction standards.	12-24 months
• Undertake a review of the implications of expansion of the secondary education system.	0-12 months
• Rationalize the bursary schemes to improve transparency and efficiency.	12-24 months
• Strengthen programs on HIV/AIDS geared to prevention and education campaigns.	0-36 months
• Raise allocation to secondary education to enhance opportunities for poor students who are deterred by the high fees.	0-36 months
Focus Area: Agriculture and Food Security	
Key Actions	
• Strengthen the link between government objectives in the sector and budget.	0-12 months
• Shift resources and services towards rural areas.	12-36 months
• Increase capital investment in rural areas.	0-36 months

CHAPTER 1. CONTEXT AND STRATEGIC SETTING

I. INTRODUCTION

1.1 **Lesotho is a small country, fully surrounded by and heavily dependent on South Africa.** Many of the key macroeconomic determinants in Lesotho are strongly influenced by the monetary union and the pegged exchange rate with South Africa under the CMA membership in the SADC and the SACU. Reliance on remittances from miners and other laborers employed in South Africa, on customs revenues from SACU and the sale of water to South Africa have all played an important role in Lesotho's growth path over the past few decades.

1.2 **In the early 1980's only about one-half of Lesotho's national income was produced domestically**. The remainder was generated through remittances from Lesotho workers in the Republic of South Africa (RSA) or from foreign transfers. Beginning around 1986/87, two developments involving foreign direct investment (FDI) contributed to change the structure of the economy: construction of the Lesotho Highlands Water Project (LHWP), and the establishment of the garment industry. At the same time workers' remittances started to decline in real terms. By the year 2000, more than 80 percent of Lesotho's gross national product (GNP) was produced domestically relative to about 60 percent in 1990. Robust economic growth of 6 percent per year on average ensued during the late 1980s and most of the 1990s, fueled by LHWP investments. Winding down of the investment in LHWP in the later part of the decade, declining remittances as well as the political unrest in 1997-98 resulted in a slowdown in growth to only about 2.6 percent per annum during 1996-2000. Real GDP growth subsequently recovered during 2001-04 to an average of 3.7 percent per annum, as exports of garments became the main engine of growth.

1.3 **Despite the relatively good growth performance, Lesotho remains one of the poorest countries in the Southern Africa region**. Poverty is widespread and unemployment is high (at about 31 percent according to the 1999 Labor Force Survey). A large segment of the population appears not to have shared the benefits of economic growth. Between 1986/87 and 1994/95, the number of poor people increased from 850,000 to 950,000, while those characterized as ultra poor increased from 500,000 to 600,000.[1] A series of poverty mapping exercises in the 1990s confirmed this trend. Lesotho has also experienced a decline in the Human Development Index, particularly in areas related to education, health and life expectancy, the latter reflecting the high HIV/AIDS prevalence rate in Lesotho (about 24 percent of the adult population is HIV-positive).

1.4 The Government now seeks to address in a more systematic manner the many challenges facing Lesotho related to:

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1 Based on the 1986/87 and 1994/95 household income and expenditure surveys.

- the slow pace of job creation in Lesotho, compounded by the continual decline in mining jobs for migrant workers in South Africa and a slowdown in GDP growth rate;
- the increase in the incidence of poverty over the past twenty years;
- a relatively large and inefficient public sector;
- excessive reliance on revenues generated by the SACU; and
- the rapid spread of HIV/AIDS (current prevalence rate estimated at 24 percent), which, if unchecked, will negate all efforts to improve the economy and welfare of the Basotho people.[2]

1.5 **The National Vision and Lesotho's PRS reflect these challenges**. The PRS,[3] prepared in a highly consultative and participatory manner, is seen as one of the key vehicles to implementing the National Vision.

II. LESOTHO'S POVERTY REDUCTION STRATEGY

1.6 **The overarching development goal of the PRS is to provide a sustainable broad based improvement in the standard of welfare of the Basotho people**. This is to be achieved through rapid and sustained economic growth. Such growth, driven by the private sector but facilitated by appropriate government interventions and policies, will create more employment and income-generating opportunities. A sound macroeconomic policy framework and consistent application of policies are essential to setting an attractive environment for foreign and domestic investment.

1.7 **The PRS identifies three key areas for government action**. The first is to facilitate economic growth that creates employment and income opportunities. The second is to empower the poor and the vulnerable and improve their access to basic services. And, the third is to deepen democracy and improve public sector performance, to ensure that policies and legal frameworks facilitate the full implementation of priorities.

1.8 **Strategies in the first area aim at attracting domestic and FDI beyond the garment sector** in order to add value to local products and expand the industrial base, including the development of the tourism industry. At the same time, an appropriate policy and institutional framework will be adopted to support local business, including those in the small, medium and micro enterprises sector. Efforts will also be made to improve agricultural production and the provision of roads and water for both domestic and industrial purposes. Steps have already been taken by the Government towards the realization of this objective. The Government, in collaboration with development partners, notably the Bank, organized the Private Sector Development Forum in April 2005 to forge a partnership between the public and private sectors to achieve sustainable private-sector-led economic growth.

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2 According to some estimates, GDP will be reduced by one-third by 2015 if corrective measures are not undertaken immediately. The structure of the population will change, with the productive core representing a smaller proportion and larger proportion of the old and very young.

3 Kingdom of Lesotho Poverty Reduction Strategy Paper and Joint Staff Advisory Note, Report no. 32541-LS, July 18, 2005.

1.9 The strategy also aims at increasing the access of families in extreme poverty to land and credit and at promoting appropriate farming practices that have been locally developed and proven to be effective. Extension services will be strengthened to provide technical support, whilst appropriate infrastructure for land and water management will also be developed.

1.10 **To reverse the downward trend in the health status of the population, the government proposes to promote access to high-quality and essential health care, reduce malnutrition, and improve access to social welfare services**. The strategy involves the establishment of a sustainable health care financing system, improving the capacity of health personnel and strengthening disease prevention programs.

1.11 **In order to make education accessible to all, the GoL introduced FPE and also absorbed the cost of textbooks and feeding in all FPE classes**. The Government plans to ensure that each child spends at least ten years at school in order to improve the chances of being wage employed. In addition to education and health services, the Government plans to improve access throughout the country through improvements in the road network, telecommunications, energy and the provision of water for both domestic and industrial purposes.

1.12 **The government proposes to enhance the effectiveness of public services to be able to achieve the objectives set in the PRS**. To that effect, an ambitious public sector reform program is envisaged during the PRS's implementation period. The goals of the proposed program are to ensure that public services are delivered in the most appropriate, effective, and efficient way, through improved public finance management, decentralization of service provision, and civil service reform. In financial management, the objectives are to maintain fiscal discipline, allocate resources more efficiently in line with government priorities, and improve the delivery of services. In addition, the accounting system will be strengthened through computerization and the relevant staff will be further trained to enhance its capacity. To ensure that the reforms are properly implemented, the government is planning to improve the office of the Auditor General by drafting new legislation to expand its independence and strengthen the functioning of the public accounts committee. As part of the decentralization of governance and public services, local government elections were held on April 30, 2005. District Administrators have been appointed, civil servants in the districts now report to district heads and not the Ministry heads in Lesotho.

1.13 **In addition to the three main pillars of the PRS, the GoL recognizes two major cross cutting themes of national importance: HIV/AIDS, and gender, children and youth**. The GoL plans to strengthen the legal, institutional and policy framework to the levels required to combat the HIV/AIDS epidemic, remove gender discriminative practices and address the urgent needs of children and the youth of today.

III. PEMFAR OBJECTIVES, METHODOLOGY, AUDIENCE AND CONSTRAINTS

1.14 **The PEMFAR is aimed at contributing ideas towards managing public finances for sustained growth and poverty reduction.** Government plays a substantial role in the economy of Lesotho, with public expenditures accounting for about 45-50 percent of GDP. The achievement of poverty reduction and MDG set forth in the PRS will require improvements in public sector productivity and increase pressure on government expenditure, both for additional public investment and to meet the increased recurrent costs of improving service delivery (especially in health and education) in order to raise international competitiveness. These pressures to redirect expenditures will take place against the background of declining revenues from the SACU.

1.15 **Achieving high and sustainable rates of growth and poverty reduction will require continued macroeconomic stability, stronger business climate, improved service delivery and greater budget flexibility to respond to external shocks, including availability of grant financing**. Public finance management matters in all of these. In recent years there have been growing concerns (shared by the Government and its development partners) regarding the effectiveness and efficiency of public expenditures, both capital and recurrent. In order to make progress towards attaining its development goals, the government will require improvements in domestic revenue mobilization as well as management of public resources. The Government will need to strengthen domestic revenues to compensate for the declining revenues from SACU, while consolidating and further expanding public expenditure management (PEM) reforms in the areas of planning, allocation, execution, reporting and financial accountability. Sustained efforts in these areas will also boost government's credibility vis-à-vis the donor community, thereby reducing the risk of a substantial decline in grant financing.

1.16 **In an effort to enhance the effectiveness of public services, the government has launched an ambitious PSIRP.** It is expected to be implemented over the next 3 – 5 years. The program is being supported by Lesotho's key development partners and its successful implementation is expected to provide a sound basis for future budget support to Lesotho's PRS. The PEMFAR will launch a multi-year exercise comprising successive expenditure reviews to help the government focus on core functions. It will strengthen the analytical base for making decisions about the size, composition, efficiency and effectiveness of public expenditure to have maximum impact on growth and poverty reduction. The agenda for public expenditure analysis in Lesotho is large. In view of the analytical and empirical complexities, it is recognized that evaluation of public spending can not be completed in a single review. Rather, the emphasis in the short-term is on building the involvement, capacity and ownership so that policy makers undertake such an exercise themselves on an ongoing basis as an integral part of their public expenditure planning, budgeting and evaluation process – with technical assistance in the early years. A core set of policy and expenditure management issues, including financial management and inter-governmental fiscal architecture will be addressed in an integrated manner over the next several years.

1.17 **This report is centered on three areas of analysis**: (i) macroeconomic and fiscal performance and prospects; (ii) inter and intra-sectoral allocation of resources; and (iii) public expenditure and financial management. A PFM assessment report prepared using the PEFA framework is included as an Appendix to the main report. It has been prepared in close consultation with the PERTT. It builds on the existing and ongoing reports prepared by the World Bank (Country Economic Memorandum, Education Country Strategy Report), African Development Bank (Lesotho: Country Governance Profile) and the Government with the support from European Union (EU), and Department for International Development (DFID). Successive PERs are expected to examine more deeply issues related to operational efficiency and service delivery (through PETS or other service delivery survey instruments). This will provide an important input into the PRS Annual Progress Reports.

1.18 **The primary audience for the report is the Government of Lesotho (GoL), in particular, policy makers responsible for managing public resources and approving and implementing reforms.** The secondary audience is civil society – NGOs, business community, academics and the press – who can play a useful role in promoting accountability and monitoring progress. The tertiary audience is Lesotho's development partners who are actively engaged in supporting the government's reform efforts. The report will be disseminated widely in Lesotho, bringing officials from line ministries as well as non-government stakeholders together to convey key messages and generate ownership for reforms.

1.19 **The analysis in this report is limited by the availability of reliable data, especially on actual spending**. Front-end accounting practices in the spending agencies (vote books) are weak, and most spending agencies do not reconcile GOLFIS data with their manually kept or computerized vote books. Back-end accounting practices or central accounting system in the Treasury is also weak. Incorrect entries and posting of transactions take place in the GOLFIS itself. These practices make closing of government accounts and the preparation of its final accounts by Treasury more difficult. Revenue transactions recorded in GOLFIS come from entries in the government's revenue account at the Central Bank. However, not all revenues are deposited in this account and subsequently do not get recorded in GOLFIS, leading to an under-reporting of revenues. Further, not all deposits into the revenue account by the Lesotho Revenue Authority (LRA) are identifiable, leading to discrepancies between LRA and GOLFIS data, which remain unreconciled. Recording revenue transactions are also not timely in the Treasury. This is largely a result of ignorance of the rules, seemingly due to lack of capacity and weak management. Delays and/or mis-posting of revenue transactions against revenue classifications, as well as low quality data received from several revenue collecting agencies are the main reasons for the questionable quality of non-SACU government revenues in GOLFIS. This is partly addressed by supplementing GOLFIS data by other sources in the compilation of Lesotho's Government Finance Statistics. It is hoped that during the course of successive PERs, reliability of data will be improved as accounting and reporting practices improve.

CHAPTER 2. MACROECONOMIC PERFORMANCE AND PROSPECTS

I. INTRODUCTION

2.1 **Fiscal policy has been the main instrument of demand management in Lesotho as monetary policy has been anchored to preserve the currency peg to the South African rand**. Government expenditure is a major component of domestic demand and the government actively manages public expenditures (bulk of which is satisfied through imports) to contain aggregate demand and ensure macroeconomic stability and sustainability of public debt.

II. MACROECONOMIC DEVELOPMENTS

2.2 **Largely driven by investment associated with the LHWP, FDI and the strong export performance of the garment and clothing sector, real GDP growth averaged about 3½ percent per annum during the period 1991-2003**. With monetary and exchange rate policies closely tied to those of RSA and bolstered by relatively prudent fiscal policies, inflation was kept under control at single-digit levels from 1994 onwards, except for a short interruption in the early 2000s. While the share of agriculture in GDP has been shrinking and that of services stagnated, the growing share of manufacturing and construction has transformed Lesotho from an informal, subsistence based economy into a more modern and more export-oriented economy. Even with the winding down of investment in LHWP, private investment has remained high at over 20 percent of GDP since 1999/2000, and the share of exports has grown steadily to now almost 40 percent of GDP. More recently, as a result of the continued erosion in the competitiveness of manufacturing, the garment sector in particular, and the adverse impact on agriculture of the continued drought, real GDP growth slowed to about 3 percent in 2004 and weakened further to 1.2 percent in 2005.

2.3 ***Monetary Developments***. Monetary developments in Lesotho are largely driven by events in South Africa, as a result of the currency peg. As such, Lesotho has been benefiting from the low inflation environment in South Africa, where inflation has remained within its target range of 3-6 percent. The inflation rate in Lesotho has more than halved over the past three years from 12 percent in 2002/03 to 4.4 percent in 2004/05. It is estimated to remain below 5 percent over the next couple years. Interest rates in Lesotho track those of South Africa, which have remained steady in recent months but the risks, while not eminent, are nonetheless on the upside due to higher oil prices and credit fueled domestic demand in South Africa. Nonetheless, the fixed exchange rate has served Lesotho well by providing macroeconomic stability and anchor inflationary expectations, despite the volatility that the rand has undergone. However, the financial stability gained under the peg has come at a price resulting from appreciating rand which has put pressure on Lesotho's exports destined outside the CMA.

2.4 ***External Developments***. Lesotho's external position has improved markedly in recent years, from a current account deficit of 50 percent of GDP in the early 1990s, to around 15 percent in early 2000. This was the result of several years of strong export growth starting at the end of the 1990s, coupled with slower growth in imports. Increase in exports, of around 30 percent over a five year period, was largely driven by depreciation of the currency, preferential access to the US market through African Growth and Opportunity Act and the resulting increase in demand for manufacturing exports from the US and South Africa. Appreciation of the loti since 2002 has meant modest growth in exports. Imports have grown less robustly because of the declining imports by the LHWP, partly offset by sharp increase in imports of intermediate manufacturing inputs for the textile sector. Despite the weakness of the garment industry, strong growth in SACU revenues and relatively strong non-textile export growth were contributing factors to a narrower current account deficit in 2004/05 - 2005/06. The current account deficit (including official transfers) narrowed from around 11 percent of GDP in 2003/04 to 2.7 percent in 2004/05 and is estimated to narrow further to just under 2 percent in 2005/06.

2.5 In the 1990s, net income from abroad (mainly from migrant workers in South African mines) made a significant contribution to the current account. Its importance has diminished in recent years as a result of the reduction in the number of Basotho workers in South Africa. However, this has partly been offset by increased average earnings. But in the long term, workers remittances is expected to decline if a law recently enacted by South Africa to restrict employment in the mining sector is enforced. Official reserves peaked at about nine months of imports in the 1990s, but have since declined to less than five months of imports. The government's cautious debt strategy, and more recently appreciating currency, have led to a manageable external debt service position. The debt-to-GDP ratio is currently around 55 percent of GDP, compared to over 70 percent in the late 1990s and early 2000s, which had resulted from increased borrowing and currency depreciation.

2.6 **Despite the favorable economic developments during the 1990s and the early 2000s, the impact on poverty reduction has been limited**. Although economic growth driven by LHWP and textile exports have increased per capita income significantly (a 4.7 percent increase per year during 1987/88-96/97, compared with one percent during 1997/98-03/04), poverty (in terms of incidence, depth and severity) remained virtually unchanged between 1980/81-86/87 and 1987/88-97/98 (May, et al., 2002) mainly because of the natural increase in the labor force, the retrenchment of mine workers and the lack of productive domestic employment opportunities. While the LHWP construction has helped to create some employment, it was largely transient and has not compensated for the sharp fall in mining jobs. On the other hand, the textile sector has employed a large number of low-skilled workers, but the poverty impact on the overall economy has been limited due to its small size in relation to GDP (5 percent), and the low wages it has offered to workers.

2.7 **The challenge for the GoL as evident from its PRS, is to ensure that its policies reverse the trends of poverty and high unemployment**. Given its small size, limited natural resource endowment and low domestic savings, at the core of the medium-term strategy for growth should be policies to enhance export competitiveness and attract FDI,[4] while improving service delivery and greater budget flexibility to respond to external shocks. Public investment

[4] See Lesotho – Country Economic Memorandum, Growth and Employment Options Study, 2005.

complementary to private activity is also essential. As private sector expansion in commercial agro-production and processing, and manufactured exports (of which garments are primary) is contingent upon the availability of public goods, public investment in these public goods is itself a source of growth. Public provision of necessary infrastructure and skills need significant and sustained political and fiscal commitment in the form of public investment.

III. FISCAL PERFORMANCE

Resource Mobilization

2.8 **Unlike many other sub-Saharan countries, Lesotho's revenue performance has been spectacular at over 40 percent of GDP since the late 1980s**. Lesotho's revenue consists of four major components: (i) customs or SACU revenue; (ii) non-SACU tax revenue (mostly from income tax and value added tax (VAT)); (iii) non-tax revenue; and (iv) grants (see Figure 2.1). Total revenue has fluctuated substantially in the past decade, declining from a high of 48 percent of GDP in 1996/97 to about 40 percent in 2002/03 and rising again to about 47 percent in 2004/05.

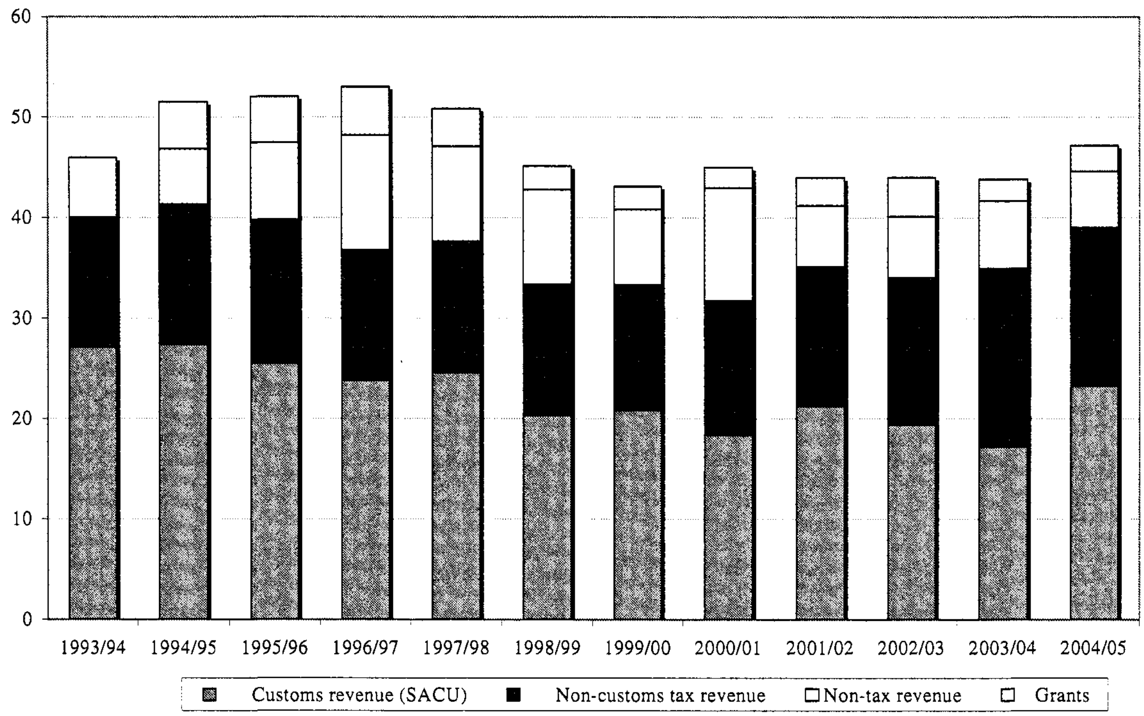
2.9 **The overall trend in resource mobilization largely mirrors the performance of SACU revenue, reflecting Lesotho's huge dependence on SACU revenue and making it vulnerable to developments in the region,** in particular, on South Africa's imports. SACU revenue accounts for more than half of total revenue. (It includes an implicit transfer from South Africa to compensate for the 'centripetal forces' effect South Africa, though the Customs Union, has on the regional economy, and it is this transfer that has allowed Lesotho's government to account for such a large proportion of GDP, in line with the other members of the customs union.) A windfall increase in SACU revenues in 2004/05, equivalent to six percent of GDP, boosted overall revenue performance significantly. This occurred because of high intermediate imports for the textile industry, which meant that actual imports in 2002/03 were significantly higher than the proxy figure used to determine the First Estimate of SACU revenues. The share of SACU revenues increased further to about 25 percent of GDP in 2005/06. The strong reliance on SACU revenues makes Lesotho vulnerable to developments in the region.

2.10 **Non-SACU tax revenue has increased somewhat, from 27-30 percent of total revenue in the late 1990s to over 35 percent in 2004/05 (or 16-18 percent of GDP).** The bulk of non-customs tax revenue consists of income tax, VAT and taxes on petroleum sales. A large part of growth in non-customs revenue has come from improved income tax collection, owing to the measures to broaden the income tax base,[5] as well as the establishment of the LRA. Another significant factor was the introduction of VAT at a standard rate of 14 percent on July 1, 2003, replacing the Sales Tax at 10 percent. While the Government decided to harmonize the VAT rate with that in South Africa at 14 percent, it was also decided to zero rate a number of basic items, such as maize and beans, to alleviate the impact on the poor. Utilities are levied at 5 percent and liquor and tobacco products are taxed at 15 percent in Lesotho whereas all these products are taxed at 14 percent in South Africa. Thus, VAT in Lesotho is now collected at four

[5] Farm income and LHDA became subject to income tax by the Amendment Act of 1999 and 2000, respectively although the Lesotho Unit Trust was exempted by Amendment Act 2004.

rates: 14, zero, 5 and 15 percent. VAT is based on a destination principle, with exports zero rated and imports of goods and services taxed.

Figure 2.1: Government Revenue and Grants
(in percent of GDP)



Source: IMF, Staff Reports, various issues.

2.11 **Non-tax Revenue.** Non-tax revenue provides a declining share of domestic revenue, falling from over 20 percent in the late 1990s to only 12 percent in 2004/05. Nearly half of total non-tax revenue comprises water royalties from South Africa (see Box 2.1). The remaining non-tax revenue consists of dividend payments from the Central Bank of Lesotho, seigniorage compensation from South Africa in the context of its membership in the CMA and various fees and charges.

2.12 **Lesotho receives only a small amount of donor grants every year despite its status as one of the poorest countries in Africa.** This is partly attributed to the limited financial management and monitoring capacity of the government. For example, budget support from the EU was terminated because weak management of information systems in education and health made it impossible to demonstrate any improvement in social indicators.[6] The largest bilateral donor is Ireland, followed by Japan and Germany. With the completion of the LHWP Phase 1A, the LHWP-related grant flows to the budget have fallen sharply. The decline in grants is also attributed to undemocratic governance prior to 1992, a decline in donor interest after the end of the apartheid regime in 1994 (a number of donor agencies have reduced their representation in

6 However, this did not affect the quantum of EU assistance provided under the EDF arrangements.

Lesotho and now manage their operations from South Africa) and civil unrest after the 1998 elections.

2.13 **There appears little room to maneuver VAT policies in Lesotho to compensate for the anticipated revenue loss from SACU**. First, the standard VAT rate of 14 percent is already relatively high, and raising it beyond South Africa's rate of 14 percent would likely encourage smuggling activities to take advantage of the rate differences and may not generate expected revenue. Second, while there is a scope to raise the rate on utilities (currently 5 percent), the government is facing pressures from the garment industry to lower utility rates. Moreover, the higher VAT rate on utilities may lower user fee collection rates. Finally, most of the zero-rated and exempted items in Lesotho are those on which there is a broad international consensus (e.g., education, health, agricultural inputs). Charging these items with VAT would not be warranted in a country with high priorities on education and health services.

2.14 **Strengthened tax administration and a higher reliance on non-SACU revenues are key to improving revenue performance.** Lesotho has made significant progress on the latter with the establishment of the LRA in 2003. With effect from October 2003, all government purchases are subject to VAT, as opposed to the tax exemptions under the General Sales Tax (GST). In addition, a tax amnesty program was introduced in November 2004, with the objective of expanding the tax base. The LRA offered a four month amnesty period, in which those registering as taxpayers would be exempted from tax arrears that have accumulated before March 1999 and interest charges on them. While the tax amnesty program ended with a rather disappointing result,[7] the introduction of VAT and expanding the coverage of income taxes to include farm income and Lesotho Highlands Development Authority (LHDA) helped lessen Lesotho's heavy reliance on SACU income and raise non-SACU tax revenue from the lowest point of 12.4 percent of GDP in 1999/00 to over 18 percent in 2004/05.

[7] LRA press release (April 8, 2005), "Tax Amnesty Lessons Learnt."

Box 2.1: Fiscal Implication of LHWP

The Lesotho Highland Water Project (LHWP) was established by Treaty between the Governments of Lesotho and the Republic of South Africa in 1986. The purpose of this joint undertaking was to transfer water from the Highlands of Lesotho to meet the growing water demands in the industrial heartland of South Africa, and to use the water to generate hydroelectricity for Lesotho at the Muela Hydropower station.

The Lesotho Highlands Development Authority (LHDA), an autonomous body, was established by the GoL for implementing operations and maintaining LHWP within the Lesotho territory. Under the Treaty signed by both governments, the Government of South Africa would ultimately meet all costs for the water transfer component (including construction, supervision, environmental protection scheme, resettlement, technical assistance for LHDA), to be constructed in four phases between 1990 and 2020, and in addition would pay 59 percent of water proceeds to Lesotho as a water royalty. All the costs for the Muela hydropower station and ancillary development related to the project would be borne by Lesotho, supported by export credits, concessionary external and commercial loans, grants, concessionary risk and treasury loans as well as direct contribution from the GoL.

In addition to the responsibility to implement and operate the project, LHDA is charged with the task of raising the required capital for approved project components. According to the Treaty, the loans owed by LHDA are explicitly guaranteed by the Government of South Africa for the water transfer component, and by the GoL for the hydropower component.

Public revenue from LHWP has accrued in the form of three flows: (i) royalty receipts from the sale of water; (ii) increased SACU revenue as a result of LHWP-related imports; and (iii) increased tax revenue due to project activities.

LHWP has also affected Lesotho's public expenditure in multiple ways: (i) part of the royalty revenue is transferred (recorded as a capital transfer) to the Lesotho Fund for Community Development (LFCD),1/ which was established in 1999 with the intent of using the water revenue for community demand driven activities with a poverty reduction focus; (ii) an annual transfer to the Lesotho Highlands Water Commission (LHWC) to cover the operational cost (recorded as a capital transfer); (iii) an annual transfer to LHDA to cover the operational cost (recorded as a capital transfer) of activities for which Government is responsible; (iv) transfers to LHDA to cover some one-off costs associated with retrenchment (recorded as a capital transfer); (iv) provision of counterpart resources to LHDA for its environment action plan; (vi) project tax refunds to the LHDA 2/; (vii) capital spending for the construction of hydropower plants; (viii) debt service payments for the concessional and commercial loans associated with the Muela station; (viii) commercial borrowing by LHDA to cover any shortfall in annual contributions; and (ix) extraordinary financial support to Lesotho Electricity Corporation (LEC), as a result of its financial difficulties. 3/

The net fiscal returns from LHWP are not absolutely clear in the absence of information regarding the financial arrangements between the government and LHDA as well as LFCD, in particular debt service responsibilities and financial transfers. For example, the nature of the amortization payment of commercial loans associated with the Muela project (paid on behalf of LHDA, the original debtor) is not clear, as it is classified as expenditure for "goods and services" in the budget. Further examination of the net fiscal costs/benefits analysis is warranted.

Notes:

1/ There are concerns about the lack of transparency in the use of resources transferred to LFCD overtime. In 2005/06 LFCD will be transferred to the Ministry of Local Government as part of the decentralization process.

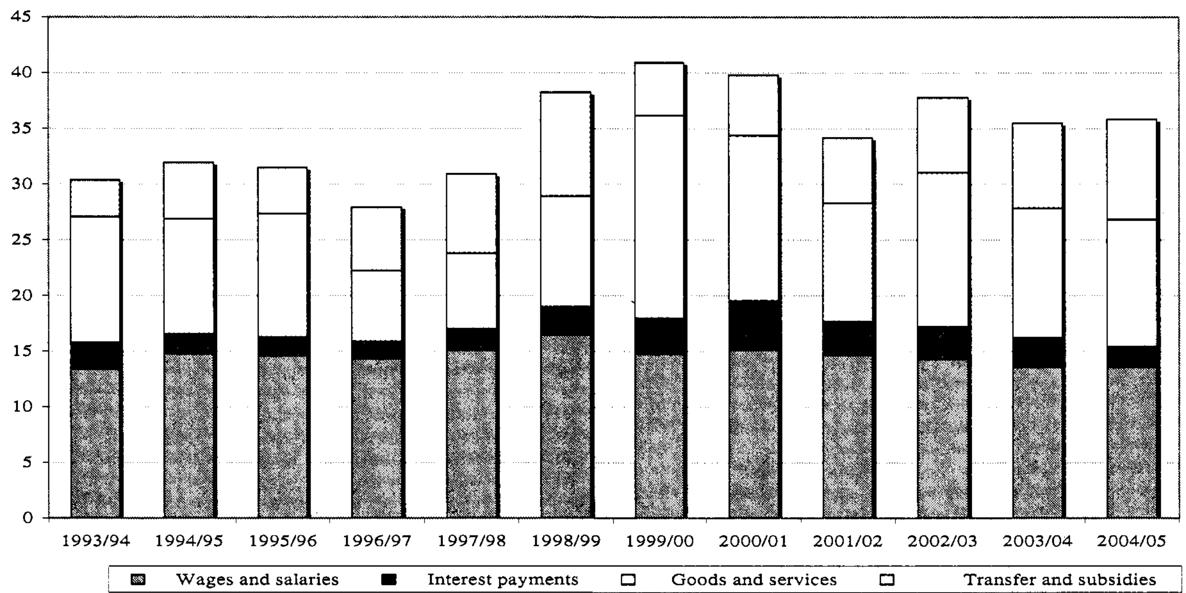
2/ Under Protocol V to the Treaty, taxes paid by the LHDA and its contractors at rates in excess of those provided for in this Protocol are repayable together with interest at 15 percent per annum. Total refunds payable, including interest, outstanding at end-March 2003 was M3.4 million.

3/ The LEC received a government loan of M3.7 million in 1999 for service connection, and government financial support of M58 million in 2000 as payments to the creditors. In addition, the LEC Annual Report 2002/03 shows the existence of numerous extraordinary government financial assistance to LEC. These include (i) GoL grants to LEC (e.g., electricity purchases from the LHDA paid by the GoL on behalf of the LEC); (ii) short-term GoL loans (e.g., for the payment of electricity purchases from Eskom); and (iii) long-term GoL loans, a significant proportion of which had been "converted" to grants as no formal agreement existed for the repayment of these loans (about M67.6 million as of end-March 2003). The latter constitutes contingent liabilities for the government.

Expenditure Trends

2.15 **Receipts from the SACU revenue sharing system have allowed an exceptionally high level of public sector spending for Lesotho by African and developing country standards.** Total expenditure (including net lending) since mid-1990s has accounted for nearly 50 percent of GDP every year, except for 1999/00, when expenditure reached nearly 60 percent of GDP. After the peak of 1999/00, total expenditure has declined slightly, to around 45 percent of GDP. While this fluctuation may appear large, it is because of the fact that Lesotho's relatively small size of total expenditure (typical for a small country) can be affected significantly by major changes in specific activities, such as the redemption of LHDA's loans (see below).

Figure 2.2: Government Current Expenditure
(in percent of GDP)



Source: IMF Staff Reports, various issues.

2.16 **Much of this spending increase was caused by current expenditure.** These have grown rapidly in the late 1990s, from 28 percent of GDP in 1996/97 to over 40 percent in 2000/01 (see Figure 2.2).[8] Part of the exceptionally high current expenditure in 1999/00 was explained by a one-off amortization payment of a commercial loan associated with the Muela Hydropower project (M284.3 million, or 5 percent of GDP, paid on behalf of LHDA). The high interest payments as a result of increased government borrowing (both external and domestic) and rapid depreciation of the rand/loti against major foreign currencies also contributed to this increase. The latter raised total interest payments in loti terms by 0.1-0.9 percent of GDP since

8 As discussed in the following paragraphs, Lesotho's disaggregated expenditure data need to be interpreted with caution due to weaknesses in the recording system. For example, many recurrent transactions are recorded under capital expenditure, and goods and services expenditure is treated as a residual to ensure balance between fiscal and monetary information.

1996/97.[9,10] Since 2001/02, current expenditure has been on a slight downward trend. With the appreciation of the rand/loti and declining external debt stock, external interest payments began to fall, while the wage bill was cut slightly. However, the need to respond to the severe famine in Lesotho once again led to unanticipated expenditures related to agricultural support (1.5 percent of GDP) and famine relief (0.3 percent of GDP) causing a sudden jump in current expenditures in 2002/03. In 2004/05 the current expenditure-to-GDP ratio stood at 36 percent of GDP.

2.17 **The wage bill is the single largest expenditure component in the government budget, accounting for nearly a third of total expenditure.** The very high level of the wage bill reflects the structural problem of an oversized civil service. Over the years, government has found it difficult to reduce its size. Lesotho's central government wage payments as a share of GDP are comparable to some of its SACU neighbors but high compared to the Sub-Saharan average (see Table 2.1). The wage bill rose from 11 percent of GDP in 1990/91 to the peak of 16.5 percent in 1998/99, mostly as a result of a sharp increase in recruitment during 1996/97-97/98. As the government froze civil service wages for several years and removed ghost workers from the payroll, the wage bill shrunk slightly in the early-2000s. The decline was also due to the change in the expenditure classification, caused by the conversion of three agencies (LRA, Lesotho College of Education (LCE), and Lerotholi Technical Institute (LTI)) into autonomous bodies.[11] In 2004/05, the wage bill as a share of GDP stood at 13.6 percent of GDP, or 38 percent of current expenditure. The 2006/07 wage bill is expected to be as high as 15 percent of GDP if the transfers to the newly established local governments for salaries are included. The personnel costs could rise substantially if the government introduces a defined contribution scheme as part of its pension reform and a medical aid scheme for civil servants.[12]

Table 2.1: Cross-Regional Comparison of Central Government Wage Bill

Country	Wage bill in percent of GDP (1996-2004 average)
Lesotho	**14.5**
Botswana	10.0
Namibia	15.9
South Africa	10.5
Swaziland	11.8
SACU countries	10.6
Sub-Saharan Africa	7.1

Source: IMF staff estimates.

9 While during 1996-98 the government relied heavily on external financing repaying domestic debt, the financing strategy reversed during 1998-00 as foreign financing became increasingly expensive due to the much faster pace of rand/loti depreciation.

10 In other words, in the absence of the rand/loti depreciation since 1996/97, the interest payments in loti terms would have been lower by 0.1-0.9 percent of GDP.

11 As a result of the conversion, the LRA, LCE and LTI are now funded through the line item "transfers and subsidies" in the budget, rather than through specific line-items. Thus, wages and salaries for the employees of these bodies are now funded through "transfers and subsidies" as opposed to "wages and salaries".

12 An earlier version of these schemes was estimated to cost over 3 percent of GDP. However, introduction of these schemes has been postponed because of cost concerns and possible design flaws.

2.18 **Spending on goods and services has fluctuated widely (6.5-18 percent of GDP) during the last decade.** It is often treated as a residual to ensure balance between fiscal and financing accounts. Thus, spending on goods and services was contained somewhat during the period when total current expenditure rose sharply to pay for the interest and wage bill. Similarly, they bounced back sharply in 1999/00 to over 18 percent of GDP, as the amortization payment associated with the Muela project was made from the budget and was recorded as spending on goods and services.[13] Since 2000/01, goods and services expenditure has accounted for about 11-15 percent of GDP.

2.19 **Current expenditures on transfers and subsidies have increased sharply in the past five years**. They have risen from the average of 5.5 percent of GDP during the 1990s to 9 percent in 2004/05. While this can partly be explained by the creation of autonomous bodies (LRA, LCE and LTI), there are concerns that the increases also reflected the lack of concrete control mechanisms for transfers and subsidies. In particular, scholarships for tertiary education awarded by the NMDS have exceeded its budget allocation.[14] As noted in Chapter 5 on the education sector, NMDS is the largest recipient of transfers and subsidies and there are some concerns about its contribution to policy objectives as well as operational efficiency. The introduction of an old-age pension scheme in November 2004 also contributed to the expenditure expansion in 2004/05. Net lending that captures both loans made to parastatals and local authorities and repayments from them on loans received from the central government is a very small component of total expenditure, except for 1999/00, when payments associated with the closure of the Lesotho Agricultural Development Bank in September 1998 and restructuring of the Lesotho Bank prior to the privatization in August 1999 (costing M612 million) were charged to net lending.[15]

2.20 **In contrast to the trends in current expenditure, capital expenditures have suffered a sharp decline over the years**, both as a share of GDP and in real terms. The decline was partly related to the completion of the LHWP-related hydropower project in 1998 that was financed externally, and a decline in external project loans, partly attributed to civil unrest in 1998. Budget allocations for domestically funded public investment also declined due to the government's weak capacity to implement projects, which has sometimes caused donors to hold back on the release of grants.

2.21 **Moreover, a large proportion of outlays recorded as domestically funded capital expenditure are in fact capital transfers and may not result in the creation of new physical assets**. These transfers are made to autonomous bodies, parastatals and extra-budgetary funds, such as the LFCD, LHDA, LHWC, as well as the Road Fund (RF) and LNDC (Lesotho National Development Corporation).[16] In the last three years (for which data are available), capital

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13 This amounted to M284.3 million for redemption of commercial loans on behalf of LHDA.

14 The policy of granting loan bursaries to all students admitted at tertiary institutions in Lesotho and South Africa has also encouraged universities and polytechnics to admit the largest possible number of students in the full knowledge that the government will sponsor them.

15 The net cost of Lesotho Bank restructuring has been reduced by positive resource flows in subsequent years.

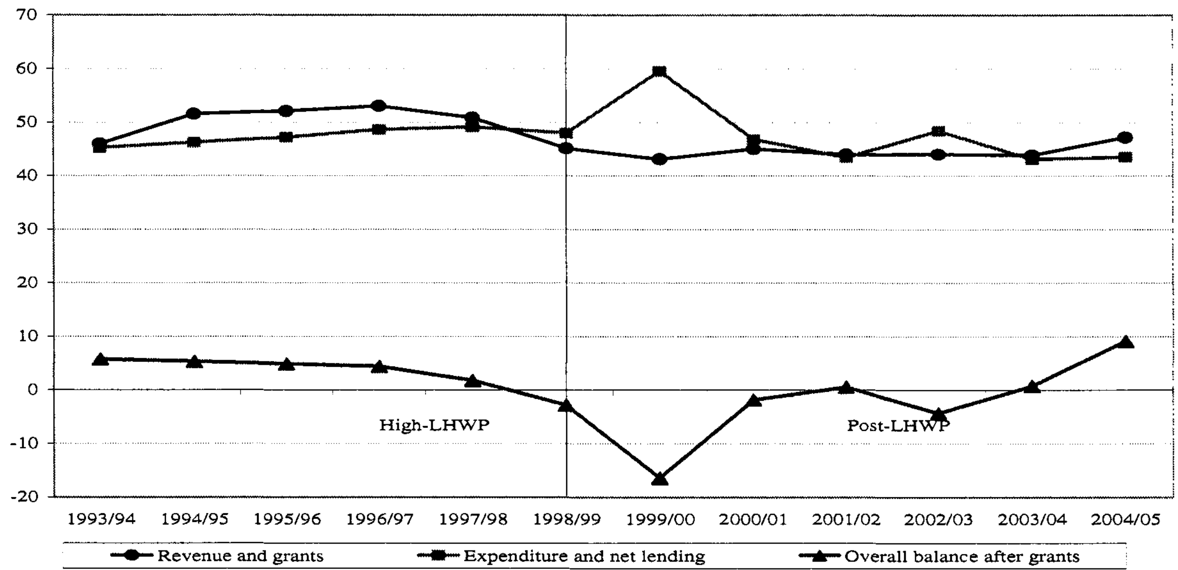
16 The RF is an extra-budgetary fund, which was created in 1996/97 to finance road maintenance. The LNDC is a parastatal agency for implementing the country's industrial development policies. The government owns 90 percent of LNDC's share and the remaining 10 percent is held by a German finance company for developing countries (DEG).

transfers comprised 25-50 percent of expenditure classified as domestically funded capital spending. The use of resources transferred to these agencies is not accounted for, and a sizeable part of capital expenditures are reportedly spent on recurrent activities.

Fiscal Stance

2.22 **Lesotho's fiscal position has been vulnerable to exogenous shocks.** Despite favorable revenue performance, Lesotho's overall fiscal position began to deteriorate in the late 1990s, after experiencing a decade of fiscal surpluses that averaged 4 percent of GDP. In 1998/99 a fiscal deficit of 2.8 percent of GDP emerged as SACU receipts began to fall, and the social unrest necessitated higher spending on public order and security. The fiscal position worsened further in 1999/00 to a deficit of over 16 percent of GDP, as a result of the extraordinary spending needs equivalent to 12.5 percent of GDP related to closure of two banks and amortization of commercial debt on behalf of LHDA. The government implemented a series of International Monetary Fund (IMF) poverty reduction growth facility-supported adjustment programs starting in 2001/02 to restore fiscal stability. Nonetheless, the need to respond to the severe famine in Lesotho once again led to unanticipated expenditures related to agricultural support and famine relief and resulted in a fiscal deficit of 4.3 percent of GDP in 2002/03. Since 2003/04 however, Lesotho's fiscal position has improved significantly as a result of unexpectedly high SACU receipts. The fiscal position was in surplus of 0.8 percent of GDP in 2003/04, and the surplus reached over 8 percent of GDP in 2004/05 and 4 percent in 2005/06. While part of the strong fiscal performance is attributed to increased non-SACU revenue collection (in particular, from income tax and VAT) and the slightly compressed wage bill, the fiscal developments witnessed over the past decade demonstrate the vulnerability of Lesotho's fiscal stance to various exogenous events.

Figure 2.3: Fiscal Performance, including Grants
(in percent of GDP)



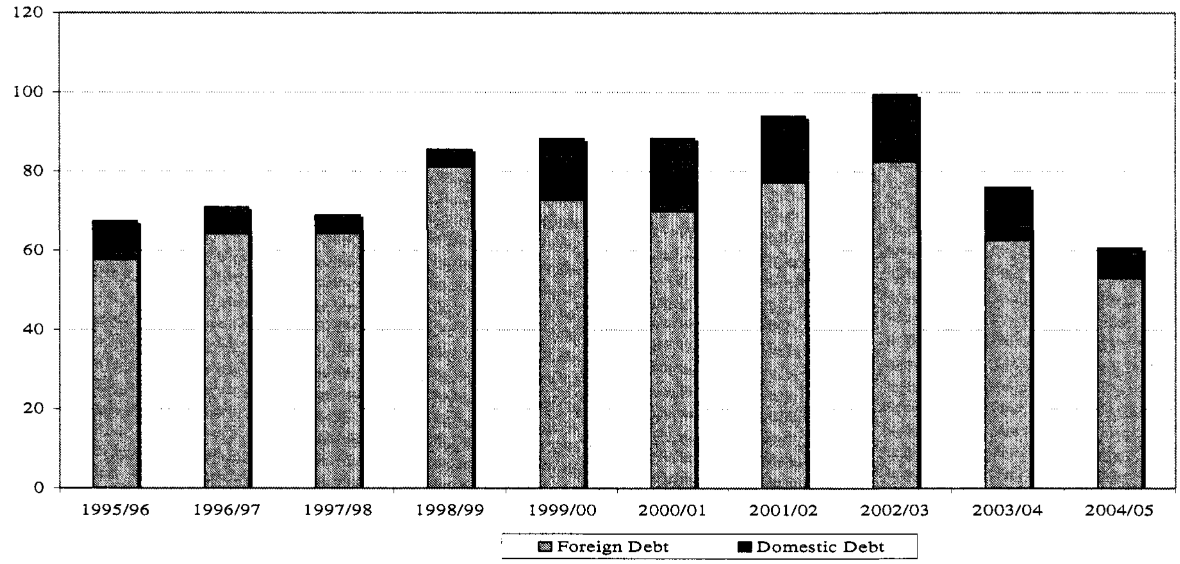
Source: IMF Staff reports, various issues.

2.23 **The deficits were largely financed domestically.** External borrowing was used sparingly since it was becoming an increasingly expensive financing option due to the sharp rand/loti depreciation against major foreign currencies. As a result domestic debt grew sharply from less than 5 percent of GDP in 1998/99 to 17 percent in 2002/03. Given the thin non-bank financial market in Lesotho, the bulk of the financing need was borne by the banking system, which has raised the domestic interest rates, widening the interest rate spread between Lesotho and South Africa and resulting in some capital inflows. Lesotho's fiscal position has strengthened since 2003/04 largely due to higher tax receipts from SACU.[17] The government capitalized on this situation and used the fiscal surpluses to repay high interest domestic debt. As of end-2004/05, the domestic debt stock was estimated at 7.5 percent of GDP.

2.24 **Lesotho's debt stock (in loti terms) is highly sensitive to exogenous exchange rate movements of the rand against foreign currencies** as a large proportion of its public debt is external debt denominated in foreign currencies. As a result of the depreciation of the rand, Lesotho's external debt in local currency tripled, from M2 billion (58 percent of GDP) in 1995/96 to M6 billion (80 percent of GDP) in 2002/03, raising the total debt stock from 67 percent of GDP to 100 percent in 2002/03. The debt stock (in loti terms) has declined sharply since 2002/03, reflecting the appreciation of the rand/loti, fiscal surpluses and negative net foreign borrowing.

[17] Particularly large windfall SACU receipts equivalent to 6.1 percent of GDP were received in 2004/05 as actual imports in 2002/03 were substantially higher than the proxy value used to determine the initial payment, resulting in an overall surplus of 9 percent of GDP.

Figure 2.4: Government Total Debt Stock
(in percent of GDP)



Source: IMF Staff Reports, various issues.

2.25 **Other than these public debts, the GoL has contingent liabilities in the form of explicit and implicit guarantees of debts owed by autonomous bodies** (e.g., LHDA), extra-budgetary accounts (e.g., Lesotho Highlands Community Development Fund), local authorities and parastatals (e.g., LNDC, LEC).[18] Currently, there is no reliable information on the scale of explicit contingent liabilities, as the government does not appear to keep good records of each transaction. Nevertheless, there are a number of occasions where the government provided financial support to bail out autonomous and parastatal bodies. These include financial support for debt service (e.g., amortization of LHDA's commercial loans in 1999/00), and "loans" that will never be serviced on (e.g., loans to the LEC that have later been "converted" to grants in the absence of a formal loan agreement).

Debt Management

2.26 **Various laws and regulations provide a strategic framework for debt management in Lesotho**. These relate to the terms of borrowing and limits on the stock of debt for the central government. The most important legislations are the Loans Guarantees Act (1967) and Amendment (1975), Local Loans Act (1967) and Loans (Statutory Bodies) Act (1975). The Loans Guarantees Act authorizes the Government to raise and guarantee external loans. The Amendment enacted in 1975 sets a limit on the total stock of external debt converted to loti terms at the prevailing exchange rate below total recurrent revenue for the preceding 3 years. The Local Loans Act authorizes the MFDP to raise funds on the domestic capital market within the limit of the outstanding stock of domestic debt in any financial year at R5 million. Borrowing by statutory bodies is restricted by the Loans (Statutory Bodies) Act, which requires the prior

[18] Implicit guarantees are the liabilities that are not explicitly guaranteed by the government, but the government may have to assume in the event of default for moral or political considerations.

approval of the MFDP for any statutory bodies to contract external loans and domestic loans or bank overdraft exceeding R10,000.

2.27 **While Lesotho's legal framework for debt management is relatively well established, several weaknesses exist**. First, while the Loans Guarantee Act and its Amendment impose a ceiling on the central government's external debt stock, it is silent about (i) the legislative ceiling on loan guarantees by the Government; (ii) what kind of appraisal criteria are applied to determine the creditworthiness of the borrower and the viability of projects, for which loans are to be guaranteed; and (iii) how loan guarantees are recorded within the MFDP. Second, by the same token, the Local Loans Act and Loans (Statutory Bodies) Act provide neither statutory limits on borrowing by state enterprises and local governments, nor the details of the processes through which approvals are provided by the MFDP. The former is particularly important so as to contain the growth of implicit contingent liabilities of the Government.

2.28 **Weak capacity at many levels limits the debt management capacity**. While Lesotho has various commissions and committees to coordinate macroeconomic and debt management, such as the Cabinet Budget Committee, Project Appraisal Committee, Debt Management Committee, and Debt Management Technical Committee, some of the committees have ceased functioning.

IV. MEDIUM-TERM FISCAL OUTLOOK

2.29 **Lesotho's medium-term fiscal prospects are shadowed with revenue uncertainties and mounting expenditure pressures**. The large SACU windfalls in the past two years are transitory, largely attributed to a strong South African economy. This has placed Lesotho in a comfortable fiscal position; however, this situation is not expected to last beyond a couple of years. While the government's response in the last two years has been appropriate – saving part of the windfall and repaying high interest domestic and external debts – there are increasing pressures to spend more and save less. Given its limited domestic income generating capacity, government should use this opportunity to raise the economy's production potential without undermining long-term fiscal sustainability.

Revenue Uncertainties

2.30 **Revenue prospects are subject to considerable uncertainties.** While the establishment of the LRA has brought substantial efficiency gains so far, the gains could be more than offset by the anticipated revenue decline in the years to come. ***First***, there are concerns that the recent renegotiation of the SACU agreement and application of the new RSF could cause a large negative revenue impact in the medium-term. The new formula links receipts from SACU directly to the overall size of the pool of tariff and excise revenues (see Box 2.2). Since the application of trade agreements (such as the RSA-EU Trade and Development Cooperation Agreement and the proposed free trade agreement with the United States) will result in the reduction of average tariff rates, it will reduce the size of the revenue pool. Although Lesotho's SACU revenue may increase in the coming financial years (as a result of the consumer boom in South Africa, which has encouraged more imports and hence more customs duties), it is subsequently projected to decline by more than one percent of GDP every year over the next few years. Independent estimates have shown that trade liberalization could lead to a decline in SACU receipts to Lesotho to about 14 percent of GDP.[19]

2.31 **Second, the high prevalence rate of the HIV/AIDS epidemic in working population means that the tax base is likely to erode over time.**[20] As labor force growth declines, labor-intensive industries such as the textile sector could be hard hit, slowing the economy's growth, unless surplus agricultural labor is mobilized. As the growth rate falls, so will the components of the tax base such as personal income, company profits, consumption and imports.[21] Tax collection may suffer further as tax administration could be undermined by the increased HIV/AIDS mortality among LRA staff.

2.32 **Third, the underlying revenue performance would be hurt by the weak economic growth.** The impact of the recent changes introduced in the company tax rates from 35 percent to 25 percent across the board and from 15 to 10 percent for manufacturing and a zero percent rate for income generated from exports outside SACU is estimated to be about one percent GDP. Unless there is a dynamic improvement in economic activity in response to this policy initiative, this could result in a permanent tax loss as against the temporary windfalls from SACU.

2.33 **Furthermore, the prospects for increased donor grant inflows are uncertain**. While high donor assistance may be forthcoming particularly to fight against HIV/AIDS, the timing and magnitude of grant flows are difficult to predict. In the case of Lesotho, grant flows will also depend on improvements in public financial management.

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19 Trade Liberalisation: What exactly does it mean for Lesotho?; By Ron Sandrey, Adelaide Matlanyane and David Maleleka; Paper prepared for the Ninth Annual Conference on Global Economic Analysis, Addis Ababa, Ethiopia, June 15 – 17, 2006.

20 The current HIV/AIDS prevalence rate is estimated at 24 percent of the adult population in Lesotho.

21 The possible scale back of the textile industry would not directly harm the tax base, since employees of the textile sector do not earn enough to be subject to the income tax, and most of the profit remains with the parent companies.

Box 2.2: SACU New Revenue Sharing Formula and Implications for Lesotho

In October 2002, Governments of South Africa and Botswana, Lesotho, Namibia, and Swaziland (BLNS countries) signed a new SACU Agreement. The new Agreement seeks to entrench a democratic approach to trade policy, while facilitating equitable sharing of revenue from customs and excise, and minimizing revenue instability during a period of declining tariffs.

The new SACU revenue sharing formula (2002 RSF), which came into operation with effect from July 2004, deals with customs and excise revenues separately and explicitly, through three distinct components, (i) a customs component; (ii) an excise component; and (iii) a development component with the aim of providing a redistribution mechanism for lower income member countries.

First, total customs revenue collected will be distributed according to each country's share of intra-SACU imports (i.e., countries that import most from within the union will receive the largest share of the customs pool). Second, 85 percent of total excise duties collected in all member countries will be distributed on the basis of each country's share of total SACU GDP, a proxy for the value of excisable goods consumed. Third, the new formula will distribute the remaining 15 percent of total excise duties near equal to each member country, but with a marginal adjustment in favor of the countries with a lower per capita GDP.1/

Under the new RSF, the actual proportion received by each member country will therefore be based on national GDP and per capita GDP of all five member countries, the overall size of the revenue pool (which in turn depends on tariff levels, duties and overall intra-SACU imports), as well as approved duty rebates. 2/ This compares with the old formula (1969 RSF with the stabilization factor), in which revenue was shared according to each country's share of imports and excisable production, with each BLNS country being guaranteed minimum receipts equal to 17 percent of their imports. To reduce the risk of preliminary and inaccurate numbers, the data used for distribution will be lagged 2-3 years, i.e., the proportion to be allocated in 2005/06 will be based on macroeconomic data for 2002/03 or 2003/04 (see Kirk and Stern, 2003). However, there will still be errors relating to the Pool forecasts and any adjustments will be incorporated into allocations for future years.

Projecting effectively the revenue impacts of the new RSF is challenging due to uncertainties associated with the outcome of the impending trade negotiations with the United States and other countries and trade blocs, as well as the weak quality of trade data. Uncertainties also arise due to different ways of interpreting the RSF in general: some members see it as being determined by trade flows while others see it as a form of development assistance. Nonetheless, it is highly likely that there would be a decline in the revenue accruing to the BLNS countries, with the completion of new tariff-reducing trading agreements, as they are expected to shrink the size of the customs pool, to which each country's revenue allocation will be linked. According to Flatters and Stern (2005), such trade liberalization could lower Lesotho's SACU receipts to 14 percent of GDP by 2020. While this estimate may be on the low side, further work is called for to study the revenue implication of trade liberalization as well as the exact workings of the customs union.

Notes:
1/ Although South Africa receives a relatively small amount in per capita terms, the redistributional effect on the BLNS is tiny. Although the difference in per capita GDP between Botswana and Lesotho is large (Lesotho's per capita GDP is less than 15 percent of Botswana's) Lesotho's share of the development component will be 21.7 percent, while Botswana's share will be 19.6 percent.
2/ Since some industrial incentives (principally the Motor Industry Development Program and Textile Duty Credit Certificate Scheme) are provided in the form of duty rebates, these schemes significantly reduce the size of the pool.

Expenditure Pressures

2.34 **Expectations are high with regard to the implementation of the recently completed Poverty Reduction Strategy. First, there will be considerably higher expenditure needs to address the HIV/AIDS pandemic.** As the HIV/AIDS prevalence rises, there will be an increasing demand for health facilities and trained health care professionals, whose number will also be hit hard by the epidemic. Substantial expenditure pressures are anticipated to expand spending for health facilities (hospitals, clinics, medical equipments), medical supplies and drugs, increased training (at least) to maintain the number of health personnel and physicians, and prevention of further spread of the infection. While part of such expenditure needs may be covered by development partners, a recent study estimates that a program to effectively fight HIV/AIDS would require additional health spending of over 3 percent of GDP per year by 2010 (Haacker, 2002). Expenditure pressure from HIV/AIDS would also increase to assist the vulnerable, especially the orphans. Due to high mortality rates among the young working population, the number of orphans is expected to rise rapidly, increasing the need for public assistance. This will also be reflected in bursaries for Orphans and Vulnerable Children (OVCs). Moreover, the HIV/AIDS-related impact may put pressures on the already high wage bill in the form of gratuity payments for surviving dependents of civil servants who have died of AIDS (World Bank, 2000).

2.35 **Second, the government's development strategies will require a substantially increased resource allocation for infrastructure investment.** Lesotho's physical infrastructure has been one of the major development constraints. Further development of the manufacturing sector, particularly the textile sector, has been hampered by non-availability of water resources in new industrial estates, while potential for FDI, a source of employment, has been shadowed by the underdeveloped infrastructure.[22] In addition, poor roads and public transport systems have constrained access to public services and markets for agricultural products. Reflecting the lack of an irrigation system, agricultural yields are highly vulnerable to droughts, while the quality of education has suffered from overcrowded classrooms. Construction and maintenance of roads, schools and hospitals in the mountain terrain, and reliable supply of electricity and water to the industrial districts will inevitably require large public resources. Infrastructure accounts for over 40 percent of the cost estimates of the PRS (M1.5 billion over three years), and not all the identified activities are included in the budget.

2.36 **Similarly, greater budget allocations will be required to improve human capital infrastructure and service delivery**. Private sector development and facilitation of FDI have been constrained by Lesotho's low labor productivity levels, which are reported to be one-third of those in Vietnam.[23] Although education spending has accounted for the highest proportion of total government spending, there are concerns about the quality of education, as reflected by high repetition and drop out rates, casting doubts about effectiveness of education spending (see Chapter 6 for further discussion on education spending). Besides overcrowded classrooms, shortages of qualified teachers are another primary factor that contributes to the low quality of education in Lesotho.[24] The problems of teacher shortages are expected to become more pronounced as the HIV/AIDS epidemic takes a toll on the qualified teachers. Maintaining the current pupil-to-qualified teacher ratio, of around 46 to one, let alone improving it, would require considerable budget resources for the medium-term. Extending the FPE to secondary levels will also put a strain on the budget and needs to be carefully examined.

2.37 **Lesotho's budget is susceptible to unanticipated expenditure demands due to external shocks which may require specific contingent measures**. For example, a rapid depreciation of the rand/loti against the US dollar and euro could raise debt service costs significantly, while drought induced poor agricultural production would necessitate unanticipated

[22] For example, textile production was disrupted in late 2003 by water shortages owing to the continuing drought, which made it necessary to divert water from the LHWP.
[23] Reported by a Taiwanese textile firm, Presitex.
[24] The proportion of trained teachers to total primary teachers has been declining, from 78 percent in 1999/00 to 73 percent in 2002/03 (source: UNESCO). This trend is more pronounced among male teachers.

provision for food security and subsidies as part of famine relief efforts. Contingent liabilities, for instance, invocations of the loan guarantee for LHDA's debt service obligation and conversion of the existing pay-as-you-go public service pension scheme into a funded scheme, could pose serious risks to the budget.[25] For this reason, budgetary implications of the introduction of new expenditure schemes, such as the old-age pension and medical aid scheme for civil servants, need to be examined carefully prior to introduction.

2.38 **Implementation of government's decentralization program is expected to put further pressure on the budget**. With the establishment of district councils and a new civil service at the local level, expenditure pressure will emerge to cover recurrent costs of administration as well as capital costs to provide office infrastructure and to meet the development needs identified by communities.

Fiscal Sustainability

2.39 **The government faces the difficult challenge of meeting rising expenditure pressures in the face of expected revenue declines**. The temporary revenue windfall in 2005/06 raises an important issue regarding the scope of raising public expenditures to support the implementation of its PRS and development programs, while maintaining fiscal sustainability. The sustainability analysis is based on a standard dynamic government budget constraint equation. It determines the fiscal balances that would be needed to achieve a target debt to-GDP-ratio of 55 percent by the policy makers (see Appendix 4 for detailed explanation of methodology). A simulation analysis is conducted to project a fiscal path over 15 years that is consistent with the target debt-to-GDP ratio of 55 percent (about the same as at end 2005/06). The simulation period is 14 years (2006/07-20/21), where 2005/06 is the base year, reflecting the estimated fiscal outturn. Table 2.2 presents the key assumptions for two scenarios: base case and higher growth cases (Appendix 4 provides further details). Tables 2.3-2.5 present results from the simulation analysis under different assumptions for growth, debt to GDP target, domestic interest rates and level of external concessionary financing.

Table 2.2: Simulation Analysis: Summary of Key Assumptions

	Base case	Higher growth case
Annual real growth rate of GDP	2.0%	2.0% till 2009/10 3.0% for 2010/11-2020/21
Annual inflation rate	5.0%	5.0%
Exchange rate of loti/US$	7.0	7.0
Nominal interest rate on external debt	2.2%	2.2%
Nominal interest rate on domestic debt	9.0%	9.0%
Discount rate	5.0%	5.0%
Note: See Appendix 4 for details		

2.40 **Under the base case scenario, the GoL could run a fiscal deficit of 3.6 percent of GDP on average**. Total expenditure (non-interest expenditure) can be raised to 50 percent (48 percent) of GDP on average, a somewhat higher level than 2005/06 without undermining fiscal sustainability in the medium-term. The composition of the debt stock is projected to change, with

[25] In addition, there would be political pressures to increase spending on the public service, e.g., buildings, ministerial housing, medical aid scheme, defined contribution scheme, etc.

the share of external debt in total debt declining from 88 percent in 2005/06 to about 65 percent in the long term, and domestic debt rising instead (see Appendix 4, Table I). Under the higher growth case scenario, where real GDP growth rate increases from 2 percent to 3 percent from 2010/11 onwards, the government could expand expenditure slightly and raise the fiscal deficit to 4.0 percent of GDP on average without threatening fiscal sustainability in the medium-term.

Table 2.3: Simulation Results: Fiscal Balance
(in percent of GDP)1/

	Real annual GDP growth rate			
	1%	2%	3%	4%
Target debt-GDP ratio in 2020/21				
40%	-1.7	-2.1	-2.6	-3.0
45%	-2.2	-2.6	-3.1	-3.5
50%	-2.6	-3.1	-3.6	-4.1
55%	-3.1	**-3.6**	-4.1	-4.6
60%	-3.6	-4.1	-4.6	-5.1

1/ Holding all other assumptions provided in Appendix 4 constant. Figures are the average for the simulation period (2006/07-20/21).
Source: World Bank staff estimates.

2.41 **These high levels of expenditure will not be sustainable with a significant decline in SACU revenues or external concessionary financing.** With an estimated decline of about 15 percentage points in SACU revenues arising from the wider trade liberalization agenda and the establishment of the SADC Customs Union planned for 2010, non-interest expenditure levels will have to decline by about 3 percent of GDP to maintain the debt to GDP ratio of 55 percent.

2.42 **Increased government domestic borrowing is expected to raise the domestic interest rates, crowding out private sector investment and slowing growth.** With higher domestic interest costs,[26] non-interest expenditure will go down. While a deficit of 3.6 percent is sustainable, the resources available for non-interest expenditures will be lower. However, if part of the deficit is financed by increasing concessional external financing, the available headroom for non-interest expenditures will increase (see Table 2.4).

26 The framework applied here assumes a fixed domestic interest rate for simplicity.

Table 2.4: Simulation Results with Varying Level of New External Borrowing
(in percent of GDP) 1/

	Level of New External Borrowing (gross)			
	2.6%	3%	3.5%	4%
External interest payments	0.8	0.8	0.9	0.9
Total interest payments	2.4	2.3	2.1	1.9
Non-interest expenditure	48.0	48.2	48.3	48.5
Net domestic financing	2.5	2.1	1.6	1.2
External debt	36.9	39.3	42.3	45.3
Domestic debt	20.8	18.4	15.4	12.4

1/ Holding all other assumptions provided in Appendix 4 constant. Figures are the average for the simulation period (2006/07-20/21).
Source: World Bank staff estimates.

2.43 **The findings are consistent with the results obtained with the application of the IMF-World Bank debt sustainability framework for low income countries.** Under this framework, debt sustainability thresholds are linked to a country's policies and performance as measured by the Country Policy and Institutional Assessment (CPIA).[27] Lesotho is classified as a medium performer. The analysis indicates that under the baseline macroeconomic scenario, Lesotho's public and publicly guaranteed external debt is sustainable throughout the projection period. It should be noted, however, that external shocks—for instance, loti depreciation, a rise in international interest rates, poor exports performance as a result of loti appreciation or retraction of the textile sector—could raise Lesotho's external debt indicators beyond the thresholds, or vice versa.

Table 2.5: Indicative External Debt Burden Indicators

	Poor	Medium (Lesotho)	Strong
NPV of debt service in percent of			
Exports	100	150	200
GDP	30	40	50
Revenue	200	250	300
Debt service in percent of			
	Quality of Policies and Institutions 1/		
Notes:	15	20	25
Revenue 2/	25	30	35

1/ Measured by CPIA.
2/ Revenue defined exclusive of grants
Source: IDA and IMF (2005)

27 "Operational Framework for Debt Sustainability Assessments in Low-income Countries—Further Considerations", International Monetary Fund and International Development Association, March 28, 2005.

V. CONCLUSIONS AND NEXT STEPS

2.44 **Owing to the SACU revenue sharing arrangement, Lesotho has enjoyed an exceptionally high level of public sector spending over time, most notably current expenditure.** Nonetheless, the high level of overall public spending has not resulted in significant poverty reduction. Critical infrastructure outlays have, however, remained at low levels. The effectiveness of public expenditure has also been a concern, as evidenced in the education sector in which the government has invested heavily but educational outcomes are poor (see Chapter 6).

2.45 **The GoL will have to face difficult tasks down the road**. Revenue prospects are uncertain, due to the anticipated decline in SACU receipts and the tax base erosion as the HIV/AIDS epidemic could take a heavy toll on the working age population, slowing economic activities gradually. The possibilities of introducing new revenue measures are limited as any attempts to increase the already high tax rates could hurt the private sector's incentive for investment. Nevertheless, further improvements in revenue collection would be possible through the recovery of outstanding tax debts and enforcement of the government's compliance with VAT, particularly import VAT. Efficiency of the LRA could further be improved with computerization.

2.46 **Expenditure pressures are likely to build up**, as the government faces numerous challenges associated with the HIV/AIDS pandemic, while ensuring a sustained level of public investment in infrastructure and human capital. Increased donor funding targeted to HIV/AIDS crisis will be essential to complement government's efforts.

2.47 **Given the temporary nature of revenue windfalls, and external vulnerabilities affecting its growth prospects, current high levels of expenditure may not be sustainable in the long run.** Nevertheless, a fiscal sustainability analysis demonstrates that current levels of expenditure do not pose a serious threat to debt sustainability in the medium-term. Given its limited domestic income generating capacity, government should use this opportunity to raise the economy's production potential. However, raising the level of expenditures or shifting them into productive sectors will not automatically lead to a higher impact on growth and poverty reduction. Effectiveness and efficiency of public expenditures will have to be raised and public expenditure management reforms will need to be consolidated and further strengthened.

2.48 **The priority in the government expenditure strategies should be to maximize the return from increased public spending**. While expansionary fiscal policy will provide an opportunity to raise PRS expenditure, the magnitude of these expenditures alone would not be sufficient to achieve the PRS goals. In this context, expenditure reprioritization and strengthened expenditure management will assume key importance, so that additional resources can be freed for pro-growth, pro-poor spending, and scarce resources can be utilized in the most effective manner. Increasing allocations for economic sectors, particularly infrastructure would necessitate reduction in allocations for general services. Further rationalization and cuts in non-priority expenditure in general services (Chapter 4), and unproductive or inefficient transfers and subsidies (for example, bursaries for tertiary education) would be inevitable. The rising wage bill and other personnel related costs are a major concern. There is a need for a comprehensive assessment of government wages, structure and size of civil service, with the aim of formulating an appropriate civil service reform strategy for rightsizing Lesotho's civil service and improving public service delivery. Further civil service pay increases should be carefully reviewed until the comprehensive civil service reform program is in place.

CHAPTER 3. PUBLIC EXPENDITURE MANAGEMENT AND FINANCIAL ACCOUNTABILITY

I. INTRODUCTION

3.1 **A good PFM system is essential for the implementation of policies and the achievement of developmental objectives by supporting aggregate fiscal discipline, strategic allocation of resources and efficient service delivery**. Effective controls of the budget totals and management of fiscal risks contribute to maintaining aggregate fiscal discipline; planning and executing the budget in line with government priorities contributes to implementation of government objectives; and managing the use of budgeted resources contributes to efficient service delivery and value for money. Lesotho's PFM system was assessed as meeting only four out of thirteen HIPC expenditure tracking benchmarks in the 2002 review.[28] Despite some budgeting improvements, the PFM system is particularly weak in the areas of accounting and fiscal reporting. This chapter reviews the PFM system in Lesotho. The analysis is based on a desk review of the existing diagnostic material on Lesotho's PFM system,[29] complemented by an update in key PFM areas as part of the PER exercise. The analysis uses the PFM Performance Measurement Framework developed by the PEFA Secretariat.[30]

3.2 **The Performance Measurement Framework identifies six critical dimensions of performance of an open and orderly PFM system.** These are:

(i) **Credibility of the budget** – The budget is realistic and implemented as intended.

(ii) **Comprehensiveness and transparency** – The budget and the fiscal risk oversight are comprehensive and fiscal and budget information is accessible to the public.

(iii) **Policy-based budgeting** – The budget is prepared with due regard to government policy.

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[28] Lesotho is not a HIPC, however the framework was considered to be useful for an assessment of the system. See IMF Fiscal Affairs Department, "Lesotho: Improving Government Accounting and Financial Management", Ian Lienert, Alemayehu Daba and V.N.Kaila, June 2002.

[29] See IMF Fiscal Affairs Department, "Lesotho: Improving Government Accounting and Financial Management", Ian Lienert, Alemayehu Daba and V.N.Kaila, June 2002; Price Waterhouse Coopers, Study in PFM in Lesotho, July 2002; World Bank, Lesotho Public Expenditure Management – Information Update and Assessment, December 11, 2003.

[30] Public Financial Management - Performance Measurement Framework, PEFA Secretariat, World Bank, Washington DC, June 2005.

(iv) **Predictability and control in budget execution** – The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds.

(v) **Accounting, recording and reporting –** Adequate records and information are produced, maintained and disseminated to meet decision-making control, management and reporting purposes.

(vi) **External scrutiny and audit** – Arrangements for scrutiny of public finances and follow-up by executive are operating.

3.3 **The result of the review indicates major deficiencies in budget execution, internal controls and fiscal reporting**. Reliable information to monitor budget execution is not available. There is a general failure to observe financial rules and regulations, leading to over expenditures on individual budget items, some unauthorized expenditures and unreliable financial reporting. The lack of adequate numbers of trained accounting staff has also been a major contributing factor. A detailed Public Expenditure and Financial Accountability Report based on the above framework is presented in Appendix 6. The following sections highlight the key issues in the areas of budget formulation and execution, and external accountability, audits, legislature oversight in Lesotho.

II. BUDGET TIMETABLE

3.4 **Lesotho has an orderly and participative budget process, involving central agencies, spending agencies and the political leadership in accordance with a pre-determined budget calendar, which is broadly adhered to.** The fiscal year runs from April 1 until the following March 31. The budget cycle or calendar is well established and timely. The budget circular is issued in early October with line ministries having until end November, or roughly two months in which to respond. The circular includes expenditure ceilings for each ministry's recurrent expenditures and in 2006 provided indicative figures for the following two out-years and capital ceilings for 2006/07 and 2007/08 (based on ministerial submissions for the 2005/06 – 2007/08 MTEF).

3.5 **Ministries have their own internal arrangements for developing their bids and a number appear to have budget committees to bring together their bids for both capital and recurrent funding.** Technical discussions on the budget bids are held with line ministries in December following which the Minister of Finance presents a draft budget to Cabinet. Cabinet discussion of the budget has been enhanced by the establishment of a Cabinet Budget Committee, chaired by the Deputy Prime Minister and comprising the Minister of Finance and eight other ministers. Following the Cabinet discussion and approval, the draft Estimates are presented to Parliament in mid-February, to be passed before the financial year commences on April 1. Although this schedule leaves little time for an effective review by Parliament, it has been approved by the legislature in a timely manner.

III. CREDIBILITY OF THE BUDGET

3.6 **The lack of effective and credible budget preparation is a serious weakness in Lesotho's PFM, particularly on the expenditure front.** Budget allocations in Lesotho have largely been made on an incremental basis, focused on inputs and without much regard to the purpose of public expenditure. Until recently, the expenditure ceilings were set without consultation with line ministries and the setting of ceilings was seen primarily as a technical exercise based on projections from the past. As a result, allocations for several ministries have largely grown in line with the total expenditures over the last five years. Actual expenditures at the end of the year vary widely from the original budget for many line ministries.

3.7 **Deviations of aggregate and most categories of domestic revenues from budgeted amounts are generally low.** During the last six years ending in FY2004/05, with the exception of 2003/04 in which value-added tax at the higher standard rate of 14 percent replaced sales tax at the standard rate of 10 percent, resulting in considerable increase in the tax revenues, the variation of total revenues from original annual budgets were between –2.4 percent in 2002/03 and + 6.7 percent in 2003/04. This generally suggests a reasonably good revenue projection capability in Lesotho. On the composition of revenues, non-tax revenues (mainly administrative fees, service charges, and fines that are collected by several line ministries) have seen more negative fluctuations than the tax revenues collected by the MFDP. The share of non-tax revenues in total government revenues ranges between 20 to 25 percent. More policy analysis and strengthening revenue projection capacity in the collection of non-tax revenues are necessary, as, with the exception of 2002/03, their collection was well below original budgets. Realism of revenue projections is presented in Table 3.1.

Table 3.1: Revenue outturn compared to original budgets in 2002/03-2004/05
(in millions of maloti)

	2002/2003			2003/2004			2004/2005		
MINISTRIES AND MAIN REVENUE ITEMS	Budget	Act.	variation (percent)	Budget	Act.	variation (percent)	Budget	Act.	variation (percent)
Finance	2,534	2,477	-2.3	2,571	2,794	8.7	3,593	3,574	-0.5
Taxes on income and Profits	711	663	-6.7	760	853	12.1	902	902	-
Taxes on international trade	1,470	1,470	0.0	1,422	1,422	0.0	2,012	2,012	0.0
Sales and value added tax	354	344	-2.8	389	519	33.6	678	660	-2.7
Other ministries mainly non-tax revenue	576	558	-3.2	633	623	-1.5	640	596	-6.9
Total Revenue	**3,110**	**3,035**	**-2.4**	**3,204**	**3,417**	**6.7**	**4,233**	**4,170**	**-1.5**

Source: Ministry of Finance and Development Planning-Budget and Treasury Departments.

3.8 **Differences between original budgets and expenditure outturns, both at the aggregate level and in line ministries are present across the board, and at times are very wide reflecting insufficient credibility of the original budgets.** It should be noted that actual data representing out-turns for expenditures is defined as payment orders issued by the Treasury Department against budget classifications, which are recorded in the actual columns of the budget documents for preceding years. These data are not based on reconciled government accounting records with its banking transactions, and, therefore, are not based on government-closed accounts. For a number of recent years, the government accounts have not been closed and have not been submitted to the Auditor General. To assess the size, composition, and reasons of these deviations, there is a need to address recurrent and capital expenditures separately, as the sources and causes of the variations are substantially different for capital and recurrent expenditures. It should also be noted that in Lesotho, like many other countries, capital expenditures do not reflect exclusively capital formation and asset creation, but include substantial amounts of recurrent expenditures, mainly financed through external grants. The term "capital expenditures" has been retained here in conformity with the government's budget terminology.

3.9 *Recurrent expenditures.* **Both aggregate recurrent expenditures and their composition vary frequently from original budgets.** From 1999/00 to 2004/05, total actual recurrent expenditures (ministries and debt service combined) varied from original annual budgets between –1.4 percent (2002/03) and –19.3 percent (2004/05). During the same period, total recurrent ministerial expenditures (excluding statutory payments) varied between +3.1 percent and –8.4 percent. These variations are wider when debt related payments are included because, with a few exceptions, interest and principal payments (both domestic and external) are either over-estimated in the original budgets or remain unpaid or both (see Table 3.2).

Table 3.2: Expenditure Outturn Compared to Original Budgets in 1999/2000 - 2004/2005

(in millions of maloti)

MINISTRY	1999/2000 Budget	1999/2000 Actual	1999/2000 Variance	2000/2001 Budget	2000/2001 Actual	2000/2001 Variance	2001/2002 Budget	2001/2002 Actual	2001/2002 Variance	2002/2003 Budget	2002/2003 Actual	2002/2003 Variance	2003/2004 Budget	2003/2004 Actual	2003/2004 Variance	2004/2005 Budget	2004/2005 Est outturn	2004/2005 Variance
AGRICULTURE & FOOD SECURITY	91.9	89.7	-2.4	103.8	99.5	-4.1	120.2	119.7	-0.4	118.0	101.1	-14.3	116.5	116.8	0.3	101.7	98.0	-3.6
HEALTH & SOCIAL WELFARE	160.8	157.5	-2.1	172.1	182.9	6.3	195.5	153.7	-21.4	205.0	246.9	20.4	246.5	249.0	1.0	261.0	270.7	3.7
EDUCATION & TRAINING	462.2	460.0	-0.5	518.2	498.9	-3.7	551.5	679.2	23.2	685.0	541.4	-21.0	747.8	731.8	-2.1	787.0	701.8	-10.8
FINANCE	104.4	86.9	-16.8	89.7	77.8	-13.3	77.5	72.3	-6.7	105.0	81.6	-22.3	134.7	121.2	-10.0	153.1	146.1	-4.5
TRADE & INDUSTRY, CO-OPERATIVES & MARKETING	14.4	15.6	8.3	18.7	18.5	-1.1	19.2	32.2	67.7	23.4	23.9	2.0	28.6	29.3	2.3	37.5	37.8	0.9
DEVELOPMENT PLANNING	101.1	100.6	-0.5	103.6	103.4	-0.2	136.8	136.4	-0.3	143.4	182.5	27.3	225.3	241.0	7.0	299.4	279.5	-6.7
JUSTICE	49.5	48.1	-2.8	50.6	41.3	-18.4	60.4	60.4	-	69.1	72.8	5.3	83.2	78.6	-5.4	91.3	86.4	-5.4
HOME AFFAIRS & PUBLIC SAFETY	121.3	133.9	10.4	127.8	112.0	-12.4	123.5	131.3	6.3	137.6	155.5	13.0	145.6	155.6	6.9	196.9	167.6	-14.9
PRIME MINISTER'S OFFICE	30.4	27.6	-9.2	32.4	25.4	-21.6	32.2	35.8	11.2	31.6	28.8	-9.0	37.9	42.7	12.9	44.6	50.0	12.1
COMMUNICATIONS, SCIENCE & TECHNOLOGY	28.0	19.0	-32.1	32.7	38.8	18.7	30.0	21.9	-27.0	32.0	33.4	4.3	35.7	34.0	-4.6	35.8	35.5	-0.8
LAW & CONSTITUTIONAL AFFAIRS	20.7	19.1	-7.7	20.9	20.3	-2.9	25.1	20.9	-16.7	23.7	23.9	0.6	27.0	24.7	-8.6	28.4	24.9	-12.4
FOREIGN AFFAIRS	74.7	86.1	15.3	85.0	83.9	-1.3	90.5	101.2	11.8	129.9	128.1	-1.4	128.5	104.3	-18.8	127.1	96.8	-23.9
PUBLIC WORKS & TRANSPORT	114.0	106.7	-6.4	114.4	116.4	1.7	121.1	120.9	-0.2	126.5	125.5	-0.8	132.4	127.5	-3.7	122.6	117.6	-4.1
FORESTRY AND LAND RECLAMATION	-	-	-	-	-	-	-	-	-	-	-	-	6.5	5.6	-14.3	28.7	24.6	-14.4
NATURAL RESOURCES	29.9	30.4	1.7	37.3	33.9	-9.1	38.0	36.3	-4.5	42.2	40.1	-4.9	44.4	42.1	-5.0	45.0	42.1	-6.4
EMPLOYMENT & LABOUR	9.1	8.5	-6.6	10.2	12.9	26.5	16.1	12.2	-24.2	17.3	19.4	12.4	16.5	15.4	-6.6	18.3	17.5	-4.4
TOURISM, ENVIRONMENT & CULTURE	19.3	20.5	6.2	22.5	69.2	207.6	18.2	21.9	20.3	28.3	21.2	-25.1	24.3	21.3	-12.3	30.8	29.8	-3.3
AUDITOR GENERAL'S OFFICE	5.6	5.6	-	7.0	6.3	-10.0	7.4	7.5	1.4	8.4	6.3	-25.0	8.9	7.8	-11.9	10.0	9.0	-9.7
HIS MAJESTY'S OFFICE	4.6	4.7	2.2	6.0	9.0	50.0	6.1	5.7	-6.6	6.5	6.1	-7.5	6.4	7.3	14.6	7.4	5.2	-30.0
PUBLIC SERVICE COMMISSION	1.8	2.0	11.1	2.4	2.3	-4.2	2.4	2.9	20.8	2.7	2.6	-5.0	3.1	3.3	5.1	3.3	3.5	5.7
PENSION AND GRATUITIES	40.3	53.2	32.0	53.0	65.1	22.8	64.0	80.2	25.3	73.0	97.8	33.9	116.2	108.8	-6.3	186.7	175.8	-5.9
STATUTORY SALARIES & ALLOWANCES	4.9	5.0	2.0	5.3	5.3	-	5.5	3.8	-30.9	5.6	5.5	-2.2	-	6.9	-	-	8.6	-
SUBSCRIPTIONS TO INT. FIN.	4.6	5.3	15.2	5.5	2.3	-58.2	1.6	3.9	143.8	3.0	3.0	-	4.0	0.5	-87.5	-	-	-
REFUNDS OF ERRONEOUS RECEIPTS	6.0	6.0	-	6.0	6.0	-	6.0	1.0	-83.3	2.0	2.0	-	2.0	1.6	-20.0	2.0	0.5	-75.0
DEFENCE & NATIONAL SECURITY	165.6	164.3	-0.8	170.3	195.2	14.6	194.7	190.2	-2.3	178.3	206.2	15.7	189.4	198.2	4.6	215.4	212.3	-1.5
NATIONAL ASSEMBLY	14.0	12.3	-12.1	17.6	11.1	-36.9	17.1	4.8	-71.9	21.3	6.6	-69.2	24.3	24.9	2.6	23.7	23.3	-1.5
SENATE	5.3	9.1	71.7	6.4	8.1	26.6	4.8	6.4	33.3	7.8	7.7	-1.2	7.7	6.5	-15.1	9.4	6.9	-26.7
OMBUDSMAN	1.5	1.5	-	1.5	1.7	13.3	2.2	2.7	22.7	2.4	2.1	-11.4	2.6	2.5	-5.2	3.2	2.7	-15.1
INDEPENDENT ELECTORAL COMMISSION	12.8	13.3	3.9	89.2	8.8	-90.1	100.7	72.2	-28.3	67.5	66.9	-0.9	153.0	20.8	-86.4	108.6	52.1	-52.0
LOCAL GOVERNMENT	73.1	57.9	-20.8	78.7	85.6	8.8	78.7	81.5	3.6	95.5	94.3	-1.3	97.6	94.0	-3.7	101.4	96.3	-5.1
GENDER, YOUTH, SPORTS & RECREATION	10.0	8.8	-12.0	12.9	12.1	-6.2	15.0	9.6	-36.0	18.3	18.4	0.4	20.9	19.6	-6.5	25.6	24.9	-2.6
PUBLIC SERVICE	9.7	11.3	16.5	11.2	11.5	2.7	12.4	13.7	10.5	13.5	15.6	15.3	14.8	12.4	-16.1	15.7	12.3	-21.9
SUB - TOTAL -- MINISTRIES	**1,791.5**	**1,770.5**	**-1.2**	**2,012.9**	**1,965.5**	**-2.4**	**2,174.4**	**2,242.4**	**3.1**	**2,424.1**	**2,367.2**	**-2.3**	**2,832.1**	**2,656.0**	**-6.2**	**3,121.7**	**2,860.1**	**-8.4**
PRINCIPAL REPAYMENTS	218.9	266.3	21.7	439.1	202.8	-53.8	402.2	112.8	-72.0	267.3	277.6	3.9	388.9	272.7	-29.9	527.0	134.6	-74.5
INTEREST CHARGES	279.5	206.9	-26.0	237.6	260.5	9.6	215.5	78.5	-63.6	214.3	220.3	2.8	208.9	224.4	7.4	216.1	124.4	-42.4
GRAND TOTAL	**2,289.9**	**2,243.7**	**-2.0**	**2,689.6**	**2,428.8**	**-9.7**	**2,792.1**	**2,433.7**	**-12.8**	**2,905.6**	**2,865.2**	**-1.4**	**3,429.9**	**3,153.1**	**-8.1**	**3,864.9**	**3,119.1**	**-19.3**

3.10 **Actual expenditures of individual line ministries vary from original budgets frequently.** These variations are very widespread, and apply to almost all ministries. Large differences in some years can be explained by specific events, such as postponement of elections or decisions on pension payments and salary increases mid-year. However, these cannot fully explain the wide-ranging differences between original budgets and their corresponding out-turn figures – reflecting over- as well as under-spending. These differences are largely due to weak institutional and legal arrangements of the budget preparation and execution processes, as well as capacity constraints. Weaknesses in the budget preparation process contributed to over- or under-estimation of ministry resource requirements, including oversight of accumulated arrears and other potential liabilities in the budget preparation process, and perhaps the most important, possibility of easy virements (see further below). The annual budgets were not always treated as the final resource allocation decisions either by the MFDP or line ministries as revised and supplementary budgets were often resorted to.

3.11 **Although the annual budget documents submitted to Parliament are very detailed, the appropriation structure is highly summarized, with one total spending limit approved by Parliament for each ministry**. There is no limit for changing of the appropriations (approved expenditures) within the budget of a ministry, but only the decision of the MFDP in responding to requests of the line ministries. This encourages the ministries to frequently apply for reallocation of their budgets as printed in the budget document during the fiscal year. On the surface, the process does not make any changes in the total expenditures of a ministry in a budget year, but the composition of allocations among its published programs and expenditure items, which in reality determines budget policies, can change in an ad hoc manner and without legislative oversight and scrutiny.

3.12 **Financing of under budgeted or unbudgeted expenditures in the absence of a comprehensive and modern legal framework for budget management is relatively easy**. In the legal context, two lump-sum amounts announced in the annual budget document–Contingency Fund and Advances–as well as supplementary budgets provide financing for increased ministerial budgets. This is because additional spending from the Contingency Fund and even supplementary budgets are only submitted to Parliament after the event for ratification rather than before spending for its approval. It is important to note that neither the relatively small amount of Advances nor the substantial amount of Contingency Fund announced in the annual budget documents are included in the total expenditures of a budget year, but only some lump sum authorizations for additional payments during the year.[31] These additional expenditures by some ministries are financed through under-spending in other ministries, unpaid debt service (savings), and additional revenues collected in some years.

3.13 **Under-spending in many line ministries reflects poor planning and lack of capacity.** A number of factors lie behind the problems of absorptive capacity. The lack of timely fiscal data by ministry and budget head mean that line ministries are often unaware of the availability of resources. Capacity in the Districts is also low both for implementation (creating bottle-necks in the use of resources) and in reporting the use of resources. These problems are compounded in some cases by the lack of commitment to execute planned expenditures.

[31] Annual Contingency Fund provision varied between M63 million to M140 million during 1999/2000-2004/2005.

3.14 ***Capital expenditures*. Variations in outturn of capital expenditures from budget estimates are very high**. During the last six years, average annual capital expenditure outturns compared to original budgets were around 70 percent, indicating a substantial lack of budget realism. The implementation rate for domestically financed capital expenditure averaged 66 percent, that of loans was 79 percent, and spending from external grants amounted to 63 percent. This is due to uncertainties associated with external loans and grants at the budget preparation phase and lack of reliable data on their actual transactions. Although some data on loan utilization are available in the debt management unit, delays in reporting from that unit to the Treasury Department hinder the provision of timely and accurate data, especially on that part of the loans that are tendered and spent outside the country by the creditors. Data on expenditure financed through external grants should be treated with special care. Unlike data on actual capital expenditures financed by GoL and on expenditures financed by external loans, which are reported by the Treasury Department, data on expenditures financed by external grants are not very reliable. Problems with data quality in the case of spending from external grants arise from two factors: first, donors do not report on the amounts that they spend on goods and services outside Lesotho. Second, the cash component of the external grants that are spent in Lesotho, by-pass the Treasury Department as their accounting and banking are operated by the line ministries outside the central treasury system. Unfortunately, line ministries do not prepare timely reports on these expenditures, although by law all government transactions should be reported to the Treasury Department.

3.15 **Apart from the low data quality issue, optimistic and unrealistic budgeting has been a major source of variance in the case of expenditures funded by external loans and grants.** On the loan side, portioning of the annual components of a multi-year loan contract has proved to be difficult due to administrative hurdles, which make the original budgets unrealistic. In the case of grants, often both donors and the Lesotho government assume that the pledges will be implemented as planned, but here again administrative hurdles and capacity limitations cause delays and make the budgets unrealistic. In sum, optimistic budget assumptions, weak budget execution, and weak data contribute to the high variance between budget and actual expenditures.

Recommendations

- Establish a baseline analysis by comparing the 2005/06 budget allocations with actual expenditures for 2004/05.
- Identify the line ministries that have the largest variance between budget estimate and prior year actual expenditure (this will indicate potential areas of over or under-budgeting).
- Identify the main causes for each of those cases and develop a framework for reconciling the differences between the cost drivers leading to the variance and the budget estimates.

IV. BUDGET COMPREHENSIVENESS

3.16 **The budget is quite comprehensive, and this situation has improved over the past few years**. The ministries of Planning and Finance were merged in 2003 to form MFDP. However, the preparation of recurrent and development still remains separate and operates in parallel, leading to some disconnect between the two budgets. For example, provision of funding for a capital project without the provision of the necessary recurrent funding to operate it undermines the credibility of the budget. The recurrent and capital budgets are separate parts of the Estimates document but covered by the same budget circular. Integration is proceeding further with moves within MFDP to have one department review budget bids for both capital and recurrent expenditures for each ministry. However, for the moment there remains a separate budget dialogue on the two components. This is also reflected in the fact that in line ministries the planning director manages capital expenditure, including liaison with international donors and the required project financial reporting, and the financial controller manages the recurrent expenditure.

3.17 **Most donor funding in the form of loans is included in the capital budget but substantial donor assistance in the form of grants remains off-budget.** Of the total capital budget of M1,043 million in the 2005/06 estimates, some M547 million is provided by about 30 donors–M273 million by grants and M275 million by loans. The capital component of the estimates document may include some recurrent expenditures for special projects e.g. for new donor funded projects.

3.18 **Some expenditures slip through budgetary controls because of weak reporting and accounting systems**. While the level of unreported extra-budgetary expenditure appears to be limited, data are not available in a systematic way to ascertain that. Below the line (BTL) transactions constitute a potential problem in budget comprehensiveness and fiscal transparency. BTL accounts cover transactions which are not included in the budget. Some of them are advances and imprest, deposits and clearing accounts which can and should be cleared by the end of the year, and which do not constitute government revenues and expenditures. However they also include trading accounts and special funds which involve government revenues and expenditures, but are not shown as part of the budget. Of the trading accounts, the largest covers government printing and stationery activities.[32] There are also some similar special funds covering the operations of the Post Office and the government vehicle fleet. Payments for some these operations are made through the GOLFIS central accounting system with its attendant problems and some are made outside GOLFIS. The Budget Circular requires a separate operating budget to be submitted for each such account and there are various requirements for these funds to prepare financial statements to be submitted to the Accountant General. However, these requirements have not in general been observed.

3.19 **The operations of parastatals and public enterprises are not fully included in the government budgeting system**. There are five major and several smaller parastatals in Lesotho.[33] However the relationship with the budget of most of these institutions – advances made and dividends or interest received is unclear from the Estimates document.[34] Revenues shown under MFDP also include a single amount for dividends but no indication as to the attribution to the different parastatals. In terms of reporting on parastatals in the Public

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[32] Note 14 to the 2002/3 Public Accounts.

[33] The major parastatals are Lesotho National Development Corporation, Lesotho Sun Hotels, Lesotho Telecommunications Authority, Lesotho Electricity Authority, Lesotho Water and Sewerage Authority.

[34] Revenues shown under MFDP include profits or dividend from the Central Bank, although it is not technically a parastatal.

Accounts, the Auditor-General's report on the 2002-03 financial statements notes that neither loans of M149 million due from parastatals nor the amount of the government investment in parastatals are shown as assets. This, coupled with the frequent lack of timely financial statements suggests inadequate oversight by MFDP of the financial operations of parastatals, thus increasing the level of fiscal risk because of the contingent liabilities involved in those which are business enterprises.

3.20 **The Estimates document is extensive but its presentation limits the ability of Parliament and civil society to monitor government policies.** It covers recurrent and capital expenditures proposed for the ensuing year, budget figures and projected outturn for the current year (which ends about two months later), along with actual figures for the previous budget year. However, information on financial transactions and relationships between the budget and parastatals are not well disclosed. Further, the budget documentation lacks adequate information on fiscal risks, including contingent liabilities.

Recommendations

- Strengthen integration of the recurrent and capital budgets by carefully accounting for the recurrent cost implications of capital expenditures.
- Improve the quality of the budget documentation by providing information on fiscal risks, including contingent liabilities, operations of parastatals.
- Enforce regulations and controls on reporting of all government receipts and expenditures.
- Establish a system to improve coverage of donor executed projects and grants in the budget.
- Provide a detailed Estimates document and in due course, budget execution reports on the MFDP website, as it is developed.

V. BUDGET AND ACCOUNTING CLASSIFICATION

3.21 **Existing budget classification is not sufficiently disaggregated**. It does not facilitate a linkage of the allocation of public resources to GoL's poverty reduction and other development objectives outlined in the PRS. Because the budget structure is limited to an administrative and very broad economic classification, it often obscures the major activities and programs being carried out by the government within and across sectors. For revenues, the classification system is based on 33 heads (or administrative entities) - 20 ministries plus other authorities. For expenditure classification, there are 44 heads, which also include certain standing appropriations such as principal repayment and interest charges on the public debt, pensions and other statutory payments. The number of heads varies with portfolio allocations.

While a program classification is used, programs are a mixture of activities, organizational sub-units or groups of objects and sub-programs. For recurrent expenditures the economic classification has a basic code of 10 digits. The economic classification comprises five broad headings: (i) personal emoluments, (ii) travel and transport, (iii) operating costs, (iv) special expenses, and (v) grants and subscriptions. These are further broken down into some 43 inputs, some of which are further disaggregated. In addition, within each ministry, 3.22 expenditures are broken down by "programs"–most of which relate to geographical areas of the country. While the recurrent budget is broken down by administrative and economic classification, the capital budget is based on individual projects and does not follow the same classification as the recurrent budget.

3.23 **Functional and program classification is weak**. MFDP has started presenting estimates based on functional classification from the 2005-06 budget onwards.[35] The current classification does not reflect well-defined programs, and neither the economic nor the functional classification conforms to international standards.[36] It is also not wholly consistent with GFS. The development of the new IFMIS provides the opportunity to reform the budget and accounting classification. With the move to an MTEF and a more performance-oriented budgeting system under the PFM reform program, a more meaningful program classification of expenditure will need to be developed. This process has started for the MTEF pilot ministries.

Recommendation

- Develop an economic and functional classification system consistent with GFS and develop an appropriate program classification.

VI. BUDGET EXECUTION

3.24 **Persistent problems relating to budget execution, internal controls and fiscal reporting have undermined the PFM system in Lesotho.** Budget execution is controlled by a system of quarterly warrants to release funds to ministries. A cash flow forecast is prepared at the beginning of each year and is updated during the year, though not on a quarterly basis. Given Lesotho's relatively healthy fiscal position in the last several years, no cash rationing in the allocation of funds to line ministries has been necessary. Funding to line ministries is therefore reasonably predictable. There is no formal system of commitment control although the ministries are required to record commitments in their vote books. The MFDP has no particular knowledge of, or system for, identifying expenditure arrears, apart from noting old invoices that line ministries may submit with their payment requests. Funds cannot be transferred between heads of expenditure except with Cabinet approval. Funds may be transferred between economic items (other than salaries) at any time during the year with the approval of the Minister of Finance, thus providing a relatively liberal virement authority. There is a Budget Contingency Fund of about two percent of total expenditures – M106 million in 2005/06 (this included M31.6 million for the newly established National AIDS Commission which had not had the opportunity to submit a detailed budget) – set aside for urgent unforeseen expenditure and controlled by the Minister of Finance. Use of the reserve is required to be regularized by supplementary appropriations during the year. Likewise any over-expenditure of items is required to be regularized by the passing of a supplementary appropriation. However, these requirements are not necessarily observed, leading the Auditor General to refer to such cases as "unauthorized over-spending."

3.25 **There is no formal provision for a regular review of budget execution**. However, in practice such a review may occur depending on the need. Supplementary estimates may be

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[35] The functional classification also appeared in the annual estimates up to 2002/03 (page 11 of the summary).

[36] However, a functional classification of expenditures is now presented in an appendix to the Budget Speech.

requested by individual ministries at any time throughout the year, depending on their needs. However this reporting on budget execution is of poor quality. The GOLFIS does not provide regular reporting to enable either MFDP or line ministries to monitor their expenditures against budget. The information produced by GOLFIS and the monthly information coming from line ministries is not reconciled. Ministries must make use of their own "top drawer" monitoring systems, which frequently contain unreliable information. For aggregate budget monitoring, the Budget Office considers the reports produced by Treasury as unreliable and therefore uses information prepared by the MFDP Fiscal Analysis and Policy Unit, which reflects data from the Central Bank at a relatively high level of aggregation.[37]

3.26 **This review has been formalized starting with the 2006/07 budget**. The Cabinet Budget Committee has been charged with the mandate to monitor budget implementation and performance throughout the year. This will involve the following tasks; ensuring that budget resources are allocated to priorities that have been approved by government; ensuring that ministries receive budget allocations in accordance with clear and precise implementation plans that will use funds expeditiously; and monitoring financial expenditures and physical progress of project implementation on a quarterly and half yearly basis and propose to Cabinet reallocation of resources from slow spending programs to fast moving ones.[38]

3.27 **The internal control climate is poor**. This is repeatedly pointed out in the Auditor General's reports. Internal controls are the checks and balances in the day-to-day procedures, such as compliance of laws, rules and regulation governing public finance, procurement, payroll, accounting, reporting, and internal audit in each government ministry and agency. The Auditor General reports on a persistent pattern of failure to observe basic financial control requirements, as highlighted in Box 3.1. This is largely attributed to ignorance of the requirements, reflecting a lack of training or accessible documentation of requirements, and lack of consequences for failure to comply–an incentives issue. This includes failure to discipline officers who do not observe the requirements of the finance regulations, or even clearly misuse public funds. The financial controllers[39] need to take a more proactive role in ensuring financial probity in their ministries. This may be both a matter of training as well as incentives.

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[37] A fiscal reporting group comprising representatives of Treasury and FAPU has been established to look at reducing reliance on FAPU reports in monitoring budget execution.

[38] Budget Speech 2006/07.

[39] The financial controllers are part of the accounting cadre of the public service that comprises some 1,000 staff in total at various levels who report to the AGO. There are both quantitative and qualitative deficiencies in this cadre. The government finds it difficult to recruit and retain qualified accounting staff because of low salaries compared with those offered in the private sector, including in South Africa. In addition, the degree courses offered by the NUL and the degree and certificate course offered by the Lesotho Institute of Accountants contain insufficient emphasis on government accounting issues.

Box 3.1: Lesotho: Selected Internal Control Weaknesses

- Significant errors in posting and classification of information;
- Failure to carry out reconciliations between the Vote book records of individual ministries and the central accounting system (GOLFIS), reflected in high level of unreconciled balances;
- Failure to reconcile bank accounts on a monthly basis, as required (AG reports unreconciled balances of M2.1 billion as at March 31, 2003);
- Failure to account for advances which are made for a wide variety of purposes, resulting in final expenditures never being brought to account (Auditor General's report on the 2002/3 financial statements refers to unrequited advances of M10 million, much of this to ministers, members of parliament, and statutory office holders;
- Expenditure charged to below-the-line accounts outside of GOLFIS and other payments made outside of GOLFIS;
- Inadequate controls over both revenues and assets, leading to losses through disappearance and/or misuse;
- Use of expenditures for purposes not authorized by the budget appropriation and unauthorized excess expenditures – M46 million in 2002/3.

3.28 **There is also a need to ensure that there are consequences of non-compliance with financial management requirements**. The Principal Secretary (PS) of MFDP has adequate powers to surcharge officers where losses have occurred or where requirements have not otherwise been met. Common examples of such failings are set out in the Auditor General's reports and include failure to safeguard assets reflected in negligence in handling cash (leading to cash deficiencies) and reckless driving leading to loss of damage to government vehicles. While the parallel powers of PSs to discipline their staff for misconduct are clear, there appears to be a need for wider use of these powers. However, this power needs to be properly used[40] and there is a need for clear signals from both the PS MFDP and the PSs of line ministries as chief accounting officers, that financial management requirements must be observed.

3.29 **The internal audit in Lesotho is highly centralized.** It is headed by the Chief Internal Auditor based at the MFDP and having 26 internal auditors with very limited capacity. Only 6 internal auditors are members of the Internal Auditors Institute of South Africa, which provides some scope to improve professional knowledge. About seven ministries are audited per year based on an audit plan considering some perceived risks. The annual internal audit work plan is approved by the PS MFDP, but it is not discussed with the Auditor General, thus missing an opportunity for coordination in the use of professional audit resources. All internal audit reports are sent to the PS of the relevant line ministry and to the Auditor General, as well as to the PS Finance and to the Accountant General. Its work seems little understood by line ministries and it does not appear that its reports are acted on. There is a general perception that the internal audit unit has little impact, that there is little evidence that internal audit reports are even read, let

[40] There is anecdotal evidence of a PS of a line ministry suspending two accounting staff because they were seeking to observe financial management requirements, against his wishes.

alone acted on, and that many public servants are not aware of their existence. In general, where this work is known it is perceived the same as external audit.

3.30 **No modern system of evaluating risks in the operations of the ministries is used and the principal accounting officers are rarely consulted while evaluating the risks.** The biggest challenge in this exercise has been finding well-kept records in ministries and departments for auditing purposes. Given that there is currently no law governing the internal audit function and no established policy/regulations for internal control, perhaps the very initial step would be to put in place the legal and regulatory basis for internal control and audit, for instance, through the introduction of an Internal Audit manual and Internal Audit Charter.

3.31 **Decentralization of the internal audit function into ministries and institutionalization of pre-audits are also important as a strategy for revamping internal control and auditing within the GoL.** The establishment of an effective internal audit will also require extensive training in relevant areas. Under the PFM reform program [41] the Internal Audit Department's work has been reviewed by a consultant and it is intended to move to a "hybrid" arrangement, under which staff will be allocated to and physically based in line ministries, reporting to the PS of that ministry but receiving professional support from MFDP, thus continuing to operate as a professional group. This is in effect a "half-way house" between the present position as being part of MFDP and the alternative of being separate units working only to the PS of the line ministry. This proposal seems appropriate to Lesotho's circumstances and should increase the impact of internal audit. This new arrangement will start as a pilot in three ministries–MFDP, Education and Justice–with each internal audit unit comprising two to three staff so as to obtain some minimum critical mass. The Ministry of Defense has also expressed a desire for its own separate unit. A proposal is currently being developed to substantially expand internal audit staff numbers to a total of 96, and this will be discussed with MFDP, before presenting the proposal to MPS. However, this proposal would also need to be considered within the context of total resources needed for audit within the public sector, including staffing of the Auditor General's Office (AGO), which is discussed below.

Recommendations

- To overcome the culture of non-compliance action should be taken on two fronts: (a) providing adequate training on financial management requirements and responsibilities, and (b) sending clear signals by principal secretaries as the chief accounting officer of their ministry and AGO, that financial management requirements must be observed, through the appropriate use of disciplinary powers, including those of surcharge by the PS, Finance.
- MFDP should take urgent steps to ensure that all outstanding reconciliations are promptly undertaken.
- All costs of audits for non-decentralized internal audit units should be borne by MFDP and not by auditees, so as to maintain audit independence.

[41] The office of the Chief Internal Auditor is a member of both the accounting and the auditing and oversight working groups.

- GoL should proceed with the proposed new arrangements of locating internal audit staff in line ministries, with their prime line of reporting being to the PS of the line ministry, but with coordination and professional support being provided from MFDP.

3.32 **Public accounting in Lesotho is weak and does not meet International Public Sector Accounting Standards.**[42] It is carried out on a cash basis. The government uses GOLFIS, which has numerous weaknesses and is not suitable to prepare timely and reliable financial reports for the government. The accounting system is not integrated with other management systems, such as budgeting and debt management. Because of the heavy reliance on manual accounting and the weaknesses of GOLFIS, the accounting system in Lesotho is susceptible to inaccuracies and delays in financial accounting and reporting. The Auditor General of Lesotho in his report for the year 2002/03, highlighted a number of evidences of poor accounting system, including: (a) non-reconciliation of ministries/departments accounts with Treasury accounts; (b) non-maintenance of proper books of accounts; (c) weak accounting and controls because of inadequacies of the GOLFIS; and (d) mis-postings, as well as misclassifications of expenditures. These are reflected in the number of suspense and clearing accounts used to accumulate unreconciled balances. The Auditor-General's report provided adverse comments on the financial statements because of these errors and omissions in the annual financial statements of the GoL.

3.33 **Although the Auditor General publishes a report on the public accounts which is considered by Parliament's Public Accounts Committee, the annual public accounts are not generally available.** In addition, the form and content of the public accounts as presented is quite unsatisfactory in terms of adequate external fiscal reporting and for the purpose of budget analysis. Formally the public accounts are required to include: (a) an abstract of receipts and payments, (b) the assets and liabilities at the close of the financial year,[43] and (c) such other matters as the National Assembly or the Minister of Finance may require.[44] The accounts are largely limited to a statement of budget execution, focusing on expenditure. They do not provide any meaningful information on the budget balance and assets, liabilities, public debt, and contingent liabilities on payment arrears are not reflected in the financial statements of the government. In addition, there is no meaningful reporting on financial assets and investments in government business undertakings.

3.34 **The capacity of the Office of the Accountant General is inadequate.** More professional staff is required to fulfill its obligation to provide timely reliable financial reports to the line ministries and also to prepare annual financial statements within time as required by the statute. It also requires the replacement of GOLFIS with a more robust IFMIS. The Government is aware of the problem and is planning to put in place an IFMIS supported by appropriate information communication technology infrastructure in due course. The government is fully aware of the need for sustainability of any new system and is exploring the possibility of establishing professional public sector accounting and financial management training program in Lesotho.

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[42] These are issued by the International Federation of Accountants

[43] These two terms are not defined.

[44] No such other matters appear to have been specified.

Recommendations

- MFDP should constitute a task force to develop a strategy to prepare financial statements for 2005/06 that would contain more reliable and complete information. External accounting assistance may be necessary for this. The objective should be to produce financial statements, aligned as closely as possible to the IPSAS standard on cash basis of accounting, that could received an unqualified audit opinion from the Auditor General, subject to resolving the issue of the opening balances.

- The Auditor General and MFDP, with the concurrence of Parliament, should reach agreement on the issue of the opening balances, to avoid the possibility of a disclaimer audit opinion in perpetuity.

3.35 **Management of Cash and Debt**. There are significant deficiencies in the management of cash flows and government bank accounts. Debt accounting is reasonably satisfactory. Loans and guarantees all require the approval of the Minister of Finance and Development Planning.

3.36 **There is no formal system of cash forecasting and management**. As previously recommended by the IMF, there is a need for a central cash management unit within MFDP comprising Treasury, Budget, and FAPU officials, as well as representatives of the Central Bank and the LRA. Based on a new commercial arrangement with the Central Bank as discussed below, such a unit would assist in managing cash flows so as to minimize interest costs. Auditor General reports have identified cases of significant delays in depositing revenues into the government's bank accounts, resulting in large amounts of cash being on hand in some ministries with consequent risks of loss.

3.37 **The current banking arrangements distort the cash management system**. Under the Central Bank of Lesotho Act 2000, the Central Bank is the government's banker. However, outside of Maseru it is necessary for sub-treasuries, projects, and ministry accounting units to use the services of commercial banks for revenue collection and regular payments, such as salaries and pensions. The Central Bank receives regular reports from commercial banks but neither it nor Treasury has full information on the number and purpose of these accounts, and thus such balances cannot be monitored by Treasury. Both the IMF and Price Waterhouse Coopers (PWC) reports have identified the need for an inventory of government accounts held at the commercial banks so that government cash balances can be comprehensively managed.

Recommendations

- Develop transparent fee for service arrangement between the Treasury and the Central Bank, and have the Central Bank pay interest on cash balances, thus providing an incentive for improved cash management.

- Undertake an inventory of accounts held in the commercial banks to consolidate accounts held in the Central Bank into a single treasury account.

- Develop a cash forecasting and planning system under a cash management unit in MFDP, so as to manage cash flows to minimize interest payments and maximize interest receipts.

3.38 **Public Procurement System**. The Lesotho Financial Regulations 1977 mandates the Central Tender Board (CTB) to control and manage all procurement activities of the GoL. The CTB is composed of civil servants, with its chairman drawn from the MFDP and six other members drawn from various ministries and departments. The Chairman and the board members are appointed by the Minister of Finance and are answerable to him. The concerned ministries and departments prepare their own specifications and bidding documents, after authority to purchase has been given by the accounting officer, who is the PS. In most ministries, there are no procurement committees and the chief accounting officers have to appoint ad hoc committees to prepare specifications and guidelines.

3.39 The existing procurement system in Lesotho is intended to function as a decentralized system by virtue of the fact that the ministries prepare bid packages, evaluate the bid, and recommend and sign contracts with the winning bidders. In actual application, the system has effectively been operating as a centralized system because of the low approval thresholds, which results in almost all the procurement being referred to the CTB.

3.40 **The existing procurement law and regulations are inadequate and do not provide the necessary guidance for public procurement in the country.** The regulations do not give the required guidance to either the CTB or the ministries on how to conduct procurement or how to advertise or to deal with open competitive bidding, bid openings, and evaluations of bids. Further, in its present form the framework does not allow for the introduction of new and innovative methods of procurement.

3.41 **Public sector procurement reform has been high on the agenda for public sector reform in Lesotho**. A task force constituted by MFDP identified the following as needed institutional improvements: (i) reviewing the legal and regulatory framework for public procurement to make it more accountable and transparent; (ii) strengthening the capacity of the CTB and its secretariat to enable it to discharge its functions more effectively, including raising the awareness of government ministries, departments, and other stakeholders about the importance of an accountable, transparent, and efficient procurement system; and (iii) considering the possibility of decentralization of procurement to allow ministries and departments to carry out purchases up to a specified threshold.

VII. EXTERNAL ACCOUNTABILITY, AUDITS, LEGISLATURE OVERSIGHT

3.42 **Public Sector Auditing**. In Lesotho, the Office of the Auditor General is an independent institution.[45] The Auditor General is appointed by the King, acting in accordance with the advice of the Prime Minister and can be removed from the office only by the King on the advice of a tribunal. The Auditor General reports directly to Parliament. From a legal perspective, the

[45] The audit of public accounts is a constitutional requirement provided for in Section 117 of the Lesotho Constitution and Section 5 of the Audit Act of 1973. According to these provisions, the Auditor General is required by law to examine all the necessary accounts relating to the Consolidated Fund and other public funds and ascertain whether such reports are properly kept and that money has been expended for purposes for which it was appropriated by the National Assembly. According to Section 6 of the Audit Act 1973, this should be done within 90 days of receipt of the Public Accounts from the Accountant General.

Auditor General's Office is well established with its independence recognized in Lesotho's legislation, including the Constitution. The primary law setting up the institution, the Audit Act of 1973, is, however, quite outdated and needs to be revised. For instance, the Act does not have enforcement clauses with regard to failure by auditees to respond to audit queries and does not give the Auditor General authority to engage and dismiss members of his/her staff.

3.43 **The Office of the Auditor General has access to all public records of GoL.** It has the express authority to audit all revenues and expenditure of government, including the military. The Auditor General also audits public enterprises in which the government has financial or other interests and has full powers to investigate the use of money either appropriated or not appropriated by the National Assembly. However, there are no enforcement clauses in the legislation to force Accounting Officers to respond to audit queries. In recent years, Parliament's PAC has stepped in to hold Accounting Officers responsible for responding to audit queries.

3.44 Although public sector auditing in Lesotho is carried out in accordance with standards set by the International Organization of Supreme Audit Institutions and the International Auditing Standards, fiduciary systems in the country cannot be regarded as fully in line with international standards.

3.45 **Although well established, the operations of the office of the Auditor General have been hampered by a number of internal and external factors**. The Auditor General can not perform his constitutional responsibility unless the annual public accounts are submitted in a timely manner. As discussed elsewhere, there are significant weaknesses in the accounting system and also a lack of adequate capacity in the Office of the Accountant General. Accounts were not prepared for the period 1996/97 to 2000/01 and have been prepared with significant delays since then. Other reasons for poor performance of the office include lack of the necessary financial resources and of suitably qualified and skilled audit personnel to discharge its mandate. The office has failed to retain such personnel because its employees are subject to civil service conditions of service and recruitment procedures.

3.46 **The government has recognized the importance of the office of the Auditor General and is putting in place measures to strengthen it.** The office is among the governance offices that are being targeted for strengthening as part of the PFM reforms under the PSIRP. In this connection, the Development Cooperation Ireland (DCI) is providing assistance to the Auditor General to develop manuals, procure computers and audit software, and to support study tours. A new Audit Act, which should strengthen the independence of the Auditor General, is also ready for submission to the Minister of Finance for onward transmission to the Cabinet.

3.47 **Legislative Scrutiny of Public Expenditures.** The Parliament does not have a committee to review the structure of the budget. However, the Public Accounts Committee reviews the Auditor General's report in some depth. But its impact was limited by the time elapsed since the issues covered in the report and by the limited technical capacity and resources allocated to the committee. The committee's report to the Parliament contains recommendations, but there is no evidence of their being acted on.[46] The work of PAC has been constrained by a

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[46] The establishment of PAC is governed by the Public Accounts Committee Order 1972. The PAC comprises 15 members (of a national assembly of 120 members elected for a five year term and an appointed senate of 33 members) of which 8 are from the governing party, but the chairman is from the Opposition. Its constitution and

numbers of factors, including delays in submission of audit findings by the Auditor General's office. This affects the timing and the effectiveness of its legislative oversight role. In addition, the PAC does not have a monitoring mechanism to review the implementation of its recommendation by the executive arms of the government. The committee also lacks technical support, including analytic capacity, and does not have sufficient time, resources, office accommodation, and support staff to effectively carry out its functions. The committee needs to be endowed with adequate resources for it to be able to address its mandate effectively.

3.48 **The Public Accounts Committee has limited capacity.** Since it was reconstituted in 2002, the Committee has issued two reports, in 2004 and 2005, on the public accounts covering the three years to1995/96 and 2001/02, meaning that the issues examined were very dated. Although it may consider any matters concerning the use of public funds, in practical terms the lack of alternative information sources limits it to the reports of the Auditor General on the Public Accounts, which have been late or non-existent. Its reports contain recommendations and are tabled in Parliament and discussed but attract little media attention. There are no formal procedures for follow up, and although the Committee itself could put forward a resolution to Parliament to review implementation of its recommendations, it has not so far done so.

3.49 The Committee has some contact with the southern Africa grouping of public accounts committees and has attended meetings in South Africa, but generally feels isolated from PAC activities and developments in other countries. Clearly it takes considerable time for the Committee to prepare its reports, which the chairman attributes to lack of resources and the need for more training for committee members, many of whom lack knowledge of government financial procedures or the principles of public financial management.

3.50 Following its current work program the Committee will inevitably be dealing with dated material – events that occurred several years ago and that are now of limited interest and the people whose actions are being reviewed may no longer be in place. Because of this, the Committee should consider "ruling a line" under the Auditor General's report on the 2002/03 public accounts and instead focusing on the report on the 2003/04 public accounts, which is about to be tabled by the Auditor General.

3.51 **There is no Parliamentary Estimates Committee to examine the budget ex ante.** Consideration should be given to developing such an arrangement to improve parliamentary oversight of the public finances. One solution would be to vest an estimates role in the PAC, giving it both an ex ante role in reviewing the proposed budget and an ex post role in reviewing the implementation of the budget.

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existence are based solely on Parliamentary standing orders, which provide for it to examine the use of public funds (which appears to also include examination of revenue collection) and to call officials and investigate as necessary. It is not authorized to question policy issues, only questions of administration. It questions principal secretaries and not ministers; although it could call a minister in the case of a specific ministerial decision it wished to review. The chairman states, however, that it has so far operated in a non-partisan manner and calling ministers might compromise this.

Recommendations

- Donors should consider providing support for the training of Committee members and funding some technical staff, possibly using programs already developed by the World Bank Institute.
- The Auditor General should consider providing at least one staff member to provide full-time ongoing technical assistance to the Committee.
- The Committee should consider taking the necessary steps to have its meetings open to the public.
- The Committee should pursue the development of appropriate arrangements for the follow up of its reports by the Executive.
- The Committee should consider not following up the reports of the Auditor General on the public accounts for the years 2001/02 and 2002/03, and instead consider commencing a review of the report on the 2003/04 public accounts when that report is tabled.
- Consider expanding the role of the PAC by providing it with a role to also carry out an ex ante review of the proposed budget as well as its ex post review of public expenditures.
- The Committee should also consider expanding its role to include the review of financial statements of parastatals, once these reports start being tabled to Parliament.

3.52 **Public access to key fiscal information**. Lesotho has historically not had a strong policy favoring proactive release of government-held information. As a result, the public has not been able to access information on issues of public interest, such as government decisions involving procurement, revenue collection, and recovery of loans. Some information is made available through informal channels, as well as tabling in the legislature. One critical way to promote transparency is by bolstering public access to financial and other information though freedom of information legislation. Freedom of information laws, common in several countries across the world, not only provide for routine release of information important for improved accountability but also allow citizens to request information, thus providing a powerful deterrent to malfeasance in government. The government needs to consider routine release of critical financial information, such as public accounts; performance reports; verbatim reports of Parliamentary oversight committees; public debt; assets and liabilities of public servants, including ministers; draft bills, administrative orders, and circulars; financial rules, codes, and laws; details of public works, past and present, including stages of completion; and full information on subsidies, off-budget borrowing, and government investments.

3.53 **Currently, the key aggregate information, except for budget execution reports, is in principle publicly available**. However, in practice the lack of copies may make it difficult to obtain them. For example copies of the Estimates document are in short supply. The MFDP component of the Lesotho government website would be an appropriate repository for this information to become more readily accessible to the public.

VIII. PFM REFORM PROGRAM AND DONOR SUPPORT

3.54 **The PSIRP[47] is a government initiative that is being formulated in collaboration with development partners in response to the need to strengthen good governance as a basis to achieve accelerated growth and poverty reduction.** It is a multidimensional reform package and its objectives are to improve the effectiveness and efficiency of public service delivery and public financial management. It is, therefore, central to the success of the efforts to implement PRS objectives. GoL understands that public sector improvement and reform programs often fail because projects tend to be too complex and attempt to do too much and too quickly with a low capacity base. Consequently, Phase I of the PSIRP sets a horizon with a focus on getting the basics right in few key components as follows, of which public financial management sub-program is a major component:

(i) **Component I: Improving Public Financial Management and Accountability** – seeks to improve public financial management through: (a) a shift to MTEF performance budgeting approach starting from the 2005/06 financial year, supported by the development of a macroeconomic model, to facilitate the achievement of the government's poverty reduction and other development goals; (b) the phased replacement of the GOLFIS through the introduction of an IFMIS; and (c) public procurement reform. In addition, the reform program will strengthen the operation of the Auditor General's Office and assist the Public Accounts Committee to execute its oversight role effectively.

(ii) **Component II: Civil Service Reform** – this is to be implemented through a series of key activities that include an impact assessment of HIV/AIDS for the whole public sector, monitoring of implementation in carefully selected priority areas, and conducting of performance appraisals and incentives for officers in top PRS priority areas.

(iii) **Component III: Decentralization for Service Delivery** – GoL is committed to ensuring the participation of the Basotho people in the development process. This component of the projects is aimed at ensuring that the legislative, fiscal, and institutional framework is in place to implement the provisions of the Local Government Act.

3.55 **Under Component I, three task forces covering the areas of planning and budgeting, accounting and reporting and audit and oversight have been established.** They have each developed a program of deliverables and report to an overarching PFM Improvement and Reform Steering Committee chaired by the PS of MFDP and comprising senior officials of MFDP. An inception report was presented and to and adopted by the government in July 2005. Reflecting its comprehensive or integrated nature it is a medium-term program expected to cover three years up to May 2008 in its initial phase. Technical support is being provided by a new reform unit in MFDP, comprising international consultants plus seconded Lesotho officials.

3.56 **The work of the planning and budgeting task force focuses on integrating planning and budgeting processes through an MTEF**. This includes improving the macroeconomic forecasting capacity and developing medium-term plans and performance measurement systems within individual ministries. However its work is outside the scope of this review.

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47 The reform program is set out in detail in Government of Lesotho, Public Sector Improvement and Reform Program, Public Financial Management Component, Inception Report, July 2005.

3.57 **The work of the accounting and reporting task force aims to develop effective budget execution and reporting systems through amongst other things**, (i) replacement of GOLFIS by an IFMIS which will become operational in 2007, but on a staged basis through an intermediate IFMIS; (ii) increasing training in accounting, IFMIS and internal control issues, including raising the competence of financial controllers and the awareness of chief accounting officers (CAOs); (iii) establishing a new treasury organization within MOF to undertake the new accounting and cash management processes proposed under the IFMIS; (iv) developing the internal audit system into a hybrid arrangement under which internal auditors will report to the top management of the ministry in which they are located, as well as to MFDP; and (v) reforms to the public procurement system based on standardized procurement documentation and streamlining procurement systems.

3.58 **The work of audit and oversight task force** focuses on (i) providing technical support to the Auditor-General's office to increase its technical capacity, and (ii) providing technical support to upgrade the capacity of the Public Accounts Committee.

3.59 **The reform program as a whole is also intended to facilitate the development of new legislation in the form of a new Budget, Financial Management and Accountability Act, which will be developed towards the end of the reform program.** The reform program covers, either specifically or potentially, all the key issues relating to PFM with the exception of reporting by and monitoring of parastatals and developing new commercial arrangements with the Central Bank.

3.60 **Donors' Support**. The Bank and other development partners are providing significant support for PFM reforms and capacity development in PFM. The following table indicates the roles and responsibilities of PFM reform in Lesotho.

Table 3.3: Areas of Intervention in PFM Reforms by Key Development Partners

Areas	DCI	DfID	EU	GTZ	UNDP	WB	AfDB
Capacity development of MFDP			X			X	X
Public finance & budgeting	X	X	X				
Planning, budgeting & MTEF	X	X	X			X	
Macroeconomic management		X	X				
Revenue collection		X					
Procurement	X	X				X	
Parliamentary reform	X		X		X		
Public sector reform						X	
Decentralization	X		X	X	X	X	
Civil societies	X	X					
Combating corruption		X					

Source: Adapted from African Development Bank, Lesotho - Country Governance Profile.

IX. CONCLUSIONS AND NEXT STEPS

3.61 **Lesotho's PFM system has seen several improvements in the last two years, particularly related to budget formulation.** The budget is relatively comprehensive and the budget process operates in an orderly and predictable way. Overall, the budget is generally realistic and credible. However there are some significant variations between budget and actual outcomes for some ministries' recurrent expenditures and a consistent pattern of under-spending of the capital budget, reflecting either over-optimism concerning the ability to implement projects or lack of predictability of donor funding for projects. The budget classification system is also outdated and does not reflect international standards.

3.62 **Despite some budgeting improvements, the PFM system suffers from major deficiencies in budget execution, internal controls and fiscal reporting**. Reliable information to monitor budget execution is not available. Often financial rules and regulations are not observed, leading to over expenditures on individual budget items, some unauthorized expenditures and unreliable financial reporting. Further, the lack of adequate numbers of trained accounting staff has been a major contributing factor to the poor quality of public accounts. The GoL is committed to PFM reforms and capacity development and is implementing the PSIRP, which includes a significant component on PFM with an emphasis on modernization, resource efficiency, transparency, and accountability. The major focus areas are to achieve improvements in planning and budgeting, accounting and reporting and audit and oversight.

3.63 **Challenges for improving PFM performance.** To ensure adequate checks and balances on the executive, internal and external accountability mechanisms on budget performance, public financial management will need to be further strengthened. The Government and donors need to make it a priority measure of working together to strengthen the following areas:

- **Internal Control and internal audit**. Lesotho needs to further strengthen internal control environment in government agencies. The internal audit functions in the governments should be strengthened. The internal audit is centralized only in the MFDP having only 25 staff. The internal audit unit should be gradually decentralized in the line ministries and government agencies for greater effectiveness. The methodology of audit should be revisited, and the government should consider introducing a risk-based audit approach, which would facilitate strategic use of limited audit resources in high-risk areas. In addition, the Government should also strengthen the follow-up mechanism of the findings of the external audits by the executive arms of the Government.

- **Budget and accounting classification**. Existing budget classification is not sufficiently disaggregated and does not facilitate a linkage of the allocation of public resources to GoL's poverty reduction and other development objectives outlined in the PRS. It is not also consistent with GFS. The classification system does include a program and functional classification. The current classification does not reflect well-defined programs, and the economic classification does not conform to international standards. In addition, there is no functional classification based on international standards.[48] The development of the new IFMIS provides the opportunity to reform the budget and accounting classification. In addition, with the move to an MTEF and a more performance-oriented budgeting system under the PFM reform program, a program classification of expenditure will need to be developed. This has already been initiated for the MTEF in pilot ministries.

[48] However, a functional classification of expenditures is now presented in an appendix to the Budget Speech.

- **Accounting and financial management**. To improve the accounting function, the government is introducing an integrated financial management information system. However, introduction of an IFMIS to replace GOLFIS will not solve the accounting problems by itself. IFMIS is expected to facilitate timely preparation of budget reports and the annual financial statements for audit by the Auditor General and submission to the Parliament. However, the following actions have to be taken for a successful implementation of IFMIS: (i) training for chief accounting officers (the principal secretaries) on the importance of sound financial management; (ii) resolving the issue of the lack of opening balances information, due to the absence of financial statements for the five years 1996/97 to 2000/01; (iii) ensuring that reconciliations between GOLFIS and subsidiary systems is undertaken (bank reconciliations, reconciliation of Vote books to GOLFIS); (iv) establishing a working group on irregularity and internal control; and (v) revamping the internal audit function.

- **Cash management**. There is no system of cash management and a central cash management unit is needed. Banking arrangements with the Central Bank do not facilitate proper cash management. There is no treasury single account and there is not full information on the number of government bank accounts held at commercial banks. For implementing the budget as passed by the Parliament, efficient cash management is a pre-condition. In periods of crisis, available cash should support the Government's priority programs, which are essential for poverty alleviation and stimulating the economy. Once the cash is in the treasury accounts, the government needs to ensure that it is spent for the purposes intended, and it does not disappear through leakage.

- **External audit**. The office of the Auditor General is well established. However, its performance is hampered by a number of internal and external factors. Its performance is intricately linked to the performance of other governance institutions, particularly the Accountant General's office.[49] For example, the public accounts of the GoL were not prepared for FY97 – FY00 for which the accounts could not be audited and submitted to the Parliament. To improve the performance of the office of the Auditor General, GoL need to provide adequate human and financial resources. A new Audit Act is being drafted to provide independence to the Auditor General. The Office of the Auditor General is being supported by DCI.

- **Legislative oversight**. The PAC is making progress in reviewing the reports submitted to it by the Auditor General. However, its performance has been hampered due to non-submission of audit reports in a timely manner. The PAC has no monitoring mechanism to review the implementation of its recommendation by the executive arms of the Government. The PAC also needs adequate technical support and adequate logistics to perform its responsibilities.

[49] Report on Governance prepared by AfDB dated February 28, 2006.

CHAPTER 4. STRATEGIC ALLOCATIONS AND BUDGETARY OUTCOMES

I. INTRODUCTION

4.1 **The broad principles guiding public expenditure allocations are based on the need to address market failure to promote growth and improve distribution to reduce poverty.** The former is largely characterized by the absence of competitive markets, existence of externalities and the undersupply of public goods. However, few expenditures fall neatly under one category or another and many expenditures have an effect on growth and poverty reduction, especially when the medium-term as well as the direct and indirect impacts of growth on poverty reduction are considered. Further, it has been generally acknowledged that public economic theory and ongoing research have been inadequate to keep pace with the challenges of development policy and in providing the necessary guidance on expenditure allocation to policy makers.[50] In practice, a country's development objectives and strategies largely define the role of the public and private sector in the economy.

4.2 **Since independence, the GoL has used medium-term planning as the key instrument for coordinating development activities in the country aimed at reducing poverty and raising living standards.** The challenge has been and still is to translate plans into actions that will result in poverty reduction and an improvement in welfare. These plans have been implemented through annual budgets. However, despite the high economic growth rates in the 1970s – 1990s, and high level of public spending, poverty has not been eradicated. With the finalization of the PRS, government efforts are now focused on implementing key policies and strategies identified therein.

II. INTER-SECTORAL ALLOCATIONS AND STRATEGIC PRIORITIES

4.3 **Compared with other African countries, GoL has a large amount of discretionary influence on the pattern of public spending by virtue of its low levels of statutory obligations.** Statutory obligations for debt service and pension and gratuities amount to less than 15 percent of total expenditure, and the remaining 85 percent is subject to the discretionary spending priorities of the government. While inter-sectoral allocations reflect for most part the Government's implicit or explicit priorities, they are not necessarily the result of careful planning to achieve ministerial objectives.

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[50] See "How Does the Composition of Public Spending Matter?" – Paternostro, Rajaram and Tiongson, World Bank Policy Research Working Paper 3555, March 2005.

Table 4.1: Share of Budgeted Recurrent Expenditure

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Agriculture And Food Security	4.0	3.9	4.3	4.2	3.4	2.6
Health & Soc.Welfare	7.0	6.4	7.0	7.4	7.2	6.7
Education & Training	20.2	19.3	19.7	23.4	21.8	20.3
Finance And Dev. Planning.	9.0	7.2	7.7	8.6	10.5	11.7
Trade & Industry, Coop.& Markets	0.6	0.7	0.7	0.8	0.8	1.0
Justice,Human Rights& Reh	2.2	1.9	2.2	2.4	2.4	2.4
Home Affairs&Public Safety	5.3	4.7	4.4	4.7	4.2	5.1
Prime Minister's Office	1.3	1.2	1.2	1.1	1.1	1.2
Communications, Sc. & Tech	1.2	1.2	1.1	1.1	1.0	0.9
Law & Constitutional Affairs	0.9	0.8	0.9	0.9	0.8	0.7
Foreign Affairs	3.3	3.2	3.2	4.4	3.7	3.3
Public Works & Transport	5.0	4.3	4.3	4.3	3.9	3.2
Forestry&Land Reclamation						0.7
Natural Resources	1.3	1.4	1.4	1.5	1.3	1.2
Employment & Labour	0.4	0.4	0.6	0.6	0.5	0.5
Tourism Envir. & Culture	0.8	0.8	0.7	1.0	0.7	0.8
Auditor General's Office	0.2	0.3	0.3	0.3	0.3	0.3
His Majesty's Office	0.2	0.2	0.2	0.2	0.2	0.2
Statutory Payments	24.3	27.8	25.0	19.5	21.3	24.3
Defence & National Security.	7.2	6.3	7.0	6.1	5.5	5.6
National Assembly	0.6	0.7	0.6	0.7	0.7	0.6
Senate	0.2	0.2	0.2	0.3	0.2	0.2
Ombudsman	0.1	0.1	0.1	0.1	0.1	0.1
Independent Elect. Comm.	0.6	3.3	3.6	2.3	4.5	2.8
Local Government	3.2	2.9	2.8	3.2	2.8	2.6
Gender, Youth & Sport.& Rec	0.4	0.5	0.5	0.6	0.6	0.7
Public Service	0.4	0.4	0.4	0.5	0.4	0.4
Total	**100**	**100**	**100**	**100**	**100**	**100**

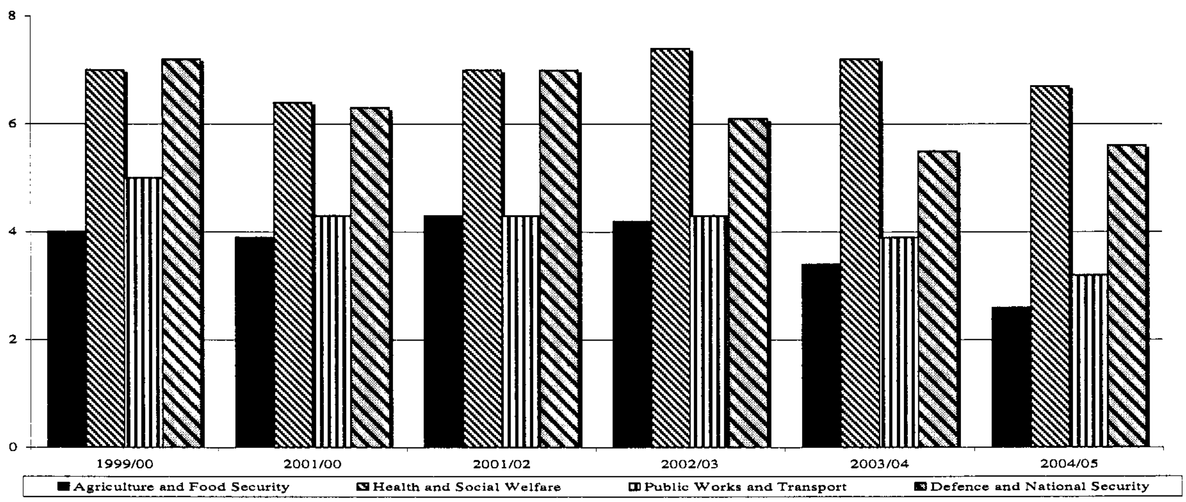
Source: GOL, Budget Estimates documents, various years.

4.4 **The composition of expenditures by function reveals gaps between the national goals and expenditure policy choices.** About 30 percent of current expenditure is taken up by government bureaucracy – general public services. The share of economic services - water, energy and mining, a key priority of the government to boost economic growth, has been declining, with the exception of 2002/03 when the level of agricultural spending was raised to meet famine relief related needs.

4.5 **Social sectors overall account for the largest share of budget allocations at over 40 percent of the total current expenditure**. In particular, the budget allocation for education has grown considerably over time and has absorbed the highest share, accounting for nearly a third of total expenditure in 2004/05. This is one of the highest in the world. Much of the growth in education spending, however, reflects salary payments to a growing number of teachers and school feeding programs associated with the introduction of FPE,[51] as well as the growing costs of tertiary scholarships.[52] As detailed in Chapter 6, resources allocated for essential teaching materials have been largely inadequate.

4.6 General services sectors, in particular, finance and planning, home affairs and national defense and security, have absorbed about 30 percent of the total budget. Allocations for defense and national security, averaging about 7 percent of total recurrent allocations during 1996 – 2005, are high compared to defense expenditures in the other countries in the region. Allocations in the sector have surpassed the allocations for agriculture and food security, averaging just over 4 percent of total recurrent expenditures. They are similar to budgeted allocation to health and social welfare which is more of a priority.

Figure 4.1: Share of Budgeted Recurrent Expenditure
(in percent of total)



Source: GOL, Budget Estimates documents, various years.

4.7 **Given limited resources, there is a need to face the trade-offs in the future if plans are to be translated into actions and results.** Budgetary resources allocated to public works and transport average about four percent of total recurrent expenditures and are declining. There are concerns that important activities like road maintenance are inadequately provided for in the budget. Cost of required annual road maintenance (i.e. routine and periodic maintenance) for the overall network is estimated to be about M90 million (2005/06 - excluding administrative costs). Funding for maintenance has, in the past few years, come from both the RF and the Consolidated Fund. While RF collections of fuel levy and other dedicated sources have been about M30 million annually – only about M23.6 million (or about 27 percent of total needs) have been provided for actual road maintenance, the rest being used to cover the administrative costs of the RF. The budget allocations have been on a downward trend in recent years and were estimated at M36 million in 2005/06 (excluding administrative costs). Combined funding for road

[51] In 2002/03, teacher salaries comprised 66 percent and school feeding accounted for 25 percent of current expenditure for primary education. For secondary education, the share of teacher salaries in current spending was 87 percent.

[52] Tertiary scholarships consisted of 21 percent of total current expenditure for the education sector in 2002/03.

maintenance has therefore been a little short of M60 million, leaving a significant funding gap of over 30 percent. Even accounting for capital expenditures, allocation for the sub-sector is less than for defense and national security. Given the political environment in Lesotho and in the region, and the stated government priority to improve agriculture and food security and develop infrastructure, current allocations suggests that some re-prioritization of expenditures is necessary.

III. LINKAGES BETWEEN THE PRS AND THE BUDGET

4.8 **As an integral part of PRS preparation, detailed activity and cost matrices were developed for each of the nine priorities specified in the PRS.** A total of 438 discrete activities were identified with an estimated cost of M3.7 billion[53] over the three year PRS period. The PRS activity and cost matrices are a useful statement of Government intentions, and they must be incorporated into annual budget allocations in order to be implemented. However, the PRS planning process and the annual budget preparation process proceeded in parallel and largely independently. In order to create stronger links between the PRS and the budget process over the medium-term, a preliminary examination of these links was undertaken for the 2004/05 budget. To assess the approximate level of provision for Year 1 PRS activities in the 2004/05 budget, a government team assigned codes to Year 1 activities, according to whether or not each was funded at least partially in the government budget.[54] The team also undertook an analysis of the budget for 2004/05 and identified poverty reducing activities (these were classified as directly and indirectly poverty reducing) that were not necessarily included in the PRS activity list.

4.9 **The analysis suggests that less than one half of the proposed Year 1 PRS activities were provided for in the 2004/05 budget** (see Appendix 5, Tables I and II). A supplementary analysis taking account of the activity cost estimates revealed that that the 2004/05 budget provided for less than half of the estimated incremental costs of planned Year 1 PRS activities. An analysis of the 2005/06 recurrent budget reveals no perceptible changes. Although the inclusion of all activities required an appraisal, existence of fiscal headroom and increased public sector productivity, the analysis is useful. If not addressed adequately, weak linkages between the proposed activities and the budget allocations could become a potential source of slippage in PRS implementation. A key challenge facing the Government is to compensate for these deficiencies in budget provisions for the PRS in subsequent annual budgets.

4.10 ***Poverty Focus of Government Budget Estimates***. The "real" PRS that can be implemented on the ground is embedded within the annual budget allocations made to each ministry. However, the pattern and boundaries of this "real" PRS can only be identified and rendered monitorable if each of the constituent budget allocations is coded as to its intended poverty impact. All recurrent and development budget allocations in the 2004/05 budget were coded by the Government, according to whether or not each allocation was intended to be poverty-reducing, and if so, whether it was directly- or indirectly-poverty reducing. The analysis was performed at the sub-program level for the 2004/05 recurrent budget level, and at the project

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53 However, this total cost estimate is only partial as only about half of the activities were costed. (see Appendix 5, Tables I and II).

54 Because additional activities were introduced into the matrix after the coding exercise was completed, only about 75 percent of the 429 Year 1 activities in the final matrix were coded.

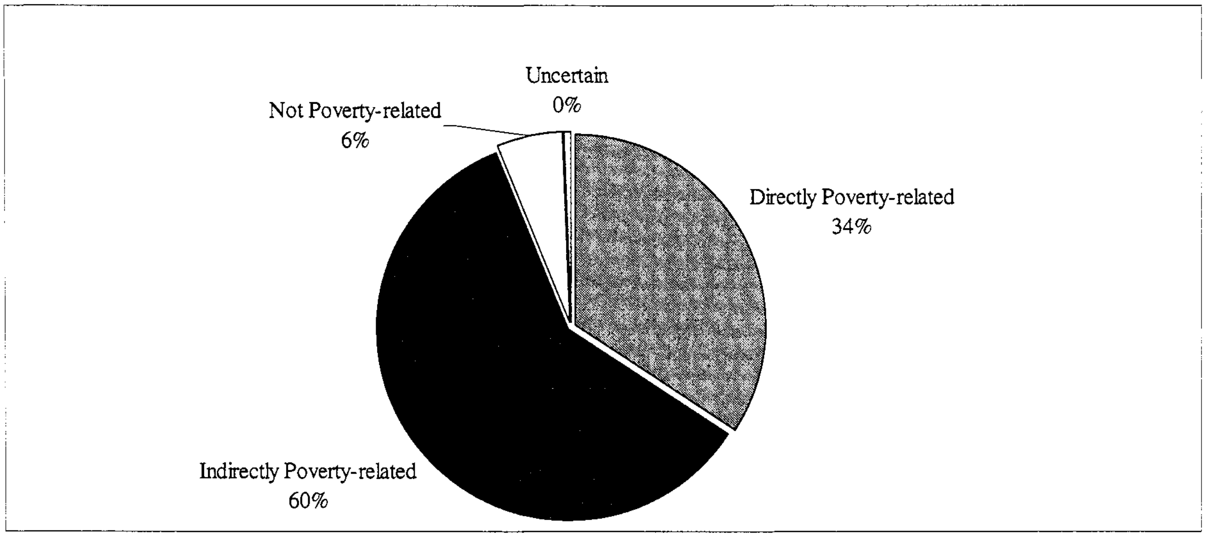
level for the capital budget. All 204 sub-programs in the 2004/05 recurrent budget were coded. These had a total value of M2,671 million. A sub-set of the 2004/05 Capital Budget was coded, consisting of direct ministry allocations for 153 projects with a total value of M804 million[55]. This sub-set, referred to as the "Development Budget" for the purposes of this exercise, constituted 95 percent of the total 2004/05 Capital Budget. This methodology, however, has some limitations and the results should be interpreted with caution. Given the broad definition of PRS priorities, it is possible to claim that most programs are poverty related and have an impact on poverty reduction. Further, some programs may be generally poverty targeted, but some components may benefit the non-poor or the implementing agents.

4.11 **As depicted in Figure 4.2, only 34 percent of the total value of recurrent sub-program level allocations was deemed to be directly poverty-related**. Eight ministries stood out in the analysis as having a high proportion (greater than 60 percent) of their total recurrent budget allocation coded as directly poverty-related. These were: Forestry and Land Reclamation (100 percent); Public Works and Transport (83 percent); Agriculture and Food Security (79 percent); Justice, Human Rights and Rehabilitation (72 percent); Local Government (67 percent); Home Affairs and Public Safety (64 percent); Gender, Youth & Sports and Recreation (63 percent); and the Prime Minister's Office (62 percent).

4.12 **Focusing on the programs in the budget, it is observed that just over one-half (53 percent) of all sub-programs in the 2004/05 recurrent budget were coded as "directly poverty related".** A further 80 sub-programs, representing 39 percent by number and 60 percent by value, were coded as "indirectly poverty-related". However, as noted above this could be due to the broad definition of poverty reducing programs or reflect the bias in interpreting programs by line ministries as poverty reducing. Sub-programs coded as "not poverty-related" or as having "Uncertain" status represented 7 percent of the total sub-program allocations in the recurrent budget.

55 Capital budget items that were not coded included: Defence and National Security; Interest Charges; Pensions and Securities; Foreign Affairs, Contingencies; Independent Electoral Commission; National Assembly; Senate; Auditor General's Office; Statutory Salaries and Allowances; Ombudsman; Refunds on Erroneous Receipts; Subscriptions to International Institutions; and Principal Repayments. Allocations to these items in the 2004/05 budget totalled M39.3 million.

Figure 4.2: Poverty Focus of 2004/05 Recurrent Budget
(percent of total recurrent budget)



Source: PER task team and staff estimates

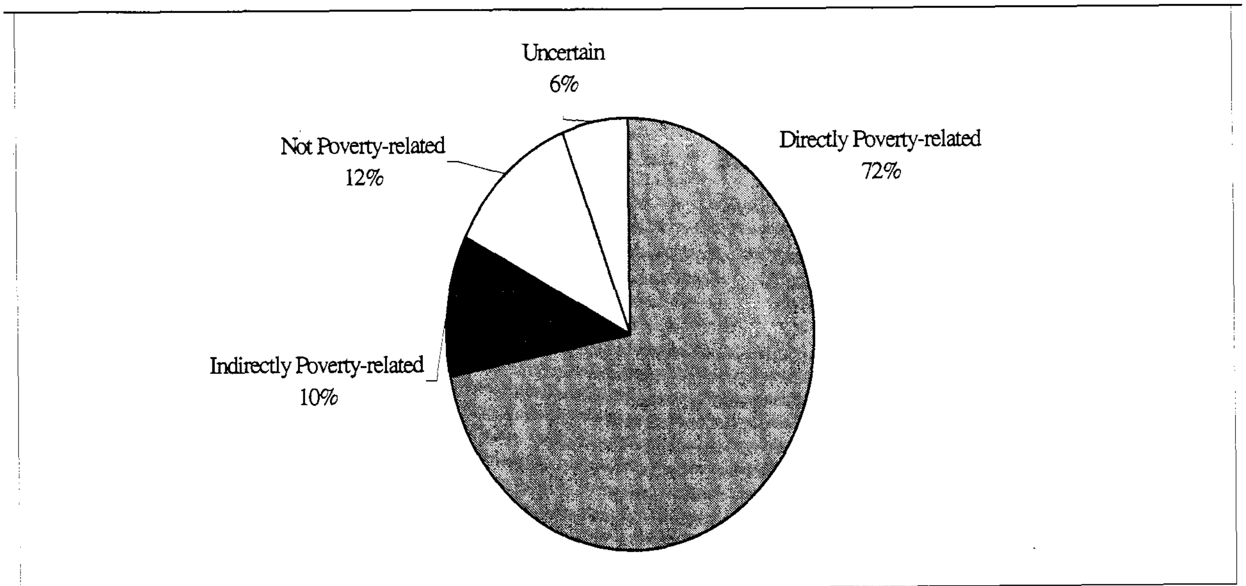
4.13 **With regard to the 2004/05 development budget, it is found that nearly two-thirds of projects in the development budget were coded as directly poverty-related.** This accounted for three-quarters of the total value of development budget allocations (see Figure 4.3 below). Projects coded as indirectly poverty-related constituted 20 percent of projects, and 11 percent of the total development budget allocations. Eighteen percent of the development allocations were either not poverty-related or of uncertain status. Ten of the sixteen ministries receiving development budget allocations showed high levels (90 percent or more) of their allocations coded as directly poverty-related (see Appendix 5, Table IV). It is important to note that capital budget (of which the "development budget" is a subset) only accounts for about 20 percent of the total budget and therefore, the focus should be on both recurrent and capital budget.

4.14 **The level and sectoral distribution of all directly poverty-related allocations account for only 43 percent of the total combined recurrent and development budget in 2004/05.** Table V in Appendix 5 shows the level and distribution of all directly-related poverty allocations in the 2004/05 budget.[56] Taken together, these allocations represent the nearest possible approximation of the "real" PRS in 2004/05. These allocations were spread across 19 ministries.

4.15 **The sector composition of these directly poverty-related budget allocations reveals that allocations to seven lead ministries accounted for over 75 percent of all directly poverty-related allocations in 2004/05.** Education receiving 24 percent and Public Works receiving 17 percent were in the lead.

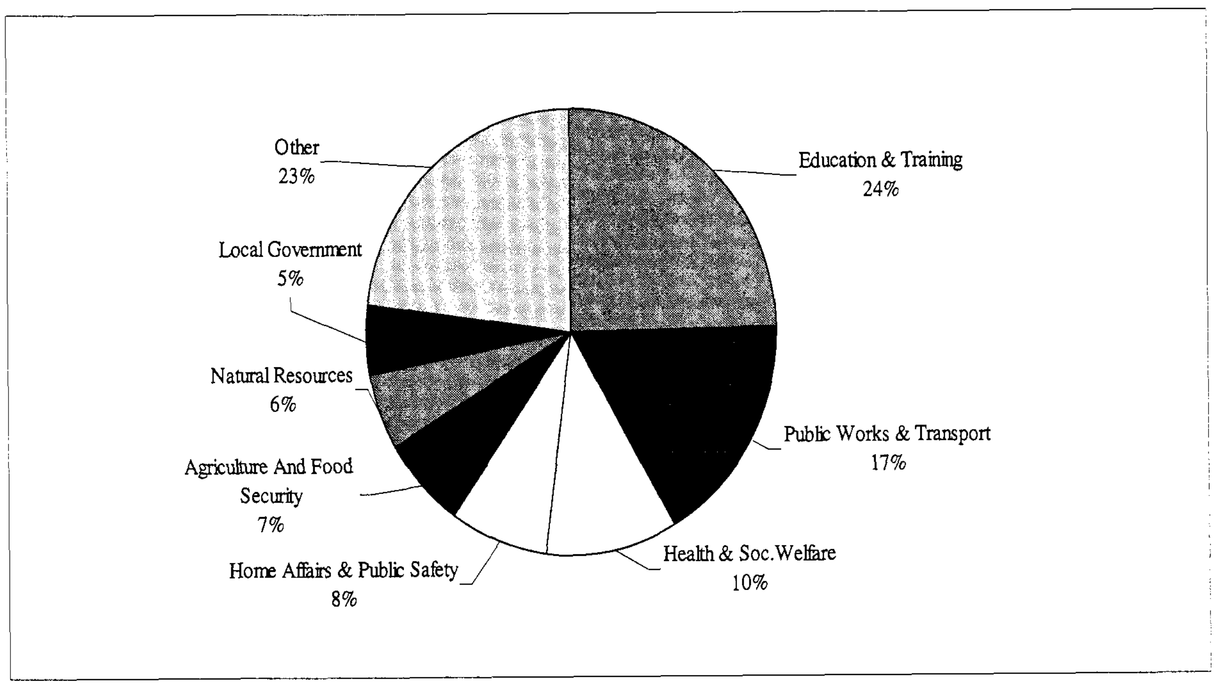
[56] This table was constructed by combining the data sets for the 2004/5 recurrent and development budgets.

Figure 4.3: Poverty Focus of 2004/5 Development Budget
(percent of total development budget)



Source: PER Task Team and Staff Estimates.

Figure 4.4: Sector Composition of all Directly Poverty-Related Items in 2004/05 Budget



Source: PER Task Team and Staff estimates.

4.16 **Five ministries had a particularly high level of direct poverty focus in their 2004/05 budget allocations, with 75 percent or more of their respective allocations coded as directly poverty-related**. These ministries (and their direct poverty focus[57]) are as follows: Forestry & Land Reclamation (100 percent); Public Works and Transport (87 percent); Agriculture and Food Security (82 percent); Prime Minister's Office (77 percent); and Natural Resources (75 percent).

4.17 **The level of congruence between the PRS and the directly poverty-related element of the 2004/05 Budget is limited**. Given perfect linkages between the PRS and the budget allocation processes, all PRS activities would be fully funded in the appropriate annual budget, and at least all directly poverty-related activities in the budget would be associated with one or more activities proposed in the PRS. While a full analysis of the congruence between the PRS and the government budget is not possible given the lack of correspondence between activity labels in the PRS and sub-program or project labels in the budget, a crude assessment of the level of coherence (if not congruence) between the two has been attempted by comparing the patterns of allocation among the lead ministries on the (i) PRS activities in the 2004/05 budget; (ii) PRS Year 1 allocations; and (iii) directly poverty related allocations in the 2004/05 budget (see Table 4.2). To facilitate comparison between these data sets, a stepwise graphical approach is taken. The first and second data sets were charted to test the level of funding of PRS-proposed Year 1 activities in the 2004/05 budget (see Figure 4.5). Then the second and third data sets were charted to test the degree to which actual poverty-related allocations in the 2004/05 budget reflected the strategic priorities as established in the PRS (see Figure 4.6). The variances between the strategic priorities identified in the PRS and the budget allocations are high. At the same time, however, in several ministries the directly poverty related allocations in the budget are higher than the PRS allocations. While some of the discrepancy could be explained by inadequate costing of the PRS, there is a disconnect between the PRS priority activities and the budget allocations. With the slow start to the implementation of the PRS, the 2005/06 budget[58] does not show a major deviation from this pattern.

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57 "Direct Poverty Focus" is here defined as the percent of total recurrent and development allocations to a particular ministry that is comprised of directly poverty-related items.

58 The analysis for 2005/06 is based only on the recurrent budget as development budget data were not readily available at the time.

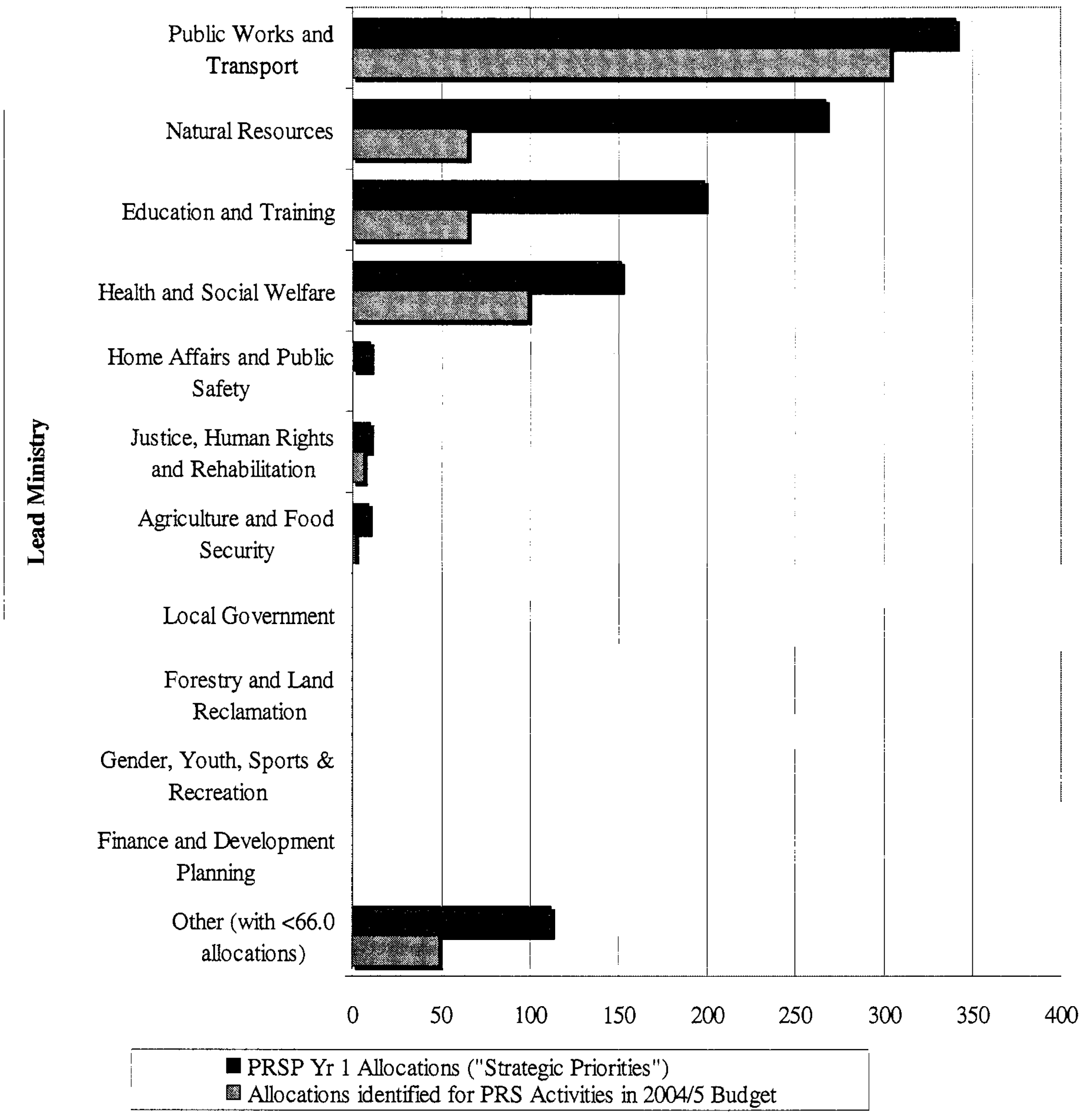
Table 4.2: Sectoral Distribution of Poverty-related Allocations
(in millions of maloti)

Lead Ministry	Allocations identified for PRS Activities in 2004/5 Budget	PRS Yr 1 Allocations ("Strategic Priorities")	Directly Poverty-Related Allocations in 2004/5 Budget
Public Works and Transport	303.0	340.9	251.3
Natural Resources	64.6	267.0	84.7
Education and Training	64.6	198.6	368.0
Health and Social Welfare	98.7	151.6	154.6
Tourism, Environment and Culture	7.3	66.4	25.0
Trade & Industry, Cooperatives & Marketing	23.3	26.9	53.4
Communications, Science & Technology	18.1	18.7	5.7
Home Affairs and Public Safety	0.0	9.9	114.4
Justice, Human Rights and Rehabilitation	6.3	9.5	65.8
Agriculture and Food Security	1.4	9.1	97.9
Employment and Labour	0.1	0.2	8.0
Local Government	0.1	0.1	74.5
Forestry and Land Reclamation	0.0	0.0	36.6
Finance and Development Planning	0.0	0.0	56.8
Gender, Youth, Sports & Recreation	0.0	0.0	21.1
Law and Constitutional Affairs	0.0	0.0	3.3
Prime Minister's Office	0.0	0.0	65.3
TOTAL	587	1099	1486.7

Source: Staff estimates.

Figure 4.5: Sectoral Distribution of Identified 2004/05 Allocations for PRS Activities compared with PRS Strategic Priorities

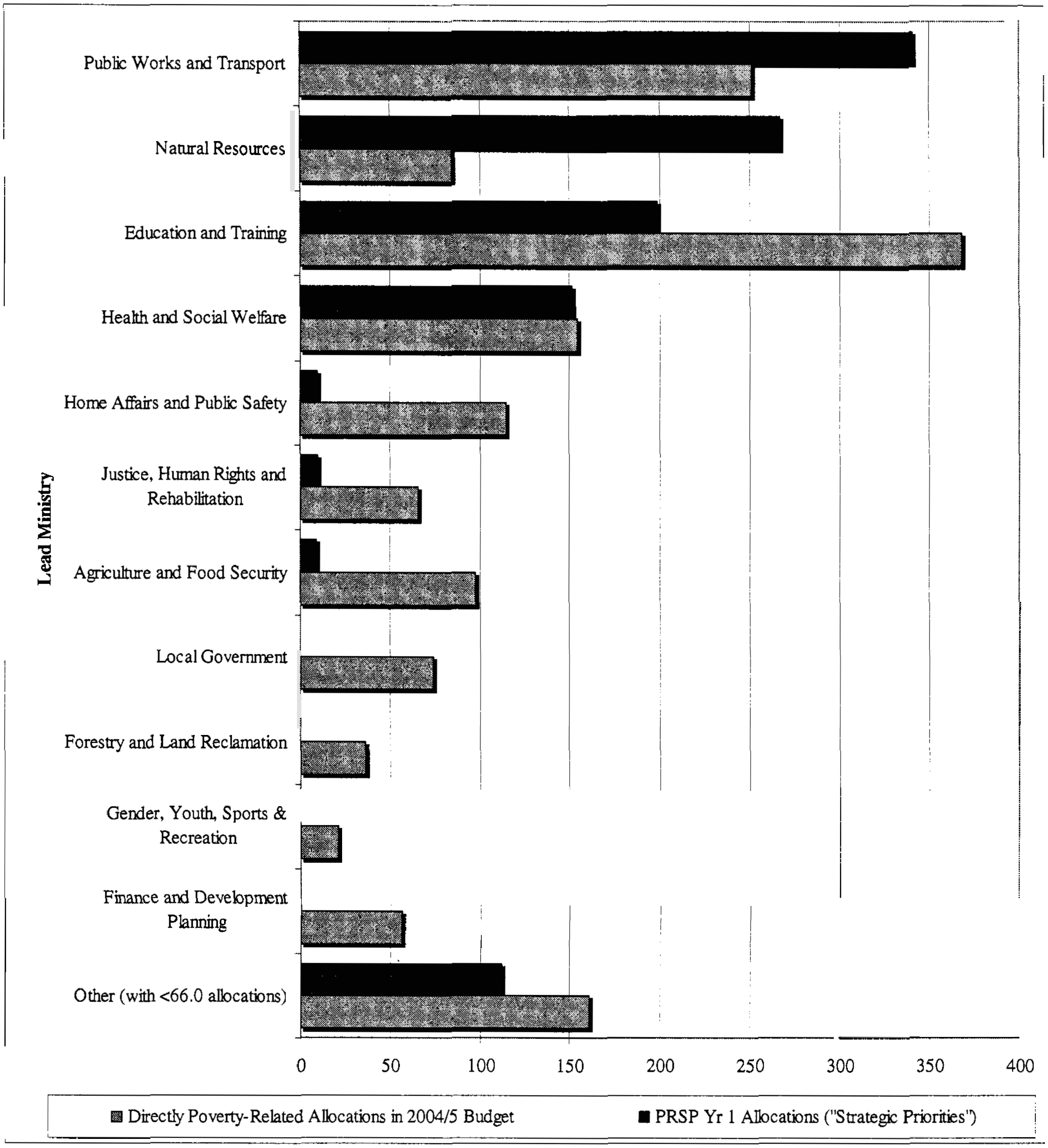
(in millions of maloti)



Source: Staff estimates.

Figure 4.6: Sectoral Distribution of Directly Poverty Related Allocations in 2004/05 Budget compared with PRS Strategic Priorities

(in millions of maloti)



Source: Staff estimates.

IV. CONCLUSIONS AND NEXT STEPS

4.18 **The above analysis shows that sectoral allocations have remained broadly unchanged over the past several years.** They have largely been made on an incremental basis, focused on inputs and without much regard for the purpose of public expenditure. Social sectors account for the largest share. However, the share of the economic sectors has suffered somewhat over the past several years vis-à-vis general services. This does not reflect the emerging importance and need for infrastructure development to provide a supportive investment climate for private sector development. While there is a need to reconsider the allocations for economic sectors, it is also important to raise the level of budget execution.

4.19 **An analysis of the 2004/05 and 2005/06 budgets reveals that the alignment of the budget with the activities identified in the PRS is generally weak.** As the PRS evolves further, with greater focus on key priorities, it is essential to strengthen the link between budget allocations and the activities identified in the PRS. Without strengthening these links, the PRS will not be successfully implemented. To deepen these links and to strengthen implementation of the priority programs, government has initiated a phased introduction of the MTEF, starting with the 2005/06 budget. In order to effectively monitor the "real" PRS over time, and against the backdrop of the PRS priorities and objectives, additional coding in the budget is required. This would involve coding all the sub-programs/projects according to which of the ten PRS priorities they primarily address. This will allow the government to monitor over time whether the budget process results in resource reallocation in favor of the PRS priorities and, if so, which one(s). While undertaking such a coding, it would be good to identify which sub-programs and projects match precisely or substantively a PRS strategy or activity. This will allow the government to monitor over time whether the PRS proposals are being taken on board by line ministries. Additional coding by district and/or by spatial zone is also desirable. Given that most absolute poverty in the country is located in mountainous rural areas, it will be necessary to ensure that sub-programs are coded as to their spatial impact. In the absence of a spatial framework (by district and ecological zone) for survey, research, administration and monitoring purposes, it will be useful to disaggregate the data by district wherever possible. The poverty focus can then be interpreted roughly by separating the four mountainous districts with the highest poverty incidence as a group.[59]

[59] A preliminary analysis with the available (recurrent budget) data shows that there is no pro-poor allocation shift evident between FY05 and FY06. The analysis is greatly hampered by the fact that dataset for many ministries (including, significantly, education) is not disaggregated by district.

CHAPTER 5. TOWARDS A MEDIUM-TERM EXPENDITURE FRAMEWORK

I. INTRODUCTION

5.1 **An MTEF provides the "linking framework" that allows expenditures to be driven by policy priorities and disciplined by budget realities.** Adoption of an MTEF is a potential solution to the disconnect problem between policy making, planning, and budgeting identified above.

Box 5.1 Medium-Term Expenditure Framework

The MTEF is intended to facilitate greater macroeconomic discipline; improved inter- and intra-sectoral resource allocation; greater budgetary predictability for line ministries; and more efficient use of public resources. Improved macroeconomic balance, including fiscal discipline, is attained through good estimates of the available resource envelope, which are then used to make budgets that fit squarely within the envelope. MTEFs aim to improve inter- and intra-sectoral resource allocation by effectively prioritizing all expenditures (on the basis of the government's socio-economic program) and dedicating resources only to the most important ones. A further objective of the MTEF is greater budgetary predictability, which is expected as a result of commitment to more credible sectoral budget ceilings. Moreover, to the extent that budgetary decision making is more legitimate, greater political accountability for expenditure outcomes should also ensue. The MTEF also endeavors to make public expenditures more efficient and effective, essentially by allowing line ministries greater flexibility in managing their budgets in the context of hard budget constraints and agreed upon policies and programs.

The MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policies and any proposed new policies and, ultimately, the matching of these costs with available resources in the context of the annual budget process. The "top-down resource envelope" is fundamentally a macroeconomic model that indicates fiscal targets and estimates revenues and expenditures, including government financial obligations and high cost government-wide programs such as civil service reform. To complement the macroeconomic model, the sectors engage in "bottom-up" reviews that begin by scrutinizing sector policies and activities (similar to the zero-based budgeting approach), with an eye toward optimizing intra-sectoral allocations (World Bank, Public Expenditure Management Handbook, 1998).

II. CURRENT STATUS

5.2 **Following Cabinet's decision to adopt an MTEF approach to budgeting, a good start was made for the 2005/06 fiscal year to set the annual budget in the strategic context of a three year fiscal framework and to use this process to begin integrating the recurrent and capital budgets.** The MFDP organized MTEF sensitization workshops, including lessons from cross-country experiences, for MFDP staff in March 2004. Cross-country experience suggests that successful implementation of an MTEF takes several years. Adopting an all at once approach by introducing changes to its budget classification and accounting system, introducing a new financial management information system, tackling recurrent and capital budget integration, multi-year fiscal policy and budget ceilings, and sectoral policies led to a failed implementation of the MTEF in Ghana in the late 1990s. Efforts are now underway to resurrect the MTEF there. In contrast, Uganda successfully followed a gradual approach, introducing multi-year fiscal estimates in the first year, followed by sector ceilings in the second year.

5.3 **Some good principles to the adoption of an MTEF include**: (i) start with the introduction of a medium-term fiscal framework; (ii) do not launch MTEF in selected sectors until there are medium-term ceilings provided by the MFDP that provide the context for the sectoral MTEFs; (iii) integration of capital and recurrent budgets can be done at a measured pace; (iv) performance information (outcomes, outputs) need not be incorporated into the budget process in the first year – these might be introduced in the second or third year of an MTEF; (iv) delegation of more flexibility for spending ministries to allocate their resources across programs, subprograms, and activities both within the year and for the budget should be introduced gradually as the overall control environment improves; (v) pressure on ministries to find resources within current expenditures may be more successful when accounting systems are in place to provide good information on program and activity costs. Various improvements can be made to the budget process that move in the direction of the ideal MTEF incrementally. The principles of multi-year forecasts, policy and resource allocation alignment, costing activities, spending ceilings for line ministries, and prioritization of competing claims for new resources, can be implemented in various ways. An MTEF needs to be customized to the country, including initial conditions in PEM, human and information technology capacity. Table 5.1 provides a multi-year perspective that correlates with the three-level framework of public financial management objectives and identifies the responsible agency, necessary pre-conditions and assesses Lesotho's readiness.

Table 5.1: Multi-year Perspective to the Adoption of an MTEF

Item	Multi-year Feature	PEM Objective	Responsible Agent	Intended Effect	Requires	Lesotho
1	Macroeconomic forecast	Macrofiscal discipline	Finance or Economy Ministry	Provides strategic framework for setting fiscal and monetary policy, and allows proactive fiscal adjustment to changing economic trends.	Forecasting model, capacity, multi-year macro variable time series, or access to multiple non-governmental forecasts	Yes
2	Multi-year revenue, debt sustainability analysis and debt policy, yielding expenditure envelope	Macrofiscal discipline	Finance or Economy Ministry	Sets upward bound for expenditures, limiting deficits, inflation, and currency depreciations; supports sustainable fiscal policy, and realistic expenditure planning within the expenditure envelope; supports focus on adequate revenue mobilization.	Forecasting models. Stronger if relationships between macro growth, income distribution, and revenues understood and modeled. Debt sustainability analysis/model, or hard rule on debt/deficit limits. More effective in changing behavior if aggregate expenditure ceilings/policy debated and approved by cabinet.	Yes, but no cabinet-level discussion, approval. Basis for debt sustainability analysis uncertain. Insufficient treatment of revenue policy.
3	Multi-year forecast of spending under current policy or current level of services, by ministry or program	Macrofiscal discipline, Allocational efficiency (sector)	Finance or Economy Ministry, or in some cases spending ministries with clear guidance	Provides broad indicator of future cost of current spending trends, identification of potential risk areas, and proactive, measured, more rational fiscal adjustment. Provides baseline for evaluating policy spending choices, including pay increases, relative to Item 2, and measuring sectoral reallocation decisions. Some incentive to examine cost-drivers for programs/sectors.	MoF provided inflators for pay, non-pay, and clear guidance for projecting costs. Can be automated. Can be budget year only, but more effective over several years.	
4	Multi-year ceilings for sector ministries	Allocational efficiency (sector), Macrofiscal discipline, Operational efficiency	Finance or Economy Ministry	Provides framework for sector ministry budget preparation, enabling more realistic planning by sectors, designing appropriate policies; provides more incentive for reviewing existing programs for effectiveness, making trade-offs and reallocations within sectors. At center of Government, allows explicit decisions on trade-offs between sectors.	Can be developed from Item 3, or from item 2 expenditure limits proportionally allocated, but these would not reflect reallocation decisions. More credible if reflecting policy choices, which requires some explicit policy directions on reallocation. Even more credible in terms of providing multi-year expenditure planning targets for spending ministries if they reflect understanding of cost inefficiencies and sectoral marginal returns/outcomes, but this requires more detailed understanding of sectors. More effective in changing behavior if approved by cabinet or parliament.	

Item	Multi-year Feature	PEM Objective	Responsible Agent	Intended Effect	Requires	Lesotho
5	Multi-year sector strategy	Allocational efficiency (sector), Operational efficiency, Macrofiscal discipline	Spending Ministry	Sector strategic plan that may link outputs/outcomes with inputs in multi-year framework. Effective with respect to macrofiscal discipline and allocational efficiency only if prepared within multi-year sectoral resource ceiling.	Strategic planning capacity at sector ministry, information on outputs/outcomes of programs, and relationship to activities and inputs.	Some ministries may have begun to develop these (Health, Education, Agriculture), though in the absence of multiyear resource ceilings.
6	Multi-year estimates of cost of **new policies or programs (recurrent)**, or expansion of existing programs, prepared by sector ministries	Operational efficiency, Allocational efficiency (sector), Macrofiscal discipline	Spending Ministries	Identifies multi-year implications of new initiatives relative to their objectives, and assessment of whether they can be financed from within existing sectoral ceilings or even within aggregate spending ceilings, and if they are financially sustainable over time.	Requires guidance/training for spending ministry staff, and spending ministry staff capacity; MoF provision of common inflators for use by ministries (pay rates, non-pay, capital costs). Less effective in the absence of multi-year sector ceilings (item 4) and cost of existing programs (item 7) and sector strategy (item 5).	
7	Multi-year estimates of cost of **existing** policies, programs, subprograms, or activities prepared by sector ministries	Operational efficiency, Allocational efficiency (sector), Macrofiscal discipline	Spending Ministries	Similar to Item 3, but prepared by sector ministry. Sensitizes sector ministry to cost drivers, affordability of existing policy or programs, attention to different means of attaining objectives, unit cost.	Can begin at program level, and progressively push down for deeper bottom-up approach in future years, adding subprogram and then activity costing. Requires trained staff at spending ministries, agencies. Requires MoF provision of guidance and common inflators for use by ministries (pay rates, non-pay, capital costs). Less effective in the absence of multi-year sector ceilings (item 4) and cost of new programs (items 6 and 8) and sector strategy (item 5).	
8	Multi-year estimates of cost of **new projects (capital)**, or expansion of existing projects, prepared by sector ministries	Operational efficiency, Allocational efficiency (sector), Macrofiscal discipline	Spending Ministries	Similar to item 6, but for capital projects. Many capital budget processes already include such estimates, including the recurrent cost implications of new capital projects.	Requires trained staff at spending ministries, guidance on costing, understanding of project design and work flow, to yield good estimates. Less effective in the absence of multi-year sector ceilings and cost of existing programs (items 6 and 7) and sector strategy (item 5).	Yes, though not all forms filled out for recurrent cost implications, and multi-year estimate accuracy can be improved.

5.4 **Some prerequisites for the adoption of an MTEF were present in Lesotho in 2004/05.** These included: macroeconomic forecast; including multi-year revenue forecast; preliminary debt sustainability analysis and a debt policy; as well as multi-year estimates of cost of new projects (capital), or expansion of existing projects, prepared by sector ministries. Other preparatory activities including revised budget forms and detailed guidance notes were prepared for the launch of the 2005/06 budget. Thereafter, line ministries were required to prepare three year budgets based on a three year medium-term fiscal framework (MTFF) and expenditure ceilings approved by Cabinet. This effort was coordinated by the MTEF Task Team in the MFDP under the chairmanship of the Budget Controller with members also drawn from the Ministry of Health and Social Welfare, the MAFS, the MET and the Ministry of Public Works and Transport (MPWT).[60] However, preparation of the aggregate resource envelop and determination of aggregate and organizational expenditure ceilings is hampered by reliance on the economic model maintained by the Central Bank of Lesotho and a relatively unreliable statistical base from the Bureau of Statistics (BoS)[61] and the poor quality and timeliness of public accounts from GOLFIS.

5.5 **However, only one year's expenditure and revenue estimates for 2005/06 were published and presented to Parliament**. The budget presentation also retained its original structure - the same line item/program format as in previous years. The late start to the detailed budget estimates preparation exercise was the result of the late release of the "call" circular and expenditure ceilings.

5.6 **Further progress was made in the second year of implementing the MTEF (2006/07)**. Three-year ceilings were given by the MFDP that provided the context for the sectoral MTEFs. In addition to all ministries preparing three year budget estimates, six pilot ministries have deepened the process through developing detailed Budget Framework Papers as an input into setting of the Ministry ceilings.[62] The six pilot ministries are (i) MAFS; (ii) Ministry of Health and Social Welfare; (iii) MET; (iv) Ministry of Employment and Labor; (v) Ministry of Tourism, Environment and Culture; and (vi) Ministry of Gender, Youth and Sports.

5.7 **Pilot ministries were required to prepare three-year activity based budgets, linking both Recurrent and Capital budgets and including both GoL and donor resources**. This involves (i) preparing an agreed list of Ministry objectives, Programs and Sub-Programs, Cost Centers (equivalent of a Department) and Sub-Cost Centers (equivalent of a Division); (ii) defining for each Program and Sub-Program the outputs and activities required for the period 2006/07-2008/09 to achieve the objectives; (iii) identifying the inputs required for the activities; and (iv) costing the inputs for the three-year period.

5.8 **The experience of pilot ministries in preparing their budget has been mixed.** The Ministry of Health and Social Welfare and the MET were more familiar with the concept as they were already preparing their budget within the MTEF with support from development partners. However, significant capacity constraints in the other line ministries and unrealistic expectations limited the achievements on the MTEF. The very detailed costing requirement at the activity level has been difficult to implement. Budget classification has remained largely unchanged and programs and sub-programs basically refer to organizational structures and are mislabeled. The budget format has remained unchanged for the 2006/07 budget cycle. Budget estimates are

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60 These efforts were supported by a World Bank team in the initial stage of development – including further sensitization and support with preparing work plans, ministerial budget submission forms and guidance notes. Subsequently, support to the development of MTEF was provided by DFID under the PFM component of the Government's overall Public Sector Improvement Reform Program.

61 Efforts are now ongoing to construct a macroeconomic model of the economy with support from the EU that will provide timely and reliable forecasts when developed.

62 The pilot ministry staff received extensive training and guidance under the DFID PFM support program.

provided for one year only and there is no integration of recurrent and development budget. A new feature of the budget is the presentation of an MTEF Appendix for the pilot ministries. This is an important initiative and provides three year estimates for aggregate recurrent and capital expenditures for all line ministries. However, the multi-year estimates are not provided at program and/or sub-program level. Rather, for each department – which is listed as a program in the main budget document – a list of expected outputs is presented. These correspond by and large to sub-programs and activities.

III. NEXT STEPS

5.9 **A comprehensive fiscal policy paper should be prepared to guide the overall preparation of medium-term budget estimates.** As an integral part of MTEF development, a medium-term fiscal framework has been prepared. This includes 3-year macroeconomic, revenue, expenditure and debt projections at an aggregate level. Three year expenditure ceilings have been given at the ministry-level. These sectoral resource ceilings should provide a linkage between current spending programs and sector strategy and objectives. As a next step, a fiscal policy paper should be prepared for discussion and approval by the Cabinet. The paper should include the estimates, identify risk factors (revenue and spending), and propose some broad policy options on revenues and expenditures. This can be adapted from the Background Paper for the Budget that has been prepared annually since February 2004.

5.10 **Fuller integration of recurrent and capital budget should be pursued over the next two budget cycles.** The existing dual-budgeting, accounting and reporting systems do not provide for a comprehensive analysis in the planning and budgeting of government operations and evaluation of their outcomes and results. Experience shows that when the preparation and execution of recurrent and development budgets are institutionally, organizationally, and technically separate, real coordination between the two is nearly impossible. Apart from organizational pattern, the integration of recurrent and development budgets require a new budget classification structure.

5.11 **A full and meaningful integration of recurrent and capital budget requires[63] the following:** (i) organizational and staffing integration; (ii) integrated budget preparation; (iii) unified budget documentation and presentation; and (iv) unified accounting and reporting systems. While the ministries of finance and planning have been merged in Lesotho, staff dealing with the development budget has remained as separate from recurrent budgeting staff as they were under two separate ministries. Unless all budget preparation staff is brought together in a single budget department, supervised by a single manager, there will be just be a coordination of the two budgets rather than integration. The budget circular requires ministries to identify the recurrent cost implications of ongoing and proposed new projects. The budget forms and accompanying guidelines make provisions for including the recurrent cost implications. Nevertheless, budgets are prepared separately and in many instances the capital budget does not reflect asset accumulation rather it contains recurrent expenditures financed under a project. It would be desirable to establish formal teams, at sector or ministry level, of planning and budget staff formally assigned to each sector and sharing offices. Also, a unified

[63] Integration of Recurrent and Development Budgets: Issues, Problems, Country Experiences, and the Way Forward, The World Bank, Public Expenditure Working Group Implementation Note, Feridoun Sarraf, July 2005.

means of resolving budget differences needs to be in place, with both capital and recurrent budgets being resolved in the same meetings with ministries.

5.12 **The Government's commitment to the adoption of the MTEF is clearly evident.** It is important, however, to pace the reforms in tandem with building capacity in the MFDP as well as other line ministries. This is critical to ensure continued ownership of the reform effort as well as its successful implementation. In this regard, government plans for sending key staff on study tours to countries where the reform program has been successfully implemented is a welcome step. Nevertheless, capacity building has to be undertaken at a much wider level, including at the decentralized levels. While steady progress is made on changing the planning and budgeting processes, some actions can be taken in the short term.

5.13 **The budget format needs to be changed immediately in order to provide a consistent display of information to promote analysis of spending on a program basis.** Each page of the revenue estimates presents expected collections by activity on a program or subprogram level. Each page of the recurrent estimates presents expenditure by economic classification on a subprogram basis. And each page of the capital estimates presents capital spending by funding source and project on a program basis. To get a complete picture of the financial operations of a program or subprogram requires searching through all three sections of the budget document and manually compiling the information.

5.14 **A relatively simple change would be to re-arrange the Estimates presentation by program**. For each program include:

- Program total, including capital and recurrent expenditures;
- New Financing Schedule, showing sources of financing for programs (external and domestic);
- Recurrent program detail, including list of sub-programs and their totals (but not the object/economic classification detail for subprograms. That could be retained in a separate, supplementary volume if necessary);
- Capital program summary, including financing schedule. The expenditure schedule could be on an object/economic classification basis;
- For capital, aggregate individual projects into the 'objective' of the projects. So, for example, Health Reform would appear as one 'project,' with each financing source appearing in the financing schedule, and perhaps the major subcomponents appearing under expenditure. Similarly, Health HQ Construction would appear as one project, with two financing sources; and
- Extend the format to include two additional years.

5.15 **Such a presentation will promote a focus on the program as the unit of analysis.** This is particularly valuable if the program coincides with an administrative unit in the Ministry. The proposed display allows some attention to subprograms, but not in excessive detail (again, that detail could be provided as a supplement). Of course, the extension to include two additional fiscal year estimates also promotes a focus on the medium-term implications of program decisions. Also, the inclusion of the new financing schedule promotes a focus on how the spending is to be financed, and the demands on own resources and reliance on external sources of finance. Some of these improvements can be implemented as part of the IFMIS reforms. For example, the new chart of accounts and improved accounting should enable much more accurate expenditure tracking.

CHAPTER 6. EXPENDITURES AND OUTCOMES IN SELECTED PRIORITY SECTORS

A. EDUCATION[64]

I. INTRODUCTION

6.1 **The GoL envisages the provision of an equitable basic education to all the people as a key developmental goal. Education and training is identified as a national priority in the PRS.** Further, as a signatory to the MDG, the government aspires to achieve 100 percent primary education completion and gender equity in primary and secondary education by 2015. Basic education is seen as an essential part of social and economic development and is regarded by the Government as a fundamental human right. It is also seen as an essential pre-condition for wage employment and secondary and post-secondary education and training.

6.2 **Reflecting its commitment to providing universal free and compulsory primary education, the Government introduced, in 2000, FPE in Lesotho on an annual incremental basis from standard one**. The free primary cycle entered its seventh year in 2006 and the first cohort of children that benefited from FPE will be ready to enter secondary schools in January 2007, creating additional resource pressures.

II. SECTOR STRUCTURE AND POLICY FRAMEWORK

6.3 ***Structure***. Lesotho's education system is divided into three levels: (i) a seven-year primary cycle intended for children aged between 6 and 12; (ii) a five-year secondary education consisting of a three-year junior level (Forms A to C) and a two-year senior level (Forms D and E); and (iii) tertiary education. Major examinations occur at the end of primary school, junior secondary and senior secondary. The primary school leaving examination measures students' basic knowledge of science, social studies, English, mathematics and Sesotho, at the end of the primary cycle. The Junior Certificate examination is held at the end of the junior secondary cycle, and the Cambridge Overseas School Certificate marks the end of senior secondary education.

6.4 **Tertiary education includes TVET, teacher training, and university education.** Lesotho has only one tertiary level TVET institution, the Lerotholi Polytechnic, which offers both certificate and diploma courses. The LCE offers teacher training courses for primary and secondary school teachers. In January 2002, the LCE began offering a Distance Teacher Education Program for primary teachers who wished to improve their teaching qualifications while continuing to work. Various undergraduate and post-graduate degree programs as well as

64 The analysis on the education sector draws on the 2005 World Bank Report, "Primary and Secondary Education in Lesotho: A World Bank Country Status Report for Education".

sub-degree programs (certificates and diplomas) are offered by the National University of Lesotho (NUL). Additionally, more than 20 percent of the new tertiary student population each year enters programs in other countries, the majority in the RSA.

6.5 **In addition to the formal schooling, Lesotho offers a system of preschool education**. The Early Childhood Care and Development (ECCD) facilities offer pre-primary schooling for children aged 3 to 5 years. All the center-based ECCD facilities are privately owned. Church organizations play an important role in the sector, particularly in primary education.

6.6 **The MET is responsible for the management, provision and regulation of education in Lesotho and is headed by a Minister (assisted by an Assistant Minister).** The PS is the ministry's administrative head and chief accounting officer and is assisted, at the executive level, by a staff of officers and directors. In line with the national strategy for decentralization, management of the education system is being gradually decentralized to offices in each of the ten districts. However, most decisions concerning education in Lesotho are made at the central level and the district education officers have no real decision-making power especially on matters related to finances.

6.7 ***Sector Policy and Planning Framework.*** In line with broad Government objectives laid out in the National Vision and PRS, the MET's policy is to move decisively towards expanding enrolment, increasing retention and improving quality of education in all educational sub-sectors. Key ministerial objectives are to improve access, equity and quality of education at all levels improve efficiency of the education and training system, ensure that school curricula and vocational, technical and non-formal education programs are responsive to the skills sought by the private sector and the communities in general, and to mitigate the spread of HIV/AIDS through education campaigns.

6.8 **GoL has prepared its ESSP to provide the MET with an effective long-term planning instrument over the period 2005 to 2015**. The ESSP is in conformity with the national constitution, and national legislation, the National Vision 2020, the PRS, Education for All Fast Track Initiative and the MDGs. The ESSP lays out (i) the broad objectives of the sector; (ii) strategic programs and cross-cutting issues; and (iii) implementation framework and financing requirements.

6.9 ***Medium-Term Expenditure Framework.*** The education sector has developed a relatively high quality planning process that is increasingly linked to the budget process and the MTEF. Following a comprehensive review in 2002, a new program structure was developed, and the sector started to prepare its budget broadly based on MTEF principles since 2002/03. Under this process, the ministry's programs have been reprioritized to match both the National Vision and the areas identified under the PRS. However, in the absence of a national MTEF, which only began to take form since 2005/06, the role of the education sector MTEF has been evolving. Up until 2005/06, there were nine programs of expenditures in the MET as follows:

01 – Administration
02 – Basic Education
03 – Secondary Education
04 – TVET

05 – Teacher Education Support and Supplies
06 – Higher Education
07 – Curriculum Assessment and Education Supply
08 – Planning, Monitoring and Evaluation
09 – Special Programs

6.10 **With the introduction of a national MTEF and the identification of MET as one of the pilot ministries for the introduction of the MTEF, MET has prepared a detailed Budget Framework Paper that underpins the development of the MTEF.** In addition to the presentation of key priorities, objectives, policies and strategy, the Paper presents the costing of the ESSP as well as the budget for each program for the 2006/07-2009/10 MTEF cycle. Further revisions have been made to the program structure starting with the 2006/07 budget to take account of (i) Decentralization – each of the ten district offices now has a budget code and is a separate cost centre; (ii) Integrated Early Childhood Care and Development (IECCD) - early childhood is all private, but the MET is providing financial incentives to encourage primary schools to attach an ECCD centre to their school. Schools that do this will get an annual subvention. This is starting on a small scale, but is planned as a rolling program; (iii) System limitations - the classification used has been restricted by GOLFIS in the past. However, recently new programs have been introduced. As a result, the following programs with the associated cost centers have been identified:

01 – Governance and Management
02 – Integrated Early Childhood Care and Development
03 – Basic Education
04 – Secondary Education
05 – Technical and Vocational Education and Training
06 – Teacher Development, Supply and Management
07 – Higher Education
08 – Curriculum Development and Assessment
09 – Education Policy, Development Planning, Monitoring and Evaluation
10 – Inclusive and Lifelong Education
11 – Decentralized Educational Management

6.11 **While MET is one of the most advanced ministries in developing the MTEF, and has prepared a three-year budget framework, it is still using the incremental line item approach for costing its programs and activities**. The finalization of the ESSP, with preliminary costing of programs provides an opportunity for MET to align its ESSP with the MTEF in terms of programs and sub-programs and financing requirements. The proposed classification for 2006/07 – 2009/10 is not fully aligned with the ESSP program classification.

6.12 ***Flow of Funds***. The MFDP approves the budget and releases funds quarterly to the MET. Almost all of the recurrent expenditure items arrive at primary schools in kind in a variety of ways. Some of these are:

- Primary teachers (except for those hired and paid directly by schools) are centrally managed by the Teaching Service Department, which issues salary payments directly to the teachers.

- The MET procures textbooks and other teaching and learning materials centrally, stores them in the School Supply Unit warehouse, and distributes them to schools through the district offices.

- School feeding is currently provided by both MET and World Food Program (WFP). WFP covers schools in the mountain areas and lowlands for non-FPE grades. WFP has its own system for administering and distributing meals to schools. The MET covers school feeding for lowland primary FPE students by paying local caterers directly, M2 per student per day.

- School maintenance was also managed and paid centrally at a nominal allocation of M5 per student per day directly to contractors.

6.13 **Central management of non-teaching inputs to schools has reduced efficiency.** Inspectors and resource teachers spend more time approving procurement of vendors, contractors and other paperwork and considerably less time to monitor the actual teaching and learning in schools, and enforcing greater efficiency.

III. TRENDS IN PUBLIC SPENDING

6.14 **Public expenditures on education are high, consistent with the priority given to education in the poverty reduction strategy.** Public expenditures in the education sector in Lesotho comprise expenditures incurred by the MET and the expenditures on the bursary program operated by the NMDS in the MFDP. In 2004-05, total public expenditure on education came to a total of M1,173 million, or 31 percent of total government expenditure (excluding interest). This level of expenditure on education, equivalent to 13 percent of GDP, is much higher than both the global average (which stood at 4 percent of GDP in 2001) and the regional average.

6.15 **In absolute terms, expenditure on education has risen over the last seven years, with the exception of 2003/04, when there were reductions in MET recurrent and capital expenditure.** In the period 1998-2004, education sector spending rose 57 percent, from M672 million to M1,173 million, roughly in line with the 59 percent increase in total government expenditure (excluding interest). Within this period MET expenditure fluctuated considerably, both in terms of recurrent and capital expenditure, while the NMDS expenditure showed a steady increase.

Table 6.1: MET and NMDS Recurrent and Capital Expenditure
(current prices in millions of maloti)

	Actual	Actual	Actual	Actual	Actual	Actual	Actual
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
MET Education - Recurrent	488	507	579	679	738	647	737
MET Education - Capital	119	25	32	109	162	98	166
NMDS	65.2	77.2	80.5	120	177	217	270
Total Education Sector	672	609	692	908	1077	962	1173
GoL - Recurrent	1943	2319	2404	2312	2857	2533	3199
Of which: non-interest Recurrent	1814	2136	2146	2109	2637	2690	3043
GoL - Capital	496	480	554	626	802	635	756
GoL - Total, excluding interest	2310	2616	2700	2735	3439	2952	3799
Gross Domestic Product	4921	5565	5964	6565	7370	8144	8851.4
	(as a percent of total recurrent expenditure excl. interest unless otherwise stated)						
MET Recurrent	**26.9**	**23.7**	**27.0**	**32.2**	**28.0**	**24.1**	**24.2**
NMDS	**3.6**	**3.6**	**3.7**	**5.7**	**6.7**	**8.1**	**8.9**
Education Total Recurrent	**30.5**	**27.4**	**30.7**	**37.9**	**34.7**	**32.1**	**33.1**
MET Capital /GoL Capital	**24.0**	**5.2**	**5.8**	**17.4**	**20.2**	**15.5**	**21.9**
Education Total/GoL Total, excl.interest	**29.1**	**23.3**	**25.6**	**33.2**	**31.3**	**32.6**	**30.9**
Ed. Total/GDP	**13.7**	**10.9**	**11.6**	**13.8**	**14.6**	**11.8**	**13.2**

Source: Primary and Secondary Education in Lesotho - A World Bank Country Status Report.

6.16 ***Functional composition of education expenditure.*** The allocation of resources between the education sub-sectors is unusual, in that the post school sub-sectors (TVET, NFE, higher education) receive a greater share of the resources than either primary or secondary education. When NMDS expenditure is included, the post-secondary sub-sectors account for 42 percent of education spending. Primary and early childhood education receives 37 percent, and secondary education receives 19 percent.

6.17 **The share of the resources devoted to post-school education has actually increased over the past six years, rising unevenly from 38 percent in 1998 to 42 percent in 2004.** In the same period the shares devoted to primary and secondary education both declined slightly from 21 to 19 percent and from 39 to 37 percent, respectively. The declining share of expenditure allocated to primary education is a concern compared to regional standards. Already, the share of education expenditure allocated to primary education is small by the standards of the region. Furthermore, the EFA Fast Track Initiative has calculated that a country with 7 years of primary education would need to devote 55 percent of its education resources to primary education in order to support universal primary education. The ESSP[65] includes a

65 Kingdom of Lesotho Education Sector Strategic Plan 2005-2015. Ministry of Education and Training, March 2005.

commitment to raise the proportion of expenditure devoted to basic education substantially, from 38 percent of MET expenditure (excluding NMDS) to 47 percent by 2015.

Table 6.2: Share Recurrent Education Expenditure Allocated to the Primary Sub-Sector

	Lesotho	Mozambique	Zambia	Tanzania	Malawi
Date of data	2003/04	1998	1999	1999	1999/00
Years of primary	7	6	6	6	6
percent to primary	37	47	54	62	60

Source: Primary and Secondary Education in Lesotho - A World Bank Country Status Report.

6.18 **Within the primary sub-sector, teachers' salaries are the largest component of the recurrent budget, accounting for 66 percent of expenditure in 2003/04**. The second major cost item is the school feeding program, which came to 25 percent of the total. The remaining nine percent was spent on other inputs, of which teacher inspection and support accounted for only about two percent of the total expenditure. This is an inefficient allocation of spending as it leaves very little for complementary spending which is necessary for improving learning outcomes.

6.19 **Teacher remuneration is the most significant cost driver in the primary education sub-sector.** Currently there are 9,294 primary teachers (including head teachers and other supervisory and support staff), with an average salary of M22,832. The starting salary for a qualified teacher is M14,988 per annum, while an unqualified teacher starts at M9,576. The cost of primary teacher salaries is likely to rise in the coming years, for a number of reasons:

- The ESSP anticipates a reduction in the pupil teacher ratio (PTR) to 40:1 by 2015.[66] The current PTR is 46:1, slightly higher than the regional average of 42:1 for Anglophone Africa.

- In-service training aimed at bringing untrained teachers up to qualified status will also bring those teachers to a higher salary scale.

- The expansion of the total number of teachers has been mainly by recruiting teachers at the starting salary. As these young teachers move up in seniority, the average teacher salary is likely to increase.

6.20 **The average teacher pay of M22,832 is equivalent to 5 times GDP per capita, which is higher than the regional average**. The starting salary for unqualified teachers is 2.1 times GDP per capita. These salaries seem sufficient to attract teachers and Lesotho reports little difficulty in filling vacant posts. Teacher attrition is relatively low at 3-4 percent per annum. The Teaching Service Commission reports that attrition is lower among the least qualified teachers.

6.21 **Although Lesotho has been successful in attracting teachers, many of the newly recruited teachers are unqualified**. The proportion of unqualified teachers has risen to one third in recent years. It has proven particularly difficult to attract qualified teachers into rural

[66] Ibid. p 45.

areas, and it is not uncommon to find only one trained teacher in a remote rural primary school. In parallel, there are serious concerns about the quality of learning outcomes, and Lesotho lags behind its neighbors in this area. Results are particularly poor in the remote rural schools. Efforts to improve quality are likely to focus on improving the standard of teachers, and may be incompatible with salaries that are attractive only to those with the least alternatives.

6.22 **This raises an apparent contradiction, as teacher salaries appear high in terms of GDP per capita and yet insufficient to attract teachers of a high caliber**. In part this may result from the atypical labour market conditions that prevail in Lesotho. Approximately 68.6 percent of the working population is engaged in subsistence farming[67], and 56 percent of the population lives on less than $2 per day.[68] At the same time Lesotho has an economy that is inextricably linked with that of its nearest neighbour, South Africa. Prices of goods and services, and wages for skilled workers, are heavily influenced by the South African economy. This highly varied income pattern is reflected in the high GINI index of 0.63.[69]

6.23 **High prevalence of HIV/AIDS among teachers is also putting additional pressure on teacher supply and quality as well as the financial burden of having to train more teachers.** It is estimated that prevalence of HIV/AIDS could peak at around 30 percent in 2007, before stabilizing and starting to decline by 2010.[70] However the impact on the sector is longer lasting as infected teachers start to die in greater numbers in outer years. It is currently estimated that AIDS related deaths among the teaching population is around 2 percent and is expected to peak around 3 percent by 2015. If these estimates materialize, the impact of HIV/AIDS on the education system could be very costly financially as well as undermining educational outcomes.

6.24 **The second major component of recurrent cost in the primary sub-sector is the school feeding scheme**. Food supplies are insecure in many areas of Lesotho, and many children get no other meal than the one provided in school. Therefore, school feeding is seen as a crucial support. Two distinct feeding schemes are in operation. In some areas food is provided by the World Food Program, and the preparation and distribution is funded by MET. In other areas (not eligible for WFP food), MET funds both the food and preparation. In addition, a small school self reliance program supports schools to develop their own vegetable gardens. Together these schemes absorbed 25 percent of the MET recurrent budget in 2003 (in addition to food provided by WFP).

6.25 **In addition to the cost, the feeding schemes impose a large administrative burden on the system.** Both of the feeding schemes are arranged by hiring local contractors on a fixed price per student basis. This generates an enormous amount of paperwork, much of which falls on inspectors, limiting the ability of inspectors to conduct inspections.

6.26 **On the capital expenditure side, school construction is the most significant expenditure**. At the start of 2005, the MET had 5,319 primary classrooms classified as viable, giving an average of 80 students per viable classroom. The government is committed to building permanent school buildings throughout the country, to provide complete primary coverage.

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67 Bureau of Statistics, Labour Force Survey 1999

68 UNDP (2004) Human Development Report, p148.

69 UNDP (2004) Human Development Report, p190.

70 Ibid p 96.

Schools are constructed to a high standard, to minimize maintenance, withstand seasonal storm damage, and to provide a reasonable standard of accommodation even in severe weather conditions. The cost of school buildings is high by regional standards. The unit cost of a 7 classroom school in the highlands is M1.9 million. The cost of construction is increased by the difficulty of getting materials to remote areas, and the shortage of suitable local contractors. Difficult terrain, dispersed population and high construction costs make school provision in remote areas prohibitive. The government is examining the possibility of lower-cost school buildings for remote areas, based on local construction and materials.

6.27 **In 2003/04, recurrent expenditures on secondary[71] education constituted 20 percent of the total education recurrent expenditure**. The major cost component was secondary teacher salaries, which accounted for 86.5 percent of the recurrent costs. A further 7.5 percent was allocated to bursaries for orphans and vulnerable children through the NMDS. The amount assigned to inspection was comparatively low, at only 1.1 percent of the total. Much of this was used in the salaries of inspectors, leaving only 0.1 percent of the budget for transport. By contrast, 2.8 percent of the budget was used in special subventions to elite secondary schools, almost of half of which went to a single school.

6.28 **With the expansion of secondary education, the pupil-teacher ratio has risen slightly, and is currently at 26:1**. Average pay for secondary teachers was M47,496 in 2004, or the equivalent of over 10 times GDP per capita. This combination of PTR and salary results in an annual salary cost per student of over M1,800.

6.29 **The Education Sector Strategic Plan (2005) anticipates that free education will gradually be expanded to include the first three years of secondary education**. This may result in significant increases in enrollment in secondary schools. As secondary enrollment expands, this level of expenditure is likely to be difficult to afford. In the medium-term, some of the pressure is likely to be taken up by increasing class sizes. In the longer term, the government may need to review teacher utilization and salaries to find an affordable solution.

6.30 **Government support for higher education institutions is given in the form of subventions to autonomous higher institutions.** In 2003/04 one third of the higher education spending was allocated to the NUL, the largest institution of higher education. Much smaller subventions were given to LCE, Lerotholi Polytechnic and the Institute of Development Management.

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[71] In Lesotho the term basic education is used to refer to primary education and the first three years of secondary education. For the purposes of this section, secondary education refers to all five years of secondary education (Grades A,B,C,D and E)

Table 6.3: Subventions to Higher Institutions in 2003/04

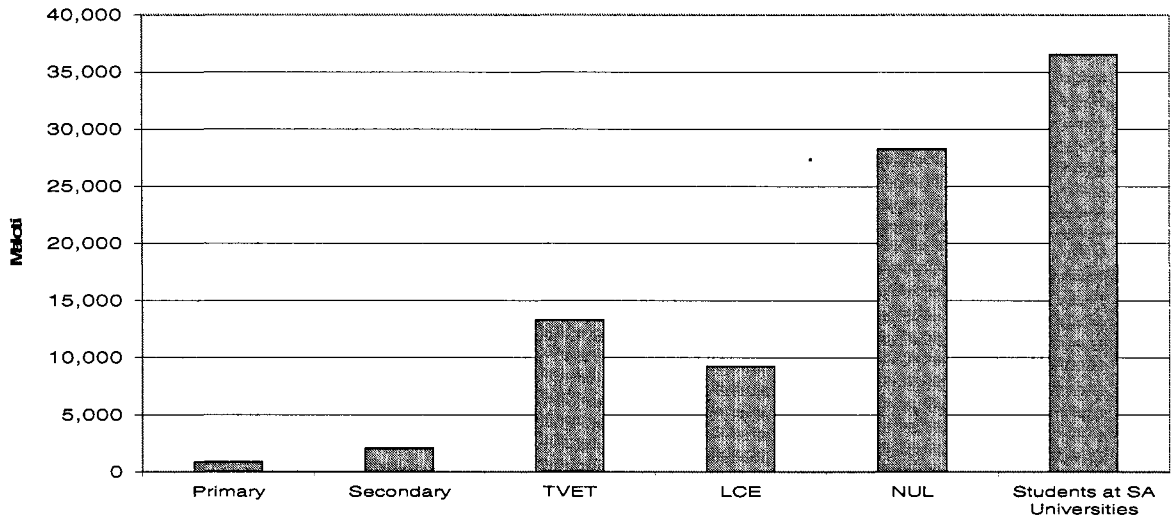
	Millions of maloti	Share
National University of Lesotho	117	33.3
Lesotho College of Education	17	4.8
Lerotholi Polytechnic	14.6	4.1
Institute for Development Management	1.9	0.5
NMDS Tertiary Bursaries	201.3	57.2
	351.77	100.0

Source: MET.

6.31 **NMDS tertiary bursaries constituted the largest component under higher education recurrent expenditure (57 percent).** Expenditure on the bursary scheme has been rising rapidly, from M65 million in 1998/99 to M270 million in 2004/05. This bursary scheme awards scholarships to the majority of students in NUL (5,247 of 7,000 in 2003) and other institutions, as well as Basotho students in South Africa. Scholarships are intended as loans, but the recovery rate is low (approximately 10 percent). This level of funding for higher education raises issues of equity, especially when secondary education involves fees (an average of M2,000 per annum), which are prohibitive to poorer families.

6.32 ***Public Spending Per Student.*** As noted above, public expenditure on education is heavily weighted towards the higher levels. This becomes even clearer when we examine unit costs at the different levels. Recurrent expenditure per student at primary level was M879 in 2004/5. Expenditure on secondary students was more than double this amount at M2,088. Each student in NUL cost the MET 32 times as much as a primary school student, at M28,240. Students given scholarships for higher education abroad cost M36,523 each, the equivalent of 49 primary school students.

Figure 6.1: Recurrent Expenditure per Student [72]



Source: Primary and Secondary Education in Lesotho - A World Bank Country Status Report.

6.33 **At the primary level, expenditure per student rose from M514 in 1998/99 to M879 in 2004/05, despite a decline when FPE was first implemented and the enrollment suddenly increased**. At secondary school level, expenditure per student also rose during the period, though at a slower rate, increasing from M1,600 to M1,993 per student. Compared to other levels, expenditure per TVET student experienced more fluctuation. There was a substantial decrease in 2001/02 and 2002/03 because NMDS bursaries for TVET students were reduced.

6.34 **Public expenditures per student for those at the Lesotho College of Education and the NUL declined during the same period, due primarily to increases in enrollment.** In 1998/99, it cost the government M13,080 every year to educate one student at LCE. By 2004/05, the cost declined to M9,243 per student. The annual figures per student for the NUL dropped substantially: from M47,547 in 1998/99, to about M28,240 in 2004/05. In terms of share of GDP per capita, expenditure per LCE student declined from 4.6 times to 1.9 times GDP per capita, and that for each NUL student declined from more than 16 times to about 6 times GDP per capita.

6.35 **When expressed as a share of GDP per capita, Lesotho's expenditure per primary student is similar to that of other countries in the region**. However, expenditures on secondary and tertiary education are much greater. In 2001, the government spent more than 12 times the GDP per capita for every student enrolled in the NUL, compared to only 56 percent of GDP in South Africa, 88 percent in Botswana, and about 2.5 times GDP in both Swaziland and Kenya.

IV. PRIVATE EXPENDITURES ON EDUCATION

6.36 ***Primary Education***. Under the government's phased introduction of FPE, school fees for one grade were abolished each year, beginning with grade 1 in 2000. This scheme has dramatically reduced the charging of fees for primary education. However, a small number of

[72] 2005 financial data, except Students at SA higher education taken from 2004 figures.

schools (3.3 percent in 2003) continue to charge fees. This was most common in "community schools" which are part funded by the local communities. In addition a minority of schools continue to impose some user charges, often in the form of a fee for textbooks, uniform or examinations.

6.37 ***Secondary Education***. Nearly every secondary school in Lesotho charges some fees. With the exception of Lesotho High School, secondary schools retain the fee income and use it at the school level. Schools have discretion in setting the fee level, and fees vary considerably. Fees for tuition and other related charges range from M650 to M2000 per year. In addition students pay an average of M1200 per year for meals and lodging. The total private expenditure on secondary education is estimated at M118.6 million, or 68 percent of the government's recurrent spending on secondary education.

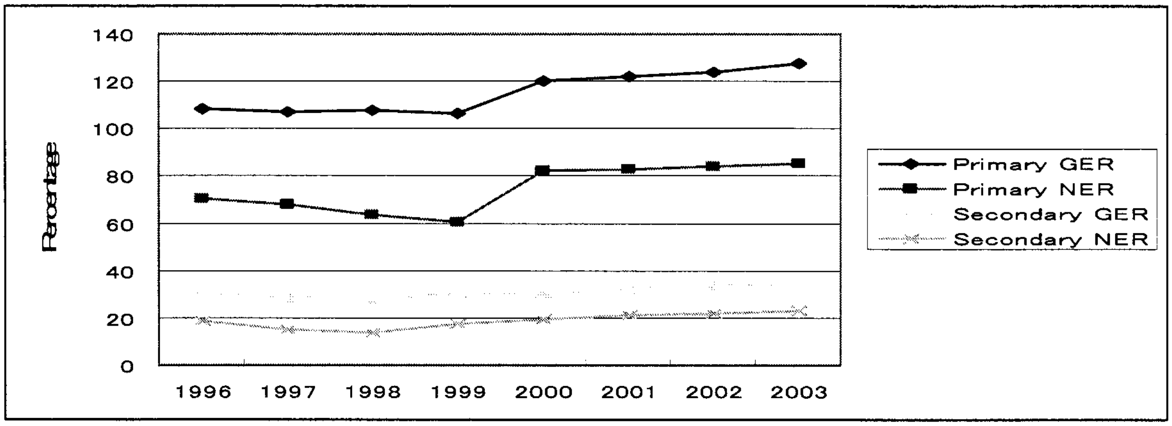
V. EDUCATION OUTCOMES AND EFFICIENCY INDICATORS

6.38 **Education in Lesotho is expanding steadily. At the primary level, the introduction of free schooling has increased enrollment, and gross enrollment ratio (GER) is over 120 percent, reflecting a high percentage of over-age children in schools**. Despite this high enrollment, about 15 percent of children are currently out-of-school, especially the children of the poorest families and those in remote areas. As the better-off sectors of society have higher participation in education, they receive a disproportionate share of public education spending. Although the survival rate is moderate, there is some cause for concern about the quality of primary education.

6.39 **The education system in Lesotho has been expanding over the last 15 years**. By 2004, about 0.6 million students were enrolled in various educational institutions, out of a total population of 1.8 million. The primary school population grew 21 percent, despite a decline between 1995 and 2000. In the same period the junior secondary enrollment grew by 82 percent and senior secondary education grew 155 percent. Higher education saw even more dramatic increases. Enrollment at Lesotho College of Education grew 400 percent, while that at NUL grew over 500 percent. Expansion was much slower in the TVET sector, which grew slowly until 2001, and actually declined in recent years.

6.40 **The GER in primary schools increased sharply with the introduction of FPE, and has climbed slowly since then, reaching 127 percent in 2003**. This rate can be expected to fall as the over-age children enrolled at the introduction of FPE pass through the system. The enrollment rates at secondary level are much lower, with a GER of 34.5 percent and net enrollment rate of 22.8 percent, but have been rising slowly.

Figure 6.2: Gross and Net Enrollment Rate in Primary and Secondary Education



Source: Education Statistics and Projected Population by the World Bank.

6.41 **There are strong indications that the introduction of FPE has had a positive impact on enrollment**. The entry rate in 1999, the year before FPE was started, was 105 percent; that rate rose to 200 percent in the following year, and then fell gradually to 121 percent by 2003. The sudden peak in the first year may result from older children entering grade 1 because it became free. Further, the FPE appears to have a positive impact on the age of entry. Only 13 percent of the new entrants in 2000 were 6 years old (the official primary school entry age) as compared with more than 42 percent in 2002.

6.42 **The cohort survival rate in Lesotho is slightly higher than the regional average and has improved significantly since the introduction of FPE in 2000.** Three quarters of the children who start school continue until at least standard seven, 57 percent begin secondary schooling in form A, and 29 percent reach the last grade of secondary school. In 1999, prior to the introduction of FPE, just over half of children who started school continued until standard seven. And of the 37 percent who started secondary school, only 14 percent reached the last grade.

6.43 **The internal efficiency of education provision is reduced by a relatively high repetition rate**. The average repetition rates in primary education have fluctuated around 20 percent over the past five years but worsened slightly in the most recent years because of high repetition in Standards 1 and 2. Repetition rates in the secondary cycle are much lower than those in the primary cycle, but have also increased in the past five years. In junior secondary education, the average repetition rate was 8.8 percent in 1999 but rose to about 11 percent in 2003. At the upper secondary level, the average repetition rate rose from 7.2 percent in 1999 to 8.4 percent in 2003.

Table 6.4: Repetition Rate by Grade and Education Cycle

	1999	2000	2001	2002	2003
Primary	19.5	19.7	18.5	19.5	21.1
Junior secondary	8.8	8.9	9.8	9.8	10.6
Upper secondary	7.2	7.1	8.0	7.8	8.4

Source: Primary and Secondary Education in Lesotho - A World Bank Country Status Report.

6.44 **Lesotho does not appear to get good value for its educational spending**. This assessment is based on a comparison of the educational development index (a measure of school life expectancy calculated from age specific enrollment rates in primary, secondary and tertiary education) and educational spending. Lesotho spends 12 percent of its GDP on education, and achieves an educational development index of 19. The efficiency of the education system can be estimated by calculating the ratio of expenditure to EDI. For Lesotho the efficiency score is 1.6 (19/12). Neighboring countries achieve much higher efficiency. The statistic is 4.2 in Botswana, 8.3 in Mauritius, 4.7 in South Africa, and 3.3 in Zimbabwe.

6.45 ***Inequities in participation.*** **In Lesotho, the enrollment rate for girls is higher than that for boys, in all grades**. In 2002, 10 percent of the children in Lesotho aged 6-14 had never attended school. This overall percentage masks wide gender differences: while 13 percent of boys in this age group did not attend school: only 7 percent of girls did not. The gender gap is greatest after standard 3, reflecting a pattern of boys dropping out of school to engage in economic activities (typically herding livestock). Historically, the economy of Lesotho was dependent on remittances from migrant workers in the gold mines of the RSA. This relatively highly paid physical work did not require education and may have encouraged boys to place a lower value on education. The gender gap in enrollment has narrowed slightly in the period 1999 to 2003.

6.46 **Significant disparities in enrollment are also observed by geographical location**. For example, 20 percent of the children in Quthing and Thaba Tseka never attended school as compared to only 5 percent in Leribe and around 7 percent in Berea and Maseru. Grade specific enrollment rates (GSER) in Maseru district range from 122 percent in grade 1 to 80 percent in grade 7. In a rural area such as Thaba Tseka, the grade specific enrollment rate was higher in grade 1, but fell to 53 percent by grade 7. There were even more marked differences in secondary enrollment, with a 62 percent GSER in Maseru in form A, falling to 23 percent by grade E, compared with only 20 percent in Thaba Tseka, which fell to 4 percent by grade E.[73]

6.47 **Socio-economic differences reflected in school attendance are also large**. The gap in school participation rate in 2002 was around 10 percentage points between children from the poorest income quintile and those who belong to the richest families. Socio-economic status also had an influence on dropout. Ten percent of the children from the poorest families drop out of school at the end of Standard 1 compared with less than 1 percent of those from the richest households. Even more dramatically, while 11 percent of the children from the richest group left school at the end of Standard 7, more than 45 percent of the children from the poorest families

[73] Further detail is available in Primary and Secondary Education in Lesotho – A World Bank Country Status Report (2005).

left the education system at this stage. Orphans are also more likely to drop out of school. Thirteen percent of the children who had lost both parents dropped out at the end of Standard 1 as compared with 5 percent of non-orphans.

6.48 **A statistical analysis of the determinants of attendance reveals that school attendance was significantly positively associated with**: (i) level of education of head of household; (ii) household income; and (iii) distance to school.

6.49 ***Public Spending by Income Group***. An analysis of the benefit incidence based on the 2002 Core Welfare Indicator Questionnaire (CWIQ) data indicates that public spending on education and training in Lesotho is substantially skewed in favor of the rich. Nearly 33 percent of public resources for education are spent on the richest 20 percent of the population, while only 13 percent are spent on the poorest quintile.

6.50 **This inequality in distribution is more regressive than the distribution in many neighboring countries**. Kenya and Namibia have each spent 17 percent of their total public education spending on the poorest quintile populations. Malawi spent 16 percent. Similarly, in Kenya and Malawi, the richest 20 percent of households receive 21 percent and 25 percent, respectively of the total public education subsidies while in Lesotho the richest 20 percent receives 33 percent of education funding.

Table 6.5: Incidence of Public Expenditure on Education by Income Quintile

	All Education		Primary Level Only	
	Poorest quintile	Richest Quintile	Poorest quintile	Richest Quintile
Lesotho (2002)	**13**	**33**	**20**	**20**
Kenya (1992)	17	21	22	15
Madagascar (1993/94)	8	41	17	14
Malawi (1995)	16	25	20	16
Namibia (2003)	17	27	17	16
S. Africa (1994)	14	35	19	28
Tanzania (1993/94)	14	37	19	18
Uganda (1992/93)	13	32	19	18

Source: Lesotho- CWIQ 2002; Namibia - Deon (2003).

VI. CONCLUSIONS AND NEXT STEPS

6.51 **While a majority of schools (approximately 90 percent) are owned and managed by a variety of church groups, teacher salaries are paid by MET**. Since the introduction of FPE, the MET also funds most of the recurrent cost of these schools. Key ministerial objectives are in line with the PRS goals and the MDGs. The policy framework is guided by the ESSP. A planning process that is increasingly linked to the budget process and the MTEF is evolving.

6.52 **Aggregate resources allocated to the sector are high; however, the distribution is skewed towards post-secondary levels.** In particular, the share of primary education needs to be raised to achieve the EFA goals embraced by the government in its ESSP. The key cost drivers in **primary** sub-sector are teacher salaries, school feeding and school construction. In

secondary education, the current class size and cost structure pose a significant barrier to expansion. Current plans do not adequately address the implications of free junior secondary education and the consequent increase in enrollment. In **higher** education, institutions are supported through two channels, a core grant, and student bursaries paid to the majority of students. The current arrangement gives the ministry limited influence on the quality, relevance or cost of courses. Expenditure per student in secondary and higher education is high by regional standards. Further work needs to be done by MET to strengthen the basis for identifying the resource requirements for implementing the ESSP and then linking it to the MTEF. The development of an education expenditure financing model to simulate various policy trade-offs and fiscal implications that is currently planned will provide a useful basis for preparing annual work programs linked to the annual budget within the MTEF.

6.53 **Quality of education remains a challenge at the primary level**. Despite relatively high expenditure, learning outcomes are poor. Although 2 percent of recurrent expenditure is devoted to the inspection service, much of the inspector's time is devoted to administrative tasks, and their impact on quality is unclear. Poor quality encourages both dropout and repetition, undermining the efficiency of the system. A concerted effort is needed to raise quality, including monitoring of learning outcomes, school support services, inspection, and improved school leadership. Efficiency gains can be made by reducing the administrative burden of the feeding program on the education management, improving the modality of support for school recurrent expenditure through direct capitation support to schools, and reviewing the construction standards in use.

6.54 **At the secondary level, the major challenge relates to expansion**. The increasing primary school participation is expected to put pressure on the secondary school system, and the government commitment to free junior secondary education will further increase enrollment pressures. The existing schools will be inadequate to meet the demand. An expansion using the current PTR and salary structures will put significant pressures on the government budget and may not be sustainable. The ministry should undertake a thorough review of the implications of expansion of the secondary education system and the proposed introduction of free junior secondary education. This should include a realistic strategy for school construction, provision of teachers, and replacement of the discretionary income of secondary schools. Government will need to review teacher utilization, working hours and class sizes to design an affordable solution as well as explore cost sharing through public-private partnership.

6.55 **A high proportion of education financing for post-secondary education is channeled through the NMDS, and does not appear as part of the MET budget**. The variety of bursary schemes financed through NMDS need to be rationalized to increase both transparency and efficiency. The bursary loan schemes for higher education have very low recovery rates, and are effectively grants for most students. The structures of post-secondary education, including higher education funding and the NMDS, need to be reviewed. Higher education funding should be structured to encourage improvements in quality of education and appropriate targeting of courses. The NMDS system should ideally be located within the MET, and should be targeted in line with a national strategy for education and skills. Loan recovery systems should be improved.

6.56 **The MET faces serious challenges brought forth by the high prevalence of HIV/AIDS in the teacher population.** This could increase the teacher attrition rate. The MET as well as the GoL recognize HIV/AIDS as a major concern from both demand and supply aspects of education. As well as recognizing the need to provide anti-retroviral drugs to teachers infected, the government is also trying to keep students that have been orphaned due to HIV/AIDS in schools by providing bursaries. The government should strengthen its programs geared to prevention and education campaigns through the MET in order to significantly reduce the infections rate earlier by educating students as well as teachers.

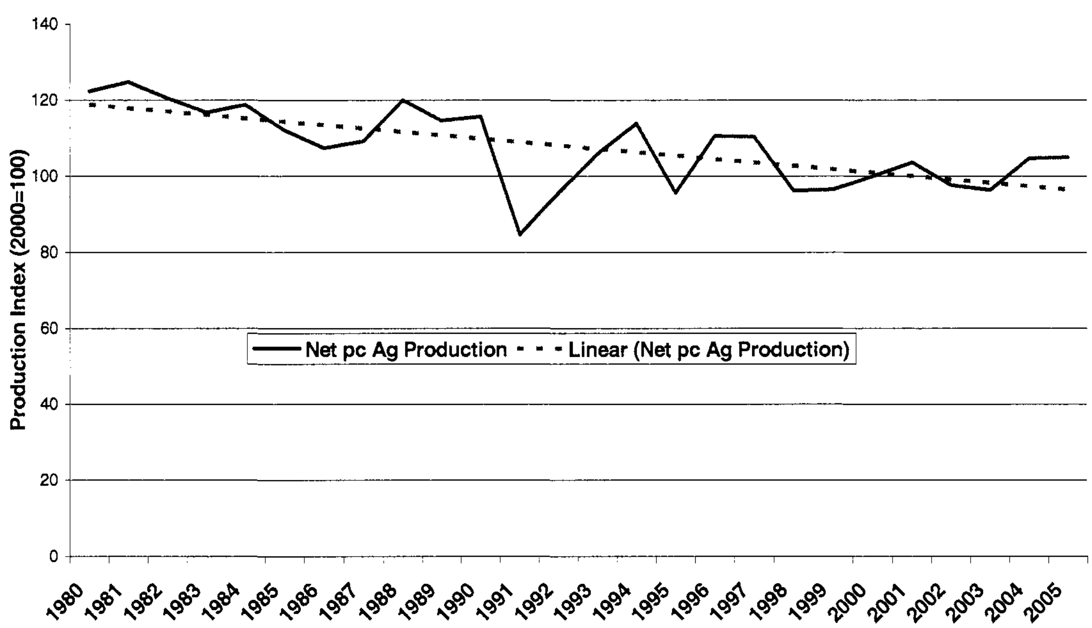
6.57 **The education system in Lesotho is inequitable, and the bulk of the relatively high expenditure serves the richest sections of society**. The primary level is the most equitable, but service provision is poorer in the remote rural areas, which have fewer qualified teachers and poorer infrastructure. At the secondary level, schools charge fees which are substantial enough to deter entry by children from the poorest families. At the same time, a small number of elite secondary schools receive special subsidies amounting to 2.8 percent of the recurrent secondary budget. At the post-secondary level, the majority of students receive bursaries from NMDS, most of which are never repaid. Hence those wealthy enough to afford secondary school are more likely to access free tertiary education. Equity could be increased by allocating a greater proportion of the expenditure to secondary education, reducing the cost at this level. This could be matched by greater cost recovery at the higher level.

B. AGRICULTURE AND FOOD SECURITY

I. INTRODUCTION

6.58 **With more than two-thirds of the population living in rural areas, facing declining work opportunities, particularly in RSA mines, agriculture has an important role to play in the socio-economic development of Lesotho**. For the bulk of rural households, agriculture is the occupation and primary source of income. The rural poor derive the majority of their income from unskilled labor, mostly in subsistence agriculture. Across the African continent, empirical evidence clearly shows that high agricultural productivity reduces poverty.[74] Thus, improving agriculture and food security is a key priority identified in the PRS in order to reverse the trend in food production deficit (Figure 6.3). Increasing crop and livestock production is a key element of Government's strategy to achieve food security at the national and household level.

Figure 6.3: Lesotho Net Per Capita Agricultural Production



6.59 **Lesotho has historically had high government expenditures in agriculture as a proportion of agricultural GDP**. However, there are widespread concerns about the efficiency

74 As evidenced by the strong negative correlation between per capita agricultural GDP and national poverty rates.

and impact (e.g., productivity, poverty reduction) of these expenditures[75] in Lesotho. This was largely attributed to: (i) inadequate planning, budget formulation, weak implementation, and inadequate monitoring and reporting systems; (ii) fragmentary organizational structure; (iii) inadequate staffing skills; and (iv) outdated regulatory framework. In addition, the ongoing efforts to enhance the autonomy and expand the decentralization process are likely to have profound implications for public expenditure management in the sector. Strengthening the existing expenditure and budget management systems is imperative if the proposed fiscal decentralization is to have the desired effect on improving service delivery throughout the country.

6.60 **The objective of this chapter is two-fold**: (i) to review public expenditures in the agriculture sector in Lesotho, and (ii) to inform and facilitate the adoption of a budget process using the MTEF as a tool to translate policy objectives and the PRS into concrete results.

II. SECTOR STRUCTURE, PERFORMANCE AND POLICY FRAMEWORK

6.61 ***Structure.*** **Agriculture in Lesotho is mainly subsistence-based.** Agriculture contributes about 17 percent to GDP, and remains largely dominated by crops (about 50 percent) and livestock (about 35 percent), with services accounting for the rest (MAFS, 2003a). While the main crops are maize, sorghum, wheat, peas and beans, maize continues to be the dominant staple crop in terms of planted area (ranging from 50-70 percent of yearly cultivated area). The livestock sub-sector consists mainly of cattle (25 percent), sheep (45 percent) and goats (30 percent). Cattle are kept for draught power, payment in kind and for sale, and also for their bi-products, milk and meat. Sheep and goats are mainly kept for wool and mohair, which comprise the largest percentage of livestock products export share (DPPA and BOS, 2002).

6.62 ***Performance.*** While the agricultural sector has grown steadily over the last two decades, because of stagnant productivity, its performance during the past 5 years has fallen short of the PRS priorities of increasing crop and livestock production to ensure overall food security.[76]

6.63 **Continued agricultural expansion would require addressing a number of constraints and challenges**, including scarce and declining agricultural land, unreliable climate and poorly developed water resources for agriculture, poor agricultural technology and practices, HIV/AIDS which diminishes labor productivity, unstable labor supply, inadequate marketing and credit facilities, insufficient and/or inconsistent policies and poor capacity and training.

6.64 **Agriculture is limited by the scarcity of arable land.** Less than 10 percent of the total area of Lesotho is classified as arable. But because of urban encroachment, soil degradation and erosion, the available arable land is declining. In addition, poor cropping and animal husbandry practices reduce land fertility. While farmers could invest in land to improve its fertility, the existing land tenure system of communal ownership discourages long-term investment in land improvement.

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[75] A review of past expenditures conducted as part of IDA-funded Agricultural Policy and Capacity Building Project (Credit 31050).

[76] Chapter 3 of the PRS (Kingdom of Lesotho, 2005b)

6.65 **Hydraulic risk is another significant challenge to agricultural production in Lesotho.** While the country's available water resources are considered more than adequate to sustain a variety of economic activities, including agricultural activities, they are inadequately spatially and seasonally distributed. Moreover, coupled with inadequate investment in water storage and irrigation infrastructure, the climate of the country is also characterized by periodic extreme weather conditions and droughts which are said to occur three out of every ten years, frequent heavy frosts and heavy unexpected rains which occur from time to time. Without a long-term integrated water management strategy, these trends are likely to worsen from the expected impacts of climate change in the region.

6.66 **Another major set of constraints facing Lesotho's agriculture relate to poor animal and crop husbandry**. This results from a number of factors including inadequate extension services/transfer of knowledge concerning improved technologies, easy and timely access to agricultural inputs because of lack of availability or lack of funds from farmers to purchase the inputs, even when subsidized, and poor veterinary services. Despite past government policy of subsidizing inputs, the problem of access to inputs is further compounded by lack of credit facilities to farmers. Moreover, even during successful crop years, the lack of marketing infrastructure (e.g. roads, storage facilities and market places) in the rural areas makes it extremely difficult for farmers to dispose of their surplus produce for cash. Recently, both crop and livestock production has been threatened by chronic theft, which is not only local but also cross-border in nature, and this is becoming a disincentive to production.

6.67 **The HIV/AIDS pandemic reduces labor availability, mobility and productivity because of poor health.** It also affects investment in agriculture, retention of knowledge about farming practices, the use of home gardens and the efficiency of extension services. The burden of work falls on inexperienced, younger and weaker, older household members. So HIV/AIDS increases the needs at the household level whilst reversing the impact of efforts to built capacity. Not only are the sick affected by the problem of AIDS, the care responsibilities of the healthy in households with AIDS patients seriously limit their movements and therefore contribution to agriculture and access to other work opportunities (MAFS, 2003a).

6.68 **Finally, agriculture in Lesotho also faces a number of institutional constraints, including inconsistent policies and at times even errors in policies (MAFS, 2003a).** These problems are exacerbated by inadequate capacity and training as well as high turnover within the Ministry. This inhibits the ability of government to develop adequate policies and implement policy decisions.[77]

6.69 **Lesotho's agricultural sector policy is driven by the National Vision of Lesotho, which makes poverty reduction, food security for all, and sound resource management the main priorities of the government in the short-term, and efficiency and output expansion a long-term priority (National Goals of the Government of Lesotho, 2002-2006).** The government has prepared its Agricultural Sector Strategic Plan to provide the Ministry with an effective planning instrument to achieve, in collaboration with all stakeholders, food security, sustainability, conservation of natural resources and growth. To achieve these objectives, the

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[77] It is important to note that the reform program started under APCBP, and which was aimed at deepening policy reform, strengthening capacity, and improving incentive structures within MAFS, was never completed.

agricultural sector has six overall goals, namely, food security, poverty alleviation, sustainable environmental management and conservation, efficiency, improved income distribution and increasing share of agriculture in GDP (MAFS, 2003a).

6.70 **In line with the Government's overall strategy for growth and poverty reduction, the private sector is expected to take a leading role in agricultural production**. The government's role will be that of creating an enabling environment for the private sector to operate effectively and competitively in productive activities. The government will limit its involvement with market mechanisms. The government realizes that there may be areas where the private sector may eventually be able to play a larger role, including extension and research, but which do not offer profitable opportunities in the short-term. In these cases, the government will remain involved until the potential for private sector involvement develops. Also, the government will continue to be involved in the provision of public goods (such as certain types of infrastructure, including multipurpose water reservoirs), and intervene to support activities directly aimed at food for the poor, particularly among those which have little access to the market and are still dependent on subsistence production (MAFS, 2003a). The government will do this through direct promotion of indigenous practices, such as the Machobane system as well as conservation farming (minimum tillage) and other home garden schemes, especially those that can be used in households where nutritional standards are particularly vulnerable because they are affected by HIV/AIDS (LG 2005).

6.71 **Government interventions and public expenditures in the sector are driven by specific sub-sectoral policies and objectives.** *Adjustment policies* are aimed at evolving the role of government from direct intervention in the sector's economy to a role of facilitation, regulation, and provision of public goods. Stagnation of the agricultural sector in Lesotho has been blamed on excessive regulation of the market system by the government which creates price distortions and marginalizes the private sector (van Schalkwyk et al., 1996; Strategic Economic Options Report, 1997; Ministry of Economic Planning, 1997; MAFS, Cooperatives, and Land Reclamation, 2002). Therefore, keeping in mind the potential vulnerability of Lesotho's economy to fluctuations and unfair trading practices in the world, government policy is now aimed at free and open trade that fosters efficient growth and pricing, whilst making decisions about the appropriate level of protection and liberalization for individual commodities on a case by case basis. To date only the grain market has been liberalized; a dozen other agricultural products continue to be regulated.

6.72 **Similarly, as part of its policy to withdraw from direct productive activities, the government is looking into the privatization and disinvestment of inappropriate or unproductive government activities**. To date 6 government farm enterprises have been earmarked for privatization (95 wool sheds, 2 sheep studs, Mejametalana vegetable farm, Tsalitlama vegetable farm, Molimo Nthuse pony trekking and the National Abattoir and feedlot complex) (Privatization Unit, personal communication, February, 2006). Out of these, only Mejametalana vegetable farm has been leased out while Tsalitlama, Molimo-Nthuse pony trekking and National Abattoir are still under negotiations. The other two enterprises are still being assessed. The expenditure impacts of this privatization program are yet to be assessed (no data was available during preparation of the present report).

6.73 **To ensure food security in the country, the crop sub-sector needs significant improvement**. Strategies planned for this sub-sector include subsidies, input distribution and a draft food security policy has also been prepared. Although Government recognizes the distortionary impacts of subsidies, a Subsidy Policy (MAFS 2003a) was adopted as a transitional policy, aimed at stabilizing farmer income and to diversify rather than support specific staple food crops, making this is an important departure from past policies focused on support for maize and other cereal crops, and allowing diversification. In addition, the policy of input distribution to farmers by government is gradually being phased out to allow provision by the private sector. Other policies deal with research efforts to help identify appropriate crops, including studies to identify sustainable marketing opportunities. In the case of the livestock sub-sector, range management and conservation are seen as essential to sustainability and productivity and must be integrated into livestock management practices (MAFS, 2003a).

6.74 **To mitigate the effects of climate variability and improve water management for increased agricultural production, the government has developed a National Irrigation Policy and Development Strategy (2002).** It has identified "land development and irrigation" as one of its strategic pillars, reflected both in the PRS and its proposed National Medium-term Investment Programme under the New Partnership for Africa's Development's Comprehensive African Agriculture Development Policy. It is estimated that out of 270,000 hectares of arable land in Lesotho, about 36,000 hectares are suitable for formal irrigation (MAFS, 2003). In addition, improvements in crop management and introduction of new irrigation technologies would allow the development of high value crops-such as horticulture and fodder crops-and linkage to the South African marketing and trade infrastructure. The investment requirements for developing a third of the potentially irrigable land, including multipurpose storage infrastructure, would be in the range of US$50-80 million over 3-5 years. Issues of implementation capacity, sustainability and economic viability would require detailed consideration.

6.75 **The Government's strategy also includes a proposal to support rain fed agriculture through conservation farming and water harvesting for backyard farms, mainly targeted at small scale and vulnerable farmers, including women, the elderly and HIV/AIDS infected people**. A draft Land Policy has also been prepared (under the Agricultural Policy and Capacity Building Project (APCBP)), combining the best of the existing land management policy, including customary law, with a number of international principles, all aimed at helping to facilitate: (i) affording the opportunity to all citizens to beneficially occupy and use land; (ii) the efficient, effective and economic operation of a land market; and (iii) appropriate regulatory arrangements for the efficient, sustainable and equitable occupation and use of land (MAFS, 2003a). While the new draft policy promises secure ownership rights of agricultural land which should provide an incentive to farmers to invest in land conservation and production thus reducing the burden of government to invest in agriculture, the failure to enact it impedes progress.

III. SECTOR BUDGET MANAGEMENT FRAMEWORK

6.76 **The MAFS is one of the pilot ministries preparing their budget within the MTEF.** A large body of work has been undertaken on sector and policy issues within the ministry, resulting in a number of key documents including a sector PER (2002 draft), a detailed agriculture sector strategy (2003), and the PRS. All these studies and documents contain sufficient direction on policies and strategies to guide prioritizing expenditures of the MAFS in the medium-term context and annual budget framework, and collectively make MAFS a suitable ministry for developing and piloting the MTEF. The budget framework paper prepared by MAFS includes (i) ministerial vision and objectives; (ii) revised programs and sub-programs; (iii) a review of performance; (iv) a review of policy; and (v) an estimate of expenditure requirements. The number of programs in the ministry has been reduced from eight to six by incorporating two programs within the other programs. The new program structure is:

01 – General Administration and Management
02 – Livestock Services
03 – Crop Services
04 – Extension Services
06 – Agricultural Training
07 – Research

6.77 **Budget classification used in the MAFS is weak.** The terms "program" and "subprograms" used in the recurrent budget, but not in development budget, refer only to organizational structures. The programs should refer to the spending units' operational packages in the form of separate recurrent activities and capital projects within a program hierarchy that flows from the functional classification. In this context, a "program" should consist of a group of interrelated recurrent activities and capital projects under a program manager, which consumes resources (inputs) to contribute toward a common result. "Recurrent activity" is defined as a package of ongoing and re-occurring operations, which consumes inputs and produces a consumable good or service, while "capital project" refers to a temporary capital work, which has limited time for operations and when completed, adds to the physical assets of an organization. Table 6.6 shows a simplified and hypothetical example on the role of each type of budget classification. At the organizational and program levels, recurrent and development budgets are integrated, although they retain their separate cost centre status at the recurrent activity and capital project levels, supported by their object classifications.

Table 6.6: Proposed framework for MAFS budget classification structure

Type of classification		Examples
Functional	Function or Main Program	Agriculture Services
Organizational	Ministry Department or Bureau under the ministry	MAFS Department of Extension Services
Program Structure	Program Recurrent activity 1 Recurrent Activity 2 Capital Project1	Extension Services Program management and general services Training of staff Construction of stores
object/ economic for each activity or project	Category Item Sub-item	Goods and services Utilities Electricity charges

Box 6.1. Key Measures and Actions Needed to Strengthen the MTEF at the MAFS

***Key elements required for the introduction of a MTEF*:**

- Developing long-term and medium-term sectoral objectives, strategies and policies;
- Aligning and determining the nature and size of the government's regulatory and operational interventions in a sector toward achieving objectives of these strategies and policies;
- Phasing and adjusting operations in accordance with the government's domestic and external resources available to a sector;
- Ensuring that government operations and services are delivered in an efficient and effective manner through developing performance indicators, and monitoring the results; and
- As a supporting measure, though related to the budget execution rather than budget formulation phase, operating a sound accounting and financial reporting system.

Actions needed to strengthen the MTEF at the MAFS

- Improve the linkages between operations and strategies in the medium-term horizon. This allows de-linking the sector's budget to GDP movements, and links it firmly to the government's fiscal policy. The 2003 Agriculture Strategy paper, the relevant sections of the 2004 Poverty Reduction Strategy Paper, and this section are considered as the starting point of a program design exercise;
- Develop a program classification on the basis suggested in Table 6.6. This will improve the quality of budgeting for the purposes of analyzing, accepting, removing or modifying an on-going or new recurrent activity or capital project in the context of a program's objectives. Once programs are classified, program objectives and description need to be identified separately;
- Fully integrate recurrent and development budgets;
- Further refine the costing of all programs by identifying inputs and calculating the cost for each recurrent activity and capital project;
- Continue to use the format and calculation techniques for medium-term expenditure projections sent out by the MFDP as attachment to the budget call circular; and
- With the implementation of the recent political and administrative decentralization, a budget structure similar to the one used at the central level should be used by district administrations.

6.78 **Budget Execution, Accounting, and Reporting Processes.** The formal components of the budget execution, accounting, and reporting systems are in place, but there is little evidence that all these function properly, comprehensively, and in a timely manner. The process includes (i) issuing of quarterly warrants (spending limits) to line ministries by the MFDP; (ii) maintenance of vote books (accounting records) in the line ministry;[78] (iii) using a central

[78] Vote books are single entry accounting records that are kept in each department of the MAFS, which record entries of quarterly warrants, expenditure commitments within those warrants, payments vouchers that are sent to

receipt, payment and recording system in the Treasury for all ministries (reporting both by the Treasury and line ministry after reconciliation of the two transaction recording systems is often deficient).

6.79 **The accounting function is decentralized to each department within the MAFS.** Instead of having a system by which spending decisions are made by the managers and implemented by a ministry-wide accounting unit, each department has its own separate accounting unit. These units keep their own vote books, and directly deal with the central Treasury in the MFDP for requesting check issuance, accounts reconciliation, etc.[79] The existing arrangements make the accounting function of the MAFS very expensive in terms of staff time and administrative costs. It also reduces the possibility of reforming the accounting system and ensuring proper implementation of the accounting policies, procedures, and standards.[80] Moreover, the arrangements adversely affect the timeliness and comprehensiveness of the reporting system.

6.80 ***Variances between budget allocations and expenditure.*** An assessment of the budgeted and actual expenditures reveals that actual agricultural public expenditure fall short of the budget. This trend is particularly evident in capital expenditures. Over the last 10 years, the ministry spent 22-56 percent of its annual budgetary allocations for capital expenditures (see Table 6.7).

Table 6.7: Actual Spending by MAFS as a Share of its Budget Allocation

	1994/95	1996/97	1997/98	1998/99	2000/01	2002/03	2003/04
Recurrent expenditures	97.5	82.7	71.5	85.7	95.9	82.2	100.0
Capital expenditures	35.3	38.1	56.2	55.6	23.3	60.7	22.0
Total expenditures	75.7	75.9	67.8	78.7	76.7	96.7	66.9

Sources: Computer Centre and Budget Estimates books, MFDP (2005)

6.81 **This tendency of under-spending, in particular on capital expenditures, can be explained by a number of reasons.** The most important is lack of capacity within the MAFS to implement programs and projects. Lack of capacity appeared to be a major constraint in operating financial accounting systems and in meeting donor requirements with respect to capital expenditures. For example, a complex financial system and low capacity to operate it delayed implementation and use of funds for the APCBP project when it started in 2000/01. High turnover and lack of incentives to retain skilled personnel also contributed to slow implementation. Preconditions set by donors also delay execution of budgeted funds. For example, sometimes donors require an increase in staff establishment, especially in extension

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the central Treasury in the MFDP for payments, and finally entering the payments acknowledged by the Treasury. Vote books are manually kept records but some departments also enter their transactions into to excel spreadsheets for internal management purposes and easy calculation of balances at any stage of expenditure execution process.

79 The Financial Controller's Office of the MAFS in addition to its role in putting together the Ministry's recurrent budget deals with the limited accounting function of the top management activities of the ministry and also has, in principle, a light after-the-event supervisory role to the accounting units of the ministry's departments.

80 When the existing Central Treasury's accounting system, Government of Lesotho Financial Information System (GOLFIS), was introduced in 1990s, the MAFS was chosen to be a pilot ministry to test the system in line ministry and extend it to the line ministries, but this never took place. With several accounting units in the MAFS, perhaps this piloting was practically impossible.

programs, as a precondition and this takes long to fulfill. It is also common that legislation has to be changed to satisfy preconditions, a process that undoubtedly takes a long time. Delays in implementation are most common in civil works where there is a lag between planned implementation and actual commitment of funds because of planning activities involved.

6.82 **Recurrent budget execution has fared better than capital budget execution throughout the period.** With a few exceptions, when actual spending has been only about 80 percent of the allocated budget, the ministry usually spends around 97 percent of its allocated budget. Looking closely at economic classifications of recurrent expenditure, there are particularly large deviations between budgeted and actual expenditures in some categories. Large and widening gaps are observed in particular with expenditures associated with personnel emoluments.[81] With the exception of three years in the late 1990s, actual spending on personnel emoluments exceeded the budged amount significantly (Table 6.8). In contrast, travel expenditures and operating costs were under-spent in most years.

Table 6.8: Actual Share of Recurrent Budgeted Expenditure by Economic Classification
(as a share of its budget allocation)

	1994/5	1995/6	1996/7	1997/8	1998/9	1999/0	2000/1	2001/2	2002/3	2003/4	2004/5
Personnel Emoluments	101.0	176.7	75.1	87.2	89.1	187.8	183.2	182.4	154.8	160.1	168.8
Travel	89.4	94.5	95.1	85.4	90.0	72.7	66.6	80.8	75.9	67.8	85.0
Operating Costs	109.0	96.8	89.1	84.3	85.9	73.3	75.6	76.0	77.8	76.0	77.8
Special Expenditures	87.8	65.4	79.5	113.8	90.8	93.3	88.5	99.5	145.4	67.9	82.7
Grants and Subscriptions	89.2	86.7	104.4	412.5	100.9	110.1	75.0	89.9	100.9	65.4	90.8

Source: Computer Center, MFDP (2005).

IV. TRENDS IN PUBLIC SPENDING

6.83 **Spending on agriculture has been on the decline as a share of overall public expenditure and also in real terms in the 2000s**, with the exception of 2002/03, when the level of agricultural spending was raised to meet drought related needs such as famine relief and agricultural support (Table 6.9).[82] Part of this decline reflects the transfer of functions, notably cooperatives to the Ministry of Trade & Industry, Cooperatives & Marketing and forestry and conservation to the newly created Ministry of Forestry and Land Reclamation in financial year 2003/04. Nonetheless, this declining trend appears to contradict the national policy of supporting and promoting agriculture to ensure food security, thus signaling a possible lack of coherence between sector objectives and budget priorities. Agriculture spending pattern also

[81] Actual expenditures for this category are increasingly in excess of budgeted allocations because sometimes salary grades of graduate staff are revised upwards in the middle of the financial year. Also sometimes preconditions of donor-funded projects require increases in staff establishments (e.g., extension staff) whose expenditures were not budgeted for.

[82] It should be noted that an analysis of Lesotho's public expenditure by functional classification is problematic due to uneven data quality.

reveals that capital spending on agriculture has fluctuated significantly, a sign of a weak budget execution capacity.

Table 6.9: Public Expenditure on Agriculture

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
	(in percent of total public expenditure)						
Recurrent expenditure	4.1	4.3	4.2	4.9	9.1	4.0	3.8
Capital expenditure	9.1	5.0	1.7	6.7	5.2	5.8	5.3
	(in millions of 2000 maloti)						
Recurrent expenditure	91.3	105.2	101.1	103.6	223.1[1]	94.1	90.7
Capital expenditure	51.4	56.0	7.1	38.2	35.4	29.4	27.3
Total expenditure	142.7	161.2	108.2	141.8	258.5	123.6	118.0

Source: IMF staff estimates.
1/ Includes famine relief expenditures.

6.84 **Within recurrent expenditures, personnel emoluments and operating costs have accounted for the largest shares** (Table 6.10). Travel related expenditure and grants and subscriptions have absorbed very small shares. While operating costs and travel-related expenditure have remained relatively steady in real terms, personal emoluments, grants and subscriptions and others, which include special spending, have experienced fluctuations. It is not clear why there are large deviations in wages and salaries payments each year. The fluctuations in grants and subscriptions and other spending are due to their contingency nature.

Table 6.10: Total Agricultural Recurrent Expenditure
(in millions of 2000 maloti)

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Personnel emoluments	25.9	40.4	36.6	35.7	45.1	34.8
Travel	16.1	12.7	11.0	10.9	13.6	14.3
Operating Costs	35.4	36.0	29.7	29.8	28.2	29.2
Grants and Subscriptions	2.9	1.8	0.6	2.3	17.0	0.9
Others 1/	24.9	10.3	25.6	144.3	-9.7	11.6

Source: Computer Center, MFDP, 2005 and staff estimates.
1/ Others include "special expenditure" and calculated as a residual. For 2002/03 they include Famine relief expenditures.

6.85 **The bulk of public spending on agriculture has been directed towards extension services, which includes district expenditures** (see Table 6.11).[83] A large part of expenditures on extension services is recurrent. Although the absence of further breakdown in data prevents a detailed analysis, wages and salaries have reportedly absorbed most of the recurrent expenditures associated with extension services.[84] Administrative expenditures, also recurrent in nature, have increased considerably since the late 1990s, accounting for about 22 percent of total agricultural expenditures. In contrast, the share of resource allocations for crops and livestock, the main

[83] Note that a strict comparison across programs is problematic due to changes in the program structure over time.
[84] Data on spending by programs are available only for total spending for each program.

productive sub-sectors, and conservation has declined for the past few years. MAFS noted that the bulk of spending for these sub-sectors was capital spending.

Table 6.11: Total Agricultural Expenditures by Programs
(as a share of total MAFS Expenditure)

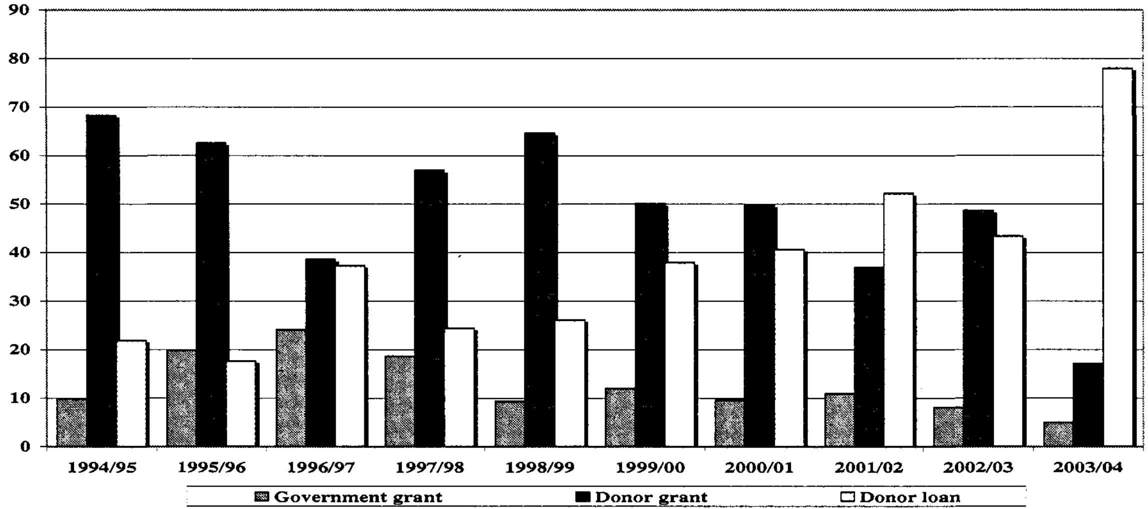
	1998/89	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Administration	10.1	19.6	23.8	17.9	18.7	22.0	22.1
Livestock	8.6	4.9	4.3	4.5	3.5	3.9	6.3
Crops	9.6	4.9	5.1	6.4	3.5	3.5	9.6
Extension services	39.1	37.6	37.6	33.7	40.2	42.1	42.2
Conservation	9.2	9.5	7.2	5.6	5.5	4.0	0.0
LAC	5.6	5.1	5.9	0.7	0.6	1.5	8.8
Research	3.3	3.1	3.1	2.9	2.5	2.5	4.3
Planning and LMPS	2.4	2.3	1.1	1.0	0.9	1.1	1.7
Range Management	0.8	1.0	0.8	0.8	0.7	0.8	0.0
TOU[85]	5.0	4.8	8.5	23.8	20.6	14.7	5.0
Cooperatives	3.1	3.5	2.8	2.7	3.2	4.0	0.0
Youth Affairs	3.2	3.7	0.0	0.0	0.0	0.0	0.0

Source: Computer Center, MFDP (2005)

6.86 **Historically, most capital expenditures have been funded by donor grants, followed by donor loans and government** (see Figure 6.4). Donor grants financed more than 60 percent of capital expenditures for agriculture in the mid-1990s, while government and donor loans accounted for 20 percent and about 18 percent respectively. However, the share of donor grants has declined steadily over the years to less than 20 percent in 2003/04. This reflects the withdrawal of some of the major donors, notably the EU, resulting from the dissatisfaction with the performance of many projects. Over time, donor loans, which are on highly concessional terms, have replaced grants as the major source of funding for capital expenditures for agriculture, accounting for nearly 80 percent in 2003/04. The role of government in public sector agricultural investment has remained minimal. The reliance on donor funding puts the agriculture sector in a vulnerable position. This, together with the weak execution capacity, is likely to be the cause of the fluctuations in actual capital spending for agriculture.

[85] Technical operations unit

Figure 6.4: Sources of Capital Budget Funds
(percentage of total)



Source: Computer Centre, MFDP (2005)

V. EFFICIENCY OF AGRICULTURAL EXPENDITURES

6.87 Among the three main production sub-sectors, crops, livestock and services, the contribution of crops has been the largest in total agricultural GDP, accounting for about 60 percent on average for the past few years (Table 6.12). However, recently the livestock sector has been growing, increasing its contribution to total agriculture GDP, while value added by services has fallen considerably.

Table 6.12: Agricultural Sector Output

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
	(in percent of total agriculture GDP)						
Crops	61.2	60.2	64.5	66.2	61.9	59.4	57.3
Livestock	32.5	34.3	30.8	29.8	34.3	36.9	39
Services	6.2	5.5	4.7	4	3.8	3.7	3.7
Total	100	100	100	100	100	100	100
	(annual growth rate)						
Crops	0.1	3.5	13.3	1	-5.3	-0.3	-6.3
Livestock	16.5	11.1	-5.1	-4.5	16.5	11.5	2.8
Services	-1.1	-60.3	-10.3	-16.9	-3.1	0.3	-2.9
Total	4.8	5.3	5.7	-1.5	1.3	3.8	-2.8

Sources: IMF staff estimates.

6.88 **The trends of expenditure shares of the three main productive sectors are in sharp contrast to the output figures**. It is noteworthy that livestock expenditures have remained below 10 percent and declined over the years. While expenditures related to crops were 16.8 percent in 1993/94, they had fallen to 9.6 percent by 2004/05. This scenario is contrary to the shares of these sub-sectors to output as displayed in Table 6.12. Table 6.13 shows that unit costs[86] of output in the livestock and crops sub-sectors declined substantially from 0.6 and 0.5 percent, respectively in 1993/94, to 0.2 and 0.1 percent, respectively in 2002/03.

6.89 **Unit costs of output have declined steadily since the 1990s.** However, compared to Kenya, unit costs for Lesotho agricultural sector are much higher. At 1.8 percent in 2000/01 and 2002/03, total expenditures per unit of overall output were six and seven times higher than those of Kenya in the two years.

Table 6.13: Expenditure Shares of agriculture sub-sectors in GDP
(in constant 1995 prices)

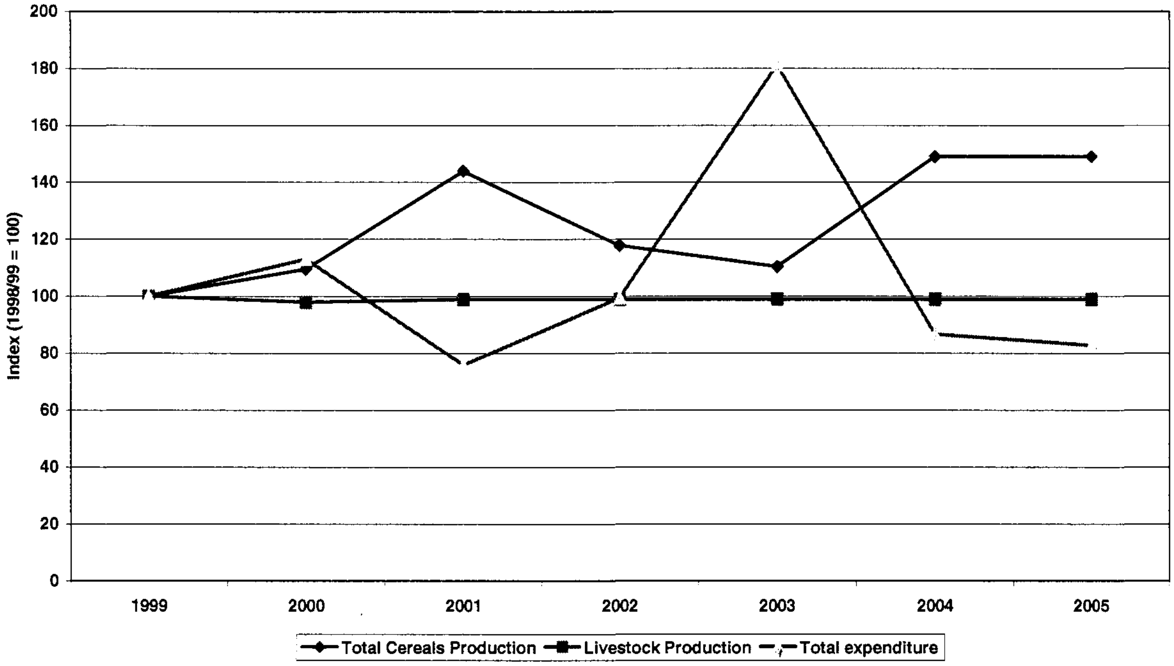
	1993/94	1997/98	2001/02	2002/03
Livestock				
Expenditures as % of GDP	0.6	0.4	0.2	0.2
Share of Output in total GDP	6.2	6.5	6.5	6.7
Crops				
Expenditures as % of GDP	0.5	0.2	0.1	0.1
Share of Output in total GDP	12.2	11.4	10.7	9.7
Sector Total				
Recurrent expenditures as % of GDP	1.8	1.6	1.6	1.5
Capital expenditures as % of GDP	0.4	0.6	0.2	0.3
Total agric expenditures as % of GDP	2.3	2.2	1.8	1.8
Recurrent expenditures as % of Agric GDP	10.9	9.7	10.3	10.2
Capital expenditures as % of Agric GDP	2.6	3.4	1.2	1.9
Total agric expenditures as % of Agric GDP	13.5	13.1	11.6	12.1

Sources: BOS and Computer Center, MFDP (2005)

6.90 **Overall, there is a very weak link between expenditure and sector performance.** Not withstanding problems related to data availability and quality, overall trends in crop and livestock production show little correlation with expenditures and as indicated in Figure 6.5, there is a need for better targeting expenditures and tracking their impacts.

86 A unit cost (ratio of the value of expenditures to the value of output) is used here as a proxy indicator of efficiency of public expenditures; however, it is important to note that, unlike sectors such as education and health where most expenditures are attributable to the public sector, sector output in agriculture is mainly the result of private spending. However, regressions using a Cobb-Douglas model show a significant positive relationship between agricultural GDP and public expenditures.

Figure 6.5: Agriculture Production Expenditure Trends



Source: FAO Stat (2006), and MAFS (expenditure data).

6.91 **Moreover, the PRS objectives for the sector need to be matched by a better structure and alignment of expenditures.** While the PRS identified six main areas of strategic importance (adoption of appropriate farming practices and timely access to inputs; development of appropriate irrigation systems; strengthening and decentralising extension services at area level within all districts; ensuring an efficient and standardised land tenure system; improving livestock and fodder production; and improving marketing systems), the estimated three year incremental cost (2004/05 – 2006/07) of about M30 million, representing some 8 percent annual increase over the next MTEF budget period, is not linked to specific outputs in the six strategic areas.

6.92 **Budgeting based on MTEF is expected to improve efficiency somewhat.** However, capacity constraints in implementation of various programs are significant and need to be addressed if service delivery is to be improved.

VI. Conclusions and Next Steps

6.93 **Aggregate resources allocated to the sector are small and declining, both as a share of GDP and in real terms.** This is in line with the trend of production in the sector but in sharp contrast to the ranking of the agricultural sector as one of the key productive sectors and government policy of supporting and promoting agriculture to ensure food security. As shown in Chapter 4, less than 15 percent of the identified PRS activities related to agriculture and food security were budgeted for in 2004/05.

6.94 **Recurrent expenditures account for a disproportionately large share of total sector expenditures, as compared to other economic sectors.** Within recurrent expenditures, personnel emoluments account for the largest share but administrative expenditures are on the rise. The change in the role played by government in agricultural production–and already initiated though the Bank financed APCBP project–if adequately reflected in budget priorities, will mean that government expenditures in the sector will need to be restructured, potentially lowering the levels of recurrent expenditures, and expanding and better targeting the level of capital budget.

6.95 **The budget system of MAFS is highly centralized**. All the district offices are currently budgeted under the Extension program which, up to a few years ago, was a sub-program of the Field Services program at head-quarter's level. District expenditures comprise more than 70 percent of total Extension expenditures, and the bulk of district expenditures are concentrated in the Maseru district for most of the years. With a large share of the population residing in rural areas, the MAFS needs to shift its resources and service delivery towards the rural areas.

6.96 **Effectiveness of overall agricultural policy has been limited.** Impact on agricultural productivity is not significant and food security has not been achieved. Some of these outcomes are a result of limited capacity for implementation. However, there have been significant issues related to the budget process – preparation, execution and monitoring.

6.97 **Recent reforms aimed at accelerating decentralization, reducing regulation in input and output markets and moving towards an MTEF hold promise for improving service delivery in the rural areas**. While the ministry has taken important strides in the development of the MTEF, several key measures and actions are needed to strengthen the MTEF in the ministry.

6.98 **With the PRS focus on decentralization and service delivery, there is a need to increase capital investment in the rural areas.** Such investment should include feeder roads, crop diversification which will require irrigation, multi-purpose water harvesting and storage schemes and rural soil and water conservation public works program. Establishing markets may also encourage commercial production, leading to higher incomes and enhanced food security.

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Appendix 1: Selected Economic Indicators

	2002/03	2003/04	2004/05	Est. 2005/06	Projections 2006/07	2007/08	2008/09	2009/10	2010/11
	(Annual percentage change, unless otherwise specified)								
National income and prices									
Real GDP	3.6	3.2	2.7	1.3	1.6	1.4	2.0	2.5	2.7
Real GNP	3.9	3.5	2.2	2.7	1.5	2.2	1.7	1.8	2.0
Consumer price index (period average)	12.2	6.4	4.4	4.0	4.6	4.8	4.5	4.5	4.5
Consumer price index (end of period)	7.9	5.2	3.6	4.3	5.2	5.2	5.1	4.5	4.2
GDP (in millions of maloti)	7,541	8,249	8,998	9,421	10,044	10,668	11,402	12,297	13,317
GNP (in millions of maloti)	9,281	10,181	11,056	11,737	12,503	13,385	14,273	15,295	16,448
External sector									
Exports, f.o.b .2/	29.8	32.0	36.4	-13.2	-11.1	-5.6	-2.6	1.1	4.7
Imports, f.o.b. 2/	21.9	28.0	24.9	-5.2	7.7	-0.1	0.8	2.1	3.4
Imports, f.o.b (including Lesotho Highlands	21.9	28.0	24.9	-5.2	7.7	-0.1	0.8	2.1	3.4
Nominal effective exchange rate 3/	12.7	14.7	-9.1	11.6	...	...	...	...	...
Real effective exchange rate 3/	12.0	12.4	-0.8	8.9	...	...	...	...	...
Money and credit									
Net foreign assets 4/	-70.6	-11.1	34.1	4.9	19.3	4.4	-5.0	1.4	2.3
Net domestic assets 4/	73.4	16.5	-27.9	-0.2	-14.1	2.1	10.8	5.1	4.6
Credit to the government 4/	15.0	-5.8	-27.8	-2.8	-9.6	2.3	1.9	-1.4	-2.3
Credit to the rest of the economy 5/	-20.2	3.7	2.3	7.8	6.6	3.8	3.7	4.1	4.4
Broad money	2.7	5.3	6.2	4.7	5.2	6.5	5.9	6.5	6.9
Velocity (GNP/average broad money)	4.3	4.5	4.6	4.7	4.7	4.8	4.8	4.9	4.9
Interest rate 6/	12.1	12.0	9.0	7.1	...	...	...	...	...
	(In percent of GDP, unless otherwise specified)								
Investment and saving									
Investment	43.0	43.9	30.1	29.6	29.9	30.1	30.0	29.8	29.0
Public	11.1	7.7	7.2	10.7	10.9	11.1	11.0	10.9	10.0
Private	24.6	30.6	19.7	19.0	19.0	19.0	19.0	19.0	19.0
Lesotho Highlands Water Project	7.4	5.6	3.2	0.0	0.0	0.0	0.0	0.0	0.0
Gross national savings (including remittances)	25.0	33.1	27.5	28.4	27.5	23.3	22.2	22.9	22.2
Public	9.2	11.0	17.9	13.4	17.2	10.7	10.5	10.6	10.7
Private	15.8	22.1	9.6	15.0	10.3	12.6	11.7	12.3	11.6
Government budget									
Revenue	40.2	41.7	48.1	47.7	53.3	47.0	44.8	45.0	44.4
Total grants	3.9	2.2	2.5	1.6	4.3	2.9	2.9	2.9	3.0
Total expenditure and net lending	48.5	43.1	41.8	45.0	54.8	51.5	49.1	49.1	48.5
Overall balance (excluding grants)	-8.3	-1.4	6.3	2.6	-1.5	-4.5	-4.3	-4.1	-4.1
Overall balance (including grants)	-4.4	0.8	8.8	4.2	2.8	-1.6	-1.4	-1.2	-1.1
Domestic balance	3.8	3.8	11.3	6.1	2.8	2.2	2.3	2.5	2.7
Government debt 7/	99.7	75.7	57.2	55.6	50.6	47.4	49.5	50.2	49.2
Domestic debt	17.0	13.3	7.1	6.7	4.6	2.1	5.4	7.1	7.1
External debt 7/	82.7	62.5	50.2	48.9	46.0	45.3	44.1	43.2	42.1
Domestic debt, net of deposits	0.8	-2.2	-8.2	-7.9	-9.9	-11.0	-13.7	-16.5	-19.2
External debt-service ratio 8/	11.8	9.1	7.3	12.8	9.7	9.9	9.2	7.4	7.1
Current account balance									
Excluding official transfers	-34.6	-25.7	-21.3	-20.3	-26.9	-26.2	-25.6	-24.9	-24.3
Including official transfers	-18.0	-10.8	-2.7	-1.2	-2.4	-6.8	-7.8	-6.9	-6.7
Gross official reserves (end of period)									
(In millions of U.S. dollars)	408.4	436.9	507.7	564.0	637.2	613.5	571.4	552.6	539.6
(In months of imports of goods and services)	4.3	3.8	4.6	5.1	5.3	5.1	4.6	4.4	4.2

Sources: Lesotho authorities; and Fund staff estimates and projections.

1/ Fiscal year beginning in April.
2/ In U.S. dollars.
3/ Based on partner-country data, new trade weights from 2004. A minus sign indicates a depreciation.
4/ Change in percent of broad money at the beginning of the period.
5/ Credit to the rest of the economy affected by a write-off of bad loans in 2002/03.
6/ The average effective rate on three-month treasury bills.
7/ The appreciation of the loti had a significant effect on the debt-to-GDP ratio in 2003/04.
8/ In percent of exports of goods and nonfactor services.

Appendix 2: Central Government Operations, 2003/04-2008/09 1/

	2003/04 Actual	2004/05 Actual	2005/06 Est.	2006/07 Budget	2007/08 Proj.	2008/09
	(In millions of maloti)					
Revenue	3,439.3	4,326.1	4,491.1	5,351.1	5,014.6	5,109.4
Tax revenue	2,887.5	3,376.3	3,984.2	4,794.3	4,423.9	4,478.9
Customs revenue (SACU) 2/	1,421.6	2,012.4	2,305.9	3,087.8	2,604.7	2,536.7
Noncustoms tax revenue	1,465.9	1,363.9	1,678.3	1,706.5	1,819.1	1,942.2
Nontax revenue	551.8	479.7	506.9	556.7	590.8	630.4
Grants	177.8	224.3	150.0	429.8	313.8	332.6
Total expenditure and net lending	3,554.7	3,762.3	4,242.7	5,504.4	5,493.3	5,589.8
Current expenditure	2,929.3	3,097.7	3,502.0	4,261.3	4,313.5	4,358.7
Wages and salaries	1,123.2	1,176.9	1,266.1	1,437.0	1,512.4	1,589.0
Interest payments	216.4	156.2	123.1	205.7	125.3	118.5
Other expenditure	1,589.7	1,764.6	2,112.8	2,618.6	2,675.8	2,651.2
Goods and services	958.4	985.5	1,133.4	1,418.4	1,432.6	1,445.1
Transfer and subsidies	631.3	779.1	979.4	1,200.2	1,243.2	1,206.1
Capital expenditure	634.9	650.5	749.5	1,252.2	1,179.8	1,231.1
Of which: domestically funded	314.3	298.7	489.9	525.5	554.4	565.5
Net lending	-9.5	14.1	-8.8	-9.1	0.0	0.0
Unexplained net revenue 3/	...	470.1	0.0	...	...	...
Overall balance, before grants 3/	-115.4	563.8	248.4	-153.3	-478.7	-480.5
Overall balance, after grants 3/	62.4	788.1	398.4	276.5	-164.9	-147.9
Domestic balance 4/	309.7	1,020.8	577.8	286.3	223.5	262.4
Total financing	-62.4	-788.1	-398.4	-276.5	164.9	147.9
External financing	-25.7	-60.2	-392.4	-29.0	92.1	127.4
Domestic financing	-37.3	-727.9	-6.0	-247.5	72.8	20.5
	(In percent of GDP, unless otherwise indicated)					
Revenue	41.7	48.1	47.7	53.3	47.0	44.8
Customs revenue (SACU) 2/	17.2	22.4	24.5	30.7	24.4	23.2
Noncustoms tax revenue	17.8	15.2	17.8	17.0	17.1	17.0
Nontax revenue	6.7	5.3	5.4	5.5	5.5	5.5
Grants	2.2	2.5	1.6	4.3	2.9	2.9
Total expenditure and net lending	43.1	41.8	45.0	54.8	51.5	49.0
Current expenditure	35.5	34.4	37.2	42.4	40.4	38.2
Wages and salaries	13.6	13.1	13.4	14.3	14.2	13.9
Interest payments	2.6	1.7	1.3	2.0	1.2	1.0
Other expenditure	19.3	19.6	22.4	26.1	25.1	23.3
Goods and services	11.6	11.0	12.0	14.1	13.4	12.7
Transfers and subsidies	7.7	8.7	10.4	11.9	11.7	10.6
Capital expenditure	7.7	7.2	8.0	12.5	11.1	10.8
Of which: domestically funded	3.8	3.3	5.2	5.2	5.2	5.0
Net lending	-0.1	0.2	-0.1	-0.1	0.0	0.0
Unexplained net revenue 3/	...	5.2	0.0	...	...	...
Overall balance, before grants 3/	-1.4	6.3	2.6	-1.5	-4.5	-4.2
Overall balance, after grants 3/	0.8	8.8	4.2	2.8	-1.5	-1.3
Domestic balance 4/	3.8	11.3	6.1	2.8	2.1	2.3
Total financing	-0.8	-8.8	-4.2	-2.8	1.5	1.3
External financing	-0.3	-0.7	-4.2	-0.3	0.9	1.1
Domestic financing	-0.5	-8.1	-0.1	-2.5	0.7	0.2
	(In millions of maloti, unless otherwise indicated)					
Memorandum items:						
GNP at current prices	10,181	11,056	11,056	12,503	13,385	14,273
GDP at current prices	8,249	8,998	9,421	10,044	10,668	11,402

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Fiscal year from April to March.

2/ Adjustment receipts of M 330 million in 2005/06 included.

3/ The budget is on a cash basis. In 2004/05, net revenue was underrecorded in the authorities' fiscal accounts by M470.1 million. The amount has been added to the overall balance to match Central Bank of Lesotho data (the domestic financing requirement)

4/ Domestic balance excludes grants, foreign-financed capital spending, foreign interest payments, and exceptional factors.

Appendix 3: Functional Classification of Government Expenditures

Table I: Government Recurrent Expenditure by Functional Classification
(in percent of current expenditure)

	2001/02	2002/03	2003/04	2004/05
General public service	30.9	32.0	30.7	30.8
of which, defense	7.7	6.1	6.2	6.8
Health, social security and welfare	13.5	13.0	13.9	11.6
Education and community service	27.4	29.5	34.5	32.4
Economic services	11.8	15.7	9.3	9.1
Agriculture and rural development	4.9	9.1	4.0	3.8
Commerce, tourism and industry	1.4	1.6	1.5	2.0
Water, energy and mining	1.5	1.3	0.8	0.7
Roads	2.1	1.7	1.7	1.4
Other transport and communication	1.9	2.0	1.4	1.2
Other spending, incl. interest	16.4	9.9	11.7	16.1
Total current expenditure	100.0	100.0	100.0	100.0

Source: IMF Staff Report, August 2005.

Table II: Government Capital Expenditure by Functional Classification
(in percent of total capital expenditure)

	2001/02	2002/03	2003/04	2004/05
General public service	29.1	20.2	27.4	15.0
of which, defense	0.0	0.0	0.0	0.0
Health, social security and welfare	15.5	4.7	7.8	18.8
Education and community service	18.7	26.2	13.3	18.2
Economic services	61.2	46.4	53.1	38.9
Agriculture and rural development	6.7	5.2	5.8	5.3
Commerce, tourism and industry	11.5	7.2	7.5	6.6
Water, energy and mining	16.2	11.2	11.4	0.0
Roads	26.9	22.6	28.4	26.9
Other transport and communication	0.0	0.3	0.0	0.1
Unallocable and other purposes 1/	-24.6	2.4	-1.5	9.0
Total capital expenditure, incl. net lending	100.0	100.0	100.0	100.0

1/ Calculated as a residual.
Source: IMF Staff Report, August 2005.

Table III: Government Total Expenditure by Functional Classification
(in percent of total expenditure)

	2001/02	2002/03	2003/04	2004/05
General public service	30.5	29.4	30.1	28.0
of which, defense	6.0	4.8	5.1	5.6
Health, social security and welfare	13.9	11.1	12.8	12.8
Education and community service	25.6	28.8	30.7	29.9
Economic services	22.3	22.5	17.0	14.4
Agriculture and rural development	5.3	8.3	4.3	4.1
Commerce, tourism and industry	3.5	2.8	2.6	2.8
Water, energy and mining	4.7	3.5	2.7	0.6
Roads	7.4	6.3	6.4	5.9
Other transport and communication	1.5	1.6	1.1	1.0
Other spending, incl. interest 1/	7.7	8.2	9.3	14.9
Total expenditure, incl. net lending	100.0	100.0	100.0	100.0

1/ Calculated as a residual.
Source: IMF Staff Report, August 2005.

Appendix 4: Fiscal Policy and Debt Sustainability

A: Theoretical Framework

Dynamic Budget Constraint
A dynamic budget constraint of the government is given by

$$(1) \qquad e\left(D_t^* - D_{t-1}^*\right) + \left(D_t - D_{t-1}\right) = P_t + r^* e D_{t-1}^* + r D_{t-1},$$

where, D^* is the government's external debt denominated in the US dollar, D the government's domestic debt at the end of period t, and e, r^* and r are the exchange rate of the rand/loti against the US dollar, interest rates for external and domestic debts respectively. For simplicity, e, r^* and r are assumed to be constant. P_t is the primary deficit including grants in period t (primary surplus if $P < 0$). All the variables are in real terms. Equation (1) says that the budget deficit must be financed by the combination of external and domestic borrowing.

Letting Y_t be GDP and dividing Equation (1) by Y_t yields

$$(2) \qquad \frac{eD_t^*}{Y_t} + \frac{D_t}{Y_t} = \frac{P_t}{Y_t} + \frac{(1+r^*)D_{t-1}^*}{Y_t} + \frac{(1+r)D_{t-1}}{Y_t},$$

Since $Y_t = Y_{t-1}(1+g)$ where g is the real GDP growth rate (assumed to be constant for simplicity), Equation (2) can be rewritten as:

$$ed_t^* + d_t = p_t + \frac{(1+r^*)eD_{t-1}^*}{Y_{t-1}(1+g)} + \frac{(1+r)D_{t-1}}{Y_{t-1}(1+g)}$$

or

$$(3) \qquad ed_t^* + d_t = p_t + \left(\frac{1+r^*}{1+g}\right)ed_{t-1}^* + \left(\frac{1+r}{1+g}\right)d_{t-1},$$

where d represents the debt-to-GDP ratio ($d \equiv D/Y$) and p is the primary deficit-to-GDP ratio ($p \equiv P/Y$).

Equation (3) shows the dynamic relationship among debt, exchange rate, primary deficit, growth and interest rates. While it is highly simplified, Equation (3) serves to demonstrate the main point that the debt-to-GDP ratio in period t (d_t^*, d_t) are determined by the level of primary balance (p) and exchange rate (e), and relationship between interest rates (r^*, r) and the economy's growth rate (g). Note that the foreign interest rate, r^*, and the exchange rate, e, are exogenous for Lesotho, while p, r and g are endogenous, and can be influenced by domestic policy.

Equation (3) says that even with a balanced primary position (i.e., $p = 0$), and a higher growth rate relative to the domestic interest rate (i.e., $g > r$), depreciation of loti against the US dollar (i.e., increases in e) and/or in rises in the external interest rate beyond the domestic growth rate (i.e., $r^* > g$) could raise government total debt stock in loti terms. Equation (3) clearly shows the vulnerability of GoL public debt position to exogenous factors.

Transversality Condition

Note that lenders impose the transversality condition, or non-Ponzi game condition for both domestic and external debt:

(4) $$\lim_{t \to \infty} \sum_t \frac{D_0}{(1 + r^t)} = 0,$$

(5) $$\lim_{t \to \infty} \sum_t \frac{D_t^*}{(1 + r^*)^t} = 0,$$

where D_0^* and D_0 are the government's foreign and domestic debt stock as of today ($D_0^*, D_0 > 0$). Equations (4) and (5) require that the present discounted value of government debt must tend towards zero in the long-run. Equivalently, the condition requires that the long-run growth rate of debt be less than the average rates of interest on government debts, which prevents debt from increasing exponentially. When the transversality condition is met, debt is said to be sustainable.

B: Assumptions for Simulation Analysis

1. This appendix describes the assumptions used for the simulation analysis conducted in Chapter 2, Section V. The simulation period is 15 years, from 2005/06 till 2010/21. We take 2005/06 outturn estimates and treat fiscal year 2005/06 as the base year.

2. This simulation framework employed in Chapter 2 is not a general equilibrium framework. Specifically, GDP is not generated within the framework, and given outside the framework. We take the nominal GDP figure from the 2005/06 Budget and apply the assumed annual real GDP growth rate of 2 percent for the base case scenario and inflation rate of 5 percent, to derive the nominal GDP series. For the high growth case, the annual GDP growth rate is assumed to be 2 percent for 2006/07-09/10 and 3 percent from 2010/11 onwards. Other assumptions remain the same as the base case.

3. Interest rates are also given outside the model. Throughout the simulation period, the nominal interest rate on external debt is assumed to be 2.2 percent, the average "effective" interest rate for external debt for 2000/01-04/05, which is derived in the US dollar term by actual external interest payments and the external debt stock outstanding at the end of the previous fiscal year. Both interest payments and debt stock are taken from the IMF Balance of Payments statistics.

4. The domestic interest rate is assumed to be fixed at 9.0 percent, which is the average "effective" domestic interest rate for 2000/01-04/05. As discussed in the main text, the weakness of this simulation framework is that increased government borrowing does not affect the domestic interest rates.

5. We assume the exchange rate of the rand/loti to be 7.0 per US dollar, and assume that this exchange rate is fixed throughout the simulation period. As regards the discount rate, the 6-month average of the US dollar long-term CIRR (commercial interest reference rate), 5.0 percent, is used.

Revenue

6. We take the SACU revenue projection for 2006/07-10/11 from the latest IMF projection. From 2011/12 onwards, it is assumed that SACU revenue will decline by 0.5 percent of GDP a year to reach 17 percent in 2020/21. The IMF projection for SACU receipts are calculated based on the actual trade data (for 2006/07) as well as projected trade activities (for 2007/08-2009/10), taking into account the commodity price movements (projection taken from the IMF World Economic Outlook) and impeding tariff reducing trade agreements. SACU receipts are exogenous, and do not depend on domestic policies.

7. Projection for non-SACU revenue for 2005/06 is taken from the budget outturn. We assume that the 2005/06 level is maintained for the rest of the projection period (i.e., non-SACU revenue grows at the same rate of nominal GDP). This means that revenue collection for 2006/07-20/21 will be determined only by changes in SACU receipts.

8. As regards external grants, we assume conservatively that the government will receive 2.7 percent of GDP (average grant receipts of 2000/01-04/05). All grant receipts will be used for investment purposes.

Expenditure

9. Expenditure figures for 2005/06 are taken from the budget outturn. In this simulation framework, the target fiscal deficit is derived from the government's target total debt-to-GDP ratio, 54.9 percent. The level of expenditure that is consistent with this target is then calculated from the target fiscal deficit, revenue and debt service projections.

Financing

10. It is assumed that the government will continue to make amortization payments as scheduled. Projections for amortization payments for 2006/07-20/21 are taken from the latest IMF projection. We assume that the government will borrow abroad concessionally for investment purposes for the amount equivalent to 2.6 percent of GDP, the average gross foreign borrowing for the past 5 years, every year. Net foreign financing is then calculated from the new loan drawings and amortization payments. With this assumption, all the remaining financing needs will have to be met by domestic borrowing.

C: Simulation Results

Table I. Key Indicators: Base case Scenario
(in percent of GDP, unless otherwise indicated)

Nominal interest rate on domestic debt:	9.0
Real GDP growth rate:	2%
Target debt-GDP ratio in 2020/21	54.9

	Act. 2004/05	Est. 2005/06	Proj. 2006/07	Proj. 2007/08	Proj. 2008/09	Proj. 2009/10	Proj. 2010/11	Proj. 06/07-20/21 Average
Revenue incl. grants	50.6	49.3	56.6	50.3	48.1	48.4	47.9	46.9
Revenue	48.1	47.7	53.9	47.6	45.4	45.7	45.2	44.2
of which SACU receipts	22.4	24.5	30.7	24.4	22.2	22.5	22.0	21.0
Grants	2.5	1.6	2.7	2.7	2.7	2.7	2.7	2.7
Expenditure, incl. net lending	41.8	45.0	59.5	53.9	51.7	52.0	51.5	50.4
Non-interest expenditure	40.1	43.7	57.9	52.1	49.7	49.9	49.3	48.0
Fiscal balance, incl. grants	8.8	4.2	-2.9	-3.6	-3.6	-3.6	-3.6	**-3.6**
Primary balance, incl. grants	10.5	5.5	-1.3	-1.8	-1.6	-1.5	-1.4	**-1.2**
Financing	-8.8	-4.2	2.9	3.6	3.6	3.6	3.6	3.6
Net external financing	-0.7	-4.2	-0.4	-0.1	0.4	1.0	1.1	0.9
New external loans	2.0	1.2	2.6	2.6	2.6	2.6	2.6	2.6
Amortization	2.7	5.3	3.0	2.7	2.2	1.6	1.5	1.9
Domestic financing	-8.1	-0.1	3.3	3.7	3.3	2.6	2.5	2.5
Debt indicators								
Total debt/GDP (target)	57.1	54.9	54.9	54.9	54.9	54.9	54.9	54.9
External debt/GDP	50.0	49.0	49.6	46.3	43.6	41.7	40.1	36.9
Domestic debt/GDP	7.1	6.7	9.5	12.6	15.1	16.7	18.1	20.8
Interest payments/GDP	1.7	1.3	1.7	1.8	2.0	2.2	2.3	2.4
External interest payments/GDP	1.0	0.8	1.1	1.0	1.0	0.9	0.9	0.8
Domestic interest payments/GDP	0.7	0.5	0.6	0.8	1.1	1.3	1.4	1.6
Interest payments/revenue	3.5	2.7	3.1	3.8	4.4	4.7	5.0	5.6
Interest payments/total expenditure	4.1	2.9	2.8	3.4	3.9	4.2	4.4	4.9
Total debt service/GDP	4.4	6.6	4.7	4.5	4.3	3.7	3.7	4.1
Total debt service/revenue	9.2	13.8	8.6	9.5	9.4	8.2	8.2	9.3
Debt service ratio	6.8	15.0	9.6	9.0	8.0	6.5	6.3	7.3
Net present value								
Total debt service/GDP		42.6						
Total debt service/revenue		95.5						
External debt service/GDP		26.8						
External debt service/exports		72.4						

Table II. Key Indicators: High Growth Scenario

Nominal interest rate on domestic debt:	9.0
Real GDP growth rate:	2% up to 2009/10, 3% from 2010/11
Target debt-GDP ratio in 2020/21	54.9

	Act. 2004/05	Est. 2005/06	Proj. 2006/07	Proj. 2007/08	Proj. 2008/09	Proj. 2009/10	Proj. 2010/11	Proj. 06/07-20/21 Average
Revenue incl. grants	50.6	49.3	56.6	50.3	48.1	48.4	47.9	46.9
Revenue	48.1	47.7	53.9	47.6	45.4	45.7	45.2	44.2
of which SACU receipts	22.4	24.5	30.7	24.4	22.2	22.5	22.0	21.0
Grants	2.5	1.6	2.7	2.7	2.7	2.7	2.7	2.7
Expenditure, incl. net lending	41.8	45.0	59.5	53.9	51.7	52.0	52.0	50.8
Non-interest expenditure	40.1	43.7	57.9	52.1	49.7	49.9	49.8	48.4
Fiscal balance, incl. grants	8.8	4.2	-2.9	-3.6	-3.6	-3.6	-4.1	**-4.0**
Primary balance, incl. grants	10.5	5.5	-1.3	-1.8	-1.6	-1.5	-1.9	**-1.5**
Financing	-8.8	-4.2	2.9	3.6	3.6	3.6	4.1	4.0
Net external financing	-0.7	-4.2	-0.4	-0.1	0.4	1.0	1.1	1.0
New external loans	2.0	1.2	2.6	2.6	2.6	2.6	2.6	2.6
Amortization	2.7	5.3	3.0	2.7	2.2	1.6	1.5	1.8
Domestic financing	-8.1	-0.1	3.3	3.7	3.3	2.6	3.0	2.8
Debt indicators								
Total debt/GDP (target)	57.1	54.9	54.9	54.9	54.9	54.9	54.9	54.9
External debt/GDP	50.0	49.0	49.6	46.3	43.6	41.7	39.7	36.0
Domestic debt/GDP	7.1	6.7	9.5	12.6	15.1	16.7	18.4	21.6
Interest payments/GDP	1.7	1.3	1.7	1.8	2.0	2.2	2.2	2.4
External interest payments/GDP	1.0	0.8	1.1	1.0	1.0	0.9	0.8	0.8
Domestic interest payments/GDP	0.7	0.5	0.6	0.8	1.1	1.3	1.4	1.7
Interest payments/revenue	3.5	2.7	3.1	3.8	4.4	4.7	5.0	5.6
Interest payments/total expenditure	4.1	2.9	2.8	3.4	3.9	4.2	4.3	4.9
Total debt service/GDP	4.4	6.6	4.7	4.5	4.3	3.7	3.7	4.1
Total debt service/revenue	9.2	13.8	8.6	9.5	9.4	8.2	8.2	9.2
Debt service ratio	6.8	15.0	9.6	9.0	8.0	6.5	6.3	7.3
Net present value								
Total debt service/GDP		42.4						
Total debt service/revenue		94.9						
External debt service/GDP		26.1						
External debt service/exports		70.5						

Table III. Varying Interest Rates on Domestic Debt
(in percent of GDP) 1/

	Nominal Interest Rate on Domestic Debt			
	9%	10%	11%	12%
Domestic interest payments	1.6	1.8	2.0	2.2
Total interest payments	2.4	2.6	2.8	3.0
Non-interest expenditure	44.9	44.7	44.5	44.3

1/ Holding all other assumptions provided in Table 2.2 constant (base case). Figures are the average for the simulation period (2006/07-20/21).
Source: World Bank staff estimates.

Table IV: Primary Balance, including Grants
(in percent of GDP)

	Real annual GDP growth rate			
	1%	2%	3%	4%
Target debt-GDP ratio in 2020/21				
40%	0.1	-0.3	-0.7	-1.0
45%	-0.2	-0.6	-1.0	-1.4
50%	-0.5	-0.9	-1.3	-1.7
55%	-0.7	-1.2	-1.6	-2.1
60%	-1.0	-1.5	-1.9	-2.4

1/ Assumes that the debt-GDP ratio falls/increases from 55 percent in 2005/06 gradually to the target debt-GDP ratio in 2020/21. Figures are the average for the simulation period (2006/07-20/21).
Source: World Bank staff estimates.

Table V: Primary Balance, including Grants with varying interest rates
(in percent of GDP)1/

	Nominal Interest Rates on Domestic Debt			
	9%	10%	11%	12%
Real growth rate				
1%	-0.7	-0.6	-0.4	-0.2
2%	-1.2	-1.0	-0.8	-0.6
3%	-1.6	-1.4	-1.2	-1.0
4%	-2.0	-1.8	-1.6	-1.4

1/ The target debt-GDP ratio falls from 55 percent in 2005/06 by 1.5 percentage points every year to 40 percent in 2020/21. Figures are the average for the simulation period (2006/07-20/21).
Source: World Bank staff estimates.

Appendix 5: PRS Budget Linkages

Table I: Costing and Coding Analysis, by Priority Area

Priority Area	No.of Activities	*% of Total Activities*	No. of Costed Activities	*% of Costed Activities*	No. of Coded Activities	*% of Coded Activities*	No. of Costed and Coded	*% of Costed and Coded Activities*
1. Employment Creation and Income Generation	87	20	45	21	66	21	40	22
2. Agriculture and Food Security	32	7	20	9	32	10	19	10
3. Deepening Democracy, Governance, Safety and Security	73	17	25	12	42	13	15	8
4. Infrastructure Development	71	16	38	18	67	21	38	20
5. Improve Quality and Access to Essential Health Care and Social Welfare Services	28	6	12	6	25	8	12	6
6. Improve Quality and Access to Education	79	18	57	27	54	17	47	25
7. Manage and Conserve the Environment	25	6	15	7	20	6	15	8
8. Improving Public Service Delivery	23	5	0	0	15	5	0	0
9. Scaling up the fight against HIV/AIDS	20	5	0	0	0	0	0	0
TOTAL	438	100	212	100	321	100	186	100

Table II: Costing and Coding Analysis, by Lead Ministry

Lead Ministry	No.of Activities	*% of Total Activities*	No. of Costed Activities	*% of Costed Activities*	No. of Coded Activities	*% of Coded Activities*	No. of Costed and Coded Activities	*% of Costed and Coded Activities*
Education and Training	72	16	52	25	48	15	43	23
Natural Resources	65	15	34	16	61	19	32	17
Tourism, Environment and Culture	37	8	28	13	35	11	30	16
Agriculture and Food Security	31	7	19	9	31	10	18	10
Justice, Human Rights and Rehabilitatior	30	7	18	8	23	7	15	8
Trade & Industry, Cooperatives & Market	39	9	19	9	26	8	15	8
Health and Social Welfare	26	6	12	6	24	7	12	6
Public Works and Transport	10	2	9	4	10	3	9	5
Communications, Science & Technology	7	2	5	2	7	2	5	3
Employment and Labour	5	1	2	1	4	1	2	1
Forestry and Land Reclamation	6	1	2	1	6	2	2	1
Local Government	21	5	2	1	17	5	2	1
Uncertain	16	4	3	1	1	0	1	1
Finance and Development Planning	17	4	0	0	12	4	0	0
Gender, Youth, Sports & Recreation	3	1	0	0	1	0	0	0
Home Affairs and Public Safety	10	2	6	3	0	0	0	0
Independent Electoral Office	1	0	0	0	1	0	0	0
Law and Constitutional Affairs	2	0	0	0	2	1	0	0
National Assembly	4	1	0	0	3	1	0	0
Prime Minister's Office	20	5	0	0	0	0	0	0
Public Service	12	3	1	0	6	2	0	0
Senate	4	1	0	0	3	1	0	0
TOTAL	438	100	212	100	321	100	186	100

Table III. Poverty Focus Coding of 2004/05 Recurrent Budget

	Not Poverty-Related		Directly Poverty-Related		Indirectly Poverty Related		Uncertain		Total	
Ministry	*No. of Sub-Prog-rams*	**Value (M Mill.)**	*No. of Sub-Prog-rams*	**Value (M Mill.)**	*No. of Sub-Prog-rams*	**Value (M Mill.)**	*No. of Sub-Prog-rams*	**Value (M Mill.)**	*No. of Sub-Prog-rams*	**Value (M Mill.)**
Agriculture And Food Security			*13*	80.4	*4*	21.3			*17*	101.7
Communications, Sc. & Tec	*1*	12.5	*1*	1.7	*5*	21.6			*7*	35.8
Education & Training	*1*	0.9	*8*	206.0	*17*	580.0			*26*	787.0
Employment & Labour			*3*	8.0	*1*	10.3			*4*	18.3
Finance And Dev. Plann.	*1*	4.3	*1*	23.5	*4*	125.2			*6*	153.1
Foreign Affairs	*3*	127.1							*3*	127.1
Forestry&Land Reclamation			*5*	28.7					*5*	28.7
Gender, Youth & Spo.& Rec			*2*	16.1	*2*	9.5			*4*	25.6
Health & Soc.Welfare			*41*	132.3	*10*	123.8			*51*	256.1
Home Affairs&Public Safet			*4*	109.4	*3*	61.0			*7*	170.4
Independent Elect. Comm.					*1*	108.6			*1*	108.6
Justice,Human Rights& Reh			*4*	65.8	*2*	25.6			*6*	91.3
Law & Constitutional Affairs			*2*	3.3	*6*	25.1			*8*	28.4
Local Government			*6*	68.2	*2*	33.3			*8*	101.4
National Assembly					*1*	23.7			*1*	23.7
Natural Resources	*4*	9.8	*3*	20.5	*5*	6.7	*4*	6.5	*16*	43.4
Planning					*3*	299.4			*3*	299.4
Prime Minister'S Office			*5*	27.8	*3*	16.8			*8*	44.6
Public Service					*2*	15.7			*2*	15.7
Public Works & Transport			*7*	102.2	*4*	20.4			*11*	122.6
Senate					*1*	9.4			*1*	9.4
Tourism Envir. & Culture			*1*	2.9	*2*	33.2	*1*	4.6	*4*	40.8
Trade & Industry, Coo.Mar			*3*	13.1	*2*	24.4			*5*	37.5
GRAND TOTAL	*10*	**154.7**	*109*	**910.0**	*80*	**1594.806**	*5*	**11.1**	*204*	**2670.6**

Table IV. Direct Poverty Focus of 2004/05 Development Budget

Ministry	Percent of Line Items that are Directly Poverty-Related	Percent of Recurrent Budget that is Directly Poverty-Related
Agriculture and Food Security	43	99
Communications Science & Technology	50	100
Education, Training	87	98
Finance, Development Planning	25	33
Forestry, Land Reclamation	100	100
Gender,Youth, Sports and Recreation	13	31
Health, Social Welfare	60	37
His Majesty's Office	0	0
Home Affairs and Public Safety	100	100
Lesotho Highlands Development A	0	0
Local Government	100	100
Natural Resources	71	93
Prime Minister's Office	80	93
Public Works, Transport	85	90
Tourism Envir. & Culture	60	50
Trade,Industrry, Crops, Marketing	75	99
GRAND TOTAL	**65**	**72**

Table V. Distribution of Directly Poverty-Related Allocations in the 2004/05 Budget

Ministry	Recurrent Budget: Directly Poverty-Related Items	Recurrent Budget: All Line Items	Development Budget: Directly Poverty-Related Items	Development Budget: All Line Items	Total Rec. + Dev. Budget: Directly Poverty-Related Items	Total Rec. + Dev. Budget: Percent of Total Directly Poverty-Related Items	Total Rec. + Dev. Budget: All Line Items	Percent that is Directly Poverty-Related
Agriculture And Food Security	80.4	101.7	17.5	17.7	**97.9**	7%	119.4	*82%*
Communications, Sc. & Tec	1.7	35.8	4.0	4.0	**5.7**	0%	39.8	*14%*
Education & Training	206.0	787.0	162.0	165.7	**368.0**	25%	952.6	*39%*
Employment & Labour	8.0	18.3			**8.0**	1%	18.3	*44%*
Finance And Dev. Plann.	23.5	153.1	33.3	101.4	**56.8**	4%	254.5	*22%*
Foreign Affairs		127.1			**0.0**	0%	127.1	*0%*
Forestry & Land Reclamation	28.7	28.7	7.9	7.9	**36.6**	2%	36.6	*100%*
Gender, Youth & Sport & Recreation	16.1	25.6	5.0	16.2	**21.1**	1%	41.8	*51%*
Health & Soc.Welfare	132.3	256.1	22.4	59.9	**154.6**	10%	316.0	*49%*
His Majesty's Office			0.0	1.2	**0.0**	0%	1.2	*0%*
Home Affairs & Public Safety	109.4	170.4	5.0	5.0	**114.4**	8%	175.4	*65%*
Lesotho Highlands Development Authority			0.0	58.2	**0.0**	0%	58.2	*0%*
Independent Elect. Comm.		108.6			**0.0**	0%	108.6	*0%*
Justice,*Human Rights*& Reh	65.8	91.3			**65.8**	4%	91.3	*72%*
Law & Constitutional Affairs	3.3	28.4			**3.3**	0%	28.4	*12%*
Local Government	68.2	101.4	6.4	6.4	**74.5**	5%	107.8	*69%*
National Assembly		23.7			**0.0**	0%	23.7	*0%*
Natural Resources	20.5	43.4	64.3	69.2	**84.7**	6%	112.6	*75%*
Planning		299.4			**0.0**	0%	299.4	*0%*
Prime Minister's Office	27.8	44.6	37.5	40.5	**65.3**	4%	85.1	*77%*
Public Service		15.7			**0.0**	0%	15.7	*0%*
Public Works & Transport	102.2	122.6	149.1	166.1	**251.3**	17%	288.7	*87%*
Senate		9.4			**0.0**	0%	9.4	*0%*
Tourism Envir. & Culture	2.9	40.8	22.1	44.0	**25.0**	2%	84.8	*30%*
Trade & Industry, Coops.& Marketing	13.1	37.5	40.3	40.6	**53.4**	4%	78.1	*68%*
GRAND TOTAL	910.0	2670.6	576.7	804.0	**1486.7**	100%	**3474.6**	***43%***

Appendix 6: Public Financial Management Performance Review

Summary

1. **Country background**. The Kingdom of Lesotho is a small, mountainous, landlocked country of approximately 30,350 kilometers completely surrounded by the RSA. Its population is about 2.3 million having a GNP per capita at about US$ 740 (2004). Lesotho is a constitutional monarchy, with the King as Head of State and the Prime Minister as Head of Government. The legislative branch is bicameral with a 120 member Parliament and a 55 member Senate of which 22 are permanently held by principal chiefs and 11 other senators who are appointed to represent the wider interests of society. However, the Parliament in Lesotho generally lacks the capacity to make the executive arms of the government accountable.

2. **Macro-economic and fiscal performance**. Lesotho has made significant progress in achieving macroeconomic stability. Lesotho's public finances are in relatively good shape. The overall fiscal balance (including grants) has moved from deficit to a surplus in the last two financial years, although the FY05 figures reflect a temporary increase in receipts from the South African Customs Union. Lesotho's public debt as a percentage of GDP has declined from 83 percent at end of March 2003 to 53 percent at end March 2005, although largely due to exchange rate appreciation. The government has established general fiscal targets for:[87] (i) ensuring aggregate public expenditure grows no faster than the growth in GDP, while at the same time maintaining the real level of public expenditures by having them keeps pace with inflation, (ii) maintaining a sustainable budget deficit in the medium-term, and (iii) reducing the level of internal debt by achieving a primary budget surplus. The government is also establishing a new system of local government and from 1 May 2005 has established one municipal council (Maseru), 10 district councils and 128 community councils, which will take over some functions devolved from national government ministries.

3. **PFM Performance**. This report assesses the performance of PFM in Lesotho and makes recommendations for improvement. The budget construction system has seen some improvements in the closer integration of the recurrent and capital budgets, although there are effectively still two separate budget processes. The budget is also relatively comprehensive and the budget process appears to operate in an orderly and predictable way. However, the budget classification system is outdated and does not reflect international standards. The budget overall is generally realistic and credible, except that there are some significant variations between budget and actual outcomes for some ministries' recurrent expenditures and a consistent pattern of under-spending of the capital budget, reflecting either over-optimism concerning the ability to implement projects or lack of predictability of donor funding for projects.

4. Despite some budgeting improvements, the PFM system has major deficiencies in budget execution, internal controls and fiscal reporting. Reliable information to monitor budget execution is not available. There is a general failure to observe financial rules and regulations,

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[87] See Excellent Progress, but Formidable Challenges Ahead, Budget Speech to Parliament for the FY06 Fiscal Year, by Honourable Timothy Thahane, Minister of Finance and development planning, 16 February 2005.

leading both to over expenditures on individual budget items, some unauthorized expenditures and unreliable financial reporting. Apart from this, the lack of adequate numbers of trained accounting staff has also been a major contributing factor. The PFM system is assessed and rated in 23 areas of which Lesotho scored well in 9 areas (scored above C). These areas are credibility and comprehensiveness of the budget, orderliness and participation in the budget process, predictability in the availability of funds for commitment of expenditures and public access to key fiscal information. In the remaining 14 areas, Lesotho scored C in four areas. The major weaknesses are in oversight of aggregate fiscal risk from other public sector entities, effectiveness of internal control and internal audit, accounting, recording and reporting (Indicators 9, 20, 21, 22, 24, and 25). Lesotho needs improvement in budget classification, recording and management of cash balances, debt and guarantees, follow-up of audit findings, legislative oversight, and donor's practices. (Indicators PI 5, 17, 26, 27, 28, and D - 3).

5. Much of the discussion in this report on PFM deficiencies concerns accounting and internal control failures. As such it seems appropriate to refer to the operations of the Accountant General's Office (AGO) and the accounting cadre of the civil service which it includes, as a contributing factor to these weaknesses. The 2002 IMF report documented some of the problems of the AGO and recommended a revitalization program.88 However inertia in the AGO has continued and even the production of financial statements for the years FY01 and FY02 cannot be regarded as a significant improvement, given their very poor quality. As discussed later, but for the need to issue a disclaimer audit opinion because of inability to verify opening balances, the many errors and omissions would have made a negative audit opinion from the Auditor General almost inevitable.

6. **PFM reform initiative.** The GoL is committed to PFM reforms and capacity development. With the support of DFID and other development partners, the GoL is implementing a PSIRP; this includes a significant component on PFM with an emphasis on modernization, resource efficiency, transparency, and accountability.89 The major focus areas are improving planning and budgeting, introduction of integrated financial management information system, and accounting, reporting, audit and oversight. Three task forces of relevant officials, covering the areas of planning and budgeting, accounting and reporting and audit and oversight have been established. Each has developed a program of deliverables and report to an overarching PFM Improvement and Reform Steering Committee chaired by the PS of Finance and comprising senior officials of MFDP. An inception report was presented and adopted by the government in July 2005. Reflecting its comprehensive or integrated nature, it is a medium-term program expected to cover three years up to May 2008 in its initial phase. Technical support is being provided by a new reform unit in MFDP. The reform program as a whole is also intended to facilitate the development of new legislation in the form of a new

[88] Ibid

[89] The reform program is set out in detail in Government of Lesotho, Public Sector Improvement and Reform Program, Public Financial Management Component, Inception Report, July 2005. Lesotho, although not a country qualifying for HIPC relief, was assessed as meeting only four of the 13 HIPC expenditure tracking benchmarks. Three of these were in budget preparation (comprehensiveness of the budget, inclusion of donor funding and budget classification) and one in budget execution (low stock of expenditure arrears). Lesotho's PFM system was assessed as particularly weak in the area of accounting and fiscal reporting.

Budget, Financial Management and Accountability Act, which will be developed towards the end of the reform program.

7. **Challenges for improving PFM performance.** These institutional measures demonstrate that the government is committed to strengthening the PFM system. However, the capacity development would be a key challenge to improve the PFM performance in Golf. Neither Internal Audit Department of MFDP, the Auditor General's Office nor the Public Accounts Committee of Parliament has adequate capacity to perform their functions. And none of them currently has any significant impact in improving the functioning of the PFM system. The Government and donors need to make it a priority measure of working together to strengthen the following areas:

- **Internal Control and internal audit.** To ensure adequate checks and balances on the executive, internal and external accountability mechanisms on budget performance, the internal audit functions in the governments should be strengthened. The unit should be gradually decentralized in the line ministries and government agencies for greater effectiveness.

- **Budget and Accounting Classification.** Existing budget classification is not sufficiently disaggregated and does not facilitate a linkage of the allocation of public resources to GoL's poverty reduction and other development objectives outlined in the PRS. It does include a program and functional classification. However, the current classification does not reflect well-defined programs, and the economic classification does not conform to international standards.
- **Accounting and financial reporting**. To improve the accounting function, the government is introducing an integrated financial management information system, which is targeted to become operational in FY07. It is expected that this will facilitate timely preparation of budget reports monitoring budget execution and also timely preparation of annual financial statements for audit by the Auditor General and submission to the Parliament.

- **Cash management and use of government resources for intended purpose.** For implementing the budget as passed by the Parliament, efficient cash management is a pre-condition. However, there is no formal system of cash management and banking arrangements with the Central Bank do not facilitate proper cash management.

- **External audit.** The office of the Auditor General is well established. However, its performance is hampered by a number of internal and external factors. Its performance is intricately linked to the performance of other governance institutions, particularly the Accountant General's office.[90] To improve the performance of the office of the Auditor General, GoL need to provide adequate human and financial resources.

[90] Report on Governance prepared by AfDB dated February 28, 2006.

- **Legislative oversight.** The PAC is making progress in reviewing the reports submitted to it by the Auditor General. However, its performance has been hampered due to non submission of audit reports in a timely manner. The PAC has no monitoring mechanism to review the implementation of its recommendation by the executive arms of the Government. The PAC also needs adequate technical support and adequate logistics to perform its responsibilities.

Introduction

Context

1. **Country background.** The Kingdom of Lesotho is a small, mountainous, landlocked country of approximately 30,350 kilometers completely surrounded by the RSA. Its population is about 2.3 million having a GNP per capita at about US$ 740 (2004). Lesotho is a constitutional monarchy, with the King as Head of State and the Prime Minister as Head of Government. The legislative branch is bicameral with a 120 member Parliament and a 55 member Senate of which 22 are permanently held by principal chiefs and 11 other senators who are appointed to represent the wider interests of society. Although GoL has committed itself to strengthening the principles of transparency and accountability, the country is facing formidable challenge to achieve this due to capacity gaps. The Parliament generally lacks the capacity to make the executive arms of the government accountable. The *Basotho* society lacks a formidable 'civic culture', which could create pressure on the government to be more accountable. As such there is a need for strengthening the Parliament, civil society and improve the transparency of the government operations.

2. **Macro-economic performance**. Lesotho has made significant progress in achieving macroeconomic stability.[91] Lesotho was successful in attracting FDI privatizing major parastatals, improving monetary policy implementation and strengthening the banking system. However, Lesotho's efforts to achieve its medium-term growth targets are constrained by a number of factors, including: the phasing out of the quota regime under the World Trade Organization (WTO) Agreement and Textiles and Clothing in 2005; excessive dependency on the SACU[92] customs receipts; declining remittances; recurrent droughts; inadequate skilled technical and managerial manpower; weak public financial management; and the rising toll of the HIV/AIDS pandemic. According to available data, the incidence of poverty is high in the country with about 60 percent of the population living below the poverty line. The incidence of poverty is very high in the rural and mountainous areas.

3. **Fiscal Performance.** Lesotho's public finances are in relatively good shape. The overall fiscal balance including grants has moved from deficit to a surplus in the last two financial years, although the FY05 figures reflect a temporary increase in receipts from the South African Customs Union. Lesotho's public debt as a percentage of GDP has declined from 83 percent at end of March 2003 to 53 percent at end March 2005, although largely due to exchange rate appreciation.

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[91] Lesotho has continued to cooperate closely with the IMF and has implemented the following programmes since 1988: (i) Structural Adjustment Facility (SAF, 1988-1991); Enhanced Structural Adjustment Facility (ESAF, 1991-1994); Stand-by Arrangements (SBAs, 1994-1995; 1995-1996; and 1996-1997); and Poverty Reduction and Growth Facility (PRGF, 2001-2004).

[92] Lesotho is a member of SACU, which governs trade for the member countries of Botswana, Lesotho, Swaziland, Namibia and South Africa. The Union has a common external tariff and guarantees free movement of goods amongst member countries. SACU's revenues were 42 percent of government revenue if FY 2002/03.

4. **Decentralization of fiscal system**. The government is establishing a new system of local government and from 1 May 2005 has established one municipal council (Maseru), 10 district councils and 128 community councils, which will take over some functions devolved from national government ministries. District secretaries, who coordinate the local service delivery of national ministries, have also been appointed. Each local government unit will prepare its own budget and financial statements. However decentralization remains limited, pending the full implementation of this initiative.

5. **Objective, Scope and Limitations.** This assessment is designed to measure the status of PFM performance of Lesotho and review the adequacy of reforms and capacity development initiatives using a methodology developed by a joint World Bank/IMF/PEFA PFM performance measurement framework. This review has been undertaken using the relevant PEFA PFM performance indicators. Of the 28 components of performance indicators and the 3 donor practices, 21 indicators and 2 donor practices are considered relevant to this review. Each is briefly summarized and "scored" under the relevant section heading below, and a summary list is set out in Appendix 1. One limitation of this approach is that the source studies were prepared at different times. The application of the methodology to Lesotho is based on existing diagnostic studies and a limited amount of fieldwork by an international consultant.[93]

PFM Architecture

6. **Legal Framework.** Articles 110-116 of the Constitution of Lesotho provides the authority and management of the public funds. Besides, the Finance Order 1988 makes detailed provision for the control and management of public funds. It provides that the minister shall have the management, supervision, control, direction of all matters relating to financial affairs of the GoL. Within a period of six months after the close of each financial year, the Accountant General shall sign, date and submit to the PS for submission to the Auditor General, accounts showing the financial position of the Consolidated Fund and other funds on the last day of such financial year.[94] As required by law, the Auditor General shall examine the accounts relating to the Consolidated Fund and other public funds and ascertain whether such reports are properly kept and that money has been expended for purposes for which it was appropriated by the Parliament.

7. Although there are several laws in Lesotho for governing PFM, these are not adequate for decentralization of the budget execution, preparing a medium-term expenditure

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93 See IMF Fiscal Affairs Department, Lesotho, Improving Government Accounting and Financial Management, Ian Lienert, Alemayehu Daba and V.N.Kaila, June 2002; Price Waterhouse Coopers, Study in PFM in Lesotho, July 2002; World Bank, Lesotho Public Expenditure Management –Information Update and Assessment, Ferroudin Sarraf, December 11, 2003.

94 The Finance and Audit Order No. 7 of 1970 provides for the control, management and audit of public funds and for the powers and duties of the Auditor General. The Audit Act of 1973 makes provisions for the audit and presentation of public accounts. This is also contained in Section 117 of the Lesotho Constitution. These provisions require that the Auditor General shall examine the necessary accounts relating to the Consolidated Fund and other public funds and ascertain whether such reports are properly kept and that money has been expended for purposes for which it was appropriated by the National Assembly.

framework and measuring performance of the ministries for use of public funds. A new law is important for more clearly defining financial responsibilities and reporting requirements in budget development and execution and allow for increased fiscal decentralization arrangements and modern budgeting developments such as the MTEF. Under the Financial Regulations, the PS of MFDP is responsible for the general supervision and management of the accounting operations of the government. Responsibility and accountability for public funds rests with the PS of each ministry who is the chief accounting officer of their ministry, responsible for ensuring adequate financial control, maintaining proper systems of accounts and ensuring that the provisions of the Act and regulations are adhered to. In addition, each ministry has a financial controller who is an officer of MFDP, reporting to the Accountant-General. The financial controller is responsible for the approval and monitoring of expenditures and for developing and monitoring of the recurrent budget.[95]

8. **PFM Reform Program.** With the support of DFID and other donors, the GoL has developed a PSIRP, which includes a significant component on PFM.[96] Three task forces of relevant officials, covering the areas of planning and budgeting, accounting and reporting and audit and oversight, have each developed a program of deliverables and report to an overarching PFM Improvement and Reform Steering Committee chaired by the PS of Finance and comprising senior officials of MFDP. The reform steering committee is supported by three sub-committees having specific terms of reference, which are: (i) *planning and budgeting task force, (ii) accounting and reporting task force*, and (iii) *audit and oversight task force*. An inception report was presented and adopted by the government in July 2005. Reflecting its comprehensive or integrated nature, it is a medium-term program expected to cover three years up to May 2008 in its initial phase. Technical support is being provided by a new reform unit in MFDP.

95 As mentioned later the capital budget is developed and managed by the planning director in most ministries

96 The reform program is set out in detail in Government of Lesotho, Public Sector Improvement and Reform Program, Public Financial Management Component, Inception Report, July 2005.

PFM Performance Review

Budget Formulation and Execution

Budget Time Table and Process

9. Lesotho has an orderly and participative budget process involving central agencies, spending agencies and the political leadership in accordance with a pre-determined budget calendar. The fiscal year runs from April 1 until the following March 31. The budget cycle or calendar is well established and timely. The budget circular is issued in early October with line ministries having until end November, or roughly two months in which to respond. The circular includes expenditure ceilings for each ministry's recurrent expenditures and in 2005 provided for the first time indicative figures for the following two out-years for the MTEF. For the capital budget only a total ceiling for all ministries is set and ministries may therefore freely bid for funds, the projects meet the criterion established by the MFDP. For the first time in 2006, the call circular included indicating ceilings for each ministry based on their 2005/06 budget submissions. Lesotho has a fixed budget calendar and adequate guidance is provided on the preparation of budget submission (score for both dimension (i) and (ii) of PI-11 set at A).

10. Ministries have their own internal arrangements for developing their bids and a number appear to have budget committees to bring together their bids for both capital and recurrent funding. MPWT indicates that it has extensive internal consultations which closely examine each department and program, and with the minister being closely involved. Ministry of Health indicates that its internal budgeting processes, which commence well before it receives the budget circular, include extensive consultation with other stakeholders covering both capital and recurrent expenditures. Its budget requests also reflect its sectoral strategy, drawing on the PRS and feeding into the MTEF, of which the ministry is one of the pilots.

11. Technical discussions on the budget bids are held with line ministries in December following which the Minister of Finance presents a draft budget to Cabinet. Cabinet discussion of the budget has been enhanced by the establishment of a Cabinet Budget Committee, chaired by the Deputy Prime Minister and comprising the Minister of Finance and eight other ministers. Following Cabinet discussion and approval, the draft Estimates are presented to Parliament in mid-February, to be passed before the financial year commences on 1 April. This timetable leaves little opportunity for effective review by Parliament. However, since the budget is approved by the legislature in the last three years before the start of the year "A" rating is recommended for this dimension.

12. On PI – 11, an A rating signifies that spending ministries, departments and agencies follow an integrated top-down and bottom-up budgeting process, involving all parties in an orderly and timely manner, in accordance with a pre-determined budget formulation calendar. Lesotho meets these criteria and as such an A rating is proposed.

Multi-Year Perspective in Fiscal Planning, Expenditure Policy and Budgeting

13. Following Cabinet's decision to adopt an MTEF approach to budgeting, a good start was made for the 2005-06 fiscal year to set the annual budget in the strategic context of a three year Medium-term Fiscal Framework (MTFF) and to use this process to begin integrating the recurrent and capital budgets. The MFDP organized MTEF sensitization workshops for selected MFDP staff in March 2004. Some prerequisites for the adoption of an MTEF were present in Lesotho in 2004-05. These included: macroeconomic forecast; including multi-year revenue forecast; preliminary debt sustainability analysis and a debt policy; as well as multi-year estimates of cost of new projects (capital), or expansion of existing projects, prepared by sector ministries. A joint DSA using the middle income country framework was prepared by the Bank and Fund staff and discussed with government in 2005. Other preparatory activities including revised budget forms with detailed guidance notes were prepared for the 2005-06 budget process. Thereafter, line ministries were required to prepare three year budgets based on a three year MTFF and expenditure ceilings approved by Cabinet.

14. Further progress was made in the second year of implementing the MTEF (2006-07). Three year ceilings were given by the MFDP that provided the context for the sectoral MTEFs. In addition to all ministries preparing three year budget estimates, six pilot ministries have deepened the process through developing detailed Budget Framework Papers as an input into setting of the Ministry ceilings. While sector strategies for several ministries exist, they have not been costed appropriately, to a large extent due to low capacity. The budget guidelines require line ministries to fully account for recurrent expenditure needs of investment expenditure in the current year as well as in the outer year estimates. The budget circular also provides guidelines for investment projects to be submitted by line ministries. A multi-sectoral project appraisal committee screens all project proposals to include those projects that meet the criteria set by government. However, the committee does not meet regularly and does not use consistent criteria for project appraisal.

Box -1: PFM Performance Indicator	Score
PI – 11 Orderliness and participation in the annual budget process A clear budget timetable exists, which is generally adhered to. A comprehensive and clear Budget Circular is issued which reflects ceilings approved by Cabinet. The legislature approves the budget before the start of the fiscal year.	**A**
PI - 12 Multi-year perspectives in fiscal planning, expenditure policy and budgeting. Medium-term expenditure framework has been adopted since 2005-06 budget. Steady progress is being made. Multi year fiscal forecasts of revenues, medium-term expenditure for mandatory expenditures and deficit financing are provided (A) (including debt sustainability (B)). While some sector strategies are developed, they are either not costed substantially or is inconsistent with the macro forecasts (C). Linkage between investment budget and forward expenditure is weak but improving (D).	**C+**

Budget Documentation and Transparency

15. The Budget Call Circular sets out an aggregate medium-term fiscal framework covering the ensuing budget year and the following two years. The 2005-06 Call Circular

also for the first time sets out indicative figures for the recurrent budget allocation for each ministry for the following two years beyond the estimate year. The budget speech[97] sets out macroeconomic assumptions and discusses in some detail the policies reflected in the proposed revenues and expenditures. The cost of all policies is not always fully disclosed as new policies are generally not costed. The appendixes to the speech also provide information on the financing of the budget, budget aggregates e.g. economic and functional classification of expenditures and projected results for the current budget year. However, there is no detailed discussion of fiscal risks, nor is information presented on other issues such as contingent liabilities [98] or tax expenditures. The Budget Call Circular provides information on the medium-term fiscal framework and government objectives and expectations in relation to proposed expenditures.

16. The Estimates documentation is extensive, covering both recurrent and capital expenditures, and under the latter incorporating projects funded by international donors. The document shows, in addition to the proposed budget for the ensuing year, budget figures and projected results for the current year (which ends about two months later), and actual figures for the previous budget year (the latter are not taken from Public Accounts, but rather reflect the figures from line ministries). However, information on financial transactions and relationships between the budget and parastatals are not well disclosed, as discussed below under parastatals.

17. Loan repayments as well as interest payments are appropriated in the budget. Expenditures for areas which can be considered sensitive, such as defense and security expenditure and the expenditure of the King, are shown with the same level of detail as for other ministries.

18. The Estimates Document, on account of its length, is not printed in great numbers nor is it widely available. However, the MFDP website, currently in the early stages of development, would be an appropriate place in which to provide this detailed information. As improvements occur in reporting on budget execution during the year (see later discussion under budget execution) it would also be an appropriate place on which to locate budget execution reports.

Box -2: PFM Performance Indicator	Score
PI - 6 Comprehensiveness of information in the budget. Between them the Estimates document and Budget Speech contain adequate to good information on macro-economic assumptions, the budget balance and its financing, the recurrent years budget and summarized budget data for revenue and expenditure according to the main budget heads. The Budget Call Circular provides general information on government objectives and expectations in respect of proposed expenditures as well as providing an aggregate medium-term fiscal framework. Discussion of new policies on revenues and expenditures is also included in the Budget Speech. However information on stock of debt and financial assets is not provided.	**B**

[97] Lesotho Government website: www.lesotho.gov.ls
[98] The pages entitled "Contingent Liabilities" in the Estimates document are blank.

Budget Realism

19. Revenue estimates are developed in the Economic Policy department of MFDP based on a macro-economic model maintained by the Central Bank. Under the Capacity Building in Economic Planning project, work is being undertaken to develop, implement and maintain a macro-economic model for Lesotho. In recent years the aggregate revenue forecast has been broadly in line with budget estimates, although significant deviations (more than 10 percent in some instances) have been observed for the different revenue components. The actual revenues have been more than 97 percent of projected revenues implying an A rating.

Table - I: Revenue Outturn Compared to Original Budget

	2002/03			2003/04			2004/05		
Ministries	Budget	Actual	Variance	Budget	Actual	Variance	Budget	Actual	Variance
Finance	2,534	2,477	-2.3	2,571	2,794	8.7	3,593	3,574	-0.5
Taxes on Income and Profits	711	663	-6.7	760	853	12.1	902	902	-
Taxes on International Trade	1,470	1,470	-	1,422	1,422	-	2,012	2,012	-
Sales and VAT	354	344	-2.8	389	519	33.6	678	660	-2.7
Non-Tax Revenue	576	558	-3.2	633	623	-1.5	640	596	-6.9
Total Revenue	3,110	3,035	-2.4	3,204	3,417	6.7	4,233	4,170	-1.5

Source: Budget estimates and 2005/06 Budget Speech Appendix.

20. Total recurrent expenditures also tend to be close to budget. For 2004/5 total recurrent expenditures (projected) were M3306 million compared with the budget figure of M3,492 million. The table below shows the recurrent expenditures excluding statutory expenditures deviated from the budget by between 5 and 10 percent in two of the last three years. In all three years the actual expenditures were below budgeted. The high under-expenditure in the last two years was largely on account of delays in local government elections, which led to low spending by the electoral commission.

Table 2: Budget, Actual and Variance – FY03-05

	2002-03			2003-04			2004-05		
	Budget	Actual	Variance	Budget	Actual	Variance	Budget	Actual	Variance
Sub-Total – Recurrent, excluding statutory expenditures (million maloti)	**2,340.4**	**2,258.9**	**355.0**	**2,710.0**	**2,538.2**	**260.9**	**2,933.0**	**2,675.2**	**289.0**
Variation			-3.5%			-6.3%			-8.8%
Sum of Absolute Deviation as % of budgeted Primary Expenditure			15.2%			9.6			9.9%
Overall Primary Expenditure Deviation – Absolute			3.5%			6.3%			8.8%
Absolute Dev. % of budgeted – overall deviation absolute			11.7%			3.3%			1.1%

Source: Budget estimates and 2005/06 Budget Speech Appendix.

21. However, there is considerable variation between budget and actual between ministries and in individual items reflecting the system of budget execution – liberal rules on virement or transfers between budget items, expenditures in excess of or without parliamentary authority and inaccurate reporting of expenditures. However, as Table 2 indicates, the variance in expenditure composition exceeded overall deviation in primary expenditures by more than 10 percent in only one of the last three years. There has been significant progress in the last two years.

Box – 3: PFM Performance Indicators	**Score**
PI -1. Aggregate expenditure out-turns compared to original approved budget. Aggregate expenditure out-turn, excluding statutory expenditures and donor funded project expenditures, deviated from the budget by between 5 and 10 percent in two of the last three years.	**B**
PI- 2. Composition of expenditure-outturn compared to original approved budget. There is considerable deviation in the composition of expenditure out-turn in one of the last three fiscal years (over 10 percent)	**C**
PI -3. Aggregate revenue out-turns compared to original approved budget. With the exception of donor funding, which is less controllable by the government, aggregate revenues tend to be close to budget.	**A**

Budget Comprehensiveness

22. The budget is quite comprehensive, and this situation has improved over the past few years. The ministries of Planning and Finance were merged in 2003 to form MFDP and the recurrent and development budgets[99] were combined from FY98-99. However, the process still remains separate and operates in parallel. It appears that there was some disconnect between the two budgets – for example provision of funding for a capital project without the provision of the necessary recurrent funding to operate it. The recurrent and capital budgets are separate parts of the Estimates document but covered by the same budget circular. Integration is proceeding further with moves within MFDP to have one department review budget bids for both capital and recurrent expenditures for each ministry. However, for the moment there remains a separate budget dialogue on the two components. This is also reflected in the fact that in line ministries the planning director manages capital expenditure, including liaison with international donors and the required project financial reporting, and the financial controller manages the recurrent expenditure.

23. The capital component of the estimates document may include some recurrent expenditures for special projects e.g. for new donor funded projects. Most donor funding in the form of loans is included in the capital budget. However, substantial donor assistance in the form of grants remains off-budget. Of the total capital budget of M1,043 million in the 2005/06 estimates, some M547 million is provided by some 30 donors - M273 million by grants and M275 million by loans.

Off-Budget Accounts

24. These appear to be limited. The 2002 IMF review documents moves to reduce the number of such accounts and include their transactions in the budget.[100] It notes that since 2000, several extra-budgetary funds were incorporated into the budget. It appears that only the expenditure of the Petroleum Fund, a price stabilization fund which receives earmarked revenue from the petrol levy and makes payments to petroleum companies, is undertaken outside the budget.

25. The RF established following a World Bank recommendation receives earmarked revenues and a transfer of budget funds and it is included in the capital budget under MFDP's appropriation. Expenditure from the fund is allocated by a board representing the private sector and the engineers association, as well as officials of MFDP and MPWT. The Fund prepares a separate annual report and financial statements audited by the Auditor-General, which are required to be presented by the minister to Cabinet, but there now appears to be no provision for reporting to Parliament and for subsequent publication.

26. The 2002 IMF report and the 2003 World Bank report [101] identify below the line (BTL) transactions as a potential problem in budget comprehensiveness and fiscal transparency. BTL accounts cover transactions which are not included in the budget. Some of them are advances and imprest, deposits and clearing accounts which can and should be

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[99] The approved pipeline of capital projects is known as the Public Sector Investment Plan – it is not published but is available on request. Decisions on capital budget allocations are managed by the Budget Department, along with the recurrent budget.

[100] Ibid, Page 52

[101] Ibid.

cleared by the end of the year, and which do not constitute government revenues and expenditures. However they also include trading accounts and special funds which involve government revenues and expenditures, but are not shown as part of the budget.

27. Of the trading accounts, the largest covers government printing and stationery activities.[102]. There are also some similar special funds covering the operations of the Post Office and the government vehicle fleet. Payments for some these operations are made through the GOLFIS central accounting system with its attendant problems and some are made outside GOLFIS. The Budget Circular requires a separate operating budget to be submitted for each such account and there are various requirements for these funds to prepare financial statements to be submitted to the Accountant General. However, these requirements have not in general been observed, although it appears that an instruction has been issued that all requirements for financial statements are to be observed from the 2006/07 year. Where accounts have been prepared there is the on-going problem of failure to reconcile the information with the GOLFIS system, leading to possible unreliable information. The Post Office has just produced accounts for its operations covering the last five years, which are currently being audited.

28. There is also a Reserve Fund which receive funds from a budget appropriation and which is intended to be used for major emergencies such as droughts or natural disasters, it has been infrequently used.

Separate Staff Budgeting

29. Provision is made in the budget contingency allowance (discussed later under budget execution) for filling of vacant positions and creation of new ones during the year. But these funds are not released to ministries. The Budget Circular requires ministries to seek the agreement of the MPS to proposed creation of new positions, the upgrading of any position and proposed promotions. The former raises the possibility that priorities determined by MPS may be not consistent with priorities perceived by MFDP.

30. The budget allocation for salaries and wages is based strictly on positions filled at the beginning of the financial year Ministries can apply throughout the year for access to the funds provided for filling of vacant or new positions. These funds are allocated by a committee of PSs chaired by MPS with MFDP participation. Once the funds are exhausted no further proposals are considered. However it appears that as vacancies occur during the year, line ministries can fill them if it is within their salaries budget allocation.

Box -4: PFM Performance Indicator	**Score**
PI - 7 Extent of Unreported government operations. The level of unreported extra-budgetary expenditure appears to be low. Donor funded projects are largely included in the budget. Grants are not fully accounted for, in particular, the grants provided by the bilateral donors'. However, further information is required on the financial transactions of BTL accounts which involve government revenues and expenditures. The requirements for trading and special accounts to prepare financial statements have not been observed.	**D**

[102] Note 14 to the 2002/3 Public Accounts.

Parastatals

31. There are six major and several smaller parastatals in Lesotho.[103] These are either autonomous agencies or government owned business enterprises. However the relationship with the budget of most of these institutions – advances made and dividends or interest received is unclear from the Estimates document.[104] Revenues shown under MFDP also include a single amount for dividends but no indication as to the attribution to the different parastatals.

32. Parastatals are required to prepare an annual report including financial statements prepared on an accrual basis which are audited by the Auditor-General. However while these are published, albeit in many cases with considerable delay, it does not appear that these are tabled in parliament by the relevant minister, apparently reflecting lack of knowledge of this requirement.

33. In terms of reporting on parastatals in the Public Accounts, the Auditor-General's report on the 2002-3 financial statements notes that neither loans of M149m due from parastatals nor the amount of the government investment in parastatals are shown as assets. This, coupled with the frequent lack of timely financial statements suggests inadequate oversight by MFDP of the financial operations of parastatals, thus increasing the level of fiscal risk because of the contingent liabilities involved in those which are business enterprises. It would be appropriate for the Public Accounts Committee of Parliament to develop an oversight role in this area (see later discussion on Public Accounts Committee).

34. In the absence of sub-national levels of government prior to the local government elections in 2005, the issue of central government monitoring of sub-national government's fiscal position is not a relevant dimension to be assessed. The rating is, therefore, based only on the first dimension and rating of "D" is proposed.

Box – 5: PFM Performance Indicator	Score
PI – 9 Oversight of aggregate fiscal risk from other public sector entities. Financial reporting by parastatals is not satisfactory – either in terms of timeliness or tabling in Parliament and publication. There appears to be no systematic central monitoring of their financial performance and position and therefore no systematic attention to any attendant fiscal risk.	**D**

Budget Classification

35. The classification system is based on 33 heads (or administrative entities) - 20 ministries plus other authorities, for revenues. For expenditure classification, there are 44 heads, which also include certain standing appropriations such as principal repayment and interest charges on the public debt, pensions and other statutory payments. The number of heads varies with portfolio allocations.

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[103] The major parastatals are Lesotho National Development Corporation, Lesotho Sun Hotels, Lesotho Telecommunications Authority, Lesotho Electricity Authority, Lesotho Water and Sewerage Authority

[104] Revenues shown under MFDP include profits or dividend from the Central Bank, although it is not technically a parastatal.

For recurrent expenditures the economic classification has a basic code of 10 digits. The economic classification comprises five broad headings: (i) personal emoluments, (ii) travel and transport, (iii) operating costs, (iv) special expenses, and (v) grants and subscriptions. These are further broken down into some 43 inputs, some of which are further disaggregated. In addition, within each ministry expenditures are broken down by "programs", which are a mixture of activities, organizational sub-units or groups of objects and sub-programs – most of which relate to geographical areas of the country.

36. While the recurrent budget is broken down by administrative and economic classification, the capital budget is based on individual projects and does not follow the same classification as the recurrent budget. Functional and program classification is weak though the MFDP has started presenting estimates based on functional classification from the 2005-06 budget onwards.[105]

Box – 6: PFM Performance Indicator	Score
PI – 5 Classification of the Budget. The budget formulation and execution is based on administrative and economic classification and can produce consistent documentation based on these standards (not GFS 2000). The classification system does not include an adequate program and functional classification.	**C**

Budget Execution

37. A cash flow forecast is prepared at the beginning of the year and is updated during the year, although not on a quarterly basis giving PI 16 (i) a "C" rating. Budget execution is controlled by a system of quarterly warrants to release funds to ministries giving a B rating to PI 16 (ii). Given Lesotho's relatively healthy fiscal position, no major cash rationing in the allocation of funds to line ministries has been necessary in the past few years (there were some across-the-board cuts in 2002/03). Funding to line ministries is therefore reasonably predictable. There are no significant in-year adjustments to budget allocations, giving it a "B" rating on PI 16 (iii).

38. Ministries are required to record commitments in their Vote books but it appears that this requirement is not always observed. Thus there is no formal system of commitment control in that commitments may be made outside the Vote book and no explicit limit is placed on the level of commitments.[106] Similarly, there is no formal or reliable data on the stock of expenditure arrears which reflects a "D" rating for PI 4 (ii). However there is no evidence of significant expenditure arrears occurring as a result, which indicates a "B" rating for PI 4 (i) giving an overall rating of "D+". For example in the event of non payment of utility bills the service will be cut off by the private providers. MFDP has no particular knowledge of or system for identifying expenditure arrears, apart from noting old invoices which line ministries may submit with their payment requests.

39. Funds cannot be transferred between heads of expenditure except with Cabinet approval. Within a Head, funds may be transferred between economic items other than

[105] The functional classification also appeared in the annual estimates up to 2002/03 (page 11 of the summary).
[106] A formal commitment control module will be part of the new IFMIS – see later discussion.

personal emoluments at any time during the year with the approval of the Minister of Finance, thus providing a relatively liberal virement authority.

40. There is a Budget Contingency Fund of about two percent of total expenditures - M106m in 2005/6, set aside for urgent unforeseen expenditure and controlled by the Minister of Finance.[107] However, it does not appear that there is any separate auditing of or reporting on its use. Use of the reserve is required to be regularized by supplementary appropriations during the year. Likewise any over-expenditure of items is required to be regularized by the passing of a supplementary appropriation. However these requirements are not necessarily observed, leading the Auditor-General to refer to such cases as "unauthorized over-spending" (Report of the Auditor General on the Public Accounts of Lesotho).

41. There is no formal provision for a half-yearly review of budget execution but in practice such a review may occur depending on the need. Supplementary estimates may be requested by individual ministries at any time throughout the year, depending on their needs.

42. As discussed below ministries maintain their own vote books on a manual basis. These record details of payment requests submitted to MFDP (Treasury) which pays all accounts centrally through the GOLFIS system. Ministries report details of their payment requests monthly to MFDP. Ministries are required to send their monthly reports to Treasury within 15 days of the end of the month but this is not always complied with and leads to delays in the preparation of the aggregate budget execution statement The MFDP is required to produce monthly expenditure reports within 20 days of the end of the month.

43. However this reporting on budget execution is of poor quality. The GOLFIS system does not provide regular reporting to enable either MFDP or line ministries to monitor their expenditures against budget. While the classification of data allows comparison to the original budget, expenditure is covered only at the payment stage, the information produced by GOLFIS and the monthly information coming from line ministries is not reconciled. Ministries must make use of their own "top drawer" monitoring systems which frequently contain unreliable information. For aggregate budget monitoring the Budget Office considers the reports produced by Treasury as unreliable and therefore uses information prepared by the MFDP Fiscal Analysis and Policy Unit, which reflects data from the Central Bank at a relatively high level of aggregation. [108] As such, although reports are prepared within eight weeks, there is serious concern about the accuracy of the data at the detailed level. As such, a "D" raring suggested for dimension (iii), "C' rating for dimension (ii) and "D" rating for dimension (i) and an average rating of "D+".

44. Within-year budget reports focus only on cash payments (not also commitments). The monthly reports prepared within MFDP are inadequate and cannot be used either by line managers or by MFDP itself in monitoring the implementation of the budget. At the central level reliance must be placed on highly aggregated reports produced from the banking system.

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[107] The contingencies provision s often used to fund activities that have not been included in the estimates (including major emergencies) or which require allocations in excess of their appropriations. In 2005/06, the provision included M31.4 million for the National AIDS commission, which had not been established by the time the Budget was presented to Parliament.

[108] A fiscal reporting group comprising representatives of Treasury and FAPU has been established to look at reducing reliance on FAPU reports in monitoring budget execution.

45. Comparisons to the budget may not be possible across all main administrative headings and a "D" rating is suggested for this dimension (i).

Box – 7: PFM Performance Indicators	Score
PI - 16 Predictability of funds for commitment of expenditures. A cash flow forecast is prepared at the beginning of the year and is updated as needed during the year, although not on a quarterly basis. Line ministries have reasonable assurance on the availability of funds, with the exception in some cases of donor funded projects (see discussion under donor funding below). Any within-year adjustments to budget allocations by MFDP are done in an orderly way.	**B**
PI -4. Stock and monitoring of expenditure payment arrears. There is no reliable data on expenditure arrears. However, expenditure arrears are known to be limited, reflecting reasonable predictability of availability of funds to line ministries. However there is no formally operational system of commitment control or systematic information of the level of arrears, and MFDP can only know of arrears when old invoices are submitted for payment by line ministries.	**D+**
PI – 24. Quality and Timeliness of Within-Year Budget Reports. Within-year budget reports are not regular and focus only on cash payments (not also commitments). While comparison to the original budget is possible at the cash payment level, the monthly reports prepared within MFDP are not adequate and reliable for monitoring the implementation of the budget. At the central level reliance must be placed on highly aggregated reports produced from the banking system.	**D+**

The Accounting System

46. GOLFIS, the central accounting system operated by MFDP, was developed in the early 1990s, and initially operated well in terms of providing relevant information for managing and monitoring budget execution. It provides centralized data capture and provides general ledger, validation, classification and reporting facilities within the Treasury in MFDP. GOLFIS also provides for cheque production, captures the budget appropriations to prevent payments in excess of appropriations and incorporates warrant control. Sub-treasuries, which are units of the Treasury located outside Maseru, and ministerial accounting units are not connected to GOLFIS.

47. Treasury, which is part of AGO, makes payments through the central computerized GOLFIS system based on requests for payment, supported by voucher documentation from spending ministries. AGO prepares a monthly statement of expenditures based on information supplied by ministries from their Vote books which are manually maintained – or from the GOLFIS system. As mentioned above these reports are of poor quality because of mis-postings and other errors, although the Auditor-General considers there has recently been some improvement in quality.[109]

48. The Treasury also operates the central payroll system, UNIQUE, which is interfaced with GOLFIS. However both systems are obsolete and have become gradually degraded

[109] Based on discussions with Auditor-General.

through lack of capacity in MFDP or other reasons, such as inertia, to undertake adequate systems maintenance. The quality of accounting information is poor because of recording and posting errors, data omissions and a failure to reconcile subsidiary records, largely maintained by ministries to the general ledger. [110] They are also too centralized to respond to the needs of line ministries and cannot readily be expanded to incorporate new modules, as discussed below.

49. This poor quality of accounting information may reflect a perception or mind-set among the accounting cadre that its task is to process transactions, rather than to also produce information for management purposes.

50. These problems with GOLFIS have led to a fragmented accounting system between Treasury and spending ministries (sub-Treasuries and ministry accounting units), reflected in a range of inefficient manual systems or small accounting packages, which are prone to error and do not permit ready aggregation of information. They are also highly susceptible to fraud and misuse.

51. The PFM Reform program envisages replacing GOLFIS and UNIQUE with a new IFMIS to commence at the beginning of the 2007/8 financial year which can handle an MTEF approach, and with current centralized accounting and reporting functions being devolved to ministry accounting units, replacing their manual systems, which cannot be incorporated into GOLFIS. A later step will be to extend the system to payroll, procurement and other modules. The new system will include a commitment control module. The first module to be implemented will be that covering budget development. The tender was expected to be placed by the end of 2006, with full implementation occurring by 2009/10. In the interim the following steps will be taken through the PFM reform program to improve the functioning of GOLFIS and UNIQUE.

- training for chief accounting officers (the principal secretaries) on the importance of sound financial management
- resolving the issue of the lack of opening balances information, due to the absence of financial statements for the four years 1996/97 to 2000/01.
- ensuring that reconciliations between GOLFIS and subsidiary systems is undertaken (bank reconciliations, reconciliation of Vote books to GOLFIS)
- establishing a working group on irregularity and internal control.
- revamping the internal audit function, as discussed later under internal audit.

52. The PFM reform plan recognizes these as necessary steps before the IFMIS can be successfully implemented. The attendant risks in implementing a comprehensive new IFMIS appear to have been fully considered. The updating of GOLFIS rather than its replacement has been ruled out because of the high costs of the reprogramming that would be required in the development of new modules.

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110 For example GOLFIS is no longer used to prepare summary fiscal information, which comes from FAPU as discussed earlier.

Management of Cash Balances, Debt and Guarantees

53. There is no formal system of cash management. As previously recommended by the IMF [111] there is a need for a central cash management unit within MFDP comprising Treasury, Budget and FAPU officials, as well as representatives of the Central Bank and the LRA Such a unit could assist in managing cash flows so as to minimize interest costs. Auditor-General's reports have identified cases of significant delays in depositing revenues into the government's bank accounts, resulting in large amounts of cash being on hand in some ministries with consequent risks of loss.

54. The current banking arrangements distort the cash management system. Under the Central Bank of Lesotho Act 2000, the Central Bank is the government's banker. However, outside of Maseru it is necessary for sub-treasuries, projects and ministry accounting units to use the services of commercial banks for revenue collections and regular payments such as salaries and pensions. The Central Bank receives regular reports from commercial banks but neither the Central Bank nor Treasury has full information on the number and purpose of these accounts, and thus such balances cannot be monitored by Treasury on a daily basis. Both the IMF and PWC reports have identified the need for an inventory of government accounts held at the commercial banks so that government cash balances can be comprehensively managed.

55. Considerable amounts of cash are held in a large number of separate bank accounts at the Central Bank. There are seven main accounts for expenditures and one for revenues. The Central Bank provides Treasury with information on the balances on a daily basis and the accounts are swept daily, however reconciliation and consolidation of accounts is lacking and "D' rating is suggested for dimension (ii) for PI-17.

56. Public debt accounting is carried out using an FMIS developed by the Commonwealth Secretariat (CS-DRMS). While this system has not been reviewed here, Auditor-General reports suggest it provides reliable information concerning external debt but less reliable information on domestic debt. External debt data are reconciled annually to provide information to the Bretton Woods institutions for their Debtor Reporting Systems and a "C" rating is suggested for PI-17 dimension (i).

57. Central government's contracting of loans is approved by Cabinet, but are not always decided on the basis of predetermined guidelines. With the adoption of the PRS and guidelines being established for inclusion of projects in the budget, the situation is expected to improve with adherence and consistent application of project appraisal guidelines. Contingent liabilities are managed by the public debt office. They arise mainly from guarantees provided to the borrowing of parastatals. Under the Loans and Guarantees Act, these require the approval of the Minister of Finance. There is no reporting of such guarantees – as discussed later these should be disclosed in the public accounts and thus be subject to audit. As such, a "B" rating is suggested for PI – 17 dimension (iii).

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[111] Ibid, page 74.

Box – 8: PFM Performance Indicator	Score
PI – 17 Recording and management of cash balances, debt and guarantees. There are significant deficiencies in the management of cash flows and government bank accounts. Debt accounting is reasonably satisfactory. Loans and guarantees all require the approval of the Minister of Finance and Development Planning.	C

Internal Controls

58. The system of internal control appears extremely weak, based on reports of the Auditor-General, and the work of the Internal Audit Department in MFDP. The Auditor-General reports on a persistent pattern of failure to observe basic financial control requirements, including:

- significant errors in posting and classification of information
- failure to carry out reconciliations between the Vote book records of individual ministries and the central accounting system (GOLFIS),
- non-reconcile bank accounts on a monthly basis, as required (AG reports un-reconciled balances of M2.1 billion as at 31 March 2003).
- failure to account for advances which are made for a wide variety of purposes, resulting in final expenditures never being brought to account (Auditor-General's report on the 2002/3 financial statements refers to un-acquitted advances of M 10 million, much of this to ministers, members of parliament and statutory office holders
- expenditure charged to below the line accounts outside of GOLFIS and other payments made outside of GOLFIS.
- inadequate controls over both revenues and assets, leading to losses through disappearance and/or misuse
- use of expenditures for purposes not authorized by the budget appropriation
- unauthorized excess expenditures – M46 million in 2002/3 (see discussion above under the budget contingency reserve)

59. There appears to have been a culture of non-compliance based on two factors: (i) ignorance of the requirements, reflecting a lack of training or accessible documentation of requirements; and (ii) lack of consequences for failure to comply – an incentives issue. This includes failure to discipline officers who do not observe the requirements of the finance regulations, or even clearly misuse public funds. In the overall public finance management, commitment control is lacking, which suggest a "D" rating for PI – 20 (i). Lesotho also needs to develop clear control rules and procedures to strengthen the expenditure management and "D" rating is provided for dimension PI-20 (ii). In addition, the core set of rules and regulations are not complied with as discussed above and also a "D" rating is proposed for dimension PI-20 (iii) giving an overall rating of "D".

60. It also appears that the financial controllers need to take a more pro-active role in ensuring financial probity in their ministries. This may both be a matter of training as well as incentives. Moves are under-way to develop a training program through the Eastern and

Southern African Associations of Accountants General and with the assistance of the World Bank to develop an Africa region public sector accounting certification, in collaboration with the Chartered Institute of Public Finance and Accountancy.

61. There is also a need to ensure that there are consequences of non-compliance with financial management requirements. The PS Finance has adequate powers to surcharge officers where losses have occurred or where requirements have not otherwise been met. Common examples of such failing are set out in the Auditor-General's reports and include failure to safeguard assets reflected in negligence in handling cash (leading to cash deficiencies) and reckless driving leading to loss of damage to government vehicles.

62. Efforts are underway to address these issues. While the parallel powers of PSs to discipline their staff for misconduct are clear, there appears to be a need for wider use of these powers. However this power needs to be properly used; there is anecdotal evidence of a PS of a line ministry suspending two accounting staff because they were seeking to observe financial management requirements, against his wishes.

63. The parallel system of staff budgeting, through the establishments role of MPS is discussed above under budget construction. All filling of vacancies, promotions or expansion of staffing numbers must go through the Establishments committee of officials, chaired by MPS but with representation from MFDP and several line ministries.

64. The payroll system itself is operated by MFDP which since 2001 has utilized "Unique" software. The 2002 IMF report identified problems of lack of consistency between the Unique and GOLFIS data bases, but commented that in principle the interface capability is good.

65. There is heavy reliance on manual accounting and the weaknesses of GOLFIS, the accounting system in Lesotho is susceptible to inaccuracies. The Auditor General of Lesotho in its report for the year 2002/03, highlighted a number of evidences of poor accounting system, including: (a) non-reconciliation of ministries/departments accounts with Treasury accounts (b) weak accounting; and (d) mis-postings, as well as misclassifications of expenditures. These are reflected in the number of suspense and clearing accounts used to accumulate unreconciled balances. The Auditor-General's report provided adverse comments on the financial statements because of these errors and omissions, regularity of reconciliation and clearance of suspense accounts and advances, which suggest a "D" rating for dimension (i) and (ii) for PI-22.

Box – 9: PFM Performance Indicator	Score
PI - 20 Effectiveness of Internal Controls for non-salary expenditure. Commitment control systems are lacking. There is a widespread failure to comply with rules and procedures, reflecting both lack of understanding of these requirements and lack of consequences of non-compliance	**D**
PI - 22 Timeliness and regularity of accounts reconciliation. There is a widespread failure to regularly reconcile bank accounts, to reconcile GOLFIS information with subsidiary information systems and to reconcile and clear advance accounts. As such information on cash balance and expenditures is unreliable	**D**

Internal Audit

66. Internal audit is centralized in the MFDP. There are currently no separate internal audit units within line ministries, directly serving line ministry top management. However, the internal audit reports are sent to the PS of the relevant line ministry and to the Auditor-General, as well as to the PS Finance and to the Accountant-General, which indicate a "B" rating for dimension PI-21(ii). The internal audit reports are not shared with the Budget and Planning officers dealing with the live agency and as such, do not make contribution in budget preparation.

67. The internal audit department has an establishment of 26 staff but in addition there are currently some vacancies in the approved establishment. There are six senior auditors who supervise the rest of the staff. They are a separate occupational classification within the public service. The annual internal audit work plan is approved by the PS Finance, but it is not discussed with the Auditor-General, thus missing an opportunity for coordination in the use of professional audit resources.

68. Under current budgetary arrangements audited organizations pay the direct costs of audits – i.e. travel and accommodation expenses. This seems undesirable, in terms of maintaining audit independence.

69. The Acting-Director of Internal Audit perceives that the internal audit unit has little impact, that there is little evidence that internal audit reports are even read, let alone acted on and that many public servants are not aware of their existence. In general, where their work is known they are perceived the same as external audit. The internal audit recommendations are generally ignored, which suggest a D rating for dimension PI-21(iii).

70. There is no formal system of risk analysis and no audit manual to provide guidance or training to staff.[112] Reports focus mainly on compliance rather than systemic issues, which indicated a D rating for dimension PI-21 (i) and thus giving an overall rating of D+.

[112] Under the PFM reform program (the office is a member of both the accounting and the auditing and oversight working groups) the Internal Audit Department's work has been reviewed by a consultant and it is intended to move to a "hybrid" arrangement, under which staff will be allocated to and physically based in line ministries, reporting to the PS of that ministry but receiving professional support from MOF, thus continuing to operate as a professional group. This is in effect a "half way house" between the present position as being part of MOF and the other alternative of being separate units reporting only to the PS of the line ministry. This proposal seems appropriate to Lesotho's circumstances and should

Box – 10: PFM Performance Indicator	Score
PI - 21 Effectiveness of Internal Audit. Internal audit has limited capacity given the small staffing numbers and lack of trained staff. It has compliance rather than a systems focus. Its work seems little understood by line ministries and it does not appear that its reports are acted on.	D+

Donor Coordination

71. As mentioned above, donor funded projects financed through loans are included in the budget, with very few exceptions, meaning that in principle they are part of the prioritization process managed through the economic policy department of MFDP. The Law requires that all such projects be negotiated through MFDP and approved by the Minister of Finance (Cabinet). However they are not managed through the government accounting system and separate financial statements are prepared using relevant project accounting units in each ministry, which are generally part of the ministry's planning department. Grant-funded donor activities do not appear to be included fully in the budget.

72. There appears to be some lack of predictability on the timing and amount of such project assistance. This appears to be one reason for the generally significant under-expenditure of the capital budget. There appears to be a need for some donors to endeavor to better align their decision making cycle with the Lesotho budget cycle.

73. New donor coordination arrangements have been developed by the Minister of Finance involving the holding of monthly meetings co-chaired with UNDP as the coordinator of the other donors. These meetings are said to have improved donor coordination with the government and amongst themselves. Individual ministries such as Health also have their own regular meetings with donors, including an annual joint review of progress on all health projects.

74. Some progress appears to have been made on harmonization of donors' requirements particularly in the area of a single audit for all donors. However, most donors still use own systems for procurement, payment/accounting, audit and reporting. Any future development of sector wide approaches can be expected to be a catalyst for further donor harmonization.

increase the impact of internal audit provided the reports are made available to relevant line ministry staff.. This new arrangement will start as a pilot in three ministries - MOF itself, Education and Justice, each internal audit unit comprising 2-3 staff so as to obtain some minimum critical mass. The Ministry of Defence has also expressed a desire for its own separate unit.

Box – 11: Performance Indicators	Score
D - 2 Financial Information Provided by donors for budgeting and reporting on project and program aid. Donor project funding is fully incorporated into the (capital) budget, reflecting full provision of information by donors. Regular accounting reports are not produced by units within line ministries and are not available to MFDP for incorporation into actual budget expenditure figures. Grant funded donor projects are not fully accounted for in the budget.	C
D - 3 Proportion of Aid that is managed by use of national procedures. No donor funds are managed through national accounting procedures, but the Auditor-General is required to audit all project financial statements.	D

III. EXTERNAL ACCOUNTABILITY, AUDIT AND OVERSIGHT

External Reporting [113]

75. This is a very weak part of Lesotho's PFM system. Under the Finance and Audit Act, the public accounts are required to be prepared by the Accountant-General and submitted to the Auditor-General within six months of the end of the year. The Auditor-General then has three months to prepare the formal audit report and submit it to the Minister of Finance, who is required to table them in Parliament within seven days, from the commencement of the next session. While the Auditor-General's report is discussed by Parliament, there seems to be no procedure in place for publishing the Public Accounts.

76. Firstly no public accounts were presented for the fiscal years 1996-97 to 2000-01, which reflects not only the problems in the operations of the AGO but also the political. A decision has been made, that given the lapse of time it would not be feasible to attempt to reconstruct the public accounts for those years. The absence of these public accounts resulted in the Auditor-General disclaiming an audit opinion on the public accounts for the years 2001-02 (presented to Parliament in August 2003) and for 2002-3 (presented to Parliament in July 2004) and is likely to do the same for the accounts for 2003-04 which have not yet been presented to Parliament (May, 2006). The timeliness requirements have clearly not been met in these three sets of financial statements and suggest a "D" rating for dimension PI-25(ii).

77. Secondly because of the many errors and mis-postings, the information cannot be relied upon. This is another factor in the Auditor-General's adverse comments on the financial statements and suggests a "D" rating for dimension PI-25 (i).

78. Thirdly, the form and content of the public accounts as presented is quite unsatisfactory in terms of adequate external fiscal reporting. Formally the public accounts are required to include: (i) an abstract of receipts and payments; (ii) the assets and liabilities at the close of the financial year;[114] and (iii) such other matters as the National Assembly or the

113 This discussion covers the public accounts. External financial reporting by parastatals is separately discussed above under parastatals and trading accounts and special funds which are part of the budget is discussed above under budget comprehensiveness.

114 These two terms are not defined

MFDP may require.[115] A "D" rating is provided for dimension 25-I (iii) giving an overall rating of "D".

79. However, the accounts are largely limited to a statement of budget execution, focusing on expenditure. They do not provide any meaningful information on the budget balance. And despite the requirement that they report on assets and liabilities, no meaningful attempt is made to address this. For example, no information is provided on the public debt, on contingent liabilities or on payment arrears. Nor is there any meaningful reporting on financial assets and investments in government business undertakings or public funds.

80. Apart from mis-postings and other errors, the Auditor-General's reports identify many other deficiencies in the reliability of the information. These are reflected in the number of suspense and clearing accounts used to accumulate un-reconciled balances.

81. The Auditor-General and MFDP, with the concurrence of Parliament should resolve the issue of lack of opening balances, so that that there will not be a disclaimer audit opinion in perpetuity for this reason.

82. The Accountant-General has expressed an intention to move towards adoption of the cash based International Public Sector Accounting Standards (IPSAS), which would provide supplementary information on assets and liabilities, as well as meaningful information on budget results.

83. A further deficiency in external reporting is the failure to publish details of the financial transactions of separate accounts such as the RF, trading accounts and the Reserve Fund (see discussion on pages 15-16 above).

84. As discussed above under Management of Cash, Debt and Guarantees, public debt information is said to be reliable concerning external debt, but there are difficulties concerning the information on domestic debt. The Public Debt Office is located within MFDP and uses a separate CS-DRMS-2000 software system developed by the Commonwealth Secretariat.

Box – 12: PFM Performance Indicator Score	**Score**
PI – 25: Qualities and Timeliness of Annual Financial Statements. The financial statements do not provide adequate information. No financial statements were produced for the four years 1996-97 to 2000-01. The statements for 2001-02 and 2002-03 were not presented in a timely manner and the Auditor-General's reports on those statements, apart from having a disclaimer audit opinion are highly critical of the many errors and omissions. The audited financial statements for 2004-05 have not been produced at this date (February 2006). The annual financial statements are not submitted to the Auditor General within 15 months from the end of the fiscal year. In addition, the financial statements are not presented in consistent format and accounting standards are not properly disclosed.	**D**

115 No such other matters appear to have been specified.

Public Access to Key Fiscal information

85. This brief section is included to bring together discussion on public access to the Estimates documents, the Budget Speech, budget execution reports and the Public Accounts and reports thereon by the Auditor-General and the financial statements of various BTL accounts and of parastatals.

86. As discussed in those separate sections

- The Estimates document, being a very lengthy document is not produced in great numbers but is not confidential and can be purchased by the public.
- The Budget speech is a public document presented to Parliament. It is also available on the Lesotho government web-site **www.lesotho.gov.ls** .
- Budget execution reports are not publicly available.
- The Public Accounts are not published, although the audit report thereon by the Auditor-General is a published document, and is available to the public.
- The financial statements of parastatals are published, although not in a timely manner and they are not tabled in Parliament, and may in practice be difficult to obtain.

Box – 13: PFM Performance Indicator	Score
PI – 10 Public Access to Key Fiscal Information. As discussed above some of the key aggregate information, except for budget execution reports is in principle publicly available.	C

External Audit

87. Under the Finance and Audit Act, the Auditor-General has functional or operating independence from the executive branch, including right of access to all necessary information and the power to report to Parliament at any time, although this is through the Minister of Finance rather than direct to the Speaker of Parliament. The Auditor-General is appointed by the government, the budget of the Auditor-General's Office is determined through MFDP as for any other government institution and the staff are public servants, with new recruits being allocated to the office by MPS (as for all other parts of the civil service), rather than selected by the Auditor-General.[116]

88. In December 2004, the office finalized new draft legislation which would give the office independence in the selection of its staffing, and some greater budgetary independence in that its budget would be reviewed and recommended by the Public Accounts Committee to Parliament and thence to the MFDP. In other words, its budget would be separately or specially developed, reflecting the independence of the office [117] and would be funded by

[116] As discussed above, this arrangement applies to the civil service as a whole, not just the Auditor-General's office.
[117] Such arrangements might also logically apply to other institutions independent of the executive such as Parliament, the judiciary and the Ombudsman.

fees levied by the office on auditees. This latter provision is seen as increasing the accountability of the office through making its costs to individual auditees transparent. Its annual work plan would be approved by Parliament on the recommendation of the PAC. It would also be able to report directly to the Speaker of Parliament, rather than having its reports tabled by the Minister of Finance. There does not appear to have yet been any response from the government to this proposed new legislation.

89. The audit covers all entities of central government. However, it seems generally accepted that the work of the Auditor-General has little impact. There appear to be several reasons for this:

- the general culture of non-compliance discussed above
- lack of a strong PAC to follow up the reports of the Auditor-General, as discussed below
- the reporting of rather dated information. Due to lateness in the preparation of the public accounts mentioned above, the Auditor-General's report on those accounts is dealing with information which is several years old. As mentioned above, the report on the 2001/02 and 2002/3 financial statements were tabled well after the twelve months limit in the law and the 2003/4 report is already well overdue (December 2005). However the Auditor-General's reporting to Parliament does not have to be confined only to reporting on the public accounts; the Auditor-General has the power to report to Parliament on any relevant matter at any time. A greater use of this power would provide more current information;
- the somewhat technical nature of the reports, which makes it difficult for a non-accountant to understand the implications of deficiencies which are being reported on. The report reads as "accountants writing for accountants", and needs to be made more user friendly for a non-accountant reader;
- the office is not being confident itself that it is adequately trained or resourced to comment on more "big ticket" items which would generate more public interest, as opposed to its traditional reporting on compliance failures;
- lack of promotion of its reports by the Office itself. While the media appears to show little interest in the Auditor-General's reports, the Office agrees that more proactive selling of its reports, e.g. through a press conference when its reports are released, could increase its impact;
- apparently limited interest by the executive in the reports. For example in tabling the reports in Parliament, the Minister of Finance does so in a pro-forma fashion, without comment.

Box – 14: PFM Performance Indicator	Score
PI – 26 Scope, nature and follow up of external audit. While all government expenditures (and expenditure of donor funds) are audited by the Auditor-General, with audits apparently conducted to reasonable professional standards, the reports are not timely due to a decision not to report except in conjunction with the Public Accounts, which have not been prepared on a timely basis. While some significant compliance issues are raised in the audit reports they are not followed up on a timely basis by the Public Accounts Committee, which also lacks professional resources. Given the focus on detailed compliance issues rather than broader systemic issues, the relatively technical and user – unfriendly nature of the reports and lack of support from the Minister of Finance and Development Planning, this audit work has little evident impact.	**D+**

Legislative scrutiny of the annual budget law and external audit reports.

91. The Parliament's budget review covers fiscal policies, aggregates for the coming year and detailed estimates of expenditure and revenue. The draft Estimates are presented to Parliament in mid-February, to be passed before the financial year commences on 1 April. This timetable leaves little opportunity for effective review by Parliament. There is no Parliamentary estimates committee, to examine the budget ex ante. In Lesotho, supplementary and revised budgets are instituted virtually in every year and although regulations and procedures for authorizing and utilizing such funds are laid down, the common practice is that authority is rarely obtained before hand. This indicates a "B" rating for dimension PI-27 (i), "D" rating for dimension PI-27 (ii), a "B" rating for dimension PI-27 (iii), and a "D" rating for dimension (PI-27 (iv) giving an overall rating of "C".

90. Since the PAC [118] in 2002, the Committee has issued two reports, in 2004 on the public accounts covering the three years to 1995/96 and on the 2001/02 public accounts, meaning that the issues examined were very dated. Although it may consider any matters concerning the use of public funds, in practical terms lack of alternative information sources link it to the reports of the Auditor-General on the Public Accounts, which as discussed earlier have been late or non-existent because of lateness or non-existence of the public accounts. Its reports contain recommendations and are tabled in Parliament and discussed but attract little media attention. There are no formal procedures for follow up, and although the Committee itself could put forward a resolution to parliament to review implementation of its recommendations, it has not done this so far.

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[118] The PAC comprises 15 members (of a national assembly of 120 members elected for a five year term and an appointed senate of 33 members) of which 8 are from the governing party, but the chairman is from the opposition party. Its constitution and existence are based solely on Parliamentary standing orders which provide for it to examine the use of public funds (which appears to also include examination of revenue collection) and to call officials and investigate as necessary. It is not authorized to question policy issues, only questions of administration. It questions principal secretaries and not ministers; although it could call a minister in the case of a specific ministerial decision it wished to review. The chairman states however, that it has so far operated in a non-partisan manner and calling ministers might compromise this. The Committee has some clerical assistance for organizing its meetings and keeping minutes and drafting its reports - but no professional assistance. Its meetings are not open to the public. Representatives of the Auditor-General and the Accountant-General attend all meetings. They find information provided by Auditor-General staff during their meetings of considerable assistance. It may be that attaching a staff member from the Auditor-General's office to the Committee would be the best way to provide required technical assistance to the Committee.

91. The Committee has some contact with the southern Africa grouping of public accounts committees and has attended meetings in South Africa, but generally feels isolated from PAC activities and developments in other countries.

92. Clearly it takes considerable time for the Committee to prepare its reports, which the chairman attributes to lack of resources and the need for more training for committee members, many of which lack knowledge of government financial procedures or the principles of public financial management.

93. Following its current work program the Committee will inevitably be dealing with dated material – events which occurred several years ago and which are now of limited interest and the people whose actions are being reviewed may no longer be in place. Because of this the Committee should consider "ruling a line" under the Auditor-General's reports on the 2001/02 and 2002/03 public accounts and instead focusing on the report on the 2003/04 public accounts which is about to be tabled by the Auditor-General.

94. The Committee considers that currently it has limited, if any, impact on the quality of PFM. It considers that some PSs may have taken greater interest in financial management issues in their ministry as a result of appearances before the Committee. It considers the Minister of Finance to be very supportive of its work. The chairman considers the major limiting factor on the work of the Committee to be the lack of training of Committee members. The Committee chairman was not aware of World Bank Institute work in supporting public accounts committees, and WBI may be able to provide with at least basic informational material.

95. Overall, the review of audit reports by PAC takes more than 12 months. However, regular in-depth hearing on the public accounts and findings of the Auditor General are not conducted due to delay in the submission of audited accounts to PAC. Although some actions are recommended by PAC, these are not systematically implemented by executive arm of the government. From the above discussions, "D" ratings are recommended for dimension PI-28 (i) and (ii), and a "C" rating for dimension (iii) and an overall rating of "D+".

Box – 15: PFM Performance Indicator	**Score**
PI - 27 Legislative Scrutiny of the Annual Budget Law. Parliament does not have a committee structure to examine the budget. There is limited time for Parliament to review the Estimates.	**C**
PI – 28 Legislative Scrutiny of External Audit Reports. The Public Accounts Committee reviews the Auditor-General's reports in some depth. However its impact is limited by the time elapsed since the issues covered in the report and by the limited technical capacity and resources of the Committee. Its reports to Parliament contain recommendations, but there is no evidence of their being acted on.	**D+**

SUMMARY SCORINGS OF PEFA PFM PERFORMANCE INDICATORS SET

(Indicators which are not scored were outside the scope of this review)

A. PFM OUTTURNS: Credibility of the budget		*Score*
PI-1	Aggregate expenditure outturn compared to original approved budget	B
PI-2	Composition of expenditure outturn compared to original approved budget	C
PI-3	Aggregate revenue outturn compared to original approved budget	A
PI-4	Stock and monitoring of expenditure payment arrears	D+
B. KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency		
PI-5	Classification of the budget	C
PI-6	Comprehensiveness of information included in budget documentation	B
PI-7	Extent of unreported government operations	B
PI-8	Transparency of inter-governmental fiscal relations	NA
PI-9	Oversight of aggregate fiscal risk from other public sector entities.	D
PI-10	Public access to key fiscal information	C
C. BUDGET CYCLE		
C(i) Policy-Based Budgeting		
PI-11	Orderliness and participation in the annual budget process	A
PI-12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	C+
C(ii) Predictability and Control in Budget Execution		
PI-13	Transparency of taxpayer obligations and liabilities	Not rated
PI-14	Effectiveness of measures for taxpayer registration and tax assessment	Not rated
PI-15	Effectiveness in collection of tax payments	Not rated
PI-16	Predictability in the availability of funds for commitment of expenditures	B
PI-17	Recording and management of cash balances, debt and guarantees	C
PI-18	Effectiveness of payroll controls	Not rated
PI-19	Competition, value for money and controls in procurement	Not rated
PI-20	Effectiveness of internal controls for non-salary expenditure	D
PI-21	Effectiveness of internal audit	D+
C(iii) Accounting, Recording and Reporting		
PI-22	Timeliness and regularity of accounts reconciliation	D
PI-23	Availability of information on resources received by service delivery units	Not rated
PI-24	Quality and timeliness of in-year budget reports	D+
PI-25	Quality and timeliness of annual financial statements	D
	C(iv) External Scrutiny and Audit	
PI-26	Scope, nature and follow-up of external audit	D+
PI-27	Legislative scrutiny of the annual budget law	C
PI-28	Legislative scrutiny of external audit reports	D+
D. DONOR PRACTICES		
D-1	Predictability of Direct Budget Support	Not Applicable
D-2	Financial information provided by donors for budgeting and reporting on project and program aid	C
D-3	Proportion of aid that is managed by use of national procedures	D