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NEPAL

Joint Staff Assessment of the Poverty Reduction Strategy Paper

Prepared by Staffs of the International Development Association (IDA) and the
International Monetary Fund (IMF)

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I. OVERVIEW

1. **Despite decades of development efforts, Nepal remains one of the poorest countries in the world with per capita income of about US\$250.** Economic performance improved during the 1990s and per capita income grew by an average annual rate of about 2½ percent. During the second half of the 1990s, however, the pace of reform implementation slowed, as politics grew more fractious and diverted attention from the development effort. This, together with sharply escalated conflict since 2001 related to the insurgency, slowed growth over the last two years. The Maoist insurgency is, in part, a reflection of the rising disenchantment with inefficiency and corruption in the public sector, large persistent inequalities including along ethnic and gender lines, and poor delivery of public services.

2. **Against this background, the Poverty Reduction Strategy Paper (PRSP), has been prepared to reinvigorate the reform effort and achieve high sustained growth.** The PRSP has been prepared by a series of governments since 2000, and reflects a reform vision shared by key political forces. It is based on extensive consultations within the public sector as well as with civil society. Furthermore, the reform process is being championed by a growing body of reform-oriented senior officials. It is reflected in the ten point priority agenda the current government has committed to and resonates with the popular demand for better governance. This reform vision comprises four broad pillars: (i) generating broad based economic growth; (ii) improving service delivery; (iii) promoting social inclusion; and (iv) improving governance.

3. **The PRSP has a number of strengths.** Among these are: (i) an appropriate focus on accelerating income and employment growth in rural Nepal, where a majority of the poor live; (ii) inclusion of alternative growth scenarios that take into account downside risks; and (iii) the introduction of explicit mechanisms to expedite reforms in critical areas to address the weak implementation track record. These mechanisms include: prioritizing public expenditures through a Medium Term Expenditure Framework (MTEF) and aligning budget allocations to performance-based cash release to high priority projects; improving social service delivery through devolution of management of basic education and health sectors to local communities; and reducing corruption through strengthening institutions such as Commission for the Investigation of the Abuse of Authority (CIAA) and improving public procurement.

4. **There are shortcomings and challenges to be addressed by the PRSP in the coming year.** These include: (i) identifying sources of growth and their linkages to poverty reduction through rigorous analytics incorporating lessons learned from past experience; (ii) improving costing of individual public policies as inputs to annual budget processes; (iii) developing the MTEF further to sharpen prioritization and cover all government spending under the prioritization exercise; (iv) implementing a coherent monitoring and evaluation strategy, including building capacity for poverty monitoring and developing an institutional framework for its implementation; and (v) further elaborating pro-poor rural strategies underpinned by past policy lessons and robust analyses to ensure social inclusion through special targeted programs and improvements across all the sectors in public service delivery.

5. **There are also major challenges and risks from exogenous shocks and the uncertainties posed by the security and political situations.** These factors could stall or severely affect the reform process. Furthermore, risks to reform implementation could arise from constraints in capacity within the government.

II. THE PARTICIPATORY PROCESS

6. **The PRSP, presented as an executive summary of the Tenth Plan, is a product of an inclusive participatory process and marks a significant departure from traditional development planning.** In preparing the Interim-PRSP, the Approach Paper of the Tenth Plan, and the PRSP, the authorities consulted widely with major political parties, private entrepreneurs, local governments, beneficiaries including those from remote communities and ethnic minorities, civil society, and the donor community. This is a departure from a long-standing tradition of preparing periodic development plans centrally driven by the National Planning Commission (NPC). The previous nine five-year plans were prepared by the NPC based on an approach paper prepared by the National Development Council, an overall resource framework provided by the Ministry of Finance and inputs from line ministries. There was little involvement of other stakeholders.

7. **The PRSP documents the process of consultations during its preparation and provides a synopsis of feedback that was received.** In particular, regional and other workshops were held from mid-2001 with nearly 4,000 participants and their recommendations were incorporated in the final approach paper, which was discussed with donors at the Nepal Development Forum in February 2002. The process of consultation demonstrates openness of the government to stakeholders' feedback and concerns. However, the PRSP includes limited description of how the poverty strategy has been modified as a result of the consultation. In addition, recent developments—including the intensification of the security problem that led to announcement of the state of emergency at end 2001 and the dissolution of local governments in 2002—reduced the capacity of the government to engage wider civil society groups and local leadership, particularly in the later stages of finalizing the PRSP. The staffs recommend that His Majesty's Government of Nepal (HMGN) reactivate and institutionalize mechanisms for continued consultations in the coming year.

8. **The government intends to deepen the participatory approach to the implementation and monitoring stages of the PRSP.** The authorities have placed the PRSP on the government's website and are starting an initiative to promote public understanding of its reform agenda. The initiative includes further consultation with stakeholders in preparing the annual Immediate Action Plan to implement the PRSP agenda and provision of wider access to the PRSP and related documents such as those of the MTEF. These measures would enable local leaders and beneficiaries to better understand and closely monitor implementation of the PRSP strategy. Staffs encourage the government to formalize the institutional arrangements and effectively implement such a communication initiative in the coming year. Staffs also note that to ensure effective dissemination, many PRSP documents that are now available in English only would benefit from translation into Nepali and languages of the major ethnic groups for whom Nepali is a second language.

III. POVERTY DIAGNOSTICS

9. **The PRSP presents a comprehensive description of the levels and spatial distribution of poverty.** This description is based on the most recent surveys—the Nepal Living Standards Survey (NLSS) 1996, and the Demographic and Health Survey, 2001—and draws on insights from the Poverty Assessment completed in 1999 and the Human

Development reports of 1996 and 2001 by the United Nations. The PRSP benchmark for consumption poverty (38 percent headcount) is, however, not survey based, as acknowledged by the PRSP, but rather based on simulations. Moreover, methodological differences between previous surveys conducted in 1976, 1984, and 1991, and the first NLSS in 1996 render a trend analysis of poverty incidence difficult except in drawing a general consensus that poverty has not decreased between 1984/85 and 1996. The new NLSS survey, to be completed by March 2004, will be useful in clarifying these issues. Staffs recommend that the authorities utilize the results of this survey to set the baseline for monitoring the progress on reduction in poverty.

10. **The analysis of the diagnostics of poverty is generally sound.** The PRSP notes that poverty is largely a rural phenomenon, and there are strong regional differences with higher incidence in the mountains and remote areas. Similar patterns also persist for human development indicators. In addition, poverty diagnostics include discussions of gender, ethnic and caste-based social exclusion, as well as the impact of the insurgency on these vulnerable groups. Staffs welcome these discussions in the PRSP as the issues of caste and ethnicity-based disparities have been considered particularly sensitive with open discussions on them rare in the past.

11. **While the document offers a good discussion of the correlates of poverty, the causal analysis is weak due to data constraints.** While the PRSP discusses the nexus between patterns of growth and poverty especially in rural areas and the importance of agricultural growth, discussion is limited on causal links between policies and changes in poverty levels. Similarly, there is no explicit link between the past policies or programs and implications for prioritization. Analysis of such linkages would clarify and strengthen priority ranking of anti-poverty measures in the coming years. Staffs encourage in-depth analysis of these issues when the new NLSS data becomes available. Staffs also recommend that the government begin a poverty and social impact analysis in some of the priority policy areas identified in the PRSP, such as agriculture and infrastructure and incorporate the results in the first PRSP annual progress report.

IV. THE POVERTY REDUCTION STRATEGY

12. **The government has presented a broad strategy for poverty reduction in its multiple dimensions—focusing on growth, particularly in rural areas, combined with an emphasis on social inclusion, improved governance, and better delivery of social and economic services.** The strategy, although ambitious, is backed by the MTEF (introduced in 2002/03), which provides a crucial link to feasibility, indicating how trade-offs are being handled in the face of resource constraints.

A. Targets, Indicators, and Monitoring

13. **The PRSP highlights indicative targets for the period of the Tenth Plan (ending 2006/07) in all areas covered by the MDGs.** The indicative targets include poverty headcount and indicators in the areas of education, health, and infrastructure, and promise to make significant progress towards achievement of the MDGs by 2015. However, refinements are needed—some further disaggregation of indicators by region, ethnicity, caste, and gender

would be welcome especially given the insights obtained through the poverty diagnostics. Furthermore, a clearer definition of intermediate indicators that are consistent with programs and budgets will be essential to track progress. This will require close collaboration with sectoral and line ministries at the regional level. In addition, information available through household surveys needs to be complemented with indicators that are available annually, like budget allocation and execution, and indicators that track access, satisfaction, and use of priority social and infrastructure services. In summary, more work will be needed in terms of developing clear and achievable indicators and targets, and this should receive the highest priority in the coming year.

14. **While the medium term goals defined in the PRSP appear feasible, they depend critically on achieving growth and well-defined baselines need to be set.** For example, the goal of reducing poverty incidence to 30 percent would require growth of around 5 percent a year (an average of the low and normal cases), and avoiding increases in inequality. For other social indicators, particularly in health, there appear to be significant discrepancies between the baseline figures presented in different places within the PRSP, such as those in obstetric services and contraception prevalence rate. An exercise of rationalization of baselines would be very important to set consistent targets and track progress.

15. **The staffs urge the government to assess data availability, enhance statistical capacity and strengthen statistical systems at both national and local levels.** The PRSP acknowledges the need for strengthening the monitoring of public expenditures as well as outcomes as a key priority. Given the importance and urgency for improving the monitoring system, to achieve this objective the first order of business is to set out clear institutional arrangements for accurate and timely monitoring. In this regard, the PRSP outlines the arrangements to undertake and oversee the establishment of a viable system for monitoring reform implementation, as well as progress in poverty and social indicators. The document also acknowledges the need for significant capacity-building assistance that will be sought from donors to enhance monitoring and evaluation capacity at the central, line ministry and local levels.

B. Growth and Macroeconomic Framework

16. **The PRSP stresses the authorities' commitment to sound macroeconomic management and structural reform implementation to foster growth and alleviate poverty.** Continued prudent fiscal policies will help ensure macroeconomic stability. These policies are to be complemented by structural reforms in key areas—financial sector, public enterprises and governance—to improve growth prospects.

17. **The inclusion of alternative macroeconomic scenarios in the PRSP, which take into account risks to the medium term outlook, enhances its flexibility.** The “normal” case aims at an ambitious increase in average annual real GDP growth to 6¼ percent over the medium term, while the “lower” case scenario envisages average annual real growth of 4¼ percent. The higher growth rates are based on improvements in the domestic security situation and a pick up in external demand. The inclusion of a lower growth scenario enhances the credibility of the PRSP. The PRSP’s growth target appears reasonable especially given the trend GDP growth rate of nearly 5 percent in the 1990s. However, since growth rates in the last two to three years

have been considerably less, the staffs' assessment is that attaining even the lower growth will require concerted reform effort by the authorities, as well as progress towards achieving sustained peace. In this regard, staffs note that the PRSP mentions but does not discuss details of the government's third scenario, the "lowest" case (for example, due to severe deterioration of the security situation), stating that there are mechanisms such as the MTEF to adjust to a weaker outturn. Nevertheless, given the economy could still face difficult security or external situations, staffs recommend that the next progress report discuss the policy response to a combination of serious downside risks. At the same time, the progress report should also discuss the authorities' response to upside potentials such as high foreign aid associated with early success with peace.

18. **The PRSP scenarios form the basis of a "realistic" medium term macroeconomic framework being discussed for a PRGF-supported program.** Growth targets under discussion for the PRGF are close to the "lower" case scenario, but public investment is more in line with that in the "normal" scenario reflecting the staff's judgment that significant infrastructure and social sector investment is required to support even the more modest growth rates. Domestic budget financing is lower in the PRGF framework than in the "normal" scenario in view of the potentially large contingent liabilities, which would need to be borne in the context of financial sector and public enterprise reforms.

19. **The PRSP makes clear that productivity gains and increased private sector activity are the key sources of broad-based growth in all sectors.** Robust agricultural growth is required for poverty alleviation, given the concentration of the poor in rural areas. In this context, the PRSP stresses the need to accelerate agricultural productivity growth through improved rural infrastructure and diversification into cash crops and livestock. The PRSP also recognizes that the manufacturing, trade, tourism, and transport sectors have been major sources of growth in the past decade but that social disorder and weak external demand have recently dampened growth in these sectors. The restoration of peace and the planned rehabilitation and reconstruction efforts are expected to provide a basis for significant recovery in these areas. The PRSP identifies the leading role of the private sector in generating growth while acknowledging that much needs to be done to improve the private business climate through structural reforms in several key areas including labor legislation. Failure to implement these reforms could reduce private investment and jeopardize achievement of PRSP goals.

20. **Key fiscal policy challenges are to improve revenue mobilization, prioritize spending and contain domestic borrowing.** The 2003/04 budget includes significant reform measures to streamline the tax system; and tax and customs administration are to be strengthened with the IMF and donor technical assistance to raise the revenue-to-GDP ratio. Over the medium term, revenue is projected to increase from about 12½ percent of GDP in 2002/03 to 13½ percent in 2005/06. Capital spending can be increased in a prioritized manner along the lines set in the MTEF. Over the medium term, net domestic financing is to be reduced to ½ percent of GDP. The framework is contingent on a significant increase in external financing, which in turn depends on a demonstrated track record of implementation. Donor assistance is projected to rise from 3 percent of GDP in 2002/03 to 4¼ percent of GDP in 2005/06.

21. **Monetary and exchange rate policies need to remain geared to supporting the peg to the Indian rupee.** The PRSP envisages maintenance of the peg arrangement, as the peg continues to serve Nepal well given close ties with India. However, the level of the peg should remain under review given an evolving external environment, including World Trade Organization (WTO) accession and phasing out of the Multi-Fiber Arrangement by 2005.

22. **Despite its liberal trade regime, significant constraints impede Nepal's trade prospects.** These constraints include delays in customs and transshipment, a rigid formal labor market, poor infrastructure, and ineffective and unpredictable public sector. The PRSP does not sufficiently emphasize the critical importance of trade and export growth in driving growth nor the challenges that Nepal's export and trade will confront in the coming years. The *Nepal Trade and Competitiveness Study* provides specific recommendations to improve trade policy, export promotion, customs, transport, the labor market and the investment climate. Staffs encourage the government to follow through on the recommendations identified in the study and develop a corresponding policy agenda in the annual progress report.

C. Prioritization in Public Expenditure

23. **The PRSP's public expenditure program is appropriately based on the MTEF, which will help prioritize expenditures.** The MTEF currently covers all development spending and represents a significant improvement over past practices. Under the framework, development expenditures have been prioritized in three categories (P1, P2, and P3) and a performance-based fund release mechanism has been implemented for projects. With this prioritization, 40 percent of the development budget has been allocated for social expenditures, 40 percent for infrastructure and the rest for agriculture development; and over 60 percent of the development budget has been allocated to P1 projects with assured funding. To facilitate implementation of priority activities, budget allocations for agriculture/rural and human/social service delivery developments are protected under alternative growth scenarios. Extending the MTEF concept to all resources, including donor resources, will be a challenge. Although such efforts are underway—for instance in health—a serious reprioritization (which is likely to bring about significant efficiency gains) will require both strong leadership by the government and willingness by donors to adjust the existing programs.

24. **Looking forward, staffs encourage the authorities to take steps to further improve public expenditure management.** Specifically, staffs recommend: (i) costing delivery of key activities (primary education, management of health posts, district hospitals to be transferred to local stakeholders) and ensuring adequate allocations for these activities starting in 2003/04; (ii) extending prioritization to regular expenditures; (iii) classifying spending into recurrent and capital; (iv) developing the fiscal decentralization framework and holding local institutions accountable for achieving targets; (v) implementing the Development Action Plan under the Country Financial Accountability Assessment and Country Procurement Assessment Report on a timely basis; and (vi) as discussed above, developing a comprehensive tracking system that covers public spending on all projects in the PRSP.

D. Governance and Decentralization

25. **Critical governance challenges need to be addressed to effectively develop and implement the PRSP policies.** The government's strategy to improve governance covers: (i) civil service reform (supported by the Asian Development Bank), (ii) financial management and accountability; and (iii) decentralization. While HMGN has made some progress in improving human resource management practices over the past few years—most notably through the creation of a computerized personnel information system—the PRSP recognizes that additional progress is needed to make the civil service more efficient, accountable and transparent. Future actions include: (i) reforming public employment, through introduction of merit-based recruitment and evaluation systems and a long-term pay policy, as well as right-sizing, improving the capacity and skills mix, and introducing an affirmative action program; (ii) improving financial management and accountability through among other things, implementing the recommendations of the recent Country Financial Accountability Assessment; and (iii) implementing the anti-corruption strategy, in part through the enactment of an Anti-Money Laundering Act and strengthening of key institutions charged with fighting corruption, including the National Vigilance Center and the CIAA.

26. **The economy wide governance efforts need to be complemented by measures in specific sectors including finance, infrastructure, health and education.** The PRSP is admirable in its intent to foster the mainstreaming of deprived communities and increasing the emphasis on social inclusion through normal sectoral programs supplemented by targeted initiatives. Moving forward, however, the main challenge for the government will be to restore representative local government so that it can effectively play a role in serving and representing local communities. In the coming year, the government would need to support this process by developing the administrative mechanisms for transferring resources, building capacity at the local level, and implementing the monitoring systems for the new arrangements. The first annual progress report should include an evaluation of the early experience with decentralization.

E. Sectoral Policies

27. **The PRSP recognizes the importance of infrastructure development in facilitating private investment.** To this end, it gives priority to the strategic road network, maintenance of major roads and highways, and the expansion of infrastructure in power and communications. Examples of reforms both already initiated or planned in the near future include establishment of an autonomous Roads Fund Board and transferring to District Development Committees the responsibility for rural roads; in power, the internal unbundling of Nepal Electricity Authority's (NEA) activities and the initiation of an explicit subsidy policy for grid-based rural electrification to improve efficiency and coverage in the rural areas; and in communications, conversion of the Nepal Telecommunication Corporation into a public company and opening up general and rural telecommunications to the private sector. Staffs endorse these initiatives and recommend parallel initiatives, particularly in the power sector, focused on developing a legislative framework to support the internal unbundling and commercialization of NEA's activities, with a view to formalizing its commercial orientation and reducing the risk of political intervention in its activities. Staffs also recommend implementing the regulatory policies contained in the Hydro Power Policy, with a particular focus on mechanisms for

sustaining predictable, cost-recovering tariffs, and facilitating entry to the sector. With regard to subsidization of expanded access, staffs recommend consideration of subsidy schemes focused on capital costs (i.e., requiring coverage of recurrent costs), and open access to both on-grid and off-grid service provision, by a range of service providers (including the private sector, cooperatives and NGOs).

28. **The PRSP also recognizes that a strong financial system is critical for private sector growth and macroeconomic stability.** Staffs fully endorse the government's moves underpinned by the Financial Sector Strategy Statement. In the medium term, a withdrawal of the government from the ownership of banks is foreseen replacing this role with a stronger supervisor and regulator over the entire system. To this end, the government's initial efforts within the sector have focused on strengthening the central bank (Nepal Rastra Bank—NRB) in its key supervisory and monetary policy functions. Both the World Bank and the Fund have provided technical assistance to strengthen its on- and off-site supervisory functions and accounting capacities, and to organizationally restructure the bank and re-engineer its human resource management to assist a transition to a modern central bank.

29. **The government has also taken measures to deal with the problems in commercial banks.** The two largest commercial banks—Rastriya Banijya Bank (RBB), fully owned by the public sector, and Nepal Bank Limited (NBL) where the public sector holds 40 percent of the shares—have suffered from weak management; poor accounting capacities; considerable political interference; and high levels of nonperforming loans. The government has brought in two external management teams to take over these banks (NBL in August 2002 and RBB in January 2003). The management teams are making progress in recovering nonperforming loans and have produced updated financial accounts. They are also revamping human resource management, improving treasury management, and installing an information technology platform. The results, to date, have been encouraging with an increasing recognition within Nepal that loan repayments would be enforced; interest rates that have become more competitive (with increasing indications of a reduction in the overall rate structure); and declining service charges as a result of increased competition. This process has been further bolstered by the establishment of a Debt Recovery Tribunal in mid-July, which is expected to deal speedily with loan defaulters.

30. **Staffs urge the government to continue to deepen the financial sector reform process.** This would require further strengthening of the central bank and the ultimate privatization of the two largest commercial banks. Staffs also recommend that further measures be taken to address issues of access to bank credit, particularly for small businesses and the rural population. The next steps in the financial reform program include issuance of the Banking and Financial Institutions Ordinance, ensuring capital adequacy, implementing cost cutting measures in RBB and NBL (including voluntary retirement schemes to reduce excess staffing), commencing the privatization process, and rapid re-engineering of the NRB.

31. **The main focus of the PRSP on reinvigorating income and employment growth in rural areas through agricultural development is welcome and appropriate.** There is still a considerable potential for agriculture productivity growth, which will have an immediate impact on income of the poorest communities. In that respect the Agriculture Perspective Plan (APP) represents a useful framework to work with, and around 20 percent of development

resources have been allocated for implementing the APP. However, on poverty grounds, the challenge will be to focus not only on agriculture but also on how to improve access to markets, assets and nonfarm income opportunities. In particular, issues of access to land, credit and basic services would need to be given increased emphasis. Finally, on security grounds, investing in rural areas is urgently needed to make any peace effort sustainable and to bridge the increasing disconnect and deterioration of human and physical capital after years of neglect and poor governance. The PRSP highlights the right components that need to be addressed in the agriculture and rural sectors, including the need for diversification, private sector development and deregulation. However, the government will need to devote particular attention to the composition and the quality of public spending in the sector. In particular, while pursuing APP objectives, the government should refrain from introducing price distortions in the incentive structure for agriculture and irrigation.

32. **The strategy in education is pro-poor and aims to be more realistic and credible.** It acknowledges weaknesses in past implementation performance, including unrealistic targets, lack of counterpart funding and prioritization, and shortfalls in monitoring leading to leakage and inefficiencies. More can be done, however, to analyze the implications of the lessons learned for future planning and implementation, and the plan could benefit from greater clarity in setting priorities. For example, in the current “lower case” scenario, it is not clear how the government would weigh the relative levels of investment across the subsectors to minimize financing distortions, or make decisions about which interventions within any subsector would bring the greatest benefits.

33. **To improve access to and quality of primary education, the strategy consists of the transfer of management of government schools to local communities and provision of block grants to these community-funded schools.** This provides a reasonable basis for achieving the goals of efficiency and improved governance within schools. Management of 8,000 government schools is to be transferred to local communities during the Tenth Plan period. In addition, more specific strategies to address structural impediments which hinder social equity and quality improvement (i.e., teacher deployment, equitable distribution of resources, timely delivery of free textbooks, poor teacher qualifications) are required.

34. **At the level of higher education, one focus is on cost recovery to produce a skilled labor force.** Higher education is beset with a number of structural and financing problems, and this single strategy may not be adequate to achieve the subsector goals. Quality improvement is a prerequisite before moving towards higher cost recovery. To achieve this, upfront investments and greater autonomy for academic institutions are required, as well as financial assistance to poor students.

35. **The health strategy in the PRSP is underpinned by a comprehensive health reform agenda.** The strategy was developed by HMGN in August 2002, with the primary objective of extending essential healthcare services to all, with special emphasis on poor rural populations. The focus on implementing a package based on preventive care, maternal and child health and family planning is appropriate and based on the diagnostics in the sector. There is also increased focus on improving access to safe drinking water to cover 85 percent of the rural population by 2005/06. Improvements in health service delivery are expected to occur through a gradual process of devolving health facilities—starting with health sub-posts—to local

communities and working increasingly with the private sector and NGOs. This process is already underway in a number of districts and results are visible in terms of improved performance through community participation, transparent service provision and performance-based fund release. As the process of devolution scales up, the increasing and complex challenge of improving access and quality will require a stronger emphasis on assessing staffing and other financing implications, and building capacity for implementation and monitoring at the local levels.

36. **The PRSP makes a welcome shift away from almost exclusive dependence on special targeted programs towards a consistent effort to “mainstream” the poor, women, and excluded caste and ethnic groups by ensuring them access to regular sectoral programs.** This concern with social inclusion is integrated throughout the PRSP’s four pillars, especially human development and governance. However, inclusion of all targeted poverty programs under the single umbrella of the Poverty Alleviation Fund and phasing out older ineffective programs seems to have been weakened somewhat as the Ministries of Local Development, Education, Health and Agriculture will continue to implement separate targeted programs. This is a matter of some concern and reflects the continued reluctance of the line ministries to relinquish control of programs or budget which stall the decentralization process.

F. Risks to the Strategy and Mitigating Factors

37. **The staffs consider that the strategy is subject to risks:**

- Progress towards peace is critical for achieving the growth targets and reducing poverty. The insurgents’ basic goals—provision of better social and economic services and representation for the poor—are consistent with the PRSP. Therefore, reforms envisaged by the PRSP—such as higher spending for social sectors and deprived groups, and structural reforms, especially governance reforms towards devolution of delivery of services—are intended to mitigate the basis for the insurgency over the medium term. There is a large distance between the insurgents and the government on the political agenda, as recently demonstrated by the withdrawal of the insurgents from the peace talks.
- Uncertainties remain on how the political standoff between the government and major parties will be resolved. As regards economic policies, however, the parties have been involved intensively in the PRSP preparation process, and steps have been taken during successive rounds to incorporate their views. As a result, the risk that economic policies would change drastically if these parties came to power is expected to have been reduced.
- It may be difficult to sustain the fiscal framework if there are revenue shortfalls or a need for higher spending on, for example, security. External aid shortfalls would also complicate fiscal management and reduce poverty related spending. Stronger revenue efforts—in particular increases in the VAT rate—or spending cuts in line with the MTEF can be undertaken to sustain the framework in the event these downside risks materialize.

- An adverse external environment would dampen growth prospects. The key risks include an increase in oil prices or a reduction in remittances and tourism arising from a prolonged global slump. The impact of these developments may be difficult to offset in the short run. However, structural reforms should help diversify exports and improve the economy's resilience to shocks over the medium term.
- Weak implementation capacity and governance pose continuing constraints to full utilization of development budgets and poverty alleviation. Governance reforms and decentralization are intended to address these shortcomings.

38. **The staffs view the reform process as a collective risk mitigation measure against the risk of widespread internal conflict and the breakdown of the development process.** The underlying causes of these risks—the insurgency, patronage-based politics, institutional weaknesses, and the failure of public service delivery—have generated the current situation in Nepal. The PRSP reforms have emerged, in part, as a response to this crisis. Based on its early efforts, which were somewhat disparate, the government has developed the PRSP as a coherent strategy to carry the reforms forward. Their strategy appears to have pushed the reforms far enough in a short time so that new norms and standards are set for public sector performance. Once the public begins to expect higher levels of performance and accountability, it is hoped that it would become politically difficult to reverse the reforms.

V. CONCLUSION

39. **The strategy outlined in the PRSP provides an adequate framework for the country's efforts towards sustainable growth and poverty reduction.** It has been prepared in a participatory manner, underpinned by the Tenth Plan of the government and through consultation with civil society. The strategy is coherent, comprehensive and explicit in its emphasis on implementation. However, as the assessment highlights, the success of the PRSP process is contingent on peace and political stability which, in turn, is key to a sustainable macroeconomic framework to protect pro-poor expenditures, and improving governance and the overall policy environment. The immediate challenges for implementation are strengthening capacity to execute the envisaged programs, improving expenditure planning and control through an improved public expenditure management system, and building an effective monitoring system. The Joint Staff Assessment has also identified some shortcomings of the PRSP that could be addressed over time and reflected in the annual progress reports to ensure the strategy is fully effective and operational.

40. The staffs of the World Bank and IMF consider that this PRSP provides a credible poverty reduction strategy and an adequate basis for IDA and Fund concessional assistance. The staffs recommend that the Executive Directors of the World Bank and IMF reach the same conclusion.