

## Appendix II

### Implementing the Previous CAS and Lessons Learned

#### A. Background

As indicated, the last CAS for Nepal was discussed by the Board of Directors on December 13, 1998. Although outcomes to be achieved during the CAS period were not explicitly elaborated, the triggers for the base case scenario provide useful insights on the main outcomes the Bank intended to influence through the CAS interventions, specifically:

- (i) at the lower end—of the base case scenario—stabilization of the situation and no further deterioration in economic and administrative management, characterized by:
  - (a) Domestic revenues as a share of GDP remaining at or above 11%, domestic borrowing below 2% of GDP, and satisfactory implementation of VAT; and
  - (b) Improved management of public expenditures, with no further increase in the number of projects in the public investment program, and adequate funding for donor-assisted and other priority projects.
  
- (ii) beyond stabilization—i.e., within a more solid base case scenario—with a modest, but clear reform effort, as reflected in the following types of steps:
  - (a) Tangible progress in decentralization and local self-government, with greater local involvement in the management of development programs;
  - (b) Action on improving central government administrative performance, such as stricter enforcement of rotation rules;
  - (c) Privatization of three public enterprises, and improvement of the efficiency and transparency of privatization procedures and decision-making processes;
  - (d) Introduction of a three-year rolling investment program, and full funding of core programs and projects;
  - (e) Progress in restructuring RBB and preparing its divestiture, completing the privatization of NBL, improving banking regulations and improving NRB's supervisory and regulatory capacity;
  - (f) Progress in telecommunications reform, including introduction of competition; and
  - (g) Introduction of new measures to reduce corruption.

An appropriate mix of Bank interventions—both lending and non-lending—were proposed to assist Nepal in achieving these outcomes.

#### B. Achievements during the CAS period

##### *Background*

For four years—until December 2002—given the limited and slow progress in implementing reforms, Nepal remained in a low case scenario. Given the fungibility of aid resources, without substantial improvements in public expenditure management and public service delivery, more financial assistance from IDA would not have been a solution to Nepal's problems. HMGN clearly began recognizing poor governance—reflected most acutely in weak implementation of reforms, poor service delivery and corruption—as a central obstacle to development (see Box 1). Growing recognition of the gravity of the financial sector conditions and the direct link to the system of poor governance—

specifically, the possible risk of a financial sector crisis, the huge drain on public resources and an indication of HMGN's willingness to do away with the 'old way' of doing business—also led the Bank to attach special importance to financial sector reform. As the first major step towards implementing the financial sector reforms, the introduction of external management teams in the two large ailing commercial banks became the 'litmus test' for moving into a base case scenario. The Bank's position in this regard was well-known and other donors—most notably the IMF and DfID—also selected this important reform measure as a key milestone for providing additional support to Nepal.

### *Outputs*

**Lending.** The low case lending program focused on community-based projects—to mobilize and leverage social capital at the grassroots level—and on supporting specific but modest reform efforts. Implicitly assuming a quick transition to the base case, the Bank continued to prepare a number of larger, 'reform-heavy' projects and in retrospect may have missed an opportunity to develop and deliver a few more 'low case appropriate' projects.

#### **Box 1: Publicizing the CAS**

The 1998 CAS was the first such document to be publicly discussed in its entirety in Nepal and also widely disseminated, including in Nepali. As a result, not only did the strategy and the various lending scenarios quickly enter the development lexicon, the benchmarks/triggers helped broaden people's understanding of governance, that previously had been narrowly understood as corruption. Since this was the first CAS that explicitly linked Bank support to overall progress against governance-related benchmarks, it took a while for Government officials to understand the implications of this shift with regard to the funding of specific sectors. However, gaining this understanding has forced some senior officials to think more holistically about development. They realized that "good performance" in their particular sector was not sufficient to warrant Bank support, but that such support can only be forthcoming with improvements in overall governance; hence, resulting in the development of a healthy peer pressure for accountability and governance improvements. As it has been put "the 1998 CAS eventually shook the whole tree to the point that the branches were sufficiently threatened."

While in the low case scenario—i.e., between December 1998 and December 2002—four projects were approved for a total of US\$94.6 million; specifically:

The **Second Basic and Primary Education Project** (BPEP, Cr. 3185-NEP) was approved in March 1999 (US\$12.5 million). Conceived as an Adaptable Program Loan (APL), the objectives of the first phase are to develop institutional capacity for qualitative and quantitative improvements in primary education. Through the project, a number of donors—including IDA, Denmark, the European Union, Finland, Norway, Japan, UNICEF and the ADB—are providing joint support to a well-formulated ten-year sectoral program;

The **Rural Infrastructure Project** (Cr. 3215-NEP) was approved in May 1999 (US\$5 million) to strengthen the institutional capacity of a decentralized governance system in its planning and managing capabilities to improve the quality, efficiency and sustainability of rural roads with active participation of project beneficiaries. Given limited Bank experience implementing community-based road projects in Nepal, a Learning and Innovation Loan (LIL) was selected as the appropriate vehicle to test this fundamental shift in approach. Through this project a number of decentralization options are being tested, including working: (i) directly with the DDCs; (ii) with DDCs through contractors; (iii) with CBOs; and (iv) through NGOs. The many implementation challenges associated with this project have made it a learning experience for all involved. Nevertheless, recent results are promising as confidence and experience are being accumulated to work more effectively at grassroots levels;

The objective of the **Road Maintenance and Development Project** (Cr. 3293-NEP)—approved in November 1999 (US\$54.5 million)—is to help achieve sustainable maintenance, rehabilitation and construction of an economically justifiable strategic road network, while also promoting more sustainable funding and efficient public sector management of road maintenance. The project supports key sectoral

policy reforms by establishing a Roads Board and Road Fund to assure a stable source of funding for maintenance expenditures, while at the same time providing motorable access to isolated districts in the mid- and far-west regions of the country (the heart of the insurgency area); and

The **Telecommunications Sector Reform Project** (Cr. 3581-NEP) was approved in December 2001 (US\$22.6 million) and supports on-going sectoral reforms and increasing rural access to telecommunications services through the licensing of a private operator (selected on a competitive basis) and establishing public telecommunications centers.

Following the move to the base case scenario in December 2002, three additional projects have been approved for a total of US\$96.9 million, specifically:

The **Financial Sector Technical Assistance Project** (Cr. 3227-NEP) was approved in December 2002 (US\$16.0 million) and supports the efforts of HMGN to improve the financial sector in order to bring macroeconomic stability and promote private sector-led economic growth. The project focuses on three major objectives: (i) helping to restructure and re-engineer the Central Bank (Nepal Rastra Bank, NRB) so that it can effectively perform its key central banking functions; (ii) initiating commercial banking reform in the two large ailing commercial banks that dominate the sector—Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL)—by introducing stronger bank management that protects their financial integrity; and (iii) supporting a better environment for financial sector reforms in areas such as enhanced credit information, better financial news reporting, and better training for staff in financial institutions;

The **Power Development Project** (Cr. 3293-NEP) was approved in May 2003 (US\$50.4 million IDA Credit and US\$25.2 million IDA Grant) to help: (i) develop Nepal's hydropower potential in an environmentally and socially sustainable manner so as to help meet electricity demand; (ii) improve access of rural areas to electricity services and (iii) promote private sector participation in the power sector as a way to improve sector efficiency and to mobilize financing for the sector's investment requirements. In early-FY04, the potential for a parallel Global Environmental Facility (GEF) operation—to possibly include contingency financing for pipeline development of small and micro hydro projects, and support for institutional development to facilitate private sector delivery of energy efficiency services—will be assessed, with a possible operation coming later on; and

Another LIL—the **Community School Support Project** (Cr. 3808-NEP)—was approved in June 2003 (US\$5 million) to support the devolution of the responsibility for management of schools to communities. The project provides support for school grants, scholarships, capacity building, and monitoring and evaluation. The lessons learned from this project will help IDA (together with HMGN and the other education development partners) design further phases of BPEP.

**Analytical and Advisory Activities (AAA).** Consistent with the low case scenario, strong emphasis was placed on helping to build the agenda and needed consensus for reform. To a large extent, the introduction of the Medium Term Expenditure Framework (MTEF) and the Immediate Action Plan (IAP) have been prompted by the Bank's dialogue with HMGN. The *Public Expenditure Review* (PER, April 2000) was very influential in this regard. The PER helped to shape the framework for many of the public expenditure reforms that are currently under implementation or envisioned. This has been followed up with intensive technical assistance and dialogue—in collaboration with the UK Department for International Development (DfID)—which have helped (and will continue to help) HMGN develop and implement the MTEF. As important, the Bank's continuing dialogue with the authorities on the topic of the financial sector reforms—including financing the RBB/NBL diagnostic studies and the *Nepal: Financial Sector Study* (October 2002)—have kept the process on track, although admittedly progress has

at times been slow<sup>1</sup>. Other key pieces have also focused on reform agenda items, including: (i) *Priorities and Strategies for Education Sector Reform* (July 2001) which helps to identify and build consensus on a comprehensive reform agenda at all levels in this fundamental sector<sup>2</sup>; (ii) *Proposed Power Sector Development Strategy* (March 2001) which identifies the key constraints and makes recommendations to expand Nepal's hydropower resource potential to service the electricity needs of the people and to generate export potential; (iii) *The Business Environment and Manufacturing Performance in Nepal* (December 2000), the first investment climate survey carried out in the South Asia Region; and (iv) more recently, the *Nepal: Trade and Competitiveness Study* (July 2003), carried out under the Integrated Framework (IF).

Another AAA focus area has been governance, including decentralization and improving service delivery. The study *Poverty at the Turn of the Twenty-First Century* (May 1999) analyzed poverty trends and projections, the poverty profile and key elements for a poverty alleviation strategy. Related to service delivery, the *Terai Options Study* (October 2000) examined experience with various institutional arrangements for delivery of rural services in the Terai and makes recommendations for future development of cost-effective service delivery in the context of decentralization. A *Country Procurement Assessment Report* (CPAR) was finalized in FY01 and many of its recommendations are being implemented. A *Country Financial Accountability Assessment* (CFAA)—carried out with an extremely committed HMGN partner and other donors—was completed in FY02, also with an agreed action plan currently under implementation<sup>3</sup>. In the area of decentralization, three areas—the proposed Poverty Alleviation Fund (PAF), fiscal decentralization, and local institutions in the delivery of services in rural areas—have been selected as focal areas for the coming years. The PAF policy note *Towards a Sustainable Approach for Poverty Reduction and Decentralization in Nepal* was finalized in November 2002.

The majority of the formal reports have been—and continue to be—followed up by policy dialogues, consensus building, and technical assistance, which have resulted in a remarkably high level of achievement on many of the original CAS outcomes, especially in the areas of public expenditure management, decentralization, financial sector reform, telecommunications, and education reform.

Among the informal studies, the Bank facilitated and OECD/DAC led a *Review of Development Partnerships*. The review—a highly consultative exercise—covered the whole gamut of donor-recipient relationships that have impacted development partnerships in Nepal. The findings complemented HMGN's own formulation of a Foreign Aid Policy (FAP) that was endorsed by the development partners during the 2002 Nepal Development Forum.

## **Outcomes**

Over the last few years, the South Asia Region has emphasized a results-focused work programming. The Nepal Country Team has been in the forefront of these efforts, and has set the

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<sup>1</sup> DfID and the IMF have been important partners in these efforts. In addition, IMF has been providing technical assistance to the central bank.

<sup>2</sup> The intense sectoral dialogue that followed this work and has continued through the implementation of BPEP has in large part been responsible for triggering the current efforts to transfer school management to community-based groups.

<sup>3</sup> Financing was obtained under two different Institutional Development Fund (IDF) Grants to assist in the efforts to implement certain recommendations/action plans of the CPAR (related to public procurement reform) and CFAA (related to public audit reform).

standard for the countries in the region. Over the last two years, the team has adopted a ‘portfolio approach’ to outcomes, in which the entire team—not an individual—is held accountable for achieving a high proportion of outcomes that have been selected using specific criteria. The approach employed—discussed below—ensures that riskier, but high importance outcomes will also be attempted. The structure used over the last two years is as follows:

∄# Each ‘outcome’ is a significant change that would be highly desirable and possible within the four-year CAS horizon. For the immediate year ahead, a specific ‘milestone’—i.e., key step toward achieving the three-year outcome—is defined;

∄# Such a milestone is expected to have less than 100% probability of happening—for practical purposes probabilities of 20, 40, 60 and 80% are assigned—even with best efforts on the part of the Bank;

∄# The set of outcomes is seen as a ‘portfolio’ in its entirety—i.e., consisting of some high-probability, but relatively low-impact outcomes, and some low-probability, but high-impact outcomes. To avoid extremes, the set of outcomes is normally constructed with an expected overall annual success rate of around 65 – 70%<sup>4</sup>.

∄# The matrix and annual milestones are updated each year, with some outcomes replaced—either through achievement or a change in strategic priorities—and new milestones defined;

∄# Rather than holding staff accountable for achievement of specific outcomes, the Country Team is collectively held accountable for the overall outcome of the portfolio<sup>5</sup>; and

∄# The same approach is applied to a set of annual milestones as well, so that annual performance can be monitored against some expected overall achievement rate.

Near the end of each FY, the country team evaluates the achievement of the milestones during the year. Reflecting on the lessons learned and the experience in general, the team then updates the outcomes matrix and annual milestones for the following FY. Such a process has led to a situation in which there is real team ownership and awareness of the milestones and outcomes. This has also resulted in a more holistic approach to the Bank’s efforts in Nepal, in which sectors and instruments are initially ‘ignored’ as the team focuses wholly on outcomes, with the discussion on instruments to achieve those outcomes becoming secondary.

The results of the review exercise for FY03 are presented in Table 1. Of the 15 milestones established for FY03, 11 were substantially achieved, resulting in an overall ‘success rate’ of slightly higher than 70%, as compared to the original expectation of 60%. It is interesting to note that a number of milestones assessed as having a relatively high probability (i.e., 80%) of being achieved in the beginning of the FY—such as developing the design of the decentralization fiscal framework, and launching a joint review of the experience of community-based rural development programs—were not achieved. However, a number of milestones assessed as having a relatively low probability (i.e., 20 or

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<sup>4</sup> This does not imply that for outcomes that are not fully achieved, there will be no progress. In many cases, it is likely that some progress toward the ultimate outcome will have been made.

<sup>5</sup> Unless an entirely unforeseen event changes the country setting profoundly, a significant shortfall in reaching the expected rate of achievement would mean either: (i) the initial assessment or strategy was unrealistic; or (ii) the Bank’s efforts were inadequate.

40%) of being achieved in the beginning of the FY—such as piloting the transfer of management of primary schools to communities, and establishing a realistic resource ceiling for development expenditures—were achieved.

Many of the outcomes adopted by the country team for the FY03-FY05 period are closely linked to the outcomes implicit in the 1998 CAS. These links, as well as an assessment of the CAS outcomes and the instruments employed to achieve these outcomes, are provided in Table 2.

### C. Lessons Learned

Today, there is a realization within Nepal that the Bank is truly concerned with the well-being of the poor and that it is not possible to simply ‘negotiate’ aid out of IDA. However, this realization was not necessarily quick or easy in coming, and along the way, a number of important lessons have been learned—both from our experiences in Nepal and world-wide, including through initiatives such as *The Global Poll* (May 2003). While many of these lessons have been alluded to above, they can be summarized as follows:

€# In an environment of poor governance, closely linking lending levels to progress in implementing reforms and achieving results on the ground—not just promises—can be tremendously effective in a country such as Nepal. In doing so, it is important to send a firm and consistent message—and most importantly, stick with it—that unless the important issues are seriously tackled—improving governance and service delivery—additional funding will not be forthcoming (at least from the World Bank). While such an approach by itself would not prompt reforms, when spontaneous reform initiatives emerge, it can provide an important and constructive discipline to the process and can even strengthen the hands of the reform leaders. Such a stance can foster peer pressure among senior officials to look at development more holistically, as they realize that sectoral funds are held hostage to improvements in larger country goals (i.e., governance);

€# A work program grounded in an outcomes approach—in which all team members share responsibility for achievement of a portfolio of outcomes—encourages a more holistic and multi-sectoral approach. Outcomes should be realistic, focused on those areas where the Bank plays a significant role, and clearly linked to stated country objectives (such as PRS objectives or MDGs). In addition, it is important to be able to measure milestones/intermediate indicators and periodically monitor and evaluate whether these milestones are being achieved;

€# The introduction of a number of important reforms—such as the MTEF, the financial sector reforms, the IAP, and the transfer of primary schools to community management—have resulted from a long Bank association and consistent dialogue with HMG. To be most effective, it is essential to invest in a solid relationship built on a strong dialogue with key counterparts. In addition to building consensus for change/reform, such an investment also builds and encourages ownership of and buy in for the reform programs, while proactive outreach contributes to a wider understanding of development challenges and opportunities;

€# Implicitly assuming a quick transition to the base case, the Bank continued to prepare a number of larger, ‘reform-heavy’ projects during the CAS period. In retrospect, opportunities were likely missed to develop and deliver a few more ‘low case appropriate’ projects—typically modest in size, and often supporting community-based projects or small, sector specific reform efforts (e.g., telecommunications sector);

€# The interplay of diverse political economy realities has an important impact on reform implementation and hence, needs to be understood better for the Bank to be more opportunistic in its

support. When reforms do happen, they often appear to be spontaneous and episodic, and tend to fall outside the conventional frameworks that donors prefer to work in. Finally, Government officials are not necessarily good at showcasing reform progress, nor are they practiced at communicating successes to the public at large. These are important aspects to stress if the benefits of reforms are to be the best arbiter for deeper reforms in the future;

€# The linkages between peace and stability, and reducing poverty are strong—i.e., a potential vicious circle. Development/poverty reduction can not be delayed/postponed until there is peace and stability, as the root causes of conflict—i.e., failure of governance, including lack of delivery of public services, and horizontal inequality and social exclusion—are often the major challenges of reducing poverty; and

€# Donor coordination is important, but is not always easy as donors often send different and mixed messages to the Government—e.g., the Nepali reform efforts of the late-1990s/early-2000s warrant low case lending levels vs. these reform efforts warrant base case lending levels. Ultimately, the Government must be encouraged to coordinate donor assistance by setting out its own development strategies and priorities. Clearly, donors—including the Bank—need to respect Government efforts to ‘regulate’ foreign assistance through vehicles such as a Foreign Aid Policy (FAP). Such an effort, along with a firm foundation for donor assistance—such as that contained in a Poverty Reduction Strategy—will encourage more holistic and coordinated development.

**Table 1: Nepal Strategic Outcomes for FY03-FY05 and Evaluation of FY03 Milestones**

	<b>Outcomes</b>	<b>FY03 Milestone</b>	<b>Assessed Likelihood</b>	<b>Evaluation of FY03 Milestones</b>
1	An effective and transparent fiscal decentralization mechanism established.	≠# Develop the design of the decentralization fiscal framework.	80%	No, DDCs were dissolved in September 2002 and never reconstituted.
2	A Poverty Alleviation Fund (PAF) established and operationalized.	≠# Establish a good PAF framework.	60%	Yes, the ordinance is awaiting approved by cabinet.
3	At least 10% of primary schools have community based management supported by Government grants.	≠# Establishment of a decentralized funding framework and initiation of piloting.	20%	Yes, transfer of 150 schools started.
4	A coherent health reform program is in place supported by HMGN and donors.	≠# Broad consensus on the sector-wide program among HMGN/donors.	40%	Yes, preparation of comprehensive program is underway.
5	A system established to support community-based rural development programs.	≠# Joint HMGN/Bank review of experience launched.	80%	No, couldn't find a suitable person to do the work.
6	Priority funding of the Agriculture Perspective Plan (APP).	≠# Significant matching of budget allocation to APP priorities.	60%	No, Focus on P1s has held, but not enough.
7	Private operators introduced in Kathmandu, rural telecom, and inland container terminals; Power Development Fund (PDF) established.	≠# PDF created. ≠# Rural telecom operator introduced.	80% 80%	Yes for PDF. No for introduction of rural telecom operator.
8	Roads Board established and operationalized.	≠# Roads Board established and its operations started.	80%	Yes, the Board has been created and expected to start working in next year.
9	RBB and NBO restructured.	≠# Management teams installed in RBB and NBL, and effectively supervised by NRB.	80%	Yes, NBL and RBB under external management teams.
10	Regulatory functions and organizations of NRB strengthened.	≠# Agreed plan for NRB strengthening.	60%	Yes, re-engineering support team is in place.
11	MTEF (with realistic resource ceiling) established and made operational; mechanisms in place to monitor and evaluate outcomes and cost-effectiveness of public expenditures.	≠# Establish realistic resource ceiling for MTEF.	40%	Yes, FY02 ceiling is soft, but priority funding for P1s has served as a reasonable ceiling.
12	Public debate on development agenda established.	≠# Regular appearances of think pieces by donors and political leaders in Nepal & English media.	60%	Yes, significant improvement in the quality of debate.
13	HMGN/donor acceptance of common principles of behavior.	≠# Acceptance of common principles of behavior.	40%	Yes, the Foreign Aid Policy paper is being respected.
14	Other fiduciary work and some preparatory work.	≠# CPAR/CFAA follow up.		Yes, recommendations of CPAR and CFAA accepted and being implemented.

**Table 2: Evaluation of CAS Outcomes**

<b>CAS Outcomes<sup>1/</sup></b>	<b>FY03-FY05 Outcomes<sup>2/</sup></b>	<b>Evaluation</b>	<b>Instruments</b>
(i) (a)	N.A.	Historical revenue to GDP ratios: FY99/00: 10.7%; FY00/01: 11.4%; FY01/02: 11.5%; FY02/03: 12.3% Real progress in implementation of VAT , although domestic borrowing has risen	Dialogue [traditionally more in the realm of IMF]
(i) (b)	11	Number of development projects reduced from 785 (mid-1990s) to 470 (FY02/03); MTEF adopted and all development projects prioritized (P1, P2, P3); Funding ensured for P1s	Dialogue, PER, MTEF/IAP support/TA
(ii) (a)	2, 3, 4	Progress in decentralization legislation and in devolving schools, health facilities, agricultural extension and postal services to local levels; some (although limited) progress towards establishing Poverty Alleviation Fund (PAF)	Dialogue/IAP; Education Reform Strategy AAA; BPEP, Community School Support Project; PAF policy note
(ii) (b)	N.A.	A hiring freeze has been maintained and a number of successful voluntary retirement schemes implemented; civil service roster and payroll computerized; Office of the Controller General producing/circulating periodic expenditure reports	Dialogue/IAP
(ii) (c)	N.A.	Butwal Power Company privatized; two SOEs closed; privatization of five additional SOEs initiated	Dialogue/IAP
(ii) (d)	11	[see (i) (b) above]	[see (i) (b) above]
(ii) (e)	9, 10	External managers in place in NBL in July 2002; external managers in RBB in February 2003; re-engineering support team in place in Central Bank in February 2003	Dialogue/IAP, Financial Sector Study, Financial Sector Technical Assistance Project
(ii) (f)	7	National telecommunications policy focused on sector liberalization adopted in 1999; 65 new private operators provide value added services; second private mobile operator selected in March 2001; license granted to second private national operator for basic services in May 2001; delays in introduction of rural operator (in part due to security situation)	Dialogue, Telecommunications Sector Reform
(ii) (g)	14	CIAA strengthened; CIAA arresting of 5 former ministers and other senior officials; independent commission review of property disclosure statements of political leaders and senior civil servants; citizen's charter in place	Dialogue/IAP, CFAA, CPAR, IDA Grants

Notes: <sup>1/</sup> CAS outcome as identified in the first paragraph of this appendix.

<sup>2/</sup> Nepal strategic outcome as identified in Table 1.