

**Document of
The World Bank**

Report No. 26509-NEP

**MEMORANDUM OF THE PRESIDENT
OF
THE INTERNATIONAL DEVELOPMENT ASSOCIATION
TO
THE EXECUTIVE DIRECTORS
ON
A COUNTRY ASSISTANCE STRATEGY
FOR
THE KINGDOM OF NEPAL**

November 24, 2003

The last Country Assistance Strategy for Nepal (Report No. 18578-NEP) was discussed on December 13, 1998 and a Country Assistance Strategy Progress Report (Report No. 24170-NEP) was discussed on December 19, 2002.

Currency and Equivalents

Currency Unit = Nepali Rupee (NRs.)
US\$1 = NRs. 74.5 (as of October 20, 2003)

Fiscal Year

Nepal: July 15–July 14 (fiscal year starting on July 15, 2003 is designated as FY03/04)
The World Bank: July 1–June 30 (fiscal year starting on July 1, 2003 is designated as FY04)

Abbreviations and Acronyms

AAA	Analytical and Advisory Activities	MDGs	Millennium Development Goals
ADB	Asian Development Bank	MFA	Multi-Fibre Arrangement
AML/CFT	Anti-Money Laundering/Combating Financing of Terrorism	MIGA	Multilateral Investment Guarantee Agency
APP	Agricultural Perspective Plan	MOF	Ministry of Finance
BPEP	Basic and Primary Education Project	MoPE	Ministry of Population and Environment
CAE	Country Assistance Evaluation	MTEF	Medium Term Expenditure Framework
CAP	Country Assistance Program	NBL	Nepal Bank Limited
CAS (PR)	Country Assistance Strategy (Progress Report)	NC	Nepali Congress (Party)
CBO(s)	Community Based Organization(s)	NDC	National Development Council
CCF	Community Carbon Fund	NDF	Nepal Development Forum
CEA	Country Environmental Analysis	NEA	Nepal Electricity Authority
CFAA	Country Financial Accountability Assessment	NGO(s)	Non-Governmental Organization(s)
CIAA	Commission for Investigation of Abuse of Authority	NIDC	Nepal Industrial Development Corporation
CITES	Convention on International Trade in Endangered Species of Wild Fauna and Flora	NLSS	Nepal Living Standards Survey
CPAR	Country Procurement Assessment Report	NPC	National Planning Commission
DDC(s)	District Development Committee(s)	NPPR(s)	Nepal Portfolio Performance Review(s)
DfID	UK Department for International Development	NTA	Nepal Telecommunications Authority
DPR	Development Policy Review	NTC	Nepal Telecommunications Corporation
EU	European Union	OED	Operations Evaluations Department
FAO	Food and Agricultural Organization	PAF	Poverty Alleviation Fund
FAP	Foreign Aid Policy	PCR	Project Completion Report
FDI	Foreign Direct Investment	PDF	Power Development Fund
FSS	Financial Sector Strategy	PER	Public Expenditure Review
FY	Fiscal Year	PERC	Public Expenditure Reform Commission
GDP	Gross Domestic Product	PIC	Public Information Center
GEF	Global Environmental Facility	PIP	Portfolio Implementation Plan
GtZ	Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation)	PCF	Prototype Carbon Fund
HMG/N	His Majesty's Government of Nepal	PRGF	Poverty Reduction and Growth Facility
IAP	Immediate Action Plan	PRS(C)	Poverty Reduction Strategy (Credit)
ICR	Implementation Completion Report	RBB	Rastriya Banijya Bank
IDA	International Development Association	RPP	Rastriya Prajastantra Party
IDF	Institutional Development Fund	SEDF	South Asia Enterprise Development Facility
IF	Integrated Framework	SMC(s)	School Management Committee(s)
IFC	International Finance Corporation	SME(s)	Small and Medium Enterprise(s)
ILO	International Labor Organization	SOE(s)	State Owned Enterprise(s)
IMF	International Monetary Fund	TA	Technical Assistance
INGO(s)	International Non-Governmental Organization(s)	UML	United Marxist Leninist (Party)
ITTA	International Tropical Timber Agreement	UNDP	United Nations Development Program
IUCN	The International Union for Conservation of Nature	UNEP	United Nations Environmental Program
JBIC	Japan Bank for International Cooperation	UNFPA	United Nations Population Fund
JICA	Japan International Cooperation Agency	UNICEF	United Nations Children's Fund
JSA	Joint Staff Assessment	VDC(s)	Village Development Committee(s)
		WHO	World Health Organization
		WTO	World Trade Organization
		WWF	World Wildlife Fund

Vice President:	Mr. Praful Patel, SARVP
Country Director:	Mr. Kenichi Ohashi, SACNP
Task Team Leader:	Ms. Deborah A. Bateman, SACNA

NEPAL: Country Assistance Strategy

TABLE OF CONTENTS

Executive Summary	i
Introduction.....	1
I. The CAS Context	2
A. Social Context.....	2
B. Political Context	3
C. Macroeconomic Performance and Medium Term Prospects	4
D. Progress Under the Last CAS and Lessons Learned.....	6
CAS Implementation.....	6
Lessons Learned.....	7
II. Nepal’s Poverty Reduction Strategy	8
A. The Reform Program	8
The Context: Nepal at the Edge of Chaos	8
The Immediate Action Plan	9
Medium Term Expenditure Framework and Fiscal Adjustments	10
B. The Poverty Reduction Strategy	11
Background.....	11
Broad-Based Economic Growth	12
Social Sector Development	13
Social Inclusion and Targeted Programs.....	13
Good Governance	14
C. Assessment of the PRS	15
III. The Country Assistance Strategy	16
A. The Context.....	16
B. The Bank’s Strategy for FY04-FY07	18
The Strategy: PRS-Based and Outcomes-Focused	18
Cross Cutting Themes	19
Instruments to Achieve the CAS Outcomes	23
Bank Group Scenarios	24
C. Portfolio Management	27
IDA	27
IFC	29
MIGA	29
IV. Implementing the CAS	30
A. Partnerships.....	30
B. Monitoring Outcomes	32
C. Risks	33

BOXES

Box 1	Nepal's Progress Towards Achieving the Millennium Development Goals	2
Box 2	The Insurgency	4
Box 3	Governance and the Financial Sector	6
Box 4	The 2003 IAP.....	9
Box 5	Improving Nepal's Trade and Competitiveness.....	12
Box 6	The PRS Consultation Process.....	15
Box 7	The Business Environment in Nepal.....	17
Box 8	The Response to Environmental Challenges	21
Box 9	Financial Management Broadly Defined	27
Box 10	The CAS Consultation Process.....	30

TABLES

Table 1	Selected Economic Indicators: FY99/00-FY05/06	5
Table 2	Key Formal Reports Since FY99	7
Table 3	CAS Outcomes	20
Table 4	Formal AAA, FY04-FY07.....	23
Table 5	Key Triggers for CAS Scenarios	25
Table 6	IDA Base Case Lending Program: FY04-FY07	26
Table 7	Project Performance at Exit	28
Table 8	IDA Portfolio Trends and Performance: FY99-FY04	28
Table 9	Partnerships in Implementing the Poverty Reduction Strategy	31

ANNEXES

Annex A2	At A Glance
Annex B2	Selected Indicators of Bank Portfolio Performance and Management
Annex B3	Bank Group Program Summary
Annex B4	Summary of Non-Lending Services
Annex B5	Social Indicators
Annex B6	Key Economic Indicators
Annex B7	Key Exposure Indicators
Annex B8	Status of Bank Group Operations
Annex B9	Summary of Development Priorities
Annex B10	CAS Outcomes Matrix
Annex B11	HMGN's Policy Matrix for the PRS Reform Agenda and World Bank/Partner Programs and Support

APPENDICES

Appendix I	The Millennium Development Goals and Related Indicators
Appendix II	Implementing the Previous CAS and Lessons Learned
Appendix III	The 2003 Intermediate Action Plan
Appendix IV	Fund Relations Note
Appendix V	The Main Findings of Two Key Fiduciary Assessments: CFAA and CPAR

Map (IBRD 26085)

NEPAL
COUNTRY ASSISTANCE STRATEGY

EXECUTIVE SUMMARY

i. Today, Nepal stands at the crossroads between a brighter future that promises more sustained poverty reduction and the possibility of the country becoming mired in a more protracted internal conflict. During the past few years, the insurgency has escalated sharply, involving an open conflict with the army since November 2001. This, combined with external developments, has undermined the economy and weakened the country's fiscal position. Despite the many positive changes Nepal has seen since the advent of multi-party democracy in 1990 and the first wave of economic liberalization measures in the early-1990s, the recent developments have highlighted the stark and worsening inequities in Nepal, not only in terms of incomes, but also of the fundamental ability of the Nepali citizen to participate in social and political decision-making processes. The deepening crisis, however, has also created the space for the reform-minded political and technocratic leaders to begin a renewed drive to build an economic and social foundation for sustained peace and poverty reduction.

ii. Important reforms have emerged in several areas over the past two years. First, to prevent a possible financial sector crisis, a key initial step was taken by putting the two ailing commercial banks under external management teams. Second, facing up squarely to the fiscal pressures, His Majesty's Government of Nepal (HMGN) introduced a Medium Term Expenditure Framework (MTEF) in FY02/03 to rationalize the development budget and instill the discipline of a hard budget constraint. Third, responding to the urgent need to improve public service delivery, HMGN has started to transfer key services to community management in primary education and primary health care. Fourth, to ensure implementation of priority reforms, HMGN devised an Immediate Action Plan (IAP) in 2002, which was effectively used to hold relevant Ministries and Departments accountable for promised actions. Fifth, a highly visible anti-corruption drive has been started by the Commission for Investigation of Abuse of Authority (CIAA), thereby giving Nepali citizens a hope that the days of rampant corruption may be coming to an end. The recently adopted Poverty Reduction Strategy (PRS)—based on the Tenth Plan (FY02/03-FY06/07)—builds on these successes, and gives the reform process much greater strategic coherence and clarity.

iii. Nepal's PRS breaks from the past, largely ineffective plans in a number of significant ways. For the first time, it explicitly identifies social exclusion as one of the fundamental development challenges. It also recognizes HMGN's constrained fiscal situation and weak implementation capacity, and places the PRS in a realistic framework of implementation abilities, both fiscal and institutional. Thus, the MTEF gives it both a medium term fiscal framework and annual budgetary translation of the strategy, while the IAP will be used as an annual implementation plan for high priority reform actions that would receive continual attention from the highest levels of HMGN. These two instruments and the track record of significant early progress give the PRS considerable credibility. With the aim of reducing poverty and improving critical public services, the PRS is built around four pillars: (i) broad-based economic growth; (ii) social sector development; (iii) social inclusion; and (iv) good governance. In implementing it, the PRS stresses decentralization, rationalization of central government functions and transparency.

iv. Despite the successes and a palpable change in the energy with which the reform leaders are pushing the agenda at the center, the benefits of the reforms have not yet been felt widely at the grassroots levels. There is clearly a need to accelerate the reform actions embodied in the PRS, including in particular greater decentralization. This would be essential not only for rebuilding the people's confidence in the state, but also for making meaningful progress toward poverty reduction and achieving the Millennium Development Goals (MDGs).

v. Given the continuing political turmoil, the Bank no doubt faces a risky environment in which to operate in Nepal. The Bank, however, should not lose sight of the most important risk the country faces, and hence by extension the Bank also faces—i.e., the risk of Nepal spiraling into a widespread armed conflict and a breakdown of state institutions. In comparison, many of the other risks are modest if not trivial. The current wave of reforms is a determined effort by the reform leaders to mitigate this fundamental risk. Unlike in typical reform episodes, the leadership for change has come more from a growing number of reform-minded technocrats and some enlightened political leaders who stand apart in an establishment that has provided largely passive support rather than explicit leadership. Because of this, the reform efforts may seem more tenuous and less spectacular. Nevertheless, the basic contents of the reform program enjoys strong support from the population at large and at least tacit support from mainstream political parties. This is not to minimize the risks that the reform process could be stifled by myopic political interests or the implementation capacity is curtailed by hostilities. Implementation of the Bank's strategy will be cognizant of these risks.

vi. Through the lean years of slow reforms, the Bank worked consistently with reform-minded leaders and facilitated the beginnings of the current reform process. The firm linking of lending levels to actual reform implementation has challenged and inspired the reformers. And, an uncommonly strong partnership has developed between these leaders and the Bank, with a strongly shared vision for the reforms that Nepal needs. More importantly, the reformers have risen to the occasion and have begun implementing the far reaching program articulated in the PRS. Because of the fiscal pressures, accelerating its implementation will require increased external resource flows, particularly of a programmatic nature. The Bank's CAS for FY04-FY07 is designed to respond to this situation by increasing financial support to facilitate Nepal's own reform efforts. To align the Bank's assistance program with the PRS, the CAS will be fully outcomes-focused, continuing the outcomes-based approach developed by the Nepal Country Team over the last two years.

vii. Given the risks of politics getting in the way of reforms, the Bank will continue to maintain sharply differentiated lending levels linked to progress on reform implementation. The base case envisions an average annual lending of about US\$190 million (consistent with the current IDA resource allocation for Nepal), including programmatic support to facilitate accelerated implementation of the core PRS priorities. If the reform process stalls (low case), the lending support will be curtailed sharply to a range of US\$0-50 million. In the high case—which is associated with peace and accelerated reforms—lending could increase to US\$200-250 million annually. With the prevailing uncertainties, however, there could be a need to revisit the strategy. As such, a CAS Progress Report (CAS PR) will be prepared in approximately eighteen to twenty-four months, or sooner should the situation warrant.

viii. The Executive Directors may wish to discuss:

€# The appropriateness of the basic strategy of providing strong support to Nepal's PRS in the face of significant political uncertainty;

€# The appropriateness of the outcomes-based approach outlined in the CAS; and

€# The choice of instruments to deliver the lending program.

ix. In many respects, Nepal is truly at a critical juncture in its development process, and it is difficult to predict which path the country will follow. While the on-going reforms offer the best hope for laying the foundation for sustained peace and development, the insurgency makes their implementation more difficult. Yet, one thing is clear. With strong support of the Bank as outlined in this CAS, the chances are much greater that the reform program will succeed, and hence, lead eventually to real improvements in the lives of Nepal's poor and most vulnerable.

NEPAL

COUNTRY ASSISTANCE STRATEGY

INTRODUCTION

1. The last Country Assistance Strategy (CAS) for Nepal—considered by the Board on December 13, 1998—identified poor governance as the fundamental constraint restricting Nepal’s development.¹ Since then, while there have been improvements, governance—broadly defined to encompass public accountability, transparency and social inclusion—remains the country’s central challenge. In part reflecting the structure of poor governance, over the last five years Nepal has gone through turbulent times. Both growth and poverty reduction have suffered from a number of factors, including: (i) successive ineffective Governments and a continuing unstable political environment; (ii) an escalation of the insurgency, interspersed with two failed attempts at peace talks (in 2001 and 2003); and (iii) harsh repercussions from the global economic slowdown that have severely affected Nepal.

2. As reported in the CAS Progress Report (CAS PR) of November 2002,² despite this instability and uncertainty—or perhaps because of it—over the last two years, Nepal has begun implementing an impressive and far-reaching reform program. Notable progress has been made in financial sector reform, public expenditures management, changes in public service delivery modalities, the fight against corruption and the infrastructure regulatory environment. To give the reform process greater coherence, the country has recently formulated a Poverty Reduction Strategy (PRS).³ Nonetheless, the impact of the reforms have not been felt widely enough to date and Nepal remains one of the world’s poorest countries, with an annual per capita income of about US\$230 and bleak social indicators. Nepal also needs to address fundamental issues related to social exclusion and redress the widespread perception that the state has been failing to deliver basic public services. While the on-going reforms offer the best hope for laying the foundation for sustained peace and development, the insurgency makes their implementation more difficult.

3. Thus, Nepal is at a critical juncture in its development process today. Nepal may be turning toward a brighter future, but the risk of the country becoming mired in a more protracted internal conflict cannot be discounted. Despite this unpredictable environment, there are several good reasons for the Bank to formulate a new CAS at this time. Most fundamentally, a new CAS will allow the Bank to align its assistance program closely to the current reform process embodied in the PRS, hence providing more effective support and encouragement to the reform efforts. Moreover, contrary to the political turmoil and uncertainties, in the last two years there has been much greater continuity and certainty in the reform process, backed by broad support from the general public. As such, there is a solid process of change that Bank assistance can and should support. This is not to minimize the risks the reform process faces, but all the more reason the Bank should have a clear strategy to deal with the various possibilities.

¹ Report No. 18578-NEP, dated November 17, 1998.

² Report No. 24170-NEP, dated November 18, 2002, and discussed by the Board on December 19, 2002.

³ The draft PRS received cabinet endorsement in May 2003. It was finalized and officially submitted to the Bank and IMF in late-June, at which time work was initiated on a Joint Staff Assessment (JSA).

I. THE CAS CONTEXT

A. Social Context

4. Despite improving economic performance during the 1990s in which per capita income growth increased to about 2.5%, Nepal remains extremely impoverished. Although the most 'recent' poverty estimates are rather outdated⁴ and comparability among different poverty estimates is questionable, it is possible to draw some broad conclusions regarding poverty trends over the last few decades. Specifically:

- €# The absolute number of poor in Nepal has increased since the mid-1980s;
- €# The distribution of income has become more unequal throughout the country; and
- €# Progress towards attaining the Millennium Development Goals (MDGs) has been slow.

The country will continue to face many challenges towards achieving the MDGs in the coming decade (see Box 1 and Appendix I).

Box 1: Nepal's Progress Towards Achieving the Millennium Development Goals

Millennium Development Goal	Nepal's Current Position
Halve, between 1990 and 2015, the proportion of people whose income is less than US\$1/day.	As of 1995, it was estimated that about 40% of Nepal's population lived on less than US\$1/day. There is little evidence that poverty has declined since the 1980s and the absolute number of poor has likely increased.
Enroll all children in primary education by 2015.	There is evidence that the net enrolment rate of primary-aged children rose in the 1990s reportedly to over 70% and the youth literacy rate increased to 63%.
Make progress towards gender equity and empowering women by eliminating gender disparities in primary/secondary education by 2005 and all levels by 2015.	There have been significant improvements in the relative access of girls to school education during the 1990s (a ratio of girls to boys in primary/secondary education of 82%); however, the ratio of young literate females to males is still less than 60%, and Nepali women are still largely without voice and influence in the public domain.
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	Within the last decade, there have been considerable reductions in infant mortality (from 100 per 1,000 live births to 66) and child mortality (from 145 per 1,000 to 91); nevertheless, large regional variations persist.
Reduce maternal mortality ratios by three-quarters between 1990 and 2015.	Maternal mortality remains high (estimated at 830 per 100,000 live births in 1995) with only about 12% of births attended by skilled health staff.
Have halted by 2015 and begin to reverse the spread of HIV/AIDs, incidence of malaria and other major diseases	It is hard to obtain an accurate assessment of the HIV/AIDS situation; however, evidence suggests that the HIV rate is rising rapidly—perhaps the early stages of a concentrated epidemic—in several vulnerable groups, notably Nepalis working abroad and sex workers.
Integrate the principles of sustainable development into country policies and programs, and reverse the loss of environmental resources.	There are issues—e.g., depletion of soil nutrients and arsenic contamination in the Terai—that show environmental sustainability remains a problem. However, other initiatives—in drinking water and forestry—indicate positive progress. A national sustainable development strategy is under preparation.
Develop a global partnership for development.	Nepal has an overall low level of telephone density and approximately two-thirds of telephones are in the Kathmandu valley.

Note: See Appendix I for the MDGs and related indicators for Nepal.

Sources: Staff estimates.

⁴

The most recent estimates are based on the 1995/96 Household Survey. A Nepal Living Standards Survey (NLSS) was launched in early-2003 to update household level information on consumption, poverty and their determinants. A full Poverty Report based on this survey will be finalized in FY05. For more details on the poverty situation in Nepal, see the Poverty Reduction Strategy.

5. With approximately 85% of the total population living in rural areas, poverty is largely a rural phenomenon in Nepal—a rural poverty incidence of 44% compared to about 23% in urban areas.⁵ Of the country's ecological regions, poverty in the mountains, at about 55%, is significantly above the national average, as it is in the more remote mid- and far-western districts (many of which are controlled by the insurgents) where poverty is as high as 70%. While there have been noticeable improvements in human development indicators in recent years, they are still quite low and show significant urban/rural and geographical variations. There has been some progress in reducing gender disparities—e.g., life expectancy, literacy levels, and school completion rates—but, great advances are still required for Nepali woman to be considered truly empowered.

6. As important, there are significant ethnic and caste-based disparities in what is recognized as a largely pluralistic society with diverse ethnic, caste, linguistic and religious communities.⁶ Broad linkages have been identified between caste and poverty, and caste and human development levels, and there are some clear messages: (i) most of the Dalit population is disadvantaged; and (ii) there are striking caste and ethnicity-based disparities in education. A number of factors—including its limited natural resource endowment, land-locked and rugged terrain, and series of ineffective and unstable Governments—have contributed to Nepal's poverty problems. Adding to these, much of the economic growth has been in non-agricultural sectors, leaving behind the majority of Nepalis living in rural areas.

B. Political Context

7. Nepal has seen extraordinary political instability in recent years—i.e., there have been twelve changes in Prime Minister in the past eight years. Peace has also eluded Nepal for more than seven years while a violent insurgency has claimed over 8,000 lives and the remit of the state machinery shrunk largely to urban and semi-urban areas in many districts (see Box 2). An important breakthrough was made on January 29, 2003 when His Majesty's Government of Nepal (HMG/N) and the insurgent leaders agreed to a cease-fire. After three rounds of peace talks, however, the insurgents unilaterally called off the cease-fire on August 27, 2003. While all sides stress the need for a peaceful resolution of the conflict, the path to peace is not obvious.

8. On the political front, the Parliament was dissolved on May 22, 2002, and Mr. Sher Bahadur Deuba remained as caretaker Prime Minister for about six months. During this time, the terms of locally elected bodies—both at the village/municipality and district levels—were allowed to expire in July 2002. With an escalation of insurgency-related violence—in part a campaign to prevent elections—Mr. Deuba recommended deferment of elections for over a year. This led the King to dismiss the Government in September 2002, and has resulted in two successive interim Governments.

9. The first interim administration—headed by Prime Minister Lokendra Bahadur Chand of the Rastriya Prajatantra Party (RPP)—was appointed by the King on October 11, 2002 with a mandate, among other things, to restore peace, hold the suspended elections, fight corruption and improve service delivery. While public opinion was firmly behind the peace talks and supported the administration, the main political parties—most notably, the split Nepali Congress (NC) Party and the United Marxist Leninist Party (UML)—continually challenged the administration's legitimacy. On the basis of the

⁵ All poverty figures cited are based on the results of the 1995/96 Household Survey and can be compared to an overall poverty incidence estimated at 42% of the population.

⁶ Nepal has over 100 languages and dialects, and more than 60 recorded ethnic groups, some of which are further sub-divided into distinct caste rankings. There are many indigenous ethnic ('Janajati') groups and 12-15% of the population are 'Dalits' or occupational caste groups who have been historically disadvantaged and continue to lag behind.

standoff that developed with the political parties agitating for the restoration of Parliament and formation of an all-party Government, the Chand administration resigned in late-May 2003, and the King appointed Mr. Surya Bahadur Thapa—also of the RPP—as the new Prime Minister on June 4.

10. As head of the second interim administration, Prime Minister Thapa has been vested with full executive powers to assemble an all-party Government, but the five main political parties have so far all declined to join, claiming that the current administration is no different from its predecessor. As such, the cabinet contains only six additional members, all from the RPP. Mr. Thapa has outlined a ten-point agenda that includes: (i) resolving the insurgency problem and establishing lasting peace; (ii) creating an environment conducive to local and general elections; (iii) establishing the foundations of good governance and strengthening the administrative machinery; (iv) effectively implementing anti-corruption measures; (v) accelerating economic reforms and facilitating an enabling environment for investment; and (vi) building consensus for political, economic and social reforms. In this context, securing a lasting peace with the insurgents, reaching a political settlement with the parties and building an environment conducive to holding elections all remain high on HMGN's agenda. Strongly related to this, HMGN's recent replacement of public servants with political appointments in local bodies (see footnote 11) can be viewed as a precursor to local elections. Nevertheless, the political situation remains tense and a speedy return to functioning democracy does not appear imminent.

Box 2: The Insurgency

The insurgency—previously a low intensity and mainly rural campaign to form a 'people's republic'—has claimed more than 8,000 lives by official accounts and has resulted in Nepal's longest and bloodiest conflict since the mid-1700s. It is clearly a political movement with a firm political philosophy, but has gained strength because of certain social-economic conditions, including in particular:

- ## Horizontal inequality and social exclusion: specifically, economic growth has largely benefited Kathmandu valley residents, with the large impoverished and deprived rural population—for decades a target of social exclusion—witnessing little social and economic progress; and
- ## Failure of governance, including lack of delivery of public services: specifically, weak institutions have failed to meet the basic needs of the population and continue to be linked with corruption, political infighting and instability.

The insurgency has increasingly challenged the fragile economy—the costs have been estimated at 8-10% of GDP, including: (i) damage to infrastructure—e.g., over 1/3 of the 3,900 Village Development Committee (VDC) buildings have been destroyed; (ii) lost economic activity due to *bandhs*—i.e., strikes—that have been taking place with greater frequency and often lasting 2-3 days; and (iii) a generally low level of economic activity caused by decreased business confidence and low tourism. Furthermore, there have been large direct impacts on the livelihoods of millions of primarily rural-based individuals, for which killing, extortion, confiscation, forced recruitment, and infrastructure destruction have created fear and resulted in migration, decreased agricultural production, and a decline in living standards—it is estimated that approximately 300,000 people have migrated to the Kathmandu valley in recent years.

C. Macroeconomic Performance and Medium Term Prospects

11. Since the last CAS, the Nepali economy has fluctuated. After growing at a rate of 5% per year during the 1990s, real GDP fell in FY01/02 primarily due to declines in manufacturing and tourism (see Table 1). A number of factors—including sluggish worldwide growth, the insurgency, market saturation, and inadequate quality control and standards—contributed to the decline, as did irregular rainfall that adversely affected agricultural production. More recently, there have been signs of a modest recovery underway, with GDP growing by 2.3% in FY02/03. Economic activity picked up noticeably after the January cease-fire with some recovery in tourism, transportation and other services, and certain manufactured exports—especially garments. Nevertheless, the economy remains weak.

12. As imports have also somewhat rebounded, the current account balance recorded a slight deficit (about 1% of GDP) in FY02/03. Remittances from Nepalese working abroad have grown tremendously

(estimated at around US\$855 million in FY02/03), with this item now larger than the value of merchandise exports. Gross official reserves remained high at about US\$1.2 billion—about six ½ months of imports—at end-FY02/03. The external debt service ratio is low (about 7.5%) of exports of goods and services, because of the highly concessional nature of external borrowing.

Fiscal Year	99/00	00/01	01/02	02/03 ^{1/}	03/04 ^{2/}	04/05 ^{2/}	05/06 ^{2/}
Real GDP (% change)	6.1	4.8	-0.5	2.3	3.5	4.6	5.4
Agricultural GDP	4.9	5.5	2.2	2.1	2.8	3.0	3.5
Non-agricultural GDP	6.8	4.3	-2.1	2.5	3.9	5.7	6.4
Manufacturing	7.2	3.8	-10.0	0.4	2.3	6.7	7.2
Other sectors	6.8	4.4	-0.6	2.9	4.2	5.5	6.4
Fiscal indicators (% of GDP)							
Total revenue	10.7	11.4	11.5	12.3	12.4	12.8	13.4
Total expenditure	15.7	17.6	17.2	16.3	18.7	18.5	18.2
Current expenditure	9.6	11.2	11.6	11.6	13.1	12.5	12.1
Capital expenditure and net lending	6.1	6.4	5.7	4.7	5.6	6.0	6.1
Overall deficit before grants	5.0	6.2	5.7	4.0	6.3	5.7	4.8
Overall deficit after grants	3.5	4.5	4.3	1.9	3.6	2.6	2.0
Domestic financing (net)	0.9	2.7	2.9	1.2	1.7	1.3	0.6
Current Account Balance (% of GDP)	0.5	1.2	2.6	-0.9	-1.7	-1.8	-2.3
Gross official reserves (US\$ millions, end of period)	1,385	1,020	1,048	1,177	1,237	1,292	1,347
In months of imports of goods & services	5.6	7.0	6.7	6.9	6.4	6.3	6.2
External debt/GDP (%) ^{3/}	51.8	49.9	52.9	52.2	47.2	44.8	42.4
Debt service ^{4/}	4.7	6.1	7.5	7.4	7.9	8.1	8.1
Source: IMF (as of October 6, 2003)							
^{1/} Estimate							
^{2/} Projected							
^{3/} Includes estimated private sector debt and short-term trade credits.							
^{4/} In % of exports of goods, services, and private transfers, including debt service to the IMF.							

13. In recent years fiscal management has come under stress, as the worsening insurgency situation and fragile economy contributed to weak revenue growth and security-related spending increased. In FY01/02, revenues were below the budget target (despite serious collection efforts, including imposition of special security surtaxes) and security spending was about 1% above the budgeted amount (although still well below the level of similar spending in other countries in the region). Anticipating further fiscal pressures, HMGN embarked on a bold fiscal consolidation exercise in FY02/03 that has been implemented with a considerable degree of success.⁷ Despite low levels of development expenditures in FY02/03, pro-poor spending has been protected. Furthermore, with revenues increasing by 13% over the previous year, the deficit before grants declined to 4% of GDP in FY02/03 (compared to the 1990s average of 6%). Fiscal management will continue to be strengthened during FY03/04 and into the second month of the fiscal year, budget implementation is strong. In the past, the deficit has largely been financed by concessional foreign financing, however, in FY00/01 and FY01/02 domestic financing rose slightly. With successful implementation of the reform program, in the future it is envisioned that foreign financing will increase.

⁷

See paragraphs 21-23 for details on the implementation of the MTEF and fiscal adjustments.

14. Led by a recovery of manufacturing and exports, stronger agricultural performance and productivity, and higher investment, in the medium term growth in Nepal is expected to increase to the 5% rates experienced during the 1990s.⁸ There are, however, several key pre-conditions for these to occur. First and foremost, renewed economic growth will require political stability and peace. Second, Nepal will need to implement a range of growth-enhancing structural reforms to stimulate a more pro-poor and inclusive growth process, including: (i) enhancing the development impact of public expenditures and improving tax administration; (ii) improving power, transport, banking and telecommunications services; (iii) boosting Nepal's export competitiveness by addressing some behind the border constraints; (iv) addressing sector specific reforms such as rationalizing irrigation subsidies in agriculture and improving labor market flexibility for manufacturing and services; and (v) undertaking governance reforms that enhance the impact of the structural measures.

15. The macroeconomic framework recently agreed by HMGN with the Bank and International Monetary Fund (IMF), as well as assistance from both institutions to implement the reform efforts—through Poverty Reduction Support Credits (PRSCs) and a Poverty Reduction and Growth Facility (PRGF)—will support Nepal's attempts to achieve more sustainable growth. The key elements of the framework are consistent with the PRS and include: (i) a fiscal strategy to improve revenue mobilization, prioritize spending—towards social and infrastructure sectors to help reduce poverty—and contain domestic borrowing over the medium term; (ii) a monetary policy geared to supporting the peg to the Indian rupee; (iii) continuation of the financial sector reforms; (iv) public sector reforms including civil service and public enterprise; and (v) governance reforms to strengthen the fight against corruption and accelerate decentralization to local levels to improve accountability and service delivery.

D. Progress Under the Last CAS and Lessons Learned⁹

CAS Implementation

16. Because of the limited and slow progress in implementing the reform program, for much of the last CAS period Nepal remained in a low case lending scenario. Given the fungibility of aid resources, without substantial improvement in the use of public resources, 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. Growing recognition of the gravity of the financial sector conditions and their direct link to the system of poor governance, led the Bank to attach special importance to financial sector reform (see Box 3). As the first major step in reforming the financial sector, the introduction of external management teams in the two large ailing commercial banks became the 'litmus test' for moving into a base case scenario. By the time of the December 2002 CAS PR significant

Box 3: Governance and the Financial Sector

Poor management of financial resources at Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL) has been a way through which powerful elite have abused public institutions. Poor management and oversight of the financial sector—in part, occasioned by heavy-handed state involvement—has resulted in problems of growing non-performing assets and capital adequacy, and an increased scope for systemic risk within the sector. RBB and NBL—accounting for about 50% of total banking system assets—are estimated to have had losses (as of mid-1998) of as much as US\$450 million—equivalent to about 46% of the budget or 8.6% of GDP. In late-2000, HMGN adopted a strategy that commits to reducing the role of the public sector in the sector as a direct owner of financial institutions, while strengthening its role as a supervisor and regulator of banks and financial institutions (see paragraph 32).

⁸ Nevertheless, a key concern will be the removal of the Multi-Fibre Arrangement (MFA) based quota protected markets that had stimulated the growth of manufacturing and trading over the last decade.

⁹ For a more detailed discussion of the experience with implementing the last CAS, see Appendix II.

progress had been achieved toward implementing the reform program, including in the financial sector, and hence the decision was made to move Nepal to the base case.

17. While in the low case (late-1998 to late-2002), the lending program focused primarily on infrastructure development, and four projects—in education, rural infrastructure, road maintenance and telecommunications—were approved for a total of US\$94.6 million. Strong emphasis was placed on helping to build the agenda and needed consensus for reform. To a great extent, the introduction of a Medium Term Expenditure Framework (MTEF) and Immediate Action Plan (IAP—see paragraphs 21-24) have been prompted by the Bank's Analytical and Advisory Activities (AAA). In addition to key formal reports (see Table 2), the Bank's follow up through technical assistance (TA) and intensive dialogue have made significant contributions to the foundations of many of the on-going and envisioned reforms. Internally, the Bank's Nepal team has also moved to an outcomes-based work programming approach to sharpen its focus on facilitating reforms (see paragraph 49). Since the transition to the base case in December 2002, three additional projects (in the financial sector, power development and education) have been approved for a total of US\$96.9 million.

Poverty Report	FY99
Public Expenditure Review	FY00
Priorities & Strategy in Education Sector Reform	FY01
Power Sector Development Strategy	FY01
Business Environment & Manufacturing Perform.	FY01
Country Procurement Assessment Report	FY01
Country Financial Accountability Assessment	FY02
Financial Sector Study	FY03
Trade & Competitiveness Study	FY03
Towards a Sustainable Approach for Poverty Reduction and Decentralization: A Note on PAF	FY03
Country Assistance Strategy Progress Report	FY03

Lessons Learned

18. Today, there is a realization in 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. In getting to this point, a number of valuable lessons have been learned—both from our experiences in Nepal and world-wide, including through instruments such as *The Global Poll* (May 2003). The following have taken into account in developing this new CAS:

€# 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 provide significant leverage. While such an approach by itself might 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 reform leaders. In addition, this fosters peer pressure among senior officials to look at development more holistically, as they realize that sectoral funds could be blocked if the overall progress is not made toward larger country goals (i.e., governance);

€# A work program grounded in an outcomes framework encourages a more holistic and multi-sectoral approach for the Bank team. Outcomes need to be realistic and focus on those areas where the Bank plays a significant role, with clear linkages to the country's stated objectives;

€# To be most effective, consistent dialogue and investment in a solid relationship with key counterparts are essential. In addition to building consensus for change/reform, such an investment also builds and encourages ownership of and buy in for reform programs. Proactive outreach helps build wider understanding of the development challenges and opportunities;

€# It takes time for reform to catch on; hence, there is a need to simultaneously develop ‘low case appropriate’ interventions—typically modest in size and often supporting community-based projects or small, sector-specific reform efforts;

€# The interplay of diverse political economy realities have an important impact on reform implementation. These need to be better understood for the Bank to be more effective in identifying and supporting emerging reform opportunities. When reforms do happen, they are often spontaneous and episodic, and often fall outside conventional frameworks that donors are accustomed to. Moreover, Government officials are not generally good at showcasing reform progress, nor are they practiced at communicating successes to the public. These are important aspects to stress and take into account if the benefits of reforms are to be the best arbiter for deeper reforms in the future;

€# The linkages between peace and stability, and poverty reduction are strong—possibly forming a vicious circle. Development/poverty reduction can not be delayed or postponed until there is peace and stability, as many of 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 also the major challenges of reducing poverty; and

€# Donor coordination is essential, but not always easy. Ultimately, the Government must be encouraged to coordinate donor assistance by setting out its own development strategy and priorities. Clearly, donors—including the Bank—need to respect Government efforts to ‘regulate’ and direct foreign assistance.

II. NEPAL’S POVERTY REDUCTION STRATEGY

A. The Reform Process

The Context: Nepal at the Edge of Chaos

19. Nepal is struggling to emerge from a period of intense turmoil and its future hangs in balance. The acutest form of this turmoil is the insurgency that escalated into a serious armed conflict involving the army in November 2001. In the backdrop, however, had been growing disappointment with the political and development processes that have failed to meet the aspirations of the people, which had been raised after the reinstatement of a multi-party democracy in 1990. With the heightened level of hostilities, the economy slowed and fiscal pressures built. When this crisis did not seem to prompt political leaders into serious corrective action, the frustration of many turned into a sense of alarm that the nation was heading for a catastrophe. From this deep sense of crisis, a new wave of reforms was born. It is being led by a growing number of reform-minded technocrats and some enlightened political leaders.

20. An important beginning was made at the Nepal Development Forum (NDF) in March 2000, where HMGN announced a comprehensive reform program that focused on improving governance and reducing poverty. As the severity of the financial problems of the two largest commercial banks became apparent in 2001, reformers became alarmed by the prospect of a financial sector crisis and began to use it as a focal point of the reform process. Then, with the fiscal situation deteriorating rapidly in 2002, HMGN started to use this as a driver for public expenditure reform. At the same time, to respond to the serious challenges caused by the insurgency, reformers began to design radical ways to improve public service delivery even under severe fiscal constraints. By the beginning of FY02/03, these somewhat disparate initiatives took shape as a more cogent strategy, embodied in the IAP and the financial sector reform program that would place the two ailing banks under external management as the first step. An integral part of the IAP has been the introduction of the MTEF to substantially rationalize the development budget. In parallel, after its legal framework was strengthened in 2002, the Commission for

Investigation of Abuse of Authority (CIAA) started to take some highly visible actions against senior civil servants and politicians on corruption charges.¹⁰ This has been met with enthusiastic support from the general public. As explained below, the PRS builds on these reform successes and expands the scope of reforms, with a more integrated approach within a medium term perspective.

The Immediate Action Plan

21. In June 2002, HMGN adopted the IAP that was designed to expedite reforms in three critical areas—prioritizing public expenditures, improving service delivery, and strengthening anti-corruption and accountability measures. Recognizing their weak implementation capacity, HMGN took pains to keep the plan selective. Main IAP actions included: (i) setting a realistic budget ceiling and eliminating a number of low priority projects; (ii) assuring funding for high priority projects, but tying funds release to performance; (iii) improving service delivery modalities by initiating the transfer of public primary schools and primary health facilities to community management; (iv) public posting of budget information and tracking of expenditures; (v) implementing public procurement and financial accountability reforms; and (vi) developing and starting to implement an anti-corruption strategy. With all the Ministries and Departments relevant to the IAP galvanized into action, nearly all of the 19 actions were completed by the end of FY02/03. Inspired by this achievement, HMGN decided to turn the IAP into an annual process to define and monitor a set of critical actions necessary for the successful implementation of the PRS. After being endorsed by the cabinet, the 2003 IAP was announced in July 2003 and the measures are expected to be implemented by the first quarter of 2004 (see Box 4 and Appendix III). In this regard, reform leaders are keenly aware that these early successes have not translated into significant impacts on the lives of average citizens at the grassroots levels, especially in rural areas. To make the reform process meaningful and sustainable, there is an urgency to accelerate the implementation, especially of the reforms that bring quick impact to the community level. The 2003 IAP is designed with this objective in mind. Lengthy delays in local elections, however, present an obstacle, as they have dampened the momentum for decentralization. In many Districts, locally elected District Development Committee (DDC) and Village Development Committee (VDC) chairs (who had executive power) tended to be strong promoters of change at the grassroots level.¹¹

Box 4: The 2003 IAP

The 2003 IAP contains 24 reform actions directly linked to the four PRS pillars. As such, it is more ambitious than its predecessor and covers reforms in about a dozen areas. In addition to areas previously covered—i.e., public expenditure management, civil service reform and anti-corruption—the 2003 IAP covers actions in agriculture, private sector development, public enterprise rationalization, infrastructure development, targeted programs and decentralization. The Reform and Development Group—a joint HMGN/donor task force—has worked diligently on developing the 2003 IAP and has identified ‘lead Ministries’ and ‘lead donor agencies’ responsible for carrying out detailed assessments of each of the actions. These assessments include an explanation of the impact/importance of the action, a preliminary cost estimate and timeframe for implementation, and an outline of the proposed arrangements to review implementation progress. Past experience has shown that sectoral ownership at the highest levels has contributed to achievements above and beyond the original targets established in the IAP (see Appendix III).

¹⁰ In FY02/03, the CIAA filed 154 cases in various courts. Of these, the Special Court for corruption has passed judgment on 55 cases, of which 43 have been in favor of the CIAA. The most prominent cases, however, are pending.

¹¹ To fill the vacuum at the local level, recently the cabinet appointed numerous DDC and municipality officials, including some former DDC chairs, vice chairs and mayors. After experimenting with running local bodies through civil servants, HMGN concluded that local bodies were better governed by political leaders; hence, the appointments.

Medium Term Expenditure Framework and Fiscal Adjustments

22. Based on the recommendations of the 2000 Public Expenditure Review (PER)¹² and the work of the Public Expenditure Review Commission (PERC) in 2001, and prompted by the worsening fiscal situation, HMGN decided to introduce an MTEF starting in FY02/03. Overcoming the entrenched tendency to seek increased foreign aid to cope with fiscal stress, the reform-minded National Planning Commission (NPC) and Ministry of Finance (MOF) used the fiscal pressures to motivate serious adjustments in budget allocations. This led to elimination of 160 low priority projects (out of 625 projects) in the FY02/03 budget. Further cuts in projects would have been desirable, but were politically impossible. Instead, HMGN chose to be pragmatic and opted for an unorthodox solution in which remaining projects were classified into three priorities—P1, P2, and P3. While funding for the top priority (P1) projects was assured, funding for lower priority (P2 and P3) projects would be contingent on actual availability of funds after all P1 projects are adequately funded.¹³ While seemingly vulnerable to political pressures, NPC and MOF nevertheless managed to use this system effectively to concentrate funding to the P1 projects and within a year established a clear understanding among line ministries of the seriousness of this prioritization exercise.

23. At the same time revenue growth was slowing during the last two fiscal years, security spending was increasing sharply as the level and scale of the insurgency escalated. From a very modest level of Rs. 7 billion (1.9% of GDP) in FY00/01 to support the police and a small standing army, security spending rose to about Rs. 15 billion in FY02/03. While in principle this increase was detrimental to the development efforts, NPC/MOF turned it to its advantage. As the increase in security spending was an absolute imperative, the resulting severe fiscal pressure made it easier to impose a hard budget constraint on line ministries and politicians who had been accustomed to much softer budget constraints in the past. The majority of the cuts hit low priority, politically motivated projects. Total development spending declined from Rs. 37 billion in FY00/01 to Rs. 27 billion in FY02/03. The developmental impact of this reduction appears to have been relatively modest, as most of the dropped and P3 projects had been ill conceived to begin with and receiving only modest annual funding without any realistic hope of completion in the foreseeable future.

24. In the meantime, through reforms to decentralize service delivery modalities—not only in primary education and health care, but also in agricultural services—the quality of recurrent spending has started to improve. In FY03/04, further measures are anticipated in this regard, including: (i) the operationalization of an autonomous Roads Board that is expected to bring more rationality and transparency to the allocation of road maintenance budget; (ii) incentive grants to schools that improve enrolment of disadvantaged groups; (iii) implementation of the essential health care package approach to focus the limited resources on priority health issues; and (iv) greater participation of the private sector in infrastructure services—e.g., establishment of the Power Development Fund (PDF) to promote private investment, introduction of a rural telecommunications operator and opening the licensing system for private cellular operators. In effect, HMGN has been able to turn the fiscal and service quality crises into an opportunity to establish a leaner and more efficient public spending program. As Nepal begins to implement its PRS in full scale and increase expenditures to support it, far greater impact from additional spending can be expected than in the past.

¹² Nepal: Public Expenditure Review, Report No. 20211-NEP, April 11, 2000.

¹³ To deal with unexpected revenue shortfalls, the budget should include some lower priority projects. The FY01/02 budget, however, contained more projects than the most optimistic revenue projection could fund.

B. The Poverty Reduction Strategy

Background

25. Nepal's PRS is based on the reform successes and limitations it has seen over the last two years, and gives the process a broader, and longer-term vision and strategic coherence. Early on, HMGN decided that the Tenth Plan (FY02/03-FY06/07) would form the basis for its PRS. Many of the past plans, however, have suffered from a number of weaknesses, including in general an overly optimistic fiscal framework and limited focus on implementation, monitoring and evaluation. Therefore, while relying on the planning framework that was familiar to HMGN, the NPC managed to build the recent reform experience (in particular IAP and MTEF) into the PRS and make it a far more credible strategy than any recent five-year plans.

26. The PRS identifies reducing the overall poverty ratio from about 40% to 30% by the end of the Tenth Plan (FY06/07) as its key target. Other targets include: (i) raising the above 15 literacy rate from 49% to 63%; (ii) reducing the infant mortality rate from 64 to 45 per 1,000 live births; (iii) raising life expectancy from 62 to 65 years; and (iv) increasing access to drinking water to 85% of the population (from 72%), access to electricity to 55% (from 40%), and providing telephone facilities to every VDC. To meet these objectives, the PRS is formulated around four key pillars:

- ⌘ Achieving sustained high and broad-based economic growth, focusing particularly on the rural economy;
- ⌘ Accelerating human development through a renewed emphasis on effective delivery of basic social services and economic infrastructure;
- ⌘ Ensuring social and economic inclusion of the poor, marginalized groups and less developed regions; and
- ⌘ Vigorously pursuing good governance both as a means of delivering better development results, and ensuring social and economic justice.

27. In implementing these pillars, the strategy stresses four cross-cutting themes: (i) re-defining the role of the State and limiting public interventions; (ii) promoting private sector development and enlisting the involvement of the private sector, Non-Governmental Organizations (NGOs), International Non-Governmental Organizations (INGOs) and Community Based Organizations (CBOs); (iii) supporting greater social diversity in the structure of governance at all levels, and more socially and geographically inclusive access to social and economic services; and (iv) accelerating the decentralization process, including community participation in and management of activities at the local levels.

28. The PRS recognizes that the four pillars are closely inter-related and address different aspects of the same problem. Nevertheless, each pillar is described separately both in the PRS and below. Furthermore, as a foundation for broad-based economic growth, the PRS recognizes the need for an appropriate enabling environment and macroeconomic stability. Thus, the PRS incorporates a sustainable macroeconomic framework, whose objectives include: (i) maintaining fiscal discipline; (ii) ensuring efficient use of public resources; and (iii) sustaining monetary and external stability. This is complemented by a structural reform agenda that aspires to make the public sector more diverse, efficient and effective, remove constraints to private sector competitiveness and improve the conditions of the poor. In this regard, key reforms are envisioned in: (i) public finance, including public expenditure management—i.e., implementation of the MTEF; (ii) financial sector reform; (iii) improving the competitiveness of private sector, including trade and labor market reform; (iv) governance, including civil service reform and decentralization; and (v) promoting private sector involvement in infrastructure.

Broad-Based Economic Growth

29. The PRS argues that higher growth will be achieved through greater productivity in agriculture and non-agriculture, along with recovery in manufacturing, tourism and exports. The agricultural growth strategy—the Agricultural Perspective Plan (APP)—aims to modernize, diversify and commercialize crop and livestock production by expanding the use of technology and increasing the access of farmers to modern agricultural inputs and credit. This strategy is closely linked to ground water development (i.e., irrigation strategy), increasing rural infrastructure (i.e., rural electrification and rural roads) and sustainable development of the forestry sector.

30. In the non-agriculture sector—for which manufacturing, trade (see Box 5), tourism, transport, construction, and financial and social services are explicitly recognized as key sub-sectors—the emphasis is on reducing the role of the State in economic activities and creating an environment more conducive to private sector investment. The strategy includes: (i) removing the impediments to private sector development; (ii) accelerating privatization of state owned enterprises (SOEs)¹⁴; (iii) streamlining regulatory processes and making them more transparent; (iv) amending labor laws to make them more flexible; and (v) introducing important private-sector friendly legislation and judicial reform. In parallel, reforms will be implemented in corporate and financial governance.

31. The PRS places importance on infrastructure development in facilitating private sector development, and hence gives priority to the strategic road network, maintenance of major roads and highways, and expansion of infrastructure in electricity and communications. The intention is for the private sector to play a more prominent role in these sectors, as well as to clarify the roles and responsibilities of private and public operators. Examples of reforms initiated and/or envisioned in the near future include: (i) in roads, improving road maintenance through establishment of an autonomous Road Fund Board and transferring to DDCs the responsibility for development and maintenance of rural roads; (ii) in electricity, internal unbundling of the Nepal Electricity Authority (NEA), establishment of a PDF and creation of an independent regulatory agency; and (iii) in information and communications, conversion of the Nepal Telecommunications Corporation (NTC) into a public company under the Company Act, opening up general and rural telecommunication services to the private sector and establishment of a legal framework creating functional autonomy of the postal service. Infrastructure development is also critical for agricultural growth and productivity

Box 5: Improving Nepal's Trade and Competitiveness

The trade to GDP ratio in Nepal is about 50%. With regard to exports, Nepal is dependent on a relatively small number of products—ready-made garments and carpets account for nearly 60% of exports—with exports to North America, Europe and India accounting for 95% of the total. Despite this narrow basis, trade was a key factor behind the acceleration of Nepal's economic growth in the 1990s.

Along with Sri Lanka, Nepal has the most liberalized trade policy in South Asia. However, there are significant constraints—including delays in customs and transshipment, an extremely rigid formal labor market, infrastructure, and ineffective and unpredictable public sector policies and institutions—that constrain the country's trade prospects. A recently completed study—*The Nepal Trade and Competitiveness Study* led by the Bank under the auspices of the Integrated Framework (IF)—provides recommendations on key issues, such as Nepal's accession to the World Trade Organization (WTO), improving competitiveness and productivity, and facilitating trade. Nepal faces significant challenges for realizing its export potential in the medium term, including the forthcoming phasing out of the MFA, the accession of China into the WTO and a more restrictive trade treaty with India. As improving competitiveness is an important component of the growth agenda, the Bank will continue to work closely with Nepal's other development partners supporting follow up of the key IF recommendations.

¹⁴ While budgetary transfers to SOEs averaged 1.8% of GDP over the last three years, total contingent liabilities are unknown. To estimate privatization costs, HMGN has stepped up carrying out audits in public enterprises and Bank sector work in this area is planned for FY05 (see Table 4).

improvements, and as such, the strategy emphasizes the infrastructure developments needed to meet these objectives.

32. Finally, it is recognized that a strong financial system is of critical importance for private sector development. In this respect, the PRS envisions continuing implementation of Financial Sector Strategy (FSS), which includes among other things: (i) restructuring and privatizing the two large ailing state banks; (ii) strengthening the monitoring and regulatory capacity of the Central Bank; and (iii) strengthening the legislative and institutional framework for the sector.

Social Sector Development

33. The PRS outlines the importance of improving service delivery through a gradual process of decentralization and greater empowerment of local communities in the management of social services. In education, guided by the goal of ‘education for all,’ the strategy aims at improving the access to and quality of primary education. In doing so, a key objective is to expand literacy programs, with special emphasis on improving educational attainment and thus, the livelihood opportunities of historically excluded groups, especially girls, Dalits and disadvantaged ethnic groups. At higher levels—i.e., secondary, vocational/technical and tertiary—the objectives are similar, with emphasis on producing manpower with higher skill levels. To achieve this, the strategy is to decentralize management of schools to local school management committees (SMCs) at the lower levels and to the governing body of the individual institutions at the tertiary level. This process at the primary level—a fundamental shift from the currently centrally-managed system—has begun over the past year with over 250 schools transferred by end-September 2003 and an additional 500 applications pending approval. In addition, the strategy envisions implementing a program of targeted scholarship programs for girls and children from Dalit and disadvantaged ethnic minority families.

34. In health, the objective is to increase and extend essential health care services to all, with special emphasis on poor populations living in rural areas. To this end, the sector strategy focuses on implementing an essential health care package that is based on preventative care, maternal and child health, and family planning. Improvements in service delivery are also expected to occur through a process of devolving health facilities—starting with sub-health posts—to local communities and working increasingly with the private sector and NGOs. Related to this, the PRS elaborates on the importance of access to safe water for health outcomes and aims to increase access in rural areas. Key actions focus on rehabilitation and maintenance of existing projects, and developing new projects using the demand-driven user group participation and empowerment approaches supported by the Rural Water Supply and Sanitation Fund Development Board (i.e., ‘Fund Board’). In urban areas, the focus will be on improving delivery of utility services, and water supply and sanitation management in some major towns is to be contracted out to the private sector over the next few years.

Social Inclusion and Targeted Programs

35. At the core of this pillar is a specific commitment that in the implementation of all PRS pillars, efforts to reduce gender and ethnic/caste-related disparities will be mainstreamed, and in new programs emphasis will be placed on ensuring equity of access for all, with special attention to the most vulnerable. In addition, the PRS proposes targeted programs for women and the most vulnerable poor ethnic minorities living in remote areas. The PRS reviews the weaknesses of past efforts and discusses using new mechanisms (e.g., the Poverty Alleviation Fund—PAF) and analytical tools (e.g., poverty mapping data) to improve effectiveness. The PRS also stresses the need for ‘quick results’ in order to gain the confidence of those who have thus far been left behind by development efforts.

36. The PRS lists a number of areas—including agriculture, forestry, wage employment and social sectors—where special efforts will be made to mainstream and empower women, Dalits and the disadvantaged through a variety of means, including targeted programs. Other reforms include: (i) revising existing laws to eliminate legal discrimination against women; and (ii) implementing affirmative action programs to increase the social diversity of public service. The approach to mainstreaming deprived communities and other vulnerable groups will be similar, in that emphasis will be placed on ensuring social inclusion in all programs.

37. Recognizing the limited effectiveness of targeted programs in the past, the PRS has adopted some new approaches, including, among others: (i) merging programs similar in nature; (ii) establishing PAF as an umbrella organization for targeted programs; and (iii) adopting a population and poverty-based resource allocation formula for fund transfer to the districts. To achieve its goals the PRS proposes to implement an integrated infrastructure development program (drinking water, small irrigation, schools, health posts and trails) in remote areas through local government, CBOs and NGOs.

38. In parallel, HMGN has shown serious commitment to addressing the inclusion agenda at the political level. In the context of the last round of peace talks, while adhering to constitutional monarchy and multi-party democracy, HMGN also proposed far-reaching reforms to the parliamentary system. The proposals included, among other things: (i) proportional representation in Parliament (as opposed to the ‘first-past-the-post’ system copied from the Westminster model); (ii) reforms to ensure wider representation in the Upper House of Parliament; (iii) strengthening of the prime ministerial system (with a provision to allow non-elected technocrats to be included in the cabinet); (iv) constitutional reservations for under-served and under-represented groups; (v) consolidation of local government structures, and wider powers and responsibilities to the local level; and (vi) a constitutional provision for referenda on issues of national significance.

Good Governance

39. The PRS recognizes that improving governance is essential if the reforms are to stimulate pro-poor growth, improve service delivery and lay the foundation for lasting peace. HMGN’s strategy to improve governance covers: (i) civil service; (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 PRS 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 Act¹⁵ and strengthening key institutions charged with fighting corruption, including the National Vigilance Center and the CIAA.

¹⁵ Related to this, last year HMGN expressed interest in receiving assistance to begin the process of establishing a regime to protect the financial sector from money laundering and the financing of terrorism (AML/CFT). If legislation is enacted as envisioned, a number of steps—including establishing an action plan for issuing regulations and guidelines, and creating the necessary institutional structures—will be required to implement and enforce the new law. The Bank stands ready to assist in these efforts.

C. Assessment of the PRS

40. The Tenth Plan/PRS has been developed in the context of the current political turmoil in Nepal in a relatively participatory manner (see Box 6). Although it stands on the tradition of the periodic plan process, the PRS has been able to break from the historical baggage of the established process in a number of important ways. While the implementation strategy of the PRS is not as sharply explained as one might like, the PRS relies on several strategic and cross-cutting instruments to achieve its basic objectives, including: (i) decentralization; (ii) re-defining the role of the State and reinforcing market functions; (iii) changing public service delivery modalities; (iv) strengthening accountability mechanisms; (v) maintaining macro/financial discipline and improving public expenditure management; (vi) targeted programs; and (vii) increasing investment in infrastructure and agriculture.

41. Beyond the more thoughtful structure of the poverty-focused strategy, there are several things that give the Tenth Plan/PRS considerable credibility, including:

€# Acknowledging the difficulty of getting away from the tradition of an ‘all encompassing plan’ document, NPC condensed the voluminous Tenth Plan in the traditional mold into a lean summary—i.e., the PRS. This shows HMGN’s ability to be selective and strategic, indicating the seriousness attached to the PRS.

€# The PRS is backed by the MTEF, giving budget prioritization a serious framework. Also, the performance-based cash release system for the high priority projects is forcing a greater focus on implementation performance.

€# Through the IAP, HMGN has succeeded in being selective in reform actions and building an internal consensus on the absolute necessity for implementing the relatively few commitments made under the IAP. HMGN now intends to use the annual IAP process as the instrument to ensure implementation of a small set of key reforms to support the PRS on a priority basis.¹⁶ By recognizing its own implementation capacity limitations and by devising a practical instrument to manage this problem, HMGN has shown a real seriousness about implementing the PRS.

€# The reformers are far more serious about poverty reduction, with particular focus on inclusion. One thing the insurgency has done is to force the Kathmandu-based power elite to think about Nepal as a nation state that will survive only if glaring disparities in living standards, and access to political

Box 6: The PRS Consultation Process

The Tenth Plan/PRS adopted a participatory and relatively ‘bottom up’ approach. An extensive consultation process was initiated at various levels to discuss and solicit feedback on the ideas and recommendations presented in various drafts. Consultations were initiated in August 2000 with numerous public meetings held—two exclusively with women’s groups—in eastern, central and western Nepal bringing together representatives from all 75 DDCs and all facets of civil society (i.e., socially excluded, minorities, academics, private sector, NGOs/CBOs). Additional regional consultations were held in June 2001 to discuss the draft Tenth Plan Approach Paper, as well as linkages between district plans and the national plan. The Approach Paper was then finalized and discussed in the National Development Committee (NDC)—composed of all Ministers, Secretaries, and representatives of all political parties, private sector, academia, ethnic minorities, labor unions, women, NGOs and CBOs—in January 2002. These efforts were complemented by consultations organized from time to time by various agencies responsible for developing key sectoral programs, thematic chapters and background papers. Throughout this process, broad consensus and wide support have been developed for the PRS/reforms. However, the conflict likely constrained the consultation process in some parts of the country and HMGN intends to address this once it is feasible. With support from the development partners HMGN is developing a comprehensive participatory implementation, monitoring and evaluation strategy. The exercise will be completed by end-2003, with civil society to play a prominent role in monitoring efforts.

¹⁶

In a sense, IAP is the equivalent of the MTEF with regard to ‘reform implementation resources.’

and economic powers are rectified. This seriousness is reflected in a frank admission in the PRS about past failures and exclusionary consequences of poor public policies and commitment to addressing them; and

€# The people are demanding the kind of changes that the PRS envisions, thereby giving the PRS the political impetus, legitimacy and sustainability.

42. Thus, the PRS, combined with the MTEF and IAP, form a sound basis on which to build the Bank's CAS.¹⁷ A Joint Staff Assessment (JSA) of the PRS was carried out by staff of the Bank and the IMF in July 2003.¹⁸ In addition to highlighting the strengths of the PRSP—many of which are listed above—the JSA suggests a number of shortcomings and challenges on which HMGN will have to focus on in the coming year, including the need to:

€# Identify the sources of growth, along with the key linkages to poverty reduction;

€# Address gaps in costing and prioritization, and link these to the annual budget and MTEF;

€# Implement a coherent monitoring and evaluation strategy, including building capacity for poverty monitoring within a clear institutional framework; and

€# Further elaborate pro-poor rural strategies, especially to ensure social inclusion through changes in the way in which public services are delivered in all sectors.

III. THE COUNTRY ASSISTANCE STRATEGY

A. The Context

43. The Bank finds itself in a particularly strong partnership with HMGN. More specifically:

€# While many aid agencies maintained high levels of aid to Nepal in recent years, the Bank took a firm position on governance and sharply cut back new lending during FY99-FY02. Highlighting poor governance as the central obstacle to development, the Bank's stance strongly resonated with the reform-minded in Nepal. It has also convinced HMGN that the Bank is not driven by any 'lending pressure' and that it is truly concerned with poverty reduction. The Bank can, therefore, engage in policy dialogue from a position of considerable credibility;

€# The Bank has been closely supporting several key reform measures taken over the last few years, including the MTEF, the IAP, financial sector and transfer of public schools to community management. This has established unusually strong collaboration between the reform leaders and the Bank. In many areas, the Bank is relied on as a trusted advisor to the reformers, giving the Bank an important role as a 'facilitator of change'; and

€# The Bank is the only donor with significant headroom for increasing lending levels just when HMGN is in serious need of additional resources, especially programmatic support. This gives the Bank not only strong influence, but also a heavy responsibility as the fiscal ability to implement the PRS may depend to a large extent on what the Bank decides to do.

¹⁷ These are also the basis for the IMF PRGF. For more details on the IMF program in Nepal, see footnote 41 and Appendix IV.

¹⁸ The complete PRS policy matrix is contained in Annex B11. This matrix—in which the outcomes and milestones supported by this CAS are highlighted—also elaborates other donor support to realizing the PRS objectives and outcomes.

44. Furthermore, in each of the PRS pillar areas, the Bank has already undertaken considerable background work, and as such, has a strong base to build on. In **broad-based economic growth**, the Bank's assistance over the last few years has focused heavily on the quality of public expenditures, the soundness of the financial system and the investment climate (see Box 7). The Bank has also supported reforms and investments in key infrastructure sectors, like the main road network, inland container terminals and customs facilities, rural roads, power generation, and telecommunications.¹⁹ In agriculture, the Bank has supported transfer of small irrigation schemes to farmer management, and improvement in research and extension services.

45. In **human development**, the Bank has focused on improving the quality of education and health care, through a HMGN-led, sector-wide approach. Supported by the analytical work completed in FY01 (i.e., *Priorities and Strategy in Education Sector Reform*) there has been considerable progress in basic and primary education, with a number of donors participating in a basket funding approach to a common program. The Bank has also played a pivotal role in supporting the transfer of public schools to community management. In health, the Bank is actively supporting an important shift to a sector-wide approach, as well as the devolution of sub-health posts to local communities. Furthermore, the Bank has been instrumental in expanding demand-driven, community-based rural water and sanitation schemes.

46. In the area of **inclusion**, aided by a policy note—*Towards a Sustainable Approach for Poverty Reduction and Decentralization*—the Bank has led the dialogue on the PAF and encouraged HMGN to use this as the main instrument to reach out to marginalized groups that tend to be overlooked by existing institutions. In specific community-based projects—e.g., Rural Water and Sanitation—the Bank has begun to address social exclusion issues more vigorously. In promoting universal primary education, the Bank has also been engaging HMGN to design ways to improve access by disadvantaged groups.

47. In **governance**, the Bank has taken a very clear and strong stance since the last CAS. The reforms in public expenditure management and banking are as much about governance as efficiency. Decentralization has also been a key focus area, both through specific projects that have tried to give local governments greater roles—e.g., Rural Infrastructure LIL—and through analytical work—focusing especially on the fiscal decentralization framework. The Bank, in close coordination with committed HMGN teams, has conducted a *Country Procurement Assessment Review* (CPAR, FY01) and *Country Financial Accountability Assessment* (CFAA, FY02), and in each case is following up with Institutional Development Fund (IDF) grants to strengthen relevant institutions and implement main policy

Box 7: The Business Environment in Nepal

An investment climate survey—*The Business Environment and Manufacturing Performance in Nepal*—was finalized in FY01. Based on a survey of private manufacturing enterprises, the report's key findings are that poor implementation of reforms, bureaucratic burdens and continued political/policy uncertainties are the greatest obstacles to doing business in Nepal. More specifically, although policies are often perceived as well-designed, they are often changed and implemented so inconsistently that they contribute to an unpredictable and risky business environment. In addition, firms suffer considerably from excessive bureaucratic red tape, long delays in provision of public services and having to deal with corrupt public officials. These problems are often facilitated by lack of clarity in laws and regulations, and unpredictability and inconsistencies in policies. The implementation of the tax regime, import regime and labor laws are specific areas that significantly affect firms and need to be urgently addressed. Private sector development—including establishing a supportive business environment—will be an important theme in the Bank's work under the broad-based economic growth pillar.

¹⁹ Formal reports include *The Public Expenditure Review* (FY00), *Power Sector Development Strategy* (FY01), *The Business Environment and Manufacturing Performance* (FY01), *The Financial Sector Study* (FY03), and *The Trade and Competitiveness Study* (FY03).

recommendations (see Appendix V). Finally, anti-corruption actions have been a continual theme in the Bank's policy dialogue.

B. The Bank's Strategy for FY04-FY07

The Strategy: PRS-Based and Outcomes-Focused

48. The Bank's strategy will build on the achievements under the 1998 CAS—which in short were to facilitate the beginnings of determined reform efforts—and support the Nepali-led reform process in a significant span and depth. Thus, in operational terms, it may seem to be simply supporting key elements under each of the PRS pillars. It is, however, backed by a successful process of supporting the reform dynamics that have been gaining strength. This strategy was presaged in the CAS PR which articulated continuation of focus on improving governance—by bringing resources to grassroots levels and improving development effectiveness—but with increased emphasis on growth and inclusion. The seven broad strategic instruments associated with the PRS (see paragraph 40) are equally important in the approach the Bank has emphasized. Furthermore, the spirit of focus on selective outcomes embodied in the IAP is consistent with the outcomes-based approach that has been pursued in the Bank's work program in Nepal for the last two years.

49. While it is easy to agree that the focus should be on development outcomes, it is not so easy to define the Bank's accountability for such outcomes, for in the end the Bank's role is only to facilitate or support the changes in a country. Thus, there is a danger that an attempt to hold staff 'accountable' for outcomes will lead the Bank to select only outcomes that are nearly certain. Clearly, failing to support riskier but more important outcomes would be a mistake. To resolve this tension, a structure has been developed over the last two years and the same approach is envisioned for the future. Specifically,

∄# An '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 four-year outcome—is defined;

∄# Each outcome is expected to have less than 100% probability of happening, even with best efforts on the part of the Bank;²⁰

∄# The matrix 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 portfolio of outcomes is constructed with an expected overall success rate of around 65–70%;²¹

∄# 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;²² and

²⁰ In practice, the probabilities of 20, 40, 60 or 80% are assigned, recognizing the relatively crude nature of the probability assessments.

²¹ 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.

²² 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.

€# 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.

50. Based on this framework for work programming, this CAS has identified 15 PRS areas—out of the 34 PRS areas—that are central to poverty reduction and are consistent with the Bank’s relative strengths vis-à-vis Nepal’s other development partners. They spell out the broad ‘development results’ or outcomes that the CAS will focus on. While the importance of these results are obvious, the CAS timeframe is too short to set direct and measureable targets for them. Therefore, these 15 higher level outcomes are translated into 26 intermediate outcomes—corresponding to the base case scenario described in paragraph 64—that are specific and meaningful for the FY04-FY07 period. In a high case scenario—with acceleration of reforms—the matrix would likely be updated to include more outcomes. These outcomes were selected based on four key criteria:

€# In each priority area, the outcome is representative of the broader change envisioned by the PRS. Thus, it is not the only change expected. If this particular change is happening, many associated changes are likely happening, thereby contributing to the larger PRS goals;

€# As much as possible, the outcomes should be linked to an action in the IAP to ensure high priority accorded by HMGN;

€# In general, the outcome is clearly defined, measurable and feasible;²³ and

€# In applying the selectivity principle, the Bank has a comparative advantage in facilitating the outcome and has a well-developed strategy to contribute materially to its realization.

51. The outcomes matrix is organized around the four PRS pillars and presented in two parts. The 15 areas and 26 specific outcomes for the CAS period are displayed in Table 3. A more detailed matrix (see Annex B10) describes briefly, for each outcome, the Bank’s strategy for achieving it, annual milestones, Bank instruments and key partners. Specific annual milestones for FY04 are provided for each outcome with some additional milestones for subsequent years. As noted, these annual milestones are updated each year, and as such, milestones for FY05, FY06 and FY07 should be seen more as indicative. The more detailed matrix also links the CAS outcomes to specific country outcomes identified in the PRS, showing the strong linkage between the Bank’s contributions and the country’s goals as established in the PRS.²⁴

Cross Cutting Themes

52. **Gender and Social Inclusion.** For the successful implementation of this CAS, there are a number of cross cutting themes—specifically, gender and social inclusion, fiduciary and environmental policies, and capacity building—that deserve special mention. In rural areas, the women’s critical role as economic providers—either through unpaid labor on the family farm or as wage workers for others—is widely recognized. Indeed, the poorer the family, the greater its reliance on the skills and labor of female family members for economic survival. While there is great variation in the gender systems of different ethnic and caste groups in Nepal, all of them to some extent discriminate against women in terms of access to property, investments in health and especially education, and in the degree to which women’s voices are heard in community decision-making or national governance.

²³ Certain outcomes are stated rather generally for lack of a better definition. In such cases, however, annual milestones tend to be quite specific to help clarify the kind of change the CAS hopes to support.

²⁴ In the PRS matrix in Annex B11, in addition to linking the CAS outcomes to the PRS outcomes, the specific intermediate indicators/activities corresponding to each of the milestones are also highlighted.

Table 3: CAS Outcomes	
Development Results*	CAS Outcome
Broad-Based Economic Growth	
Improved public expenditure management	<ul style="list-style-type: none"> ## Outcome focused budgeting and monitoring in place ## Magnitude of SOE financial problems recognized by HMGN and strategy/ action plan developed
Expanded private investment, trade and employment opportunities	<ul style="list-style-type: none"> ## Reform labor laws to allow greater flexibility in employment ## Lowered costs of doing business by liberalizing business support services ## Increased institutional capacity for trade policy formulation/implementation
Strengthened financial sector	<ul style="list-style-type: none"> ## NRB performing regulatory and supervision functions effectively ## RBB/NBL privatized or liquidated
Increased agricultural growth and broad-based rural development	<ul style="list-style-type: none"> ## Improved enabling environment for factor and output markets ## Increased agricultural productivity and farm incomes
Well-developed road network	<ul style="list-style-type: none"> ## Percentage of main road network in poor condition reduced to 10% ## Share of population with close access to roads increased by 4%
Improved telecommunication	## Private operator introduced for rural telephone service in Eastern Region
Expanded coverage and improved quality of electricity	<ul style="list-style-type: none"> ## Improved efficiency of NEA (as measured by a reduction in system losses to 20%), combined with greater private sector participation ## 30,000 additional households in remote areas served by micro-hydropower
Social Sector Development	
Improved quality of and access to primary, secondary and tertiary education	<ul style="list-style-type: none"> ## 25% of public schools under community management, and providing socially inclusive and higher quality education ## Efficient and timely textbook distribution system in place, as measured by all primary school children having books at the beginning of the school year ## Progress towards financial sustainability of public universities
Improved basic health care services, with emphasis on poor/underserved populations	## Essential health care services implemented in 25 districts, at least half with low health indicators
Improved quality of and access to sustainable rural drinking water and sanitation	<ul style="list-style-type: none"> ## Extend rural water supply to an additional 10% of the population ## Extend coverage of sanitation services to an additional 5% of the rural population
Social Inclusion and Targeted Programs	
Social inclusion promoted through equitable education	## Reduced out of school primary aged children (primarily girls, Dalits and disadvantaged Janajati groups) by 50%
Improved fiscal transfers to disadvantaged groups	## Increased public funds used by disadvantaged rural groups for services
A civil service that better reflects the gender, caste and ethnic diversity of Nepal	## Affirmative action policy and implementation system for improving the diversity of the civil service in place and functioning
Good Governance	
Enhanced development through stronger locally elected governments	## Decentralization (as designed in the Local Self Governance Act) advanced substantially, with good monitoring systems in place
Improved incentives and mechanisms to ensure a more performance oriented and accountable public service	<ul style="list-style-type: none"> ## Clear delineation of responsibilities between Ministers and civil service to ensure autonomy and accountability of civil service ## Improved accountability and transparency
* Items in BOLD are objectives associated with actions in the Immediate Action Plan (IAP); see Annex B11 and Appendix III.	

53. Gender is clearly one important dimension of social exclusion in Nepal, however, more recently—especially in the years following the reinstatement of democracy—other dimensions of social exclusion—namely caste and ethnicity—have come into greater prominence as indigenous groups (Janajati) and formerly ‘low caste’ (Dalit) groups have been able to organize and speak out. In response to this—and to the insurgents criticism that the Nepali state has largely been in the hands of males from the dominant caste and ethnic groups—the PRS has recognized the disparities resulting from gender, ethnicity and caste. To better understand the institutional underpinnings of caste, ethnic and gender-based social and economic exclusion in Nepal and how these affect poverty outcomes—as well as the options for policy and institutional reforms—a Social and Gender Analysis is currently being carried out and will be completed in FY04. Furthermore, in all interventions—especially in the sector-wide approaches to be employed in education, rural water supply and health—efforts will be made to ensure that social and gender inclusion issues are explicitly recognized and receive close attention. To ensure that gender and

social aspects are fully integrated at both the project and policy level work of the Nepal program, in the last year a Lead Social Scientist was posted in Kathmandu.²⁵

54. **Fiduciary and Environmental Policies.** Similarly, in implementing the CAS, ensuring adherence to sound fiduciary and environmental policies will be crucial. As mentioned, a CPAR was finalized in FY01 and a CFAA was completed in FY02 (see Appendix V), with IDF grants supporting implementation of the key recommendations.²⁶ While the legal and regulatory framework for ensuring public sector financial accountability is impressive, implementation—including compliance with the framework—is generally weak. In the area of procurement, very few countries today still follow the system used by Nepal—under which public procurement is governed by a set of financial rules issued by the Government—and hence, the major need is to enact a modern, transparent, and competitive public procurement law.

55. Despite a rather comprehensive framework for environmental protection, in addition to weak capacity and poor coordination, the main environmental challenges in Nepal pertain to the sustainable use of natural resources and adequate integration of environmental planning in development programs and their implementation. In response, HMGN has incorporated conservation activities in selected sectoral plans and programs, while environment-related provisions have been incorporated in various acts (see Box 8). Among the accomplishments: (i) the donor-supported Community Forest Program has been successful in helping to reverse deforestation in the hill regions; (ii) endangered mammal species have been recovered in the Terai; and (iii) careful attention to designated conservation areas supported by eco-tourism have had important impacts on poor and remote rural communities. Beyond the five key environmental issues—forest depletion, soil degradation, solid waste management, water quality and air pollution—a number of new challenges have emerged, such as rapid but uncontrolled and haphazard urbanization (resulting partially from insecurity and violence in rural areas), glacial lake outburst floods, arsenic contamination of groundwater, indoor air pollution from

Box 8: The Response to Environmental Challenges

HMGN has responded to the environmental challenges by incorporating conservation activities in sectoral plans and programs. Furthermore, environment-related provisions have been incorporated in various acts such as: (i) the Local Self-Governance Act (1998) that specifies the role of DDCs and VDCs in environmental planning, forest and biodiversity conservation, land-use management, and public sanitation; (ii) the Forest Act (1992), and the National Parks and Wildlife Conservation Act (1973 and amended in 1993) that provide for community involvement in forest management and species conservation; and (iii) the Environment Protection Act (1996) and the Environment Protection Rules (1997) that contain provisions for institutionalizing environmental impact assessment and expanding pollution control activities. In addition, a National Environmental Policy and Action Plan was prepared (1993) to help implement Agenda 21 of the Rio Earth Summit; an Environment Protection Council was constituted as a policy advisory body (1992); and a Ministry of Population and Environment (MoPE) was established (1995). Nepal is a party to 16 environment-related international Conventions and Agreements, including CITES and ITTA.

Despite these efforts to address environmental management, weak institutional capacity and poor coordination between MoPE and sectoral agencies has constrained the implementation of environmental policies and programs. There is also a significant gap between the content of the international environmental conventions and their implementation at the national level. There are many donors (e.g., Denmark, Germany, UNDP, UNEP) and international (e.g., WWF, IUCN) and national (e.g., King Mahendra Trust for Conservation of Nature) NGOs active in the environmental arena and funding is not a constraint.

²⁵ This has been made possible in part through the generous support of the United Kingdom's Department for International Development (DfID).

²⁶ It is important to note, however, that the team looks at fiduciary issues in a much broader context than that covered by the CFAA. See Box 9 for details.

biomass burning and food contamination. With the large donor and NGO presence, Bank involvement in the environmental agenda will be selective and focus on helping HMGN articulate an effective strategy for environmental conservation and management and capacity building. Accordingly, a Country Environmental Analysis (CEA) is planned for FY05. Using this as a basis, we would focus on possible outcomes for Bank support and then determine appropriate instruments. Given Nepal's biological diversity, however, there are possibilities for use of funds from the Global Environmental Facility (GEF)—e.g., support to sustainable gathering, processing and marketing of high value plants and herbs, micro-hydropower, or remediation of glacial lake outburst floods. There are also good prospects for implementation of programs supported by the Prototype Carbon Fund (PCF) and the Community Carbon Fund (CCF)

56. **Capacity Building.** As institutional weaknesses and lack of capacity are well-recognized constraints, an important cross cutting theme of the CAS is capacity building. According to some estimates, over US\$100 million per year is spent by donor agencies and INGOs in Nepal on what can be broadly termed 'capacity building' activities. The outcome is clearly very disappointing, and both HMGN and donors agree that a serious rethinking is in order. There is, however, an entrenched thinking to equate provision of consultants and training with capacity building, which in part explains the continued attempt to 'throw money' at the capacity building challenge.

57. A strong public sector institution requires: (i) sound institutional set-up; (ii) 'enabling environment' for the institution—especially a system that shields the institution from undue political interference and rewards professional performance; (iii) good people—which requires a performance-oriented and financially decent incentive system as well as training; and (iv) experience. In Nepal, development partners have tended mainly to focus on institutional set-up and training people, without paying sufficient attention to the other aspects or finding effective ways to get at them. Improving the 'enabling environment' and creating a performance-oriented incentive system are inherently political processes, and donors can only encourage indigenous efforts. Thus, donor support needs to be somewhat opportunistic. An important dimension that has tended to be neglected by donors is helping the institutions to build experience. If anything, by substituting for HMGN's own work, development partners may have tended to hamper the ability of Nepali institutions to strengthen through experience. The Bank's knowledge in supporting key reform initiatives indicates that capacity building is more about creating space for the Nepalis to think for themselves and act on their own, and providing knowledge only where it is specifically demanded.²⁷ Money is seldom the real constraint to capacity building in Nepal. Based on this perspective, the Bank's efforts will focus on:

€# Facilitating country-led changes, as in the end this is what capacity building is about. The primary concentration will be on helping HMGN build its own policy formulation and implementation capacity at the central level through experience. This effort depends critically on the ability of the country-based staff—especially Nepali staff—to engage and motivate HMGN counterparts in reform thinking, backed by the ability to bring in global knowledge from the rest of the Bank and/or internationally as needed. While this concept of decentralization is already working well, further efforts will be made, especially to strengthen the capacity of the country-based staff; and

€# Where there are legitimate needs for more traditional TA and training that arise from the Nepal-led and Bank-supported reform efforts, the Bank will continue to be prepared to provide such assistance through a variety of means. Since all IDA-funded projects involve important reform elements, almost all include TA and/or training components. To maximize their impact, however, the Bank relies heavily on identification of needs by the reform leaders themselves. In some areas—such

²⁷ Good examples of this are the experience with the introduction of MTEF and development of IAP as noted in noted in paragraph 43.

as public expenditure management, monitoring and evaluation in conjunction with PRS implementation, and improving financial accountability systems—TA and training of central importance will be supported by IDF grants and direct TA.

Instruments to Achieve the CAS Outcomes

58. A critical element for achieving the CAS outcomes is an internal alignment of the work program with the outcomes. The formulation of the annual work program is used as an important process to develop a consensus on the annual milestones toward achieving the longer term CAS outcomes, and the broad strategy and specific instruments to reach those milestones. This has helped to develop organic integration of a range of AAA instruments (e.g., formal reports, informal policy notes, TA, seminars, policy dialogue, strategic communication) and lending instruments. It has also enabled much more effective cross-sectoral efforts directed toward the shared outcomes. This process, combined with regular monitoring of progress from the outcomes perspective, is the cornerstone of the outcomes-based approach.

59. In relation to many outcomes, AAA will continue to play an important role and will be used more consciously to overcome specific obstacles to reforms. During the past four years, while the lending program remained in the low case and the work program focused on motivating reforms, the Bank learned to use AAA more strategically for engaging Nepali authorities in policy dialogue and has been effective in evoking change. The shift by the Bank toward an outcomes-focused approach also changed the nature of AAA. From the outset, each AAA piece is conceived as part of a strategy to help facilitate some specific development outcome. This has led to two important changes: (i) unlike in the past, dissemination of AAA outputs is no longer an afterthought, but is an integral part of the motivation for the AAA task itself; and (ii) there is much greater use of small, informal, and targeted reports that are designed to help the reform leaders in Nepal themselves rather than bulky reports whose target audience is often unclear. Under this CAS, these trends will continue. In addition to supporting the MTEF, IAP and overall structural reform efforts, dialogue and TA will continue to be used widely to help achieve the CAS outcomes, including in power, higher education, fiscal decentralization, civil service reform and special interest issues such as child labor and trafficking.

60. Going forward, formal AAA will continue to help lay a foundation for building the agenda and needed consensus for reform (see Table 4). Contributing to the completion of all core diagnostic pieces²⁸ and helping to prioritize future policy reform areas, a *Development Policy Review* (DPR) is envisioned for FY04, along with key studies on agriculture, labor remittances, and a social and gender assessment. Also during the

Table 4: Formal AAA, FY04-FY07

FY04
Development Policy Review
Note on Rural Sector Issues
Social and Gender Assessment
Study on Labor Remittances
FY05
Poverty Report
Public Expenditure Analysis—Evaluating the MTEF
Public Expenditure Analysis—The SOE Sector
Country Environmental Analysis
Rural Factor Market Study
FY06
Country Economic Report
Financial Sector Reform: Lessons and Next Steps
Update on Child Labor
FY07
An Evaluation of Community Managed Schools
Re-evaluating Social and Gender Issues
Update on Fiduciary Assessments

²⁸

As mentioned (see paragraph 47), the CPAR and CFAA have been completed. With regard to other core diagnostic AAA: (i) a PER was completed in FY02 and a number of follow up pieces—evaluating the MTEF and analyzing SOEs—are envisioned for FY05; (ii) a Poverty Assessment was completed in FY99, with an update planned for FY05; and (iii) a CEA is planned for FY05.

CAS period, important work will be undertaken analyzing the impacts of the financial sector reforms and providing an update of the child labor situation,²⁹ as well as continuous public expenditure analysis.

61. The **International Finance Corporation (IFC)** and **Multilateral Investment Guarantee Agency (MIGA)** will both play important—albeit relatively limited—roles in the implementation of the strategy. **IFC** will continue to support export-oriented manufacturing, private investment in telecommunications and power generation and distribution, financial market development, and the growth of small and medium enterprises (SMEs). Due to the still weak security situation and political uncertainties, currently there are few investment opportunities in Nepal large enough for direct financing, so IFC does not expect to make many new investments during the CAS period. Instead, IFC will focus on technical assistance for SMEs through the South Asia Enterprise Development Facility (SEDF) based in Dhaka. This facility—funded by IFC in partnership with Canada, Netherlands, Norway, the UK, Asian Development Bank (ADB) and the European Union (EU)—will deliver programs in Nepal to increase access for SMEs to financing and business development services, improve the business environment for SMEs and develop linkages with larger enterprises. SEDF will closely coordinate with the Bank’s efforts in the financial sector to provide TA and training to banks, including introducing best practices and new products for SME lending. SEDF will also work with selected business associations in the agribusiness and tourism sectors. SEDF intends to locate a staff member within the Kathmandu office to manage these programs. Over the upcoming CAS period, **MIGA** will continue to support suitable foreign direct investments into Nepal as they present themselves.

Bank Group Scenarios

62. Given the current rather significant political uncertainties, the CAS must be able to respond constructively to a wide range of possible eventualities. Without a doubt, the greatest source of uncertainty is the insurgency. If a peace settlement is reached, there will likely be a need for a large scale ‘nation re-building’ program and the Bank would be expected to be part of it.³⁰ On the other hand, renewed hostilities could turn more intense and severely curtail the ability of HMGN to implement the PRS. In either of these extremes or in between, the nature of the reforms envisioned in the PRS will remain relevant. Therefore, it is useful to think of the following three scenarios that naturally correspond to the standard CAS scenarios:

Base (‘central’) case—in which the hostilities are limited or not severe enough to interfere seriously with development work and the current reforms continue to move forward;

Low case—in which renewed hostilities hamper implementation of the PRS—thus, reducing the external funding needs—or the reform efforts themselves become stalled—thus, making it difficult to justify high levels of IDA funding; and

High case—in which it is assumed that a peace agreement is reached and/or the reforms accelerate, thereby creating both a need and environment for larger aid flows.

²⁹ This will follow up on *Understanding Children’s Work in Nepal* (March 2003). This study—carried out jointly with ILO and UNICEF—includes a set of recommendations and proposed policy actions that will help formulate a more comprehensive framework for handling issues associated with child labor.

³⁰ Purposely, the word ‘reconstruction’ is avoided, as the reconstruction needs are likely to be modest given that conflict-affected areas tend to suffer from under-investment. Instead, what is required is a major effort to upgrade infrastructure and social services in these regions that have long been under-served.

63. In all scenarios the scope and nature of the reforms identified in the PRS remain valid and as such, the CAS outcomes remain relevant.³¹ The main difference between the various scenarios would be the speed at which Nepal can be expected to achieve each of the specific outcomes. Therefore, the broad work program that flows from the PRS matrix is expected to be fairly resistant to these very different possible circumstances. Besides the peace dimension, from the reform perspective there are also important uncertainties arising from possible changes in the cabinet before or after national elections. Although the PRS agenda is broadly supported by most political leaders, if only tacitly, short term political dynamics could cause slowing or even backsliding in the reform process (as discussed below in the risk section). To maximize the chance of the reform process being sustained, the lending levels for the three scenarios are significantly different, thereby reconfirming the message that the Bank's financial support will be tightly linked to the speed of reforms. These lending levels, along with the key triggers, are highlighted in Table 5.

Table 5: Key Triggers for CAS Scenarios	
Scenario	Key Triggers
(average annual lending range)	
Low Case (US\$0-50 million)	<ul style="list-style-type: none"> ⚡ Implementation of annual IAP falls significantly short of targets (less than half attained). ⚡ Decentralization of basic service delivery—especially in education and health—stalls. ⚡ Banking reform stalls—i.e., restructuring by FY05 not in sight. ⚡ Management of public expenditures weakens—i.e., weakened application of MTEF/project prioritization system/similar mechanisms. ⚡ Anti-corruption drive loses momentum.
Base Case (US\$120-200 million)	
High Case (US\$200-250 million)	<ul style="list-style-type: none"> ⚡ Annual IAP implementation is complete and the process is deepened. ⚡ Decentralization of basic services accelerates. ⚡ Fiscal decentralization accelerate, with full decentralization implemented in some districts. ⚡ Strong measures implemented to improve access to basic education for disadvantaged children. ⚡ NBL/RBB restructuring plans agreed and implementation initiated. ⚡ Continued satisfactory portfolio performance to confirm absorptive capacity.

64. A notional **base case lending scenario** is presented in Table 6 in which the IDA lending program would average about US\$190 million per year, consistent with Nepal's current IDA allocation.³² In each year, the lending program would be anchored in a PRSC providing programmatic support to the implementation of the PRS/IAP (see Box 9). The first PRSC aims to: (i) support Nepal's reform champions in implementing far-reaching reforms that revive growth, improve service delivery, promote social inclusion and improve governance; and (ii) contribute to maintaining a sound macro framework and in protecting high priority anti-poverty programs by filling part of Nepal's financing gap. Future PRSCs will focus on key elements that are critical to achieve the CAS outcomes. In the broad-based growth pillar, these include: (i) public expenditure management; (ii) labor market; (iii) infrastructure (e.g., the main road network and rural roads); and (iv) financial sector reform. In social sector development and inclusion, the focus will be on improving service delivery—in education, health and water/sanitation—in addition to implementing targeted programs for excluded groups. Finally, in governance the focus will be on public/civil service reform as well as re-activating and strengthening the decentralization process.

³¹ As indicated, the outcomes in Table 3 are those explicitly linked to the base case scenario and in a high case scenario there would likely be more outcomes.

³² While the base case envisages an average annual lending program of about US\$190 million, there is some uncertainty associated with the ability of HMGN to implement projects under different security and political situations. As such, a realistic range—US\$120-200 million—has been established.

65. In each year, the PRSC would be complemented by three or four investment or sectoral operations to support key programs in the focus areas. With increasing emphasis on growth, the lending program will continue to focus on infrastructure investment. Since the existing portfolio already has a strong tilt toward infrastructure, the base case lending program does not show large new infrastructure projects. In part, this also recognizes the difficulty of implementing large-scale projects during a conflict. Nevertheless, if the opportunities arise, financial support for infrastructure can be readily increased through both the PRSC and, in case of peace, additional investment operations. The necessary technical work has been built into the base case program.

66. Given its low income level, it is assumed that Nepal will continue to receive a portion of its IDA allocation in the form of grants at least for a part of the CAS period.³³ HMGN has expressed a preference to use IDA grant financing for: (i) key priorities in the social sectors (including for PAF), and (ii) for technical assistance.³⁴ Although the base case lending program represents a significant increase in the level of IDA lending to Nepal (the base case was US\$70-120 million under the 1998 CAS), this should not pose any debt service difficulties. With a highly concessional debt structure, the public debt service to GDP ratio stands at a modest 1.6% and external debt servicing is only about 7.5% of exports of goods and non-factor services.³⁵

67. In a **low case scenario**, the lending volume would be significantly less than in a base case—i.e., averaging US\$0-50 million per year. The nature of IDA assistance in the low case would depend on its circumstance. If the cause is renewed hostilities—and the consequent narrowing of the reach of HMGN—then it would be appropriate to cut back on investment operations to account for the reduced physical scope of reform implementation. On the other hand, if the cause is slow implementation of the reforms, then the focus of lending activities would revert back to supporting decentralization and community-based projects (which would likely lay the foundation for better governance dynamics in the future) and whatever specific reforms that nonetheless managed to proceed at the central level.

Table 6: IDA Base Case Lending Program: FY04-FY07
(values in US\$ millions)

FY04	235.0
Poverty Reduction Support Credit I	70.0
Basic and Primary Education Project, Phase II	50.0
Poverty Alleviation Fund	15.0
Rural Water Supply and Sanitation II	30.0
Financial Sector Restructuring, Phase II	70.0
FY05	185.0
Health Sector Operation	50.0
Poverty Reduction Support Credit II	70.0
Rural Access Improvement	30.0
Reform Technical Assistance/Capacity Building	10.0
Higher Education	25.0
FY06	205.0
Agriculture Sector Operation	30.0
Poverty Reduction Support Credit III	70.0
Poverty Alleviation Fund II	30.0
Financial Sector Restructuring, Phase III	75.0
FY07	140.0
Poverty Reduction Support Credit IV	70.0
Infrastructure Development	40.0
Decentralization Support	30.0

³³ Availability of IDA grants in FY06-FY07 will depend on the outcome of the IDA14 replenishment deliberations.

³⁴ This is consistent with HMGN's Foreign Aid Policy (FAP) that states "technical assistance for project design, institutional and capacity building, technical backstopping, and project monitoring and review are more suitable for grant financing than for concessional loans."

³⁵ Nepal is a 'less indebted low-income' country with a ratio of external debt to GDP of 53% and a total public debt to GDP ratio of 70% (end FY01/02). IMF simulations suggest that if key variables remained at their average value of the last ten years, the total debt to GDP ratio would decline to 53% in FY06/07.

68. A **high case scenario**—associated with peace and/or an acceleration of the reform program—envisions annual lending levels averaging US\$200-250 million. Related to reform acceleration, the high case would be triggered by stepping up fiscal decentralization efforts, as well as accelerating decentralization of basic services, initiating the restructuring of the two large commercial banks, and deepening implementation of the IAP (see Table 5). The nature of the additional support in a high case would likely include some additional interventions related to ‘nation rebuilding’ activities, but it is difficult to be very specific about such interventions at this time, as they must emerge from the peace process itself. With the prevailing uncertainties, there may be a need to revisit the assistance strategy in eighteen to twenty-four months or even sooner. As such, a CAS PR will be prepared at least by early-FY06 or as the situation warrants.

Box 9: Financial Management Broadly Defined

When evaluating whether a country is considered ‘ready’ for programmatic support, it is common to evaluate its financial management capacity. Financial management, however, should not be equated with narrow matters of financial rules and regulations. But, it is fundamentally concerned with effective use of financial resources. First, therefore, financial management is about good resource allocation. Through the MTEF, HMGN’s resource allocations have improved considerably over the last two years, eliminating much of the fat, imposing a firm budget ceiling and prioritizing development expenditures. Second, financial management is about improving service delivery modalities. Through many programs initiated during the last two years—e.g., transferring management of schools and sub-health posts to local communities—HMGN has demonstrated commitment to improving service delivery. Finally, at the next level, financial management is about providing decision-makers with sufficient, accurate and timely financial information to evaluate: (i) overall public sector financial management performance; (ii) stewardship of resources placed under public sector control; and (iii) the extent to which resources are used in accordance with prescribed budgets and mandates. Although admittedly further strengthening is required, there are serious programs under way—e.g., implementing the CFAA recommendations, capacity building for accounting and auditing staff, and increased monitoring of financial and physical progress. Therefore, when looking more broadly at financial management, Nepal has come a long way and has fully demonstrated its seriousness to tackle the right issues.

C. Portfolio Management

IDA

69. The operating environment in Nepal has been characterized by weak public management, a low skills base, political instability and the aftermath of an armed insurgency that has affected a majority of the country’s 75 districts. Despite these heavy odds, project implementation performance and outcomes have improved in the last five years. On many accounts—satisfactory outcomes, project sustainability and institutional development—performance of the Nepal portfolio substantially improved and compares favorably to both the region and Bank (see Table 7). As such, overall the Bank’s contribution to development in Nepal in the last five years can no longer be considered as “*unsatisfactory* in outcomes, *modest* with respect to institutional development impact and highly *uncertain* in terms of sustainability” as summarized in the Country Assistance Evaluation (CAE) by the Operations Evaluation Department (OED).³⁶ Furthermore, more recently there has been greater borrower commitment as shown by adequate levels of counterpart funding and efforts to improve project staffing and management. While in the past project implementation has suffered from political interference—in part seen through frequent staff transfers—the dedication and commitment of reform-minded senior civil servants and project staff have helped to achieve the improved outcomes. Perceived or real corruption and lack of accountability in public institutions remain a drag on project performance, but recent actions by the public sector to rectify these ills should help to improve accountability and strengthen governance.

³⁶

Report No. 19850-NEP, dated November 1, 1999.

Table 7: Project Performance at Exit

	FY77-89	Nepal FY90-97	FY98-02	Regional Average	Bank Average
Number of projects	27	26	11	140	1,236
Satisfactory outcome	63%	64%	81%	77%	74%
Likely sustainable	44%	16%	64%	64%	64%
Sustainable institutional development	23%	28%	45%	42%	44%
Bank performance (supervision)			83%	83%	81%
Borrower performance (implementation)			75%	66%	67%

Note: Regional and Bank averages are for the period FY98-02.

Source: OED audits of Implementation Completion Reports (ICRs) and Project Completion Reports (PCRs).

70. Following the implementation of Portfolio Implementation Plans (PIPs) in FY99 and FY00³⁷—which included actions to improve the performance of individual projects, as well as specific measures to address generic issues—there was a remarkable improvement in the status of the Nepal portfolio, with projects at risk dropping to 13% of the portfolio. This was not to last, however, as the declaration of a national emergency in November 2001 resulted in an escalation of violence and impaired security. This affected much of the portfolio—especially in the remote and less developed mid- and far-western regions—with IDA unable to carry out adequate supervision and project activities slowing or even coming to a halt in some instances under force majeure. By January 2003, 43% of the projects and over 70% of IDA commitments were considered at risk, but following the cessation of hostilities, there had been a steady improvement and by end-FY03, the portfolio risks have been reduced to more manageable levels (see Annex B2). The Bank shares the experience with other donors that truly community-owned projects tend to be largely unaffected by the insurgency.

71. The current IDA portfolio in Nepal consists of nine active projects, of which five are due to close in the next eighteen months (see Table 8). Active operations as of September 15, 2003 represented an

Table 8: IDA Portfolio Trends and Performance: FY99-FY04

(As of September 15, 2003)

	FY99	FY00	FY01	FY02	FY03	FY04
Number of projects under implementation ^{1/}	10	9	8	8	10	9
Average implementation period (years) ^{2/}	3.6	3.1	3.7	3.7	3.2	3.3
Commitments (US\$ million)	17.5	54.5	0.0	22.6	96.6	0.0
Disbursements (US\$ million)	59.9	46.1	47.3	38.0	27.2	6.2
Number (%) actual problem projects ^{3/}	2 (20.0)	2 (22.2)	1 (12.5)	1 (12.5)	2 (20.0)	2 (22.2)
Number (%) projects at risk ^{4/}	6 (60.0)	5 (55.6)	1 (12.5)	2 (25.0)	2 (20.0)	2 (22.2)
Proactivity index	100	100	100	100	100	100
Realism index	33	40	100	100	100	100

^{1/} As shown in the Annual Report on Portfolio Performance, including GEF.

^{2/} Average age of projects in the portfolio as of the end of each FY.

^{3/} Projects rated U or HU (unsatisfactory or highly unsatisfactory) on Development Objective (DO) or Implementation Progress (IP).

^{4/} Number of actual and potential problem projects.

³⁷

The FY98 Annual Report on Portfolio Performance identified Nepal as a priority PIP country—i.e., a country with more than 50% of the portfolio and/or more than 33% of commitments at risk, with more than eight active projects and/or US\$250 million in commitments.

aggregate IDA commitment of about US\$298 million (net of cancellations), of which US\$167 million remains undisbursed. The portfolio declined from fourteen projects in FY98 to eight projects in FY01/FY02 as a result of the low lending levels since FY99, closing of aging projects and a deliberate policy to ensure adequate quality at entry. With the move to the base case in December 2002, the portfolio has increased slightly.

72. Despite the noted improvements, the portfolio remains at risk and could be adversely affected by a resumption of insurgent activities or a period of protracted political instability. To mitigate the risks, the Bank—primarily through the staff in the country office—has been proactively supporting and monitoring project implementation. In this effort, the Bank, together with HMG, ADB and the Japan Bank for International Cooperation (JBIC) have been carrying out joint Nepal Portfolio Performance Reviews (NPPRs) since 2000. The main objective of these reviews is to discuss generic issues affecting portfolio management—such as security, passage of laws and regulations, procurement, financial management and safeguards—and agree on time-bound action plans to resolve the identified issues. A memorandum of understanding is signed by all parties and the actions are closely monitored and reviewed semi-annually. The most recent review was conducted in October 2002, with a mid-term review taking place in May 2003.³⁸ These joint reviews are complemented by quarterly reviews of the implementation progress of IDA projects, along with close supervision and monitoring with frequent site visits. In addition to placing emphasis on quality at entry and quality of supervision, Bank staff are active in identifying and resolving potential issues before they become problems.

73. A number of initiatives—i.e., the preparation of the CPAR, the CFAA and Public Works Directives with ADB assistance—have provided a sound framework for addressing generic implementation issues and improving the general operating environment. Special committees have been established to implement the CPAR and CFAA recommendations, and are expected to modernize, as well as simplify and streamline, the public procurement and financial accountability regimes, resulting in a higher level of transparency in public procurement and enhanced accountability in financial transactions. Portfolio performance is expected to improve further with the implementation of performance-based budget allocations and fund releases under the MTEF, and systematic project and program monitoring by sector agencies and the NPC. There is an increasing awareness to strengthen environmental and social safeguards in all public investments, but as indicated, implementation remains weak and will require continued support.

IFC

74. IFC's current held exposure in Nepal is US\$79.9 million—US\$53.0 million from IFC's own account and US\$26.9 million in B loans—in four projects, of which two are in private power generation, one in tourism and one in leasing. The investment in the tourism sector was restructured as the performance of the company suffered due to the political instability and insurgency. The remaining portfolio is in good condition, with a loss reserve ratio of only 4% of total exposure.

MIGA

75. To date, MIGA has facilitated estimated foreign direct investment into Nepal in the amount of US\$122.4 million. MIGA's outstanding portfolio in the country consists of four contracts of guarantee

³⁸ The mid-term review acknowledged progress and achievements since the NPPR, noting that the reforms have had a positive impact on portfolio performance. However, a number of generic issues—including effectiveness delays, poor quality of civil works, financial management, and cost and time over-runs—were noted as requiring priority action. The 2003 NPPR will be carried out in November.

for the Himal Power Limited project—a 60 MW run-of-the river project located on a tributary of the Tama Khosi River—which was the first foreign direct investment in the energy sector in Nepal.

IV. IMPLEMENTING THE CAS

A. Partnerships

76. As strengthened through the consultation process (see Box 10), effective partnerships with Nepal's other development partners will be essential in CAS implementation. Partnerships will be maintained/developed in the context of HMGN's leadership of donor coordination efforts³⁹, respecting the Foreign Aid Policy (FAP).⁴⁰ There are three types of partnerships that will be important: (i) official partnerships; (ii) partnerships with the private sector; and (iii) partnerships with civil society. The Bank will continue to work closely with key multi-lateral and bi-lateral partners with whom there are many examples of strong, effective coordination efforts, including:

≠# The Reform and Development Group—HMGN and seven donors that are prepared in principle to consider programmatic-type assistance to Nepal (ADB, Denmark, IMF, Japan, Norway, UK and the Bank)—has been supporting development, implementation and monitoring of the IAP.

≠# Significant sectoral collaborations have taken place in: (i) the financial sector reform efforts with coordination between the Bank, IMF⁴¹ and DfID; (ii) the power sector where the Bank, UNDP, Germany, US and Norway are collaborating in several areas, including the PDF and development of micro-hydro systems in rural areas; and (iii) the education sector in which a number of donors—

Box 10: The CAS Consultation Process

As noted (see Box 6), Nepal's PRS was prepared through a very consultative process. As such, the overwhelming focus of the CAS consultations has been on aligning donor support around the PRS with emphasis on: (i) discussing the Bank's proposed strategy and its relationship to the PRS to ensure that in the aggregate, donor support is adequate to cover implementation of key PRS programs; and (ii) identifying specific areas of collaboration. The Bank has worked closely with DfID—which is preparing an outcomes-focused Country Assistance Plan (CAP)—including holding a one-day joint workshop in Kathmandu to discuss ways to support PRS implementation effectively. Taking the collaboration with DfID to a new level of closeness, DfID and the Bank have agreed on a set of PRS-based outcomes as the common goals for DfID's new CAP and the Bank's new CAS. In addition, small focus groups—with representatives of HMGN, NGOs and civil society—have been convened along the way to discuss various CAS drafts. To be most effective in assisting HMGN implement the PRS, consultation with Nepal's other development partners will be a continuous process throughout the CAS lifetime.

³⁹ In May 2003, the local donor coordination group agreed to break from the tradition of having the United Nations Development Programme (UNDP) and the Bank as co-chairs and invited HMGN to chair the group.

⁴⁰ HMGN has made impressive efforts in the preparation and initial implementation of the FAP that outlines objectives, guidelines, strategies and policies aimed at guiding the flow and composition of foreign aid to ensure better aid utilization.

⁴¹ Board presentation of the IMF PRGF is anticipated for mid-November. Overall, IMF-Bank collaboration has been excellent. The proposed PRSC I has been prepared in parallel with the PRGF and the two institutions are working closely to ensure that the programs reinforce each other. For more information on the IMF program in Nepal, see Appendix IV.

including IDA, Denmark, the EU, Finland and Norway—are providing joint support to a well-formulated ten-year primary education reform program⁴²; and

€# As mentioned (see paragraph 72), for a few years the Bank together with HMG, ADB and JBIC have been carrying out joint implementation performance reviews.

77. In line with the PRS philosophy, various sectoral ministries—e.g., education and health—are taking a proactive leadership role in the coordination of programs supported by development partners. While a shift of this nature takes time, Bank assistance and the deployment of programmatic support instruments in particular will provide leverage to Nepali reformers to expand and accelerate this process. Where cross-cutting interventions are critical (e.g., in HIV/AIDS) the Bank will work with other development partners to improve the framework for inter-agency collaboration and coordination. An important part of the coordination effort revolves around selectivity in implementing the PRS and ensuring that the key PRS programs can be implemented. The multi-lateral and bi-lateral partnerships for implementing the PRS are summarized in Table 9.

Table 9: Partnerships in Implementing the Poverty Reduction Strategy

PRS Area	Bank	Multi-laterals	Bi-laterals
Broad-Based Economic Growth			
Macroeconomic stability	J	ADB, IMF	Denmark, Germany, UK
Agriculture	J	ADB, IFAD, OPEC Fund, UN Agencies	Australia, Canada, Denmark, Finland, Germany, India, Japan, Kuwait Fund, Norway, Saudi Fund, Sweden, Switzerland, UK, US
Irrigation	J	ADB, EU, OPEC Fund, UN Agencies	Canada, Japan, Kuwait Fund, Saudi Fund, US
Trade	J	IMF, UN Agencies, WTO	Norway
Labor	J	ILO, IMF, UN Agencies	Germany
Roads	J	ADB	China, Germany, India, Japan, Switzerland, UK, US
Power	J	ADB, UN Agencies	Canada, Denmark, Finland, Germany, Japan, Norway, Sweden, US
Information/communication	J	ADB	Denmark, Finland, Japan
Tourism		ADB, UN Agencies	Japan, Netherlands, UK
Industry		UN Agencies	Japan, US
Food security		UN Agencies	Canada, France, Germany, Japan, UK
Social Sector Development			
Education	J	ADB, EU, UN Agencies	Canada, Denmark, Finland, Germany, Japan, Norway, Switzerland, UK
Health	J	EU, UN Agencies	Australia, Canada, China, Germany, India, Japan, Norway, Switzerland, UK, US
Drinking water/sanitation	J	ADB, UN Agencies	Canada, Germany, Japan, Norway, Sweden, UK
Social Inclusion	J	ADB, EU, UN Agencies	Canada, Denmark, Germany, Netherlands, Norway, Switzerland, UK
Good Governance			
Civil service reform	J	ADB, UN Agencies	UK, Switzerland
Anti-corruption		ADB	Denmark, Norway, Switzerland, UK
Decentralization	J	ADB, UN Agencies	Canada, Denmark, Germany, Netherlands, Norway, Switzerland, UK, US
Human rights			Canada, Denmark, Norway, Switzerland, UK
Integrated security development plan			US

⁴² Similar joint support is being developed to assist implementation of the Health Sector Strategy. The Ministry of Health has established a Health Sector Reform Committee to lead the reform process, including key donors (Germany, IDA, Japan, UNFPA, UNICEF, UK, US and WHO), NGOs, and the private sector.

78. Through two participatory NDFs (2000 and 2002) and the PRS, HMGN has come to engage civil society and the private sector more effectively in policy dialogue. Also, in Bank-financed projects, HMGN has shown greater willingness to benefit from partnerships with NGOs and CBOs, in particular those that involve community mobilization, service delivery and monitoring in remote rural areas. The Bank will continue to encourage these efforts. In addition to policy dialogue, partnerships among HMGN, the private sector and the Bank will remain central to the efficient provision and expansion of basic infrastructure services, particularly in power and telecommunications. The Bank Group's capacity to work with the private sector will be enhanced with the introduction of the SEDF (see paragraph 61). Partnerships in capacity building will also be strengthened with institutions key to development effectiveness, such as local bodies and media. As with official partnerships, the Bank's dialogue and coordination with the private sector and civil society will be guided by principles established in the PRS with a view towards strengthening national ownership of the development agenda.

79. Helping to reinforce these partnerships, the Bank will continue to communicate its development support to Nepal through outreach mechanisms already in place—e.g., the Nepal website, and regular consultative and dissemination events—as well as partnerships with the media. A Public Information Center (PIC)—currently located in the country office—will be built up and moved to a publicly accessible location and managed in collaboration with an external partner. The Bank will also work closely with other donors to support HMGN in the delivery of a strategic communication program built around the Tenth Plan/PRS.

B. Monitoring Outcomes

80. Given that the CAS supports implementation of the PRS and CAS outcomes are closely aligned with PRS outcomes, effective monitoring will only be possible if HMGN's monitoring and evaluation capacity is enhanced. Therefore, much of the Bank's efforts will be through capacity building to help establish an in-country monitoring and evaluation capacity. HMGN's past efforts have been limited largely to expenditure monitoring, with few linkages to outputs and service delivery. Although reviews were held every two months within the Ministerial Development Action Committee and quarterly at the National Development Committee (NDC—chaired by the Prime Minister), a fundamental focus on achieving development outcomes was lacking. To redress these weaknesses, since the beginning of FY02/03 several initiatives have been started by HMGN to monitor both financial and physical progress, including: (i) publishing on the internet detailed work programs with monitorable output indicators for all P1 projects; (ii) releasing funds based on satisfactory implementation performance, as certified by the line ministries;⁴³ and (iii) regular reporting—through the mid-term budget review and other means—of expenditure performance of P1 projects to the NPC and MOF. Though there have been some delays, the system has proven effective, especially in the scarce cash budget management environment. Another new initiative has been the monitoring of IAP activities that has led to satisfactory completion of the IAP activities and has embedded a culture of joint monitoring/partnership among core ministries.

81. Cognizant of the need to align and strengthen HMGN's integrated financial management system with public sector monitoring and evaluation to effectively implement and assess the country's progress in achieving the annual PRS targets towards the MDGs: (i) a Central Monitoring Division has been established within the Poverty Monitoring Unit at the NPC; and (ii) the Central Bureau of Statistics has been entrusted with gathering survey data for poverty monitoring. HMGN has prepared a poverty-monitoring framework, initiated streamlining of the existing surveys to be linked to PRS monitoring and identified preliminary indicators under each of the four PRS pillars. Though these indicators are by no means complete, efforts are under way to: (i) develop intermediate indicators; (ii) identify appropriate

⁴³ Performance is assessed every three months. Upon announcement of the cease-fire, this rule was relaxed to expedite resource flow to insurgency-affected areas where project activities had been severely affected.

surveys and frequencies to monitor these indicators; (iii) institutionalize IAP reporting; (iv) strengthen the link between the fund release mechanism and measurable outcomes; (v) initiate a poverty mapping exercise to direct basic social sector infrastructure to the poor and marginalized groups; and (vi) extend expenditure tracking and client surveys through participatory monitoring exercises on specific areas and sectors. Under the direction of the Vice Chairman of the NPC, the Poverty Monitoring Unit will prepare annual poverty reports—the country report on progress towards the MDGs—to be reviewed by NDC.⁴⁴ The Bank is working closely with HMGN to develop this capacity and at the same time, will take advantage of these efforts to ensure that all CAS outcomes can be measured and regularly evaluated.

C. Risks

82. The most important risk that Nepal faces today is one of the country spiraling into a widespread armed conflict and a breakdown of state institutions. By extension, this is the gravest risk the Bank should be concerned with. The current reform process has in fact emerged as an antidote against the risk of widespread internal conflict and the breakdown of the development process. Hence, supporting it must be at the core of the Bank's own risk management strategy. Nevertheless, at the next tier of the risk structure, it is useful to consider various risks to the reform process itself, so that the Bank is well-prepared to support the reform process under different circumstances. The fragile security situation and political turmoil present obvious uncertainties. At a deeper level, however, there are two types of blockages that may arise: (i) the possibility that the reform process itself is stymied or reversed; and (ii) the possibility that capacity to implement the reforms—even if commitment is sustained—becomes seriously curtailed.

83. While the major political parties and political leaders have tacitly supported the current reform process, the risk of their undermining the reform efforts out of short term political considerations cannot be discounted and would be consistent with the politics of Nepal in the past. If the peace process advances, there is also a risk that some of the more control-oriented economic policy agenda and unrealistic elements of welfare state agenda of the insurgents (e.g., restrictive trade policies, stopping privatization of SOEs, ban on private schools, free social services) may influence the reform program. When the more technocratic interim Governments make way for an elected Government, there is a risk of old-style patronage politics returning and with it tendencies for rent-seeking, slowing of reforms and crowding out of the reform-minded senior civil service leaders.

84. The reform leaders are acutely aware of these risks and believe that the best safeguard is the broad popular support for the reforms. By giving the people and communities more power and immediate benefits, they can expand the political constituency for reforms. This thinking is clearly reflected in the 2003 IAP which places a strong emphasis on service delivery. In the medium term, as the broader PRS is implemented, the Nepali people at large should begin to expect good public service delivery and public policies, rather than more personal gains, from the political process. Such a change could eventually transform the patronage-based politics of the past into a democracy that focuses on public interests. In this regard, the basic strategy of the Bank is to support the reformers to accelerate the reform process. Close coordination among the development partners to send consistent messages is a key element of the Bank's strategy. An added risk mitigation measure is the starkly differential lending scenarios—i.e., the difference between the low and the high case is potentially US\$250 million per year—that continue to send a strong message that the Bank's financial support is linked to continued reform implementation.

85. The second risk is mainly associated with renewed and escalated hostilities that would sharply reduce HMGN's ability to implement the programs envisioned by the PRS. While it would make the reform process more difficult in the conflict-affected areas, it may well stiffen the resolve of the reform

⁴⁴ Utilizing available information, the first such report has already been issued.

leaders to accelerate reform implementation in the rest of the country. In such a situation, continued support by the Bank would no doubt give considerable encouragement to HMGN to carry forward the reform process. Renewed and severe hostilities would also pose a fiscal challenge. Security spending would rise and revenues would suffer from further slowing in economic activities. Although the rise in security spending would be in part offset by slowing development activities, the net impact on HMGN's fiscal position would likely be significantly negative. HMGN has already positioned itself to cope with such a situation in an orderly manner based on its prioritized development program. Aware that this is the only way to counter the fiscal problems, the reformers—as in the last two years or so—may also use the fiscal pressure and the need to obtain budget support from the Bank and other development partners as a tool to further rationalize spending and accelerate reforms.

86. A political impasse has developed between the major political parties and the interim Governments (and by association, the King who appointed them). Although the increasingly belligerent attitude of the major political parties has dismayed many Nepalis, there is a risk that this will lead to wide-spread civil disorder and distract the administration. In such a situation, even the reform-minded technocrats would find it difficult to get cabinet decisions on further reforms and to keep the civil service focused on improving public services. The Bank can do little to mitigate such a risk, but it will monitor the situation closely.

87. Lastly, an additional risk is that the economic situation will continue to deteriorate and Nepal will be even more vulnerable to the external environment. Given Nepal's dependence on tourism and exports, unless there is a recovery in the global and domestic economic situations, Nepal's medium term prospects remain bleak. Again, implementing the reform agenda—specifically maintaining fiscal and macroeconomic stability, and increasing economic productivity and competitiveness—provides the best chances for mitigating this risk.

88. The challenges Nepal faces in taking the reform process forward are formidable. The cost of a failure, however, is nothing short of widespread internal conflict, likely resulting in the breakdown of the development process. The current reform leaders are very conscious of the risks and the high stakes. In essence, implementing reforms with more speed and vigor is their strategy to reduce the risk of reversal, and ultimately achieve peace and poverty reduction. Supporting this process is the core of the Bank's own strategy and risk mitigation. This is consistent with the basic strategy that the Bank has followed over the last several years—support reform actions consistently and forcefully.

James D. Wolfensohn
President

By:
Shengman Zhang