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Nepal
Managing Public Finances for a New Nepal

A Public Finance Management Review

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ABBREVIATIONS

ADB	Asian Development Bank
AG	Auditor General
APP	Agriculture Perspective Plan
BMIS	Budget Management Information System
CIAA	Commission for the Investigation of Abuse of Authority
CPN-M	Communist Party of Nepal-Maoists
DALY	disability-adjusted life year
DDC	District Development Committee
DDF	District Development Fund
DECS	District Expenditure Control System
DfID	UK Department for International Development
DHS	Demographic and Health Survey
DoLIDAR	Department of Local Infrastructure Development and Agricultural Roads
DoR	Department of Roads
DTCO	District Treasury and Controller Office
DTMP	District Transport Master Plan
DTW	deep tube well
EHCS	essential health care services
FAR	Financial Administration Regulations
FCGO	Financial Comptroller General Office
FMIS	Financial Management Information System
FUG	forest user group
GDP	gross domestic product
GFS	Government Fiscal Statistics (of the IMF)
IPSAS	International Public Sector Accounting Standards
LBFAR	Local Bodies (Financial Administration) Regulations
LSGA	Local Self-Governance Act
LTO	Large Taxpayer Office
MDG	Millennium Development Goal
MoF	Ministry of Finance
MoHP	Ministry of Health and Population
MoLD	Ministry of Local Development
MPPW	Ministry of Physical Planning and Works
MTEF	Medium-Term Expenditure Framework
NARDF	National Agriculture Research and Development Fund
NER	net enrollment rate
NGO	nongovernmental organization
NLSS	Nepal Living Standards Survey
NPC	National Planning Commission
NRB	Nepal Rastra Bank
OECD/DAC	Development Assistance Committee of the Organisation for Economic Co-operation and Development
PAC	Public Accounts Committee
PAF	Poverty Alleviation Fund
PEFA	Public Expenditure and Financial Accountability
PFM	public finance management
PPIS	Project Performance Information System
PPMO	Public Procurement Monitoring Office
PRS	Poverty Reduction Strategy

GoN	Government of Nepal	RBN	Roads Board Nepal
HIPC	Heavily Indebted Poor Countries	SMC	School Management Committee
HSS	health sector strategy	SOE	state-owned enterprise
IA	internal audit	SRN	Strategic Road Network
IAP	Immediate Action Plan	STW	shallow tube well
IDA	International Development Association	SWAp	sectorwide approach
IDP	internally displaced people	VAT	value added tax
IFMIS	Integrated Financial Information Management System	VDC	Village Development Committee
IMF	International Monetary Fund	WTO	World Trade Organization

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Acknowledgments

1. The Public Finance Management Review process that led to this report was initiated in August 2005 under the guidance of Shankar Sharma, Vice-Chairman of the National Planning Commission, and Bhanu Prasad Acharya, Secretary for Finance. It was completed under the guidance of Jagadish Chandra Pokhrel, Vice-Chairman of the National Planning Commission; Vidyadhar Mallik, Secretary for Finance; and Rameshore Prasad Khanal, Secretary for Finance, Revenue. Working groups in government were formed to carry out several parts of the analysis. The Public Expenditure and Financial Accountability performance assessment was carried out under the leadership of Dev Raj Pathak, Joint Financial Comptroller General, by a team of 40 members representing various government agencies including the Ministry of Finance, the National Planning Commission, the Office of the Auditor General, the Financial Comptroller General Office, and the Ministry of Local Development, as well as representatives from a few line ministries and departments.

2. This document also builds on earlier reports, including the World Bank's 2000 Public Expenditure Review; the 2001 report of the government's Public Expenditure Reform Commission; the 2002 Country Financial Accountability Assessment, its development action plan and its 2005 update (carried out jointly by the government, the World Bank, and the UK Department for International Development); the 2002 Country Procurement Assessment Review; and the 2005 report of the government's Public Expenditure Commission.

3. The World Bank team was led by Roshan Darshan Bajracharyan and Stéphane Guimbert. Bigyan Pradhan led the financial management component and, together with Kiran Ranjan Baral, the procurement component. The team was composed of Shahnaz Sultana Ahmed, Abhishek Basnyat, Binod Bhattarai, Misha Bonsh, Mahesh Dahal, Shreehari Dhungana, David Hotchkiss, Rajendra Dhoj Joshi, Surendra Govindra Joshi, Uche Mbanefo, Chandra Bhadur Nemkul, Yoga Raj Pokhrel, Tirtha Rana, Narayan D. Sharma, Suman Sharma, Pradeep Shrestha, Mona Sur, Sailesh Tiwari, Joel Turkewitz, Ram Prakash Yadav, Sunita Yadav, and Christine Zhen-Wei Qiang. Support and comments were provided by Deborah Bateman, Elena Glinskaya, Shyam Sundar Ranjitkar, Geeta Sethi, Tashi Tenzing, and Hassan Zaman. The team worked under the guidance of Kenichi Ohashi, Country Director, and Kapil Kapoor, Sector Manager. Peer reviewers who provided comments included Dr. Bimal Prasad Koirala, former Chief Secretary; Vinaya Swaroop, World Bank; Anand Rajaram, World Bank; Dr. Shankar Sharma, former Vice Chairman of the National Planning Commission; and Para Suriyaarachchi, Consultant, together with Mr. Bishnu Bahadur KC (former Auditor General) and Paul Sisk (World Bank) for Financial Management/Public Accountability and Irina Luca (World Bank) for Procurement.

4. The concept note for the work program was reviewed in December 2005. Workshops on the Public Expenditure and Financial Accountability (PEFA) framework and the procurement assessment were held in Kathmandu in March 2006. These were followed up by intensive support from the World Bank team to the government of Nepal team as it prepared a self-assessment. Quick feedback support was provided for the preparation of the 2006/07 budget. Analysis of the Public Finance Management Review was incorporated in consolidated financial statements for fiscal 2005 and fiscal 2006 and in the most recent midyear review. Preliminary findings of the agriculture expenditure review were shared at a workshop on the Agriculture Perspective Plan in [November 2006]. The 123PRSP model (box 8.1) was presented to the National Planning Commission, the Central Statistics Bureau, and the Nepal Rastra Bank in December 2006. Preliminary findings of the Public Finance Management Review report were reviewed with the World Bank country team in March 2007 and a review meeting was held on May 22, 2007.

Executive Summary

1. The People's Movement of April 2006, known as Jana Andolan II, has created a sense that a "New Nepal" that is peaceful, inclusive, just, and prosperous is at hand. Such "open moments" are rare in the history of a country, and the opportunity must be seized. However, the road ahead is challenging. Despite remarkable achievements in reducing poverty over the last decade and despite a good growth potential, Nepal faces major investment climate constraints—notably weak infrastructure, weak governance, weak trade facilitation, and rigid labor laws. Recent economic growth has stagnated around 1 percent per capita, despite growth in neighboring China and India. Investment has been sluggish despite large liquidity excess, notably from the income remitted by Nepali workers abroad. This Public Finance Management Review outlines the key objectives of the government's development strategy and explores the potential contribution of sound public finance management to this agenda.

2. The first part of the report (chapters 1 and 2) outlines the development challenges facing Nepal and recent trends in public finance management (PFM). The second part (chapters 3–7) reviews the composition and effectiveness of expenditure programs ("doing the right things"), and the third part (chapters 8–11) considers ways to finance and implement them ("doing things right"). Chapter 1 takes stock of the current environment in Nepal, looking at the overall political and economic situation to distill elements of the development strategy that impact public finances. Chapter 2 reviews public finance management to assess its recent trends and performance and its potential contribution to the development strategy. Chapter 3 reviews the composition of public expenditures, with the issue of geographic patterns as a cross-cutting theme. For each of the four selected sectors (education, health, local roads, and agriculture), a review of public expenditures leads to recommendations for improving the effectiveness of public spending through reallocation or more effective spending (chapters 4–7). The third part of the report assesses how to finance (chapter 8), formulate (chapter 9), and execute (chapter 10) the budget. Chapter 11 reviews similar issues at the district level. Finally, chapter 12 concludes with a few illustrative fiscal scenarios and a proposed strategy to improve public financial management.

3. This review has been conducted by the government of Nepal (GoN) and the World Bank, working in partnership under the guidance of the government's National Planning Commission (NPC) and Ministry of Finance (MoF). The scope of the review was finalized in December 2005. Workshops were held in March 2006 to outline frameworks for assessing PFM and procurement performance, and working group meetings were subsequently held. Support was provided in early 2006 for the preparation of sectoral business plans and subsequently for the preparation of the budget. Dialogue with the MoF and the NPC underpins the expenditure data and analysis.

Three Achievements

4. The effectiveness of Nepal's PFM systems has contributed to three major achievements (see box 1 for some key facts about the budget and public financial management).

5. **First, Nepal has maintained fiscal and macroeconomic stability** (chapter 2). This is no small achievement considering the tumultuous political history of the country, a protracted conflict, and several economic shocks. It is due to the robustness of some of the systems in place—including the Medium-Term Expenditure Framework (MTEF) established since 2002, as well as a system of performance-based releases—and to the leadership of senior bureaucrats in particular.

Box 1: Nepal's Public Finances in Numbers

The public sector is dominated by the central government, which collects some 95 percent of all revenues. Local government spending is less than 8 percent of the central government's. In addition, a large number of funds, boards, and committees manage significant financial flows outside the budget; the Auditor General reviews 800 such accounts every year.

In 2004/05, revenues of the central government amounted to 13 percent of gross domestic product (GDP) and expenditures 16½ percent of GDP (only 5 percent for capital expenditures). The gap (3½ percent) was financed by external grants (2¾ percent), external financing (½ percent in net terms), and domestic financing (¼ percent).

Total external assistance amounts to 5¾ percent of GDP. Only 3¼ percent of GDP goes through the budget, of which 2 percent is tied to particular projects or is in-kind.

Between 1997/98 and 2003/04, the primary deficit was reduced from 5 to 2 percent of GDP, and capital expenditures went down from 7½ to 4½ percent of GDP.

The debt-to-GDP ratio is around 50–60 percent, and the debt is mainly composed of external debt.

On average over the last eight years, actual revenues and current expenditures amounted to 91 percent of their budgeted values. But capital expenditures were only 77 percent, grants 66 percent, and net external financing 48 percent of their budgeted values.

Every year about 47 percent of the total budget is spent during the last trimester.

A third of the budget is allocated to social sectors, a quarter to economic services, another quarter to general administration, including the security sector, and the rest to other items.

With around 19 percent of the budget allocated to education, net primary enrollment increased from 57 to 72 percent between 1995/96 and 2003/04 (9 to 15 percent for secondary education). With around 5 percent of the budget allocated to health, under-five mortality went down from 118 to 65 per 1,000 live births between 1996 and 2006 (79 to 51 for infant mortality). With 1½ percent of the budget allocated to local roads, more than half the rural population can now access the nearest all-season road in less than two hours. With 5-6 percent of the budget allocated to agriculture, growth in the sector has rebounded in recent years.

Public sector accountants maintain some 12,000 bank accounts. Each year, the Auditor General identifies irregularities equivalent to around 2 percent of GDP, but in 2004 and 2005 it cleared more irregularities than it identified new ones.

6. **Second, expenditures have gradually become more aligned to sound sector strategies** (chapters 3–7). This is particularly evident in education and health, sectors in which this positive outcome has been rewarded and facilitated by donors partnering around sectorwide approaches (SWAps). The realignment of expenditure programs with the Tenth Plan, combined with sound sector policies, underpins some of the progress made toward the Millennium Development Goals (MDG). Indeed, Nepal is well on track to meet the education MDGs, thanks to progress in prioritizing primary education and rolling out the policy of devolving school management to communities. In health, vaccination campaigns and focusing of public expenditures on a package of essential health services have contributed to continued progress in reducing child mortality.

7. **Third, some key features of a reasonably well-designed PFM system, expected to enable good management, control, governance, and accountability, are in place** (chapters 8–11). The GoN undertook in 2006/07 a self-assessment of its PFM performance, using the Public Expenditure and Financial Accountability (PEFA) methodology that was developed by a consortium of international institutions to assess and benchmark PFM performance. This assessment reveals a system that is well designed, although unevenly implemented (see below). In particular, in recent years the budget has become a credible policy tool, clearly linked to outcomes and policies in some sectors, with a solid control of aggregate outturns and a reasonable control framework at the transaction level, notably for payroll. Similarly, a Procurement Act was enacted recently and the anti-corruption legislation was amended to allow bidders to report acts of corruption, with harsher penalties imposed for these acts: this is creating the basis for a public procurement system in line with international standards. Finally, and crucially, these PFM systems have turned out to be resilient to significant political volatility.

Six Challenges

8. Nevertheless, the review identifies six main challenges that need to be addressed as they could enable—or hamper—economic growth and service delivery.

9. **First, responding to the expectations of the People's Movement and accelerating growth require steps to create fiscal space.** At the moment, growing pressures on recurrent spending, a large revenue gap (defined as the gap between actual tax collection and an estimate of the tax potential), weak external assistance, and self-restrained domestic borrowing leave limited scope for maneuver. On the expenditure side, there is some room for prioritization; indeed, the MTEF prioritization criteria are becoming less effective given the large share of projects that are ranked "high priority." But there are serious needs, especially the need to accelerate investment in infrastructure, a major constraint to growth (chapter 1). On the revenue side, Nepal has satisfactory policies by and large, with reasonably low tax rates applied to a reasonably large tax base (chapter 8). Additional revenue mobilization will result from a tightening of the revenue administration: although the potential is large, this cannot be expected to generate significant short-term gains. Prospects for external assistance appear good, but Nepal's long history of over budgeting aid flows should caution against excessive optimism in this respect. Finally, domestic borrowing could be expanded in the short term, given the large liquidities available. But this is only a short-term solution, as private sector demand for credit is expected to pick up, and Nepal's debt situation is already fragile.

10. A key challenge for fiscal policy is the debt situation (chapter 2). While the debt-to-GDP ratio is not very high by international standards and is even declining, and debt service is still manageable, a debt sustainability analysis classifies Nepal as at "high risk of distress." This assessment takes into account the large risks of the macroeconomic framework, including (a) uncertain impact of the political transition on the investment climate and growth; (b) uncertain responsiveness of growth to public expenditures; (c) large contingent liabilities (in public enterprises and pensions) and extrabudgetary activities; and (d) uncertain prospects for scaled-up external assistance. Addressing the mismatch between large needs and limited resources while mitigating risks will require significant prioritization, sustained revenue mobilization, and effective debt management.

11. **Second, the numerous obstacles to accelerating growth and service delivery require further progress in sector expenditure programs.** For sectors that have a well-established strategy, the need is to press ahead with existing policies (e.g., devolution of school management to communities) while reviewing and adjusting those policies (e.g., considering whether to give higher priority to secondary education). The implementation of these strategies also requires due attention to issues of quality and efficiency of public spending. For sectors without a well-defined sector strategy, efforts should be made to develop such a strategy. For instance, in the road sector, a better prioritization of roads could maximize the economic returns of the investment; this often requires a connection to the Strategic Road Network and plans to ensure the longevity of the road, with good quality at the beginning and continuing attention to maintenance. This in turn requires a more concrete business plan that builds on existing district-level plans and Perspective Investment Plan. Similarly in agriculture, the long-term vision of the Agriculture Perspective Plan needs to inform a concrete business plan for implementation.

12. **Third, these expenditure programs need to address various types of disparities.** Disparities in opportunities have been identified as a key source of the decade-long conflict, and they continue to fuel demands from various parts of the population. The distribution of spending and outcomes across districts is uneven. Only a part of these disparities can be justified by differentiated access, population density, and topography. To be sure, some of these disparities are being addressed: for instance, expenditures in the Terai, which are lower than the

national average, have been increasing over the last few years faster than the national average. Schemes that address these disparities, such as the formula-based allocation of block grants to districts, should be scaled up. Disparities between poorer and richer Nepalis are also important to address in order to attain Nepal's objective of reducing poverty. These disparities include, for instance, the higher secondary enrollment for richer households, reflecting important demand-side factors; the large bias of health spending toward the rich, reflecting demand-side factors that penalize poorer households and reduce their use of publicly funded services; and weaker connectivity for poorer households, reflecting a lack of targeted investment in good-quality roads to underserved areas.

13. **Fourth, the review of PFM performance reveals important, and persistent, gaps between the rules and the reality.** Despite a very advanced set of laws, regulations, and processes, PFM practices indicate weaknesses in the control framework, significant implementation constraints, and large fiscal activities outside the scope of the central government budget. The perception of an inefficient, if not corrupt, system persists. Actions to further refine laws and regulations, upgrade management systems, and train civil servants are important parts of the agenda. Many reviews of PFM performance have focused on these issues, and this report also lists a number of possible improvements. Nevertheless, it is important to stress that Nepal already has a very elaborate set of laws and regulations that are by and large sound. Effective innovations have been developed in several areas, such as the way the MTEF was piloted and rolled out, and a large number of management information systems are operating. Throughout the government, a large cadre of professional civil servants—and a lot of goodwill—are making the system work. But, with a few exceptions, the performance of the system has been rather stable despite many improvements in laws and regulations. Hence, adjustments to the formal PFM system are unlikely to fundamentally change its performance.

14. This fourth challenge can only be tackled by understanding the principles that underlie the existing system and how the system is being used. To begin with, most stakeholders have adjusted to the formal system. For instance, although the system produces aggregate control, it is characterized by fragmentations of all sorts that make it impossible to apply formal rules consistently (more than 12,000 bank accounts to manage the budget; some 800 accounts for extrabudgetary entities). In procurement, some of the formal rules seem moot in the rural road sector as only a handful of the qualified firms bid on each contract. Decentralization is another case in point: a clear, ambitious policy contrasts with at best mild support from the center and the bureaucracy. The absence of elected bodies has further weakened the advocates for decentralization, and has created an excuse for delaying decentralization on the grounds of lack of local accountability. The political situation also did not create, until recently, any reason to implement the formal rules that ensure democratic accountability. Furthermore, budgets and PFM can focus on performance only if the whole government cares about performance: PFM cannot be viewed in isolation from human resources and management practices. Fundamentally, the origin of several of the weaknesses in PFM can be traced to the weak demand from both government and external stakeholders for better budget information (financial and physical) and better management. Donors, for their part, are inadvertently introducing mixed incentives with respect to progress on PFM. While this is gradually changing with the shift toward SWAps and budget support, the traditional project-focused approach—and even more for off-budget funding—does not create any incentive to improve systems and might even weaken them, for example by inducing capable staff to move to better-paid project units.

15. **Fifth, despite repeated policy announcements, local public finances are not utilized to their potential.** Irrespective of the structure of government that will be decided by the new Constitution, sound PFM at the local level will be critical. However, the current practice reveals a wavering commitment to this agenda. Nowhere is that clearer than in the tiny revenue base

assigned to the local bodies and the extremely constrained grants that they receive. The central government's weak commitment to this agenda as noted above, materializes through issues such as unclear roles and responsibilities, overly constrained guidelines and funding mechanisms, an overly elaborate flow of funds, and insufficient reporting from the center to the local bodies. Addressing these issues should unleash the capacity of local bodies to perform a specific set of tasks. In parallel, the issue of local bodies' accountability will need to be addressed, including through transitory means before local elections are held. Responding to this fifth challenge will complement the progress made in giving communities a voice in planning, management, and oversight processes—but in the medium term, a clear division of tasks between communities and local governments will be necessary.

16. **Finally, effective management of external assistance is a critical challenge.** Although external assistance is not very high in Nepal, a large part is implemented outside budgetary channels (box 1), and some sectors rely heavily on aid (e.g., aid accounts for two-thirds of the spending in infrastructure). Risks to poorly managed external assistance are well known, and several of them are happening in Nepal. Project-oriented aid promotes fragmentation and weakens policy coherence; it has mixed effects on accountability and governance systems, bringing resources to develop capacity and providing some external oversight but also in some cases undermining civil servants' accountability. Fragmented external assistance has high transaction costs, which amounts to a tax in a low-capacity country. Nepal and its international partners have achievements to build on, including a sound Foreign Aid Policy; the Tenth Plan, MTEF, and associated sector strategies; SWAps in education and health; and reliable country systems, recently upgraded through a Procurement Act compatible with international standards. The scaling up of external assistance in the context of the peace process needs to be managed to build on these achievements while mitigating these risks.

A Four-Point Agenda

17. This report puts forward for discussion with stakeholders in Nepal an agenda to improve the contributions of public finances to Nepal's transition. This four-point agenda will support the four blocks of Nepal's development strategy. It will require appropriate sequencing, piloting, monitoring, evaluation, and adjustments. The importance of sequencing cannot be overstated, given the complexity of the transition process the country has to go through. Box 2 identifies some potential "quick wins" that could become immediate priorities.

18. The central themes of this agenda are the need to (a) seize quick wins to deliver results, (b) gradually scale up public expenditures and PFM performance as capacity is built, (c) boost the use of monitoring systems and ex post evaluation as management tools to strengthen efficiency and accountability, (d) simplify complex systems when necessary, and (e) ensure that external assistance meshes with these objectives. This agenda can be summarized around the following four points.

- **A sound fiscal policy.** The immense needs and expectations have to be reconciled with the financial capacity of the GoN, constrained in particular by the level of debt and other fiscal risks; with the need to preserve macroeconomic stability; and with important implementation capacity constraints. While external assistance can be expected to increase and domestic borrowing could offer a short-term option, large expenditure needs have to be reconciled with limited financing. This suggests focusing attention on an expenditure path that would provide for a gradual and steady increase as capacity is built and bottlenecks are addressed. Beyond the immediate priorities identified in box 2, medium-term challenges will include the need to expand revenues collection to reduce aid dependency and manage fiscal risks, especially those resulting from extrabudgetary funds, pensions, and public enterprises.

Box 2: Quick Wins toward More Effective Public Finance Management

1. Focus fiscal policy, and dialogue with donors, on a realistic growth in expenditures.
2. Consolidate and disclose financial data for extrabudgetary boards and funds.
3. Get budget presented to Parliament one or two months before the end of the fiscal year (and explore option of changing the timing of the fiscal year to reduce end-of-year bunching).
4. Realign education allocations on a per-student basis and develop a means-tested scholarship system.
5. Realign health expenditure allocation based on a mix of population, accessibility, and performance, and further prioritize the package of essential health services within the health sector.
6. Scale up use of formula-based grants to District Development Committees (DDC) and Village Development Committees (VDC), with simple guidelines.
7. Revise prioritization criteria to improve selectivity and reduce budget fragmentation.
8. Adopt a series of simple in-year budget implementation reports for analytical and management purposes (including to ensure timely budget implementation) and for accountability to citizens.
9. Require the MoF budget department to report to Parliament on how information about previous years' performance has been used to guide budget allocations.
10. Create a Public Procurement Monitoring Office as required by the new Procurement Act. The office would oversee the procurement system; establish a simple statistical monitoring system, with public disclosure of key information, and a complaint registration system; and enforce mandatory preparation of procurement plans.
11. Adopt confidence-building measures for better aid management. Donors should provide better reporting, commit to follow the new Procurement Act, and commit to reduce off-budget delivery of aid. The GoN should develop a PFM plan and improve budget transparency.
12. Prepare a business plan for PFM sector, using the PEFA framework as a monitoring tool, and encourage donors to coalesce around it.

- **Prioritized and effective expenditure policies.** To improve expenditure policies, a priority is to scale up existing successful programs. Given financing and implementation constraints, alternative delivery mechanisms—for example, through communities or user groups—have to be deployed appropriately. Another priority is to accelerate infrastructure expenditures, including by building a pipeline of projects and investing in the Strategic Road Network. A number of immediate steps could help align expenditures with needs and priorities (box 2), while a medium-term approach is to expand the number and quality of sector strategies, monitor their efficiency and impact (including their effect on how public expenditures address important disparities), and ensure that lessons learned feed back into policy making and budgets. In education, medium-term challenges include the funding and effectiveness of secondary education and the role of non-public sector service providers. In health, they include the affordability of health services for the poor and the need to improve the nutritional status of young children. In local roads, they center on the need to further shift resources to maintenance and address implementation issues. In agriculture, the main medium-term challenges are to operationalize the Agriculture Perspective Plan and clearly define the role of the public sector.
- **Stronger PFM performance.** Strengthening public finance management systems requires embracing a holistic, yet realistic approach to management of reforms. One option for sequencing reforms is to define a series of platforms, each around one particular outcome. The series of platforms would provide a way to focus capacity and ensure synergies between reform efforts. In the short term, the priorities would be to maximize the credibility of the budget, simplify some processes, realize the analytical and policy potential of reporting, implement the Procurement Act, and strengthen tools to hold policy makers accountable for the budget and its outcomes. At the local level, a stronger commitment from the central government is needed to simplify guidelines, move toward block grants with fewer constraints, and provide support to local bodies. Beyond this first platform and the immediate priorities identified in box 2, a more evidence-based (for budgeting) and risk-based approach to audit (of expenditures as well as taxes) and controls (ex post review of

expenditures as opposed to painstaking ex ante planning) can be envisaged. Progress in this area will be closely related to progress in other areas of good governance in the civil service and its environment.

- **Effective aid delivery.** The quality of aid delivery will be a key outcome of PFM performance—and a driver of the quality of expenditures. Beyond the priorities identified in box 2, more effective aid delivery can be achieved through implementation of the 2002 Foreign Aid Policy, especially by building on the positive experience of SWAps.

19. **The impact of this four-point agenda will depend in part on the contribution from donors.** For a sound fiscal policy, generous but—equally important—predictable and flexible financing is necessary, especially for infrastructure whose financing is largely driven by aid. Prioritized and effective expenditure policies will require policy coherence and coordinated support, for which SWAps provide a workable model. Donors can support strong PFM performance in several ways. They can (a) coalesce around the government's PFM sector strategy to provide coordinated funding and jointly track progress in PFM performance using the PEFA indicators; (b) emphasize the need to finance existing policies (e.g., scholarships in education) adequately before embarking on new investments (this could translate into joint discussions of the fiscal policy objectives); and (c) pay more attention to the Auditor General's reports and raise the issue of follow-up more consistently.

20. **Finally, progress with this agenda will materialize only if the constituency for reform expands.** Support for changes needs to extend beyond the existing group of reform-minded specialists in the bureaucracy. One suggestion is to form a team of secretaries to nurture their interest in PFM performance and address their specific demands for such performance (e.g., for good physical and financial information). In addition, steps should be taken to open venues for dialogue with parliamentarians, interested donors, and members of civil society, including the media and academics.

1. Toward a New Nepal

Key Messages

- After the People's Movement of April 2006, a peace process is under way that opens the possibility of a "New Nepal." Seizing this opportunity is challenging, however, and will require realistic prioritization and sequencing.
- Public finance management can help strengthen the four pillars of Nepal's development strategy, which are to (a) provide key services (notably infrastructure) to enable growth and create jobs, (b) provide key social services, (c) contribute to an inclusive society, and (d) promote good governance.
- Despite remarkable progress in reducing poverty in the last 10 years, Nepal remains a poor country. While landlocked, Nepal has solid growth potential, for instance in hydropower and tourism.

1.1 The People's Movement of April 2006, known as Jana Andolan II, has created a sense that a "New Nepal" that is peaceful, inclusive, just, and prosperous is at hand. Such "open moments" are rare in the history of a country, and the opportunity must be seized. However, the road ahead is challenging. This chapter first reviews this political and historical context. It then summarizes Nepal's development strategy, with a focus on the potential role of sound public finance management. The chapter concludes with a review of recent economic and social developments.[1]

A. Political Context

1.2 **Nepal's political history over the last two decades has been tormented.** In the spring of 1990, a first Jana Andolan ("People's Movement") toppled the partyless Panchayat regime and restored the multiparty parliamentary polity disbanded in 1961. But poverty remained widespread and exclusion very entrenched. The Maoist insurgents launched their "people's war" on February 13, 1996. The conflict remained low-intensity until 2001, when the scale and severity of the attacks increased following the breakdown of a cease-fire and attempts at talks between the insurgents and the GoN. The death toll escalated during the state of emergency between November 2001 and August 2003. In May 2002, the House of Representatives—the lower house of the legislature—was dissolved in anticipation of fresh parliamentary elections, but these were postponed on grounds of the adverse security situation. A cease-fire held between January and August 2003; government and the insurgents met three times during this period, but the talks collapsed. On February 1, 2005, King Gyanendra dismissed the coalition

[1] This chapter builds on the GoN's Poverty Reduction Strategy (PRS); the *Nepal Development Policy Review: Restarting Growth and Poverty Reduction* 2004 report; the *Unequal Citizens: Gender, Caste and Ethnic Exclusion in Nepal* 2006 report; and the *Resilience Amidst Conflict: An Assessment of Poverty in Nepal, 1995-96 and 2003-04* 2006 report.

government and formed a new Council of Ministers under his own chairmanship. A state of emergency suspended a number of civil liberties. In response to the king's move, the insurgency declared a nationwide, indefinite "bandh" (a shutdown of transport and businesses). The conflict is estimated to have taken some 14,000 lives, deprived thousands of others of basic human rights, and disrupted economic and social activities.

1.3 **In April 2006, Jana Andolan II effectively marked the beginning of the peace process.** The key milestones of this process are as follows:

- *May 2006*: Restoration of the Parliament and coalition government . On May 18, in a historic proclamation, Parliament declared itself Nepal's sovereign authority, curtailed the king's powers and privileges, including his command over the army, and declared Nepal a secular state.
- *November 21, 2006*: Signature of a comprehensive peace agreement between the GoN and the Communist Party of Nepal-Maoists (CPN-M) to lay out a road map to a lasting peace and the construction of a new governance structure.
- *December 2006*: Creation of seven main "cantonments" and 21 satellite camps for the Maoist People's Liberation Army and separation of their arms. A process of verification was initiated under United Nations supervision.
- *January 15, 2007*: Promulgation of an Interim Constitution and entry of the CPN-M in Parliament, with 83 out of 330 seats. CPN-M leadership then announced the dissolution of parallel structures.
- *April 2007*: Formation of an interim government with CPN-M participation. Constituent assembly elections are planned for November 2007. Eventually, perhaps by 2009–10, a new Constitution should be promulgated, paving the way for election of a new Parliament and formation of a new government. In addition, agreement has been reached to undertake a process of rehabilitation of Maoist combatants and a process of national reconciliation.

1.4 **This process opens a new opportunity for Nepal**. However, the ongoing fluidity of the situation poses challenges. Of particular concern are the unrest in early 2007 in the Terai region (where the Madhesis have raised their long-standing demand for greater autonomy and proportional representation in the national political process) and the unresolved differences between the CPN-M and other political parties in terms of their political and economic philosophies.

B. Nepal's Development Strategy

1.5 **The government's development strategy, finalized in 2003, explicitly defines poverty reduction as its primary objective.** Nepal's Tenth Plan (2002-2007) is also its Poverty Reduction Strategy (PRS). The strategy is structured around four pillars: broad-based economic growth, social sector development, social inclusion, and good governance. A number of the strategy's principles have an important bearing on public finance management. First, one of its objectives is to change the role of the state, especially by exploring alternative delivery mechanisms such as devolution, contracting-out, and community-level management. Second, to make growth and development inclusive, the Tenth Plan has a two-pronged approach: (a) promote mainstream inclusiveness across sectors, and (b) develop dedicated strategies, for instance, for lagging regions or targeted groups (affirmative action).

1.6 **The priorities of this strategy remain relevant in the post–April 2006 context.** By and large, this strategy is consistent with analytical work that emphasizes the need to create jobs, deliver basic services, ensure inclusion of all Nepalis, and develop good governance (see below). In the political context of an "open moment," the importance of building up the state's legitimacy cannot be overstated: this requires good governance, accountability, inclusiveness, and a capacity to deliver on promises. The sources of the decade-long conflict also point to the need to address failures of development, create jobs, and ensure inclusion. In addition, the development experience of Nepal highlights the significant developmental role of communities (box 3.1). Finally, the strategy echoes some of the rights embedded in the Interim Constitution.

1.7 **In 2007, the GoN is developing an interim three-year development plan.** This plan is expected to focus on the immediate needs of the reconstruction agenda, with four selected priorities: (a) post-conflict relief and rehabilitation; (b) additional and better-quality employment, especially in agriculture, industry, tourism, and trade expansion; (c) infrastructure, especially rural infrastructure including water and sanitation; and (d) social justice and social inclusion. Around 2010, with the political process settled, this plan could be followed by a new five-year plan.

C. Economic and Social Profile

1.8 **The economic and social profile of Nepal changed significantly with the political changes of 1990 and the economic reforms that followed.** Income per capita grew at 2.6 percent per year during the Eighth Plan (1992–97) and at more than 1 percent during the Ninth Plan (1997–2002) (figure 1.1). Strong economic growth was accompanied by a stable macroeconomic framework featuring tamed inflation, a stable exchange rate pegged to the Indian rupee since 1994, and an open economy without significant external imbalance. Economic growth, notably leading to dynamic agriculture wages, combined with vibrant remittances, improved connectivity, urbanization, and a decline in the dependency ratio. These factors led to a significant drop in poverty incidence, from 42 percent in 1995/96 to 31 percent in 2003/04 (table 1.1).

1.9 **Nepal remains a poor country (GDP per capita is US$300), with significant gaps in social outcomes and large disparities across the population.** Households that tend to remain poor include those of agricultural wage earners, those that own little or no land, those with illiterate household heads, and those with seven or more members. Inequities are large and have increased during the last decade through higher returns on physical and human assets, which are unevenly distributed. This uneven distribution of assets also translates into disparities of wealth between rich urban areas and poorer rural areas; between regions (the Mid-western and Far-western regions, where the population has limited access to paved roads, health facilities, and market centers, are lagging, as discussed in chapter 3); and between various population groups (poverty incidence in highest for Hill and Terai Dalits and Hill Janajatis).

Table 1.1: Economic and Social Profile of Nepal

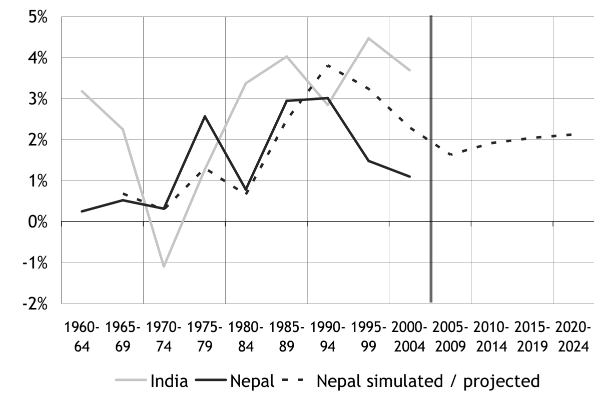
The country		**Poverty**		**Water and sanitation (% population)**	
Population (million)	25.8	Overall (incidence, % population)	30.9	Improved sanitation facilities	27
Surface ('000 sq km)	147	Urban	9.6	Improved water source	84
The economy		Rural	34.6		
GDP (US$ billion)	7.5	**Education**		**Health**	
GDP per capita (US$)	297	Net enrollment, primary, all (%)	72.4	Child mortality (per 1,000 live births)	51
Inflation	7.2	Net enrollment, primary, girls (%)	66.9	Under-five mortality (per 1,000)	65
Gross fixed investment (% GDP)	18.5	Net enrollment, secondary, all (%)	15.1	Maternal mortality (per 100,000)	740
Exports of goods and services (% GDP)	18.9	Net enrollment, secondary, girls (%)	13.4	Underweight children (%)	45
Current account balance (% of GDP)	2.7	Literacy rate, 15 years and above (%)	48.6		
Remittances (% of GDP)	16.8				

Sources: World Development Indicators; NLSS II; DHS 2006; IMF.

Note: Data for 2007 or most recent year.

1.10 **Economic performance has weakened over the last few years.** During a period when India accelerated growth, the political turmoil and conflict in Nepal led to a marked deceleration in its growth (figure 1.1). While growth in agriculture continued its medium-term trend, growth in industries and services slowed down. This is reflected in a weak trend for exports. While public investment was faltering, private investment remained somewhat dynamic despite a large risk premium; it was fuelled by growth in the region and availability of funds from remittances. However, total investment remains significantly below total savings, which include large remittances: the resulting current account surplus is a testimony to the weak investment climate in Nepal.

Figure 1.1: Per Capita Economic Growth: Performance and Prospects



Sources: World Development Indicators; staff estimates (based on Ianchovichina and Kacker 2005).

Note: Projections are from a simple cross-country model based on structural features of the economy (see Guimbert and Tiwari 2007). The key drivers of the projections are initial conditions (level of income per capita and output gap vs. potential output); macroeconomic environment (terms of trade, real exchange rate, volatility, trade openness, banking crises, financial sector); human and physical capital endowment (such as education, telephones); and role of government (governance and government consumption).

1.11 **Macroeconomic management has, however, been sound** (see annex – Table A.3 . The central bank, Nepal Rastra Bank (NRB), has maintained a cautious monetary policy over the past few years. Inflation has been contained, notwithstanding an acceleration in 2005 caused by the combination of rising international oil prices, an increase in the value added tax (VAT), and disruption of supply chains by the conflict. Nepal's external sector has suffered severe setbacks since around 2001, with a series of terms-of-trade shocks and the ending of the multi-fiber agreement in 2005. Despite the persistent trade deficit, Nepal's current account balance remains positive, largely due to the offsetting effect of remittances that have registered phenomenal growth in recent years and now amount to about 16 percent of GDP. Total international reserves in 2006 were sufficient to cover about six and a half months of imports of goods and services. This context has enabled Nepal to keep its currency pegged to the Indian rupee.

1.12 **What will it take to generate faster economic growth?** Simple projections suggest that, assuming gradual improvements in structural issues (e.g., education, infrastructure) and maintenance of an appropriate macroeconomic environment, economic growth per capita could increase to 2 percent per year or more (figure 1.1). Sources of growth could include tourism, hydropower, agro-processing, and some segments of the textile industry. Nepal's advantages include its proximity to dynamic economies (especially India and China), its water resources, and its tourism potential.

1.13 **Some of the key constraints to growth are not directly related to PFM.** Constraints to growth are unlikely to result from insufficient access to financing, as evidenced by a surplus in the current account and large liquidities resulting from remittances (although there are problems with access to this financing, reflecting governance issues in the financial sector). Rather, constraints to growth are primarily constraints to the rates of return that entrepreneurs receive from their investments. The first such constraint, which is not directly related to PFM, has to do with the continued large risk premium. This was initially due to the conflict and is now related to political uncertainties (e.g., about the policies of the coalition government, and about the timing and implications of the constituent assembly elections) and unsettled conflict issues (e.g., continued illicit taxation by insurgents). In addition, some very rigid labor regulations constrain growth (World Bank 2007a).

1.14 **Beyond this set of issues, there are three main areas where public finance management can help alleviate constraints to growth.**

1.15 *Infrastructure development* is key, as poor access to infrastructure raises costs. Addressing this constraint requires a mix of (a) public capital investment, including in rural roads, discussed in chapter 6; (b) private sector investment in transport, power, and telecommunications; (c) restructuring of utilities, notably the Nepal Electricity Authority; (d) recurrent cost management (stronger maintenance of roads, depoliticization of tariffs for electricity); and (e) regulatory reforms, such as harmonization of border procedures. The fact that infrastructure is a key constraint to growth has important implications for the fiscal policy and PFM systems: although leveraging private investment will be critical (especially in power), the role of the public sector is critical.

- *Trade facilitation* is important as a means to overcome the weakness of the export sector and harness Nepal's development to rapid economic growth elsewhere, especially in the region. Developing connectivity and reforming customs are essential steps. Fiscal policy not only is relevant to infrastructure issues (see previous point), but also helps shape an enabling trade regime and ensure good governance in customs.
- *Growth in agriculture* is critical for poverty reduction, given that poverty is in large part a rural problem. It requires a number of additional investments and policy reforms, notably to promote the commercialization of agriculture. Chapter 7 reviews in more detail the role of the public sector in enabling private sector–led growth in agriculture, with a focus on issues with externalities (e.g., research).

1.16 **While economic growth will be a key driver, other policies and programs are necessary to meet the MDGs.** In education, net enrollment and youth literacy have been improving, and Nepal is likely to meet the education and gender-related MDGs. Similarly, substantial gains with regard to child mortality , albeit with large regional variations, put Nepal on track to meet these MDGs. However, child malnutrition and maternal mortality remain high, and the prospects of achieving these MDGs are unclear. In addition, beyond these aggregate indicators, a number of disparities among regions and social groups need to be addressed. Making progress in the education and health sectors has fiscal implications, as reviewed in chapter 4 and 5 in particular assesses the role of the public sector and public expenditures in making further progress in education and health with given levels of investment.

2. The Role of Public Finance Management in Nepal's Development

Key Messages

- Sound public finance management will contribute a great deal to Nepal's development by promoting macroeconomic stability, enabling economic growth, delivering services to citizens, and making government legitimate through good governance.
- Public finance in Nepal has been disciplined. However, with low resource mobilization, pressures on recurrent spending, and severe implementation bottlenecks, this had led to an undesirable decline in capital spending. In addition, a series of fiscal risks — including pensions, extrabudgetary funds, and liabilities from state-owned enterprises — further undermine the fiscal situation.
- The assessment of Nepal's performance in public finance management suggests a system that is well designed but unevenly implemented.

2.1 This chapter first outlines the critical role of public finance management in the peace and development process. The balance of the chapter then takes stock of recent PFM developments. Section B outlines the fiscal structure of Nepal and the key fiscal trends over the last few years, while section C assesses the performance of the PFM systems. This analysis forms the platform from which sound PFM can contribute to the emergence of a new Nepal.

A. Critical Contributions of Public Finance Management

2.2 **The most immediate contribution of PFM could be to make fiscal space for the costs associated with the transition.** This could include establishing and maintaining the camps of former soldiers; implementing a demobilization, disarmament, and reintegration process; rehabilitating internally displaced people (IDP); and holding elections.

2.3 **PFM can enable a number of contributions from the public sector to broad-based economic growth, the first pillar of the PRS.** Fiscal management should create space for infrastructure (investment in new facilities and operation and maintenance of existing ones), thus addressing a key constraint to economic growth (chapter 1). Expenditures in the agriculture sector are important for rural development (chapter 7). Good PFM also contributes to macroeconomic stability, which is important for economic growth (box 8.1). Although this may be obvious to Nepal, which has a history of fiscal discipline, international experience demonstrates the importance of sound fiscal management for macroeconomic stability—itself an enabler of peace and development. This in particular requires PFM systems to promote fiscal sustainability. In addition, appropriate oversight of fiscal risks will contribute to the health of the financial sector.

2.4 **The delivery of social services, the second PRS pillar, remains dependent in many ways on good PFM.** The implications for education and health in particular are discussed in chapter 4.

2.5 **The drive toward inclusion, the third PRS pillar, is closely related to PFM.** Results in this area do not depend only on targeting of programs. Equally important is the good management of general-purpose programs, such as in health and education. The distributional impact of these programs is reviewed in this report. Revenue collection also is not distribution-neutral.

2.6 **Good governance, the fourth PRS pillar, critically relies on good PFM performance.** Budgets bring focus and prioritization to government's work. They are a good way to introduce a measurement system, and thus support accountability. Sound and fair taxation is also an important element of the compact between the state and its citizens. Comprehensiveness and transparency of the budget, solid financial controls, and procurement systems are all important for the legitimacy of the GoN. If the procurement system is too complex, there is limited participation, in particular from Nepali contractors, and contracts end up being more expensive. On the other hand, if the procurement system does not ensure adequate competition and sound technical review, there is a risk that opportunities for higher quality standards and lower prices stemming from competition will be missed. Good reporting, accounting, and external auditing are also building blocks of accountability. PFM systems are also a critical factor in enabling local governments to perform their tasks with effectiveness and accountability. Performance management in the bureaucracy is intertwined with performance in PFM: government cannot perform if its budget does not (box 9.2; Schick 2003).

2.7 **The budget is a political instrument, a critical factor in the political process under way in Nepal.** It is important to the relationship between Nepali civil society and the Nepali government, as well as to relations within government, between the partners of the political coalition. Failure to generate information on development results, on contract awards, on financial accounts, or on audits contributes to suspicion and lack of trust between the government and its citizens. A mismatch between the government's capacity and its policy decisions can also weaken the legitimacy of the government.

2.8 **Finally, the budget is a critical tool for aid coordination** (chapter 9). Managing aid through the budget allows for a more strategic approach to resource allocation, a comprehensive monitoring framework, and a clear set of accountability relationships.

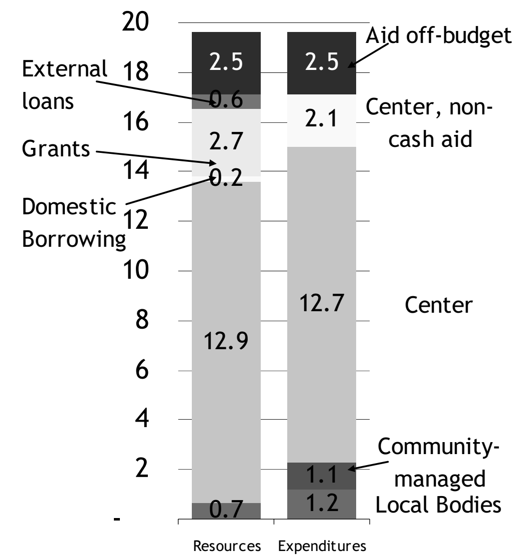
B. Key Fiscal Trends

Fiscal Structure

2.9 **The fiscal structure in Nepal is mainly organized around the central government.** In particular, the central government collects 95 percent of all domestic revenues. On the expenditure side, the ratio is just slightly lower, at 93 percent, but a significant portion of the center's share is spent through local departments and communities (7 percent), while 13 percent is non-cash donor assistance (direct payments and in-kind assistance). Besides central and local governments, the fiscal structure includes a large number of extrabudgetary activities for which no comprehensive data are available. Some indications suggest these could account for as much as 5–6 percent of GDP (para. 2.28) .But there are no clear data, and the amount that is additional to government expenditures is unclear; indeed parts of this amount are simply transferred from the central government budget.

2.10 **Another key feature of Nepal's fiscal structure is the reliance on external assistance.** For the central government, aid accounts for 20 percent of all resources, of which only a third is cash aid. With domestic revenues only slightly higher than recurrent expenditures, this implies that a majority of capital expenditures are dependent on external aid. In addition, some aid does not flow through GoN systems but is spent directly by donors through direct contracting with the private sector or local communities and sometimes local bodies as well; it is similar in amount to the aid flowing through GoN systems.[2]

Figure 2.1: Fiscal Structure (% GDP in 2004/05)



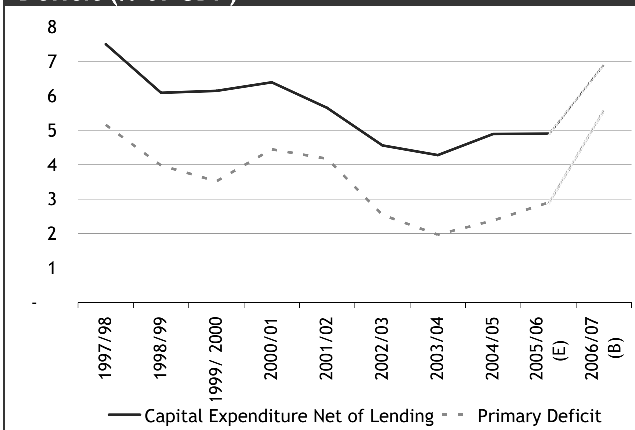
Sources: GoN; OECD/DAC; staff estimates.

2.11 **Compared to other countries, Nepal has a relatively small public sector** (annex A Table A.4). With one civilian central government employee for every 100 Nepalis, the civil service is not large. Domestic revenues are in the average range for low-income countries, while domestic borrowing is at the low end of this range. Aid per capita, at US$16, is above the regional average but below the average of a large sample of countries. Revenues and expenditures of local bodies are small for a country that has adopted decentralization as its policy.

Trends

2.12 **The main fiscal trends over the last decade are a parallel decline in capital expenditures and reduction in the primary deficit until 2003/04** (figure 2.2).[3] The causality between these two trends is unclear. While a conservative fiscal stance, driving the contraction in the primary deficit, may have weakened public investment, several other bottlenecks have slowed down public investment, hence reducing the deficit (box 2.1). Both trends have been somewhat reversed since 2004/05.

Figure 2.2: Capital Expenditures and Primary Deficit (% of GDP)



Sources: GoN; staff estimates.

Note: The primary deficit is calculated as expenditures net of interest minus revenues.

2.13 **The wage bill, a key driver of current expenditures, remains under control.** At 6.4 percent of GDP, it is not very high compared to regional and international comparators, although it has increased recently because of spending pressures in the security sector. Employment in the civil service has

[2] Off-budget assistance is calculated as the residual between total external assistance to Nepal (source: OECD/DAC) and assistance flowing through the budget (source: GoN).

[3] This section covers trends by economic classification, with trends across sectors reviewed in chapter 3.

remained more or less stable in recent years. The growth of headcount in the core civil service has averaged 1.1 percent per year since 1999, in part the result of recent efforts at "right-sizing" in which 7,000 positions were eliminated. On average, civil service wages are equivalent to 4.6 times GDP per capita, a level similar to many other countries. The GoN has recently introduced a partial indexation of salaries on inflation, which could cost around Rs. 1.5 billion per year. In addition, civil servants benefit from a pension scheme (see below), making the compensation package relatively attractive on average. However, the salary scale is very compressed, making it difficult to attract, retain, and motivate civil servants. These two facts—average salary level and high compression—are especially problematic for professionals, for whom the compensation package is likely to be unattractive compared to what is offered by the private sector. The composition of the civil service itself is skewed heavily in favor of lower tiers: the ratio of professional and technical staff (the gazetted category) to nonprofessional or support staff (the non-gazetted and classless category) is 1 to 13.

Table 2.1: Fiscal Trends

	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 (E)	2006/07 (B)
CENTRAL GOVERNMENT										
Total Revenue (GoN)	*10.9*	*10.8*	*11.2*	*12.4*	*12.4*	*12.3*	*12.5*	*13.1*	*12.0*	*13.3*
Total Revenue and Grants	**12.3**	**11.4**	**12.2**	**13.5**	**13.5**	**14.5**	**14.4**	**15.6**	**14.5**	**16.8**
Total Revenue	**10.5**	**10.2**	**10.7**	**11.9**	**11.9**	**12.0**	**12.2**	**12.9**	**12.2**	**13.1**
Tax Revenue	8.6	8.4	8.7	9.5	9.3	9.3	9.7	10.1	10.2	10.9
Non Tax Revenue	1.8	1.7	1.9	2.3	2.6	2.5	2.4	2.7	2.2	1.9
Grants	**1.8**	**1.3**	**1.5**	**1.6**	**1.6**	**2.5**	**2.3**	**2.7**	**2.3**	**3.7**
Total Expenditure (GoN)	*18.6*	*17.4*	*17.4*	*19.4*	*19.5*	*18.4*	*18.0*	*19.2*	*19.2*	*22.4*
Total Expenditures (Net of lending)	**16.9**	**15.3**	**15.5**	**17.5**	**17.5**	**16.0**	**15.5**	**16.5**	**16.4**	**19.9**
Current expenditure	9.2	9.4	9.6	11.2	11.5	11.4	11.2	11.6	11.5	13.0
Capital Expenditure Net of Lending	7.5	6.1	6.1	6.4	5.6	4.6	4.3	4.9	4.9	6.9
Deficit Before Grants	**6.4**	**5.2**	**4.8**	**5.6**	**5.5**	**4.0**	**3.3**	**3.5**	**4.2**	**6.7**
Deficit After Grants	**4.6**	**3.9**	**3.3**	**3.9**	**4.0**	**1.5**	**1.0**	**0.8**	**1.8**	**3.1**
Primary Deficit	5.2	4.0	3.5	4.4	4.2	2.5	2.0	2.4	2.9	5.5
Financing (net)	**4.6**	**3.9**	**3.3**	**4.5**	**4.0**	**1.5**	**1.0**	**0.8**	**1.8**	**3.1**
Domestic Financing	1.9	1.4	1.1	2.7	2.5	1.7	0.6	0.2	1.5	1.6
Financing from Abroad	2.8	2.5	2.1	1.8	1.5	(0.2)	0.4	0.6	0.3	1.5
Total Public Debt	66.6	68.4	62.8	61.6	67.9	67.2	65.4	59.5	56.7	54.7
LOCAL GOVERNMENT										
Revenues					1.5	1.3	1.3	1.3		
Expenditures					1.3	1.1	1.1	1.2		
CONSOLIDATED GOVERNMENT										
Revenues					12.9	12.8	12.9	13.7		
Expenditures					18.3	16.6	16.0	17.2		
AID										
Total (from donor reporting)	8.3	7.4	6.8	6.9	6.8	6.9	6.7	5.8		
On budget (grants and loans)	4.5	3.8	3.6	3.5	3.1	2.3	2.6	3.3		
Off budget (as residual)	3.7	3.6	3.1	3.4	3.7	4.7	4.1	2.5		

Sources: GoN; IMF; OECD/DAC; staff estimates.

2.14 *Government's expenditures on pensions* have increased above 0.5 percent of GDP, and government also contributes 10 percent of basic wages to the Employee Provident Fund. Nevertheless, with the existing "defined benefit" scheme, there are large unfunded pension liabilities amounting to roughly 14 percent of GDP, excluding military and police. A new "defined-contribution" scheme was introduced in 2005 but has not yet been implemented. However, this new scheme would not reduce preexisting unfunded liabilities, which would require a change in the parameter of the existing scheme (e.g., indexation of pensions on prices instead of wages).

2.15 *Non-salary current expenditures* (45 percent of current expenditures) include a low 15 percent of current expenditures for office and service operations and maintenance and a high 30 percent of current expenditures for grants and subsidies. The latter go mostly to nonprofit institutions, including community-managed schools, but also to public enterprises, local government, and social security. Interest payments remain low, at 1–1.5 percent of GDP (or around 10 percent of revenues).

2.16 As noted above, the fall in *capital expenditures*, from more than 7 percent of GDP at the beginning of the Ninth Plan to less than 5 percent during most of the Tenth Plan, is a key feature of the recent fiscal history of Nepal (figure 2.2).[4] Even though this has been somewhat offset by an increase in private investment since 2000, it has a negative impact on Nepal's growth potential (chapter 1). There are multiple specific bottlenecks behind this decrease and the most effective sequence for removing them remains subject to debate (box 2.1).

Box 2.1: What Is Constraining Public Investment?

Several factors are related to the decline in capital expenditures:

- PFM processes are not always supportive. First, the prioritization process has been weakened over time (chapter 9). Second, the budget is approved on July 15, but with projects that are not always ready for implementation. Given the time needed to finalize planning, authorize allocations, procure goods, works, and services, and initiate the work — with delays compounded by the monsoon, the festival season, and then the winter — work often starts late in the year. In addition, unrealistic budgets have blurred the attention to too many projects with inadequate funding, although this has much improved since the introduction of the Medium-Term Expenditure Framework in 2002. As a result, while budgets have systematically sought to redress the decline in capital expenditures, actual implementation has consistently been lower for capital than for current expenditures (figure 9.1).
- Absorptive or implementation capacity remains weak, a bottleneck due to the human capacity of the bureaucracy, complex processes, and weak accountability.
- Financing constraints have also been important, either because donor funding comes late in the year (or is uncertain) or because necessary counterpart funds are in short supply. The systematic overestimation of foreign assistance in the budgets is a cause and symptom of these constraints (figure 9.1).
- Security constraints have also reduced the capacity to implement projects in some areas and have increased the implementation costs in other areas.

The causality between these various factors and capital expenditure, however, remains uncertain. For example, are shortfalls in donor funding the cause or consequence of capital budget shortfalls? For instance, delays in the Middle Marsyangdi power project and in the Melamchi drinking water project have been due to a combination of technical design, security, financing, and political issues.

2.17 **While expenditures were fluctuating around 16 percent of GDP, domestic resources—tax, non-tax, and borrowing—have been fluctuating around 13 percent of GDP.** This stability in mobilizing domestic resources, however, masks the fact that an increase in tax and non-tax revenues (from 10.5 percent of GDP at the beginning of the Ninth Plan to 13 percent in recent years) has offset a decrease in domestic borrowing. Tax revenues have increased in line with GDP, even slightly faster in recent years (the "buoyancy" is slightly above 1). Only major tax reforms have managed to generate a jump in revenue collection, notably the introduction of a value added tax in 1997 (and its subsequent rate increases) and the income tax reform in 2002. This has led to an increase in the share of taxes on goods and services and of taxes on income and profits. Another important development is the gradual decrease in customs duties, due to trade liberalization.[5] Recent measures, in January and July 2006, have led to some increase in the tax base, including through reinforced enforcement of tax collection, coupled

[4] In addition, capital expenditures include both the acquisition of new assets and capital grants to state-owned enterprises and local bodies. Acquisition of fixed assets has decreased from 5.5 percent of GDP in 1996/97 to 2.4 percent in 2004/05.

[5] Actual import duty collections declined as a share of imports from 8–9 percent around 2000 to 7–8 percent in recent years (one of the lowest ratios in the region), but they remained at about 2.7 percent of GDP due to higher import levels.

with various changes in import duty rates. It is too early to assess the financial impact of these reforms. Non-tax revenues have been growing rapidly, mainly a reflection of ad-hoc transfers from public enterprises: they accounted for more than 20 percent of total revenues in 2002–5, more than in most other countries (even if Nepal does not have large underground resources, typically a large source of royalties). Finally, as discussed above, the decline in domestic borrowing is the result of both a deliberate effort toward such reduction and difficulties in implementing the capital budget.

2.18 **External assistance to the budget has shifted from loans to grants, and has somewhat declined.** While net loans were higher in the late 1990s, grants are now the predominant form of external financing to the budget. Grants declined slightly in the late 1990s but have now recovered to their highest level since the early 1980s, when they amounted to 3–3¼ percent of GDP. The decrease in net external loans is in part due to recent increase in external debt servicing from 5 percent of GDP in the mid-1990s to 10 percent in the last few years.

2.19 **This led to a reduction in the primary deficit between 1997/98 and 2003/04, from 5.2 to 2.0 percent of GDP** (figure 2.2). This brought the deficit after grants to about 1 percent of GDP, while it fluctuated around 4–5 percent per year during the Ninth Plan and was in the range of 7–9 percent around 1990.

2.20 **To summarize, fiscal outcomes have dramatically changed over the last decade** (figure 2.3). During the Ninth Plan (1997–2002), higher resources resulted from some increase in revenues and in domestic financing, offset by a decrease in external financing. This space was mainly used to increase expenditures, primarily recurrent expenditures. A different dynamic emerged between 2002 and 2005, with a successful attempt to reduce domestic financing complemented by an effort to increase revenues. However, external financing has at the same time been stable, requiring a reduction in expenditure. Given pressures on recurrent spending (notably wages, in the security sector in particular), the adjustment fell largely on capital expenditures.

2.21 **These trends have been somewhat reversed since 2005.** In 2005/06, mobilization of resources (both domestic and external) was poorer, while expenditure pressures continued to increase, notably for the security sector. This has led to a large increase in domestic borrowing. For 2006/07, ambitious targets to mobilize external assistance (plus modest increases in domestic revenue mobilization and domestic borrowing) are set to create fiscal space for a significant increase in expenditures, notably capital expenditures. However, by the middle of the fiscal year, while revenue growth was solid, projections of foreign assistance and capital expenditures were revised downward and recurrent expenditures upward. [6]

[6] The budget for recurrent costs was increased from Rs. 83.8 billion to Rs. 88.1 billion to reflect the cost of distributing citizenship, managing Maoist camps, election activities, and so on.

Figure 2.3: Key Fiscal Outcomes (change in % of GDP)

Sources: GoN; staff estimates.
Note: External financing includes grants and net financing from abroad.

Fiscal Risks

2.22 While the fiscal policy appears disciplined, the fiscal framework faces a number of risks. These risks are either explicit or implicit, and either direct or indirect (table 2.2).

2.23 **The main fiscal risk is related to the level of debt.** Nepal's public debt is mainly (about 70 percent) external—and the external debt is almost exclusively on concessional terms and to multilateral institutions. Somewhat surprisingly, given the large fiscal deficit throughout the 1990s, the debt-to-GDP ratio remained constant between 1990/91 (64.9 percent) and 2003/04 (65.4 percent) and even declined in 2004/05 (table 2.3). There are indeed mechanical factors that inflated the denominator: (a) a growth effect, accounting on average for an annual 2.4 percent reduction in the ratio; (b) a real interest rate effect (0.3 percent); and (c) an exchange rate appreciation effect (0.2 percent). In fact, after accounting for the deficit and mechanical factors, the debt ratio should have declined 2.1 percent per year, more than the actual 0.7 percent decline. The residual is likely to be the result of other liabilities, such as off-budget funds and public undertakings in the financial and non-financial sectors, as well as the residual multiplicative of the effects discussed above. In other words, without these "hidden deficits," the debt-to-GDP ratio would have decreased significantly.

Table 2.2: Main Fiscal Risks

	Direct liabilities (obligation in any event)	**Contingent liabilities** (obligation if a particular event occurs)
Explicit Government liability as recognized by a law or contract	Public debt: around 50–60% of GDP Nondiscretionary component of government expenditure (e.g., wage bill, 6% of GDP) Arrears: small (but measurement problems, see PFM indicator 4)	No direct guarantee since early 2000s No state insurance scheme
Implicit A moral obligation of government that reflects public and interest group pressures	Unfunded pension liabilities: 14% of GDP (excluding military and police) New insurance scheme for civil servants Future recurrent costs of public investment projects	Contingent liabilities from state-owned enterprises (accumulated losses, arrears, etc.): 1–15% of GDP depending on valuation of their assets Off-budget funds: possibly 5% of GDP plus 2.5% of GDP for external aid Default of subnational governments (borrowing limited to municipalities): limited (but unmonitored) risk Banking failure Failure of a nonguaranteed funds such as Provident Fund Cost of post-conflict agenda and public expectations

Sources: GoN; staff estimates; Polackova 1998.

2.24 **Since 2004, the debt-to-GDP ratio has started to decrease.** This mainly reflects the reduction in the primary deficit discussed above. In addition, the Nepali rupee has slightly appreciated over recent years, eroding the value of the external debt.

Table 2.3: Debt Dynamics

	1995/96	2004/05
Public sector debt (% GDP)	66.4	59.5
Of which: foreign-currency denominated	52.9	43.4
1995-2005 average annual change in public debt (% GDP)		
1. Total (2)+(5)		(0.7)
2. Identified debt creating flows (3)+(4)		(2.1)
3. Primary deficit		2.1
4. Automatic debt dynamics		(4.2)
Contribution from interest rate/growth differential		(4.0)
Of which: contribution from average real interest rate		(0.3)
Of which: contribution from real GDP growth		(2.4)
Contribution from real exchange rate depreciation		(0.2)
5. Residual		1.4
1995-2005 average interest rates (%)		
Nominal, on public debt		2.2
Nominal, on foreign debt		1.1
Nominal on domestic debt		6.1
Real		(0.5)

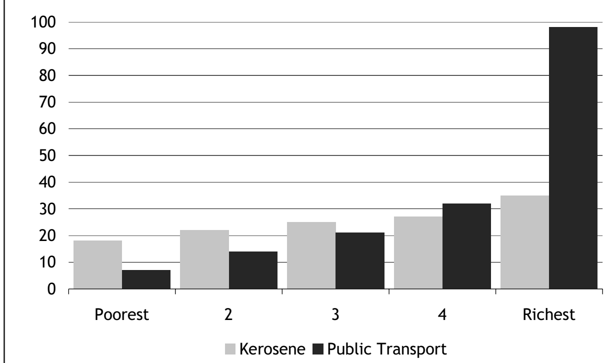
Sources: GoN; IMF; staff estimates.

2.25 **Looking forward, a debt sustainability analysis highlights a "high risk of debt distress."** A framework developed by the International Monetary Fund (IMF) and the World Bank calls for reviewing debt levels under various scenarios, including "stress tests" under which extreme values of certain parameters are tested. This analysis suggests that Nepal's debt dynamics are subject to a "high risk of debt distress." This reflects a combination of factors, including uncertain growth prospects, weak export income, fiscal risks caused by large contingent liabilities, and weak institutions.[7]

2.26 **Unfunded pension liabilities are another fiscal risk.** The liability of 14 percent of GDP (excluding military and police) is not higher than pension liabilities in other countries in the region; the figures are 25 percent and 33 percent in Pakistan and India respectively, both including police but excluding military. However, it represents a significant liability with respect to Nepal's revenue mobilization.

[7] A simpler analysis of sustainability consists of assessing the primary deficit that would allow government to stabilize its debt-to-GDP ratio (say at the 2004/05 level, around 60 percent). This primary deficit depends on the growth rate and the interest rate on debt because the value of future primary surpluses must be at least equal to the face value of current debt. This suggests that to finance the primary deficit planned for 2006/07 (5.5 percent of GDP) without increasing the debt-to-GDP ratio, Nepal would have to accelerate growth toward 7 percent and keep real interest rates around 1 percent. At the current low growth level of 3 percent or less, with a real interest around 1 percent, a primary deficit of 2.6 percent would be needed to stabilize the ratio.

Figure 2.4: Petroleum Product Subsidies (Rs./month/household)



Source: Staff estimates based on NLSS II.

Note: Prices in 2003/04 are Rs. 27 per liter of kerosene from the community price survey results and Rs. 31 per liter of diesel, the official price after May 8, 2003. The subsidy is calculated based on a price of Rs. 38 per liter of kerosene and Rs. 45 per liter of diesel. The forecasts for public transport represent an upper bound as they assume that all public transport vehicles run on diesel, the fare covers only the vehicle operating cost, and 20 percent of the vehicle operating cost is the fuel cost.

2.27 **Another type of fiscal risk is related to state-owned enterprises (SOE).** Some modest progress has been made with SOE restructuring. But overall, the financial flows from government to SOEs as a group remain large, at around Rs. 2 billion per year. With the exception of the Nepal Telecommunication Corporation and the National Insurance Corporation, most SOEs make losses. The Nepal Oil Corporation has large liabilities due to the subsidized prices of petroleum products: while monthly losses went down to around Rs. 50 million in 2007, accumulated losses amount to some Rs. 14 billion. The subsidies in this SOE highlight that such liability typically has a pro-rich bias (figure 2.4). The Nepal Electricity Authority, which was still making profits until 2002, has now turned to losses of several billion rupees per year. The Nepal Airlines Corporation also has large accumulated losses. For these SOEs, contingent liabilities could range from Rs. 8 billion, if assets of the loss-making SOEs were realized at their book value, to Rs. 82 billion, if selling these assets generated no proceeds (ADB 2006). This is equivalent to 1 to 15 percent of GDP. In addition, in the financial sector, large state-owned banks reverted to operating profits, even though they keep a large negative net worth (more than Rs. 22 billion for the Nepal Bank Limited and Rastriya Banijya Bank together. Despite important capital injections, the financial situation of these banks remains fragile (World Bank 2007b).

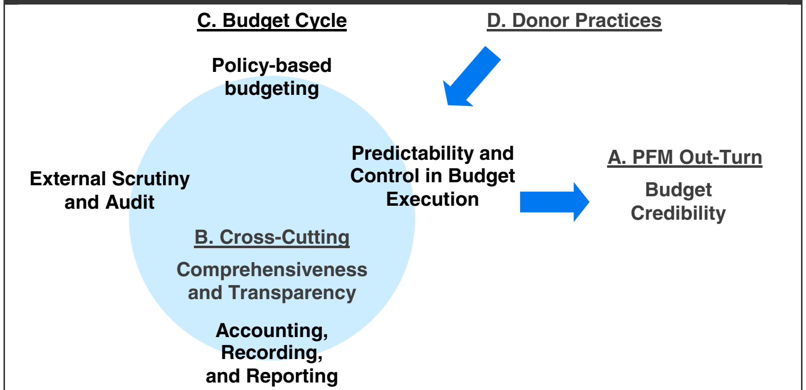
2.28 **Other fiscal risks result from significant off-budget activities.** These activities also have institutional implications for budgeting and accountability, which are discussed in chapter 9. The main source is probably external assistance: for every dollar on budget, another dollar is off budget (figure 2.1), leading to almost half of aid flows, or 2.5 percent of GDP, being off budget. In addition, there are a number of extrabudgetary funds such as development funds and boards, as well as universities, possibly accounting for some 3–4 percent of GDP.[8] Also extrabudgetary, the Army Welfare Fund, to which the United Nations channels revenues for the service of Nepali military personnel, accounts for 1.5–2 percent of GDP, with parts of its assets at risk. The Policy Welfare Fund similarly channels revenues from the rent of government property.

2.29 **Finally, fiscal activities of local bodies are poorly monitored** (chapter 11). Local bodies do not create a substantial fiscal risk at this time: expenditures amount to about 1 percent of GDP (table 2.1), and borrowing is hardly used. But a move toward decentralization—including through federalism—could create substantial fiscal risks if not properly monitored.

[8] No specific data are available. However, the 2006 Auditor General reports auditing Rs. 41 billion worth of transactions for committees and other institutions: this amount (7.6 percent of GDP) includes both revenues and expenditures for these entities, hence the assumption of around 3–4 percent of GDP in terms of expenditures. The same report refers to some 767 audited entities, including 75 DDCs, 33 SOEs (including banks), 68 committees under the Development Committee Act 2013, 27 committees under the Work Operation Fund Act 2043, and 244 committees under the Education, Sports, and University Act.

C. Assessment of Public Finance Management Performance

Figure 2.5: Linkages among the Six Core Dimensions of PFM Performance



Source: PEFA 2005.

2.30 **Assessing the performance of the PFM system provides a basis for evaluating progress and identifying areas of weakness for priority actions.** A PFM performance rating system has been developed recently by the Public Expenditure and Financial Accountability (PEFA) multi-agency partnership program. It is intended to provide an objective, internationally comparable framework for assessing the performance of a country's PFM system (PEFA 2005).[9] The assessment for Nepal is presented in table 2.4 and further discussed in chapters 9 and 10

2.31 **The assessment of Nepal's performance in PFM suggests a system that is generally well designed but unevenly implemented.** In recent years the budget has become a policy tool that is largely credible and clearly linked to policies in some sectors, with a solid control of aggregate outturns and a reasonable control framework at the transaction level (notably for payroll). However, there are gaps in the control framework, constraints on implementation, and large fiscal activities outside the scope of the central government budget. These weaknesses in part reflect the weak demand from both government and external stakeholders for better budget information (financial and physical) and better management.

2.32 *Credibility of the budget*. The budget is credible at the aggregate level for revenues and recurrent expenditures. However, the capital expenditure chronically falls short of budgeted amount (box 2.1). In addition, the credibility of the budget is undermined by significant deviations in terms of expenditure composition—in part due to shortfalls in capital spending—and large fiscal activities outside the budget (see previous section).

2.33 *Comprehensiveness and transparency*. The budget is based on a solid classification system, in need of minor improvements, and is transparently published. The GoN in recent years has made good efforts to improve the coverage of the budget with reports on a "consolidated fund" and monitoring of some fiscal risks, notably the situation of public enterprises. However, a

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[9]. See the PEFA Web site at www.pefa.org. The PFM system and the PEFA indicators do not attempt to measure fiscal outcomes, the substantive appropriateness of public expenditure policies and decisions, or the actual impacts and value for money achieved through public expenditures. The PFM system instead should be seen as a crucial enabler for achieving broader development goals and substantive outcomes, including in the public finance sphere, which depend on sound government strategies, policies, and institutions. PEFA has identified six critical dimensions of a well-functioning PFM system. Four of these comprise important parts of the budget cycle: policy-based budgeting; predictability and control in budget execution; accounting, recording, and reporting; and external scrutiny and audit (figure 2.5). Another relates to key cross-cutting features of the budget process, that is, comprehensiveness and transparency, and the last covers outturns of the PFM system, namely the credibility of the budget. Figure 2.5 also signals that, given the importance of donors in providing financial support to many developing countries, donor practices have a significant impact on the performance of the PFM system. In order to operationalize the PFM performance assessment framework, 28 high-level PFM performance indicators have been developed, each of them measuring performance in one of the six critical dimensions. Three additional indicators of donor performance have also been developed.

significant—and possibly growing—gap comes from fiscal activities of (a) many development funds and boards and (b) local-level governments (covered by annual audit reports but not by the budget itself or any other public report). In addition, transparency could be improved, especially to systematize the reporting on past achievements and make reports more analytical.

2.34 *Policy-based budgeting*. Significant progress has been made toward a sound policy-based budget system with the roll-out of the Medium-Term Expenditure Framework throughout the budget and the creation of "business plans" for several sectors. Gaps include (a) lack of engagement of the political leadership in the MTEF and budget preparation, (b) inadequate engagement or understanding of the MTEF by civil servants at the middle level and below, (c) insufficient focus on past achievements and monitoring of outputs, and (d) residual focus on fragmented projects as opposed to programs structured around sector strategies or "business plans" (chapter 9).

2.35 *Predictability and control in budget execution*. Predictability in budget execution has been significantly improved by guaranteeing cash releases to high-priority "P1" projects, contingent on satisfactory implementation. Payroll controls are also well developed. Procurement has positive features, with some gaps (complaint mechanism and monitoring system, for example) to be addressed by the new law; however, the use of less-competitive procurement methods is often not adequately justified. A basic control framework for non-salary expenditures that includes physical verification is in place, but is unevenly implemented. There is no commitment control. Internal audit focuses on pre-audit of transactions, with no system reviews. Service delivery units receive information about budget releases, but there is little monitoring at this level of actual expenditures and outputs. On the revenue side, much progress remains to be made toward better accounting of revenues and services to taxpayers.

2.36 *Accounting, recording, and reporting*. Current cash-based accounting practices are generally well established and accounts are frequently reconciled (with the exception of the revenue accounts). However, incomplete computerization weakens the timeliness and quality of accounting. In addition, there are gaps between accounting policies and international standards, with no official public sector accounting standards. Annual reporting and financial statements are timely and of acceptable quality, although with some gaps in the content. Within-year reporting is weak and not public.

2.37 *External scrutiny and audit*. Annual financial statements are audited by an independent Auditor General in a timely manner and are discussed by a Public Accounts Committee (although the reality was weaker in recent years given the political situation). However, annual audit reports and external scrutiny focus more on catching "irregularities" than on identifying and correcting systemic issues, and there is little evidence of follow-up to clear any irregularities identified by the Auditor General. External scrutiny is also weakened by a long political uncertainty, a lack of public access to information (including accounts of local-level governments and contracts), and weak process to induce the legislature to discuss the MTEF and scrutinize the annual budget.

Table 2.4: PFM Performance Assessment

A. PFM outturns: Credibility of the budget		Result	A B C D
PI-1	Aggregate expenditure outturn compared to original approved budget	B	
PI-2	Composition of expenditure outturn compared to original approved budget	C	
PI-3	Aggregate revenue outturn compared to original approved budget	A	
PI-4	Stock and monitoring of expenditure payment arrears	D+	
B. Key cross-cutting Issues: Comprehensiveness and transparency			
PI-5	Classification of the budget	C	
PI-6	Comprehensiveness of information included in budget documentation	B	
PI-7	Extent of unreported government operations	B	
PI-8	Transparency of intergovernmental fiscal relations	C	
PI-9	Oversight of aggregate fiscal risk from other public sector entities	D+	
PI-10	Public access to key fiscal information	B	
C. Budget cycle			
	C(i) Policy-based budgeting		
PI-11	Orderliness and participation in the annual budget process	C+	
PI-12	Multi-year perspective in fiscal planning, expenditure policy, and budgeting	C+	
	C(ii) Predictability and control in budget execution		
PI-13	Transparency of taxpayer obligations and liabilities	C+	
PI-14	Effectiveness of measures for taxpayer registration and tax assessment	C	
PI-15	Effectiveness in collection of tax payments	D+	
PI-16	Predictability in the availability of funds for commitment of expenditures	C+	
PI-17	Recording and management of cash balances, debt, and guarantees	C+	
PI-18	Effectiveness of payroll controls	C+	
PI-19	Competition, value for money and controls in procurement	C	
PI-20	Effectiveness of internal controls for non-salary expenditure	C	
PI-21	Effectiveness of internal audit	D+	
	C(iii) Accounting, recording and reporting		
PI-22	Timeliness and regularity of accounts reconciliation	C+	
PI-23	Availability of information on resources received by service delivery units	C	
PI-24	Quality and timeliness of in-year budget reports	C+	
PI-25	Quality and timeliness of annual financial statements	C+	
	C(iv) External scrutiny and audit		
PI-26	Scope, nature, and follow-up of external audit	D+	
PI-27	Legislative scrutiny of the annual budget law	D+	
PI-28	Legislative scrutiny of external audit reports	D+	
D. Donor practices			
D-1	Predictability of direct budget support	D	
D-2	Financial information provided by donors for budgeting and reporting on project and program aid	D	
D-3	Proportion of aid that is managed by use of national procedures	D	

Source: GoN assessment.

Note: Ratings are subject to revisions as the GoN finalizes its assessment and discusses it with its development partners.

2.38 *Donor practices*. Despite progress in recent years toward general and sector-specific budget support, much remains to be done to meet the principles of Nepal's 2002 Foreign Aid Policy (and the Paris Declaration). In particular, the quality of financial information provided by donors is weak, and the proportion of aid that uses national procedures is far below 50 percent (source: PEFA assessment).

2.39 What are the implications of this performance for key fiscal outcomes? As discussed above, **the performance in terms of fiscal discipline is generally positive, but it is threatened by four main weaknesses.** First, lack of monitoring of fiscal risks, including those related to donor funding, is creating significant uncertainties. Second, poor capital budget preparation and implementation weakens the GoN's capacity to make the best use of existing fiscal space. Third, weak sector strategies prevent the GoN from managing medium-term fiscal space. And fourth, weak reconciliation of revenue accounts reduces available resources.

2.40 **Similarly, the progress in strategic allocation of resources—through the MTEF, business plans, and prioritization of projects for cash management—has somewhat realigned resources but falls short of its promises.** This is the result of (a) weak capital budget preparation and implementation; (b) insufficient reporting systems (in-year financial data and monitoring of outputs); and (c) large amounts of spending outside mainstream reporting systems (dedicated funds and boards, donor-funded projects, etc.). It is compounded by insufficient engagement on the part of the political leadership and weak external scrutiny of the strategic allocation across sectors.

2.41 **The efficiency of delivering services has improved, notably through more predictable cash releases and some devolution of resources.** However, it is hampered by several factors, including lack of procurement plans and non-observance of competitive tendering; narrow focus of internal audit on transactions and external audit on "irregularities," as opposed to systemic improvements; and major gaps in monitoring systems. These factors lead to an ineffective bunching of expenditures toward the end of the fiscal year.

2.42 **Finally, progress has been made toward a transparent and accountable management of public finance.** However, critical gaps remain, including coverage of fiscal reports, within-year reporting, access to information on taxpayer liabilities and procurement activities, quality of external audit report, and engagement of the legislature.

3. Allocation of Public Expenditures

Key Messages

- An emphasis on poverty reduction — and support by donors through "sectorwide approaches" — has translated into increasing budget expenditures and outputs in the health and education sectors. Other important sectors, such as agriculture and infrastructure, have been less favored, despite their role in poverty reduction.
- The geographic distribution of public expenditures highlights important disparities, which are largely accounted for by issues of accessibility, population density, and topography. There is no evidence that expenditures are targeted at poorer districts.
- Moving forward, a review of needs demonstrates the importance of making choices based on prioritization and realistic assessment of implementation capacity.

3.1 This chapter reviews the allocation of expenditures, its recent trends, and prospects. Section A opens with a review of budget allocations across and within sectors, focusing particularly on what can be considered as pro-poor expenditure. Section B reviews budget allocations across districts. Section C assesses what needs to be done, based on Nepal's development strategy (chapter 1), and emphasizes the importance of making choices.

A. Structure of Public Expenditures by Sector

3.2 **Some progress has been made toward a better allocation of expenditures** (table 3.1). A 2001 Public Expenditure Review identified considerable misallocations and inefficiencies (World Bank 2001). The preparation of the Tenth Plan combined with progress in budget preparation and management (chapters 9 and 10) has contributed to a more satisfactory allocation.

- A positive outcome was the rebound in *social sectors*, now accounting for a third of all expenditures. This increase is mainly driven by the education sector, while health expenditures have stayed constant as a share of GDP and other social services have somewhat decreased. These achievements have a lot to do with the implementation of SWAps in health and education (box 9.3). Estimates for 2005/06 suggest a further increase in social sector spending. As discussed in chapters 4 and 5, private expenditures have been increasing as well, leading to a very significant expansion of resources in these sectors.
- At the same time, expenditures on two key *economic sectors*—agriculture (including irrigation and forestry) and infrastructure—declined sharply, and now account for just a quarter of all expenditures.[10] This decrease in part reflects three factors: (a) completion of several large infrastructure projects in the early 2000s, with a weak portfolio going forward; (b)

[10] This decline is in fact slightly less marked if grants to DDCs (Rs. 4 billion), which are classified as "social services," are reclassified as "economic services." Indeed, as reviewed in chapter 6, these grants go in large part to finance local roads.

termination of ineffective subsidies for fertilizer in agriculture and for shallow tube wells in irrigation (chapter 7); and (c) high dependence on external assistance (figure 3.1), which has been declining for this sector – infrastructure- in recent years.[11] As in education and health, the decrease in agriculture has been offset by an increase in household expenditures.

- An important feature has been the gradual growth of spending controlled by *communities*, from hardly 0.1 percent of GDP to more than 1 percent of GDP. This is in line with the Tenth Plan. Box 3.1 highlights two successful community-based programs.

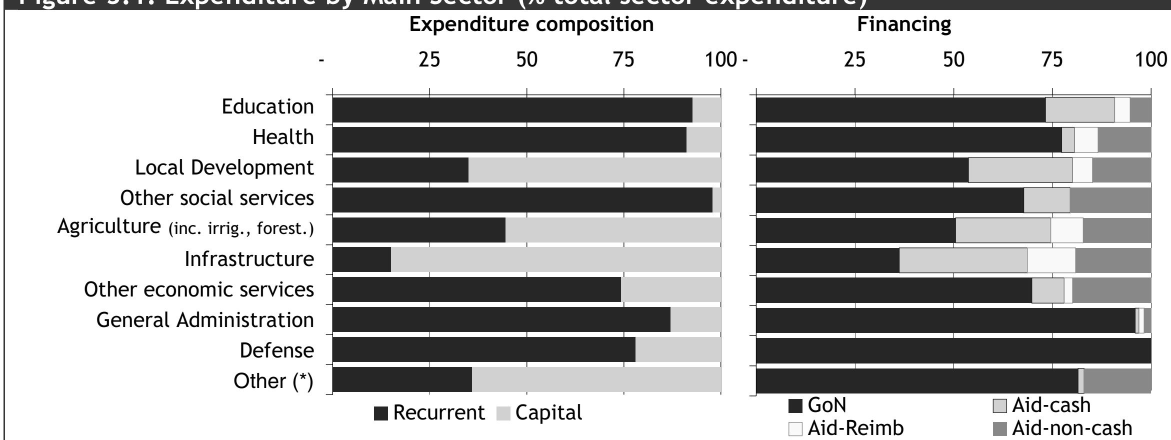
Table 3.1: Sectoral Trends

	9th Plan					10th Plan					Structure
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 (E)	2006/07 (B)	2004/05 % total
Social Services	**5.9**	**5.3**	**5.6**	**5.7**	**5.8**	**5.6**	**5.5**	**5.9**	**6.3**	**8.1**	**37.5**
Education	2.6	2.2	2.4	2.7	3.1	2.9	2.9	3.2	3.3	3.5	19.6
Health	1.0	0.8	0.9	0.9	0.9	0.8	0.8	0.9	1.0	1.4	6.0
Drinking Water & Sanitation	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.4	0.5	1.0	3.2
Local Development	1.2	1.1	1.1	1.1	0.9	1.1	0.9	1.0	1.0	1.5	5.9
Other Social Services	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.7	3.0
Economic Services	**6.6**	**5.8**	**5.5**	**5.8**	**4.9**	**4.1**	**4.0**	**4.3**	**4.1**	**5.2**	**24.2**
Agriculture (*)	2.0	2.0	1.9	2.1	2.0	1.4	1.4	1.4	1.4	1.7	8.5
Industry	0.2	0.2	0.3	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.5
Transportation	2.0	1.6	1.3	1.4	1.2	0.9	0.9	0.9	0.9	1.2	5.1
Communication	0.6	0.3	0.2	0.2	0.3	0.6	0.2	0.3	0.2	0.3	1.3
Power	1.6	1.4	1.5	1.7	1.0	0.9	1.0	1.4	0.9	1.3	5.6
Other Economic Services	0.3	0.3	0.4	0.3	0.2	0.2	0.4	0.3	0.5	0.7	3.1
General Administration	**1.3**	**1.4**	**1.4**	**1.8**	**2.2**	**2.0**	**1.9**	**2.0**	**2.2**	**1.8**	**13.1**
o/w Police	0.8	0.8	0.9	1.3	1.4	1.4	1.3	1.4	1.4	1.2	8.3
Defence	**0.9**	**0.9**	**0.9**	**0.9**	**1.4**	**1.6**	**1.7**	**2.1**	**2.0**	**1.6**	**11.8**
Others (**)	**2.2**	**2.2**	**2.1**	**3.3**	**2.8**	**2.6**	**2.3**	**2.1**	**2.3**	**3.1**	**13.4**
Total (***)	**16.9**	**15.4**	**15.5**	**17.5**	**17.0**	**16.0**	**15.5**	**16.5**	**16.8**	**19.9**	**100.0**
Memo											-
Infrastructure	4.1	3.3	3.0	3.3	2.5	2.3	2.1	2.5	2.0	2.8	12.0
Community-controlled funds	n/a	0.1	0.2	0.2	0.3	0.7	0.8	1.0	1.1	n/a	6.7
Pro-poor Expenditure	6.2	6.2	6.5	6.6	6.1	6.0	6.1	6.6	6.9	9.3	41.1

Sources: GoN; staff estimates.

Note: (*) Including irrigation, forestry, and land management (chapter 7). (**) Royal Palace, Constitutional bodies, interest payments, and miscellaneous. (***) Government Fiscal Statistics definition (i.e., excludes loan and principal payments).

Figure 3.1: Expenditure by Main Sector (% total sector expenditure)



Sources: GoN; staff estimates.

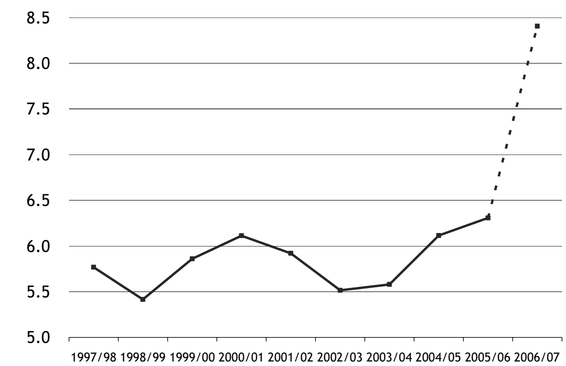
Note: Based on expenditures by ministry and agency in 2004/05. Aid includes only on-budget funds and is broken down into (a) cash (e.g., SWAps); (b) reimbursables; and (c) non-cash (e.g., direct payments).

[11] Between 1997/98 and 2005/06, the ratio of economic services to social services expenditures went down from 1.1 to 0.6 for government expenditures and from 4.9 to 0.6 for donor assistance (source: OECD/DAC).

- In parallel, as the conflict intensified, expenditures on *police and defense* gradually increased. Together with general administration, this block of expenditures accounts for almost a quarter of total expenditure.
- The budget for 2006/07 plans a sharp increase in spending and a reduction in security spending to allow a scaling up of spending in social sectors (notably in local development, with a scheme to double grants to VDCs) and a rebound in agriculture and infrastructure.

3.3 **A comparison with other countries does not highlight gross anomalies** (see annex, Table A.5), although the comparability of such expenditure is weak. Spending on education and health is similar to that in other countries, with health spending somewhat on the low side but offset by large out-of-pocket expenditures and off-budget donor funding. Spending on economic services is low in other countries as well, often at or below 2 percent of GDP. Expenditures on the security sector moved toward the high side of the distribution during the period of intense conflict.

Figure 3.2: Pro-Poor Spending (% GDP)



Sources: GoN; staff estimates.
Note: Pro-poor spending includes all rural and community-based activities.

3.4 **Within sectors, a major development is the rebound in pro-poor spending** (figure 3.2). Pro-poor spending—defined as including all rural activities and community-based activity—averaged 6.4 percent of GDP during the Tenth Plan. Fiscal year 2002, end of Ninth Plan Period. Education accounts for 44 percent of total pro poor expenditure , local development for 15 percent, health for 10 percent, agriculture and irrigation for 10 percent, electricity for 6 percent, roads for 4 percent, and drinking water and sanitation for 4 percent. Although the concept of pro-poor spending is not without problems,[12] the rebound since 2003/04 can be related to the focus on primary education in the education sector and on the package of essential health services in the health sector (at the expense of funding for higher education and hospitals respectively). In other sectors as well, some redistribution toward rural areas is expected to be pro-poor. The major increase planned for 2006/07 has to do with these same programs, plus the doubling of grants to VDCs.

B. Geographic Composition

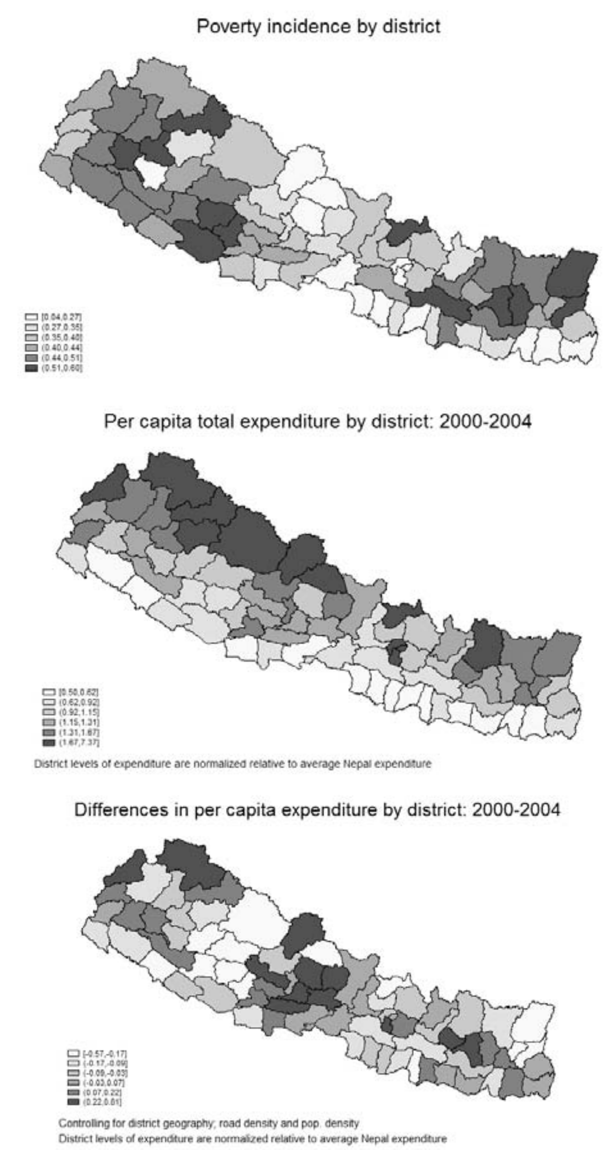
3.5 **There are important disparities across regions in Nepal.** The country is typically divided into three elevation zones, from south to north: Terai, Mountains, and Hills. There are also five development zones or regions: Far-western, Mid-western, Western, Central, and Eastern. Poverty incidence varies from 32 percent in the Terai to 36 percent in Hills and from 28 percent in Central to 46 percent in Mid-western and Far-western regions (see annex table A8**)** for poverty incidence and chapters 4 and 5 for other social indicators). Expenditure per capita

[12] While the GoN's definition of pro-poor spending is sensible, it is not feasible to draw a definitive line between pro-poor and non-pro-poor spending. On the one hand, categories included in the government's definition may not be entirely pro-poor (see, for example, benefit incidence of rural roads, chapter 6). On the other hand, categories excluded from the definition might be critical for the poor. For example, expenditures to ensure a smooth peace process might be the most important for the livelihoods of the poorest at the moment.

varies from 65 in Terai to 126 in Hills and from 84 in Eastern to 106 in Central, on an index where 100 is Nepal's average.

3.6 **Spending patterns are heavily influenced by issues of accessibility.** At first, per capita expenditure by district does not appear related to poverty incidence (figure 3.3, top two panels). The distribution of expenditures seems related instead to geography, with priority to Mountain districts first and Hill districts second. However, after taking into account accessibility and population density, the distribution is quite different (figure 3.3, bottom panel). In fact, after taking these factors into account, per capita expenditures is in some sectors appear negatively correlated with poverty incidence, with lower spending in poorer districts (see regressions in annex A. Table A.7).

Figure 3.3: Poverty Incidence and Expenditure Per Capita, by District



Sources: NLSS II; GoN; staff estimates

3.7 **However, the distribution of expenditures is improving.** Indeed, there has been some convergence in expenditure per capita across districts, with faster growth in Terai and Mountains than in Hills (see annex A Table A.7)

3.8 **This may possibly highlight the impact of recent reforms that need to be continued.** In particular, the Ministry of Local Development now allocates unconditional grants to DDCs using a weighted formula (50 percent for human development index, 20 percent for population, 10 percent for area, and 20 percent for district-wise cost index). However, these grant accounts for only a small part of grants (chapter 11). The MTEF and sector strategies might also have contributed to a realignment of expenditures. In health and education, there is scope to further improve the targeting of resources (chapters 4 and 5).

3.9 **In addition, the GoN could consider continuous monitoring and further evaluation of these patterns.** Such analysis could prove very useful as a means to document and address the claims of various parts of the country.

C. Making Choices

3.10 **Looking forward, sustaining peace through implementation of Nepal's development strategy will have large fiscal costs** (table 3.2). The immediate cost of the peace process has been evaluated by the government at Rs. 3 billion. The costs of subsequent steps of the peace process will include costs of the development strategy plus possibly a number of other programs (disarmament and reintegration of ex-combatants, cash-for-work schemes, etc). The reform of the security sector can also entail significant fiscal costs. Despite a number of methodological issues, the MDG costing exercise provides a useful reference point, estimating needs at Rs. 55 billion per year over 2005–15. Large infrastructure needs could add around Rs. 20 billion per year for roads and power. Chapters 4–7 review the expenditure implications of implementing the government's strategy in education, health, rural roads, and agriculture.

3.11 **Furthermore, as noted in chapter 2, a number of fiscal risks could create additional expenditure pressures.** The most important is the unfunded pension liability. The liability of the Nepal Oil Corporation alone amounts to Rs. 14 billion. Other structural reforms, such as a wage decompression to improve incentives in the civil service, would also have a significant cost.

Table 3.2: Fiscal Pressures and Financing (Rs. billions per year)

Possible pressures		Financing options	
Post-conflict immediate transition	3	10% increase in all revenues	7
Demobilization, reintegration	2	1 VAT point	2
IDP reintegration	1	1% GDP of domestic borrowing	6
Elections	2-3	10% increase in grants	1
Three-year Interim Plan	65	Heavily Indebted Poor Countries Initiative	4
MDG needs assessment	55		
Infrastructure:			
Roads	6	**Memo items**	
Power	12	Total health spending	6
Wage bill decompression	10	Total education spending	17-20
Pensions (over 10 years)	8	Total police and defense spending	20
Removal of local development fee			
NOC (total accumulated losses)	14	Off-budget external assistance	20

Sources: GoN, staff estimates (see Table A.6).

3.12 **Even though some increase in the resource envelope can be expected (chapter 8), significant expenditure prioritization will be needed.** Indeed, a "needs-based" approach ignores macroeconomic fundamentals (e.g., impact of such aid on macroeconomic management), implementation capacity constraints, and the possibility of alternative modalities of delivery through communities and the private sector. Prioritization is inherently a political process—but prioritization is also politically important, lest unrealistic expectations lead to disenchantment with the government given budget constraint.

3.13 **Effective prioritization will require a review of criteria.** Currently, MTEF prioritization is based on five criteria: (a) involvement in providing direct services, (b) contribution to maintaining good governance, (c) contribution to raising revenues, (d) contribution to developmental works, and (e) other contributions (human resource development, environmental conservation, regional balance). This is a good basis for future improvement, but it misses three important factors. First, does the proposal fit into a well-designed sector strategy, with adequate sequencing over time, a good definition and monitoring of results, and supporting policies? Second, implementation capacity is crucial: are there physical, technical, or managerial capacity constraints to implementing the proposal? Third, some basic analysis of cost-effectiveness must be done: for example, would alternative interventions achieve similar results at a lower cost? In addition, prioritization needs to be seen with three dimensions:

across sectors, within sectors, and across time. Prioritization over time should, in particular, suggest ways to rebuild a pipeline of large infrastructure projects.

3.14 **Effective prioritization should assess whether public expenditures are justified given limited resources.** Important reallocations have been done, for instance away from subsidies with a weak justification for public sector intervention (chapter 7). Such review could also assess the role of the public sector in, for instance, tourism, given the strong role of private businesses in this sector. Further expenditure reallocations and prioritization are discussed in chapters 4–7. Chapter 8 reviews financing options for these expenditure scenarios. Chapter 12 concludes this discussion by highlighting a few fiscal scenarios.

Box 3.1: Successful Community-Driven Programs

A number of community-driven programs in Nepal have shown considerable success in reversing the neglect of common property (the so-called tragedy of the commons), managing funds better, and getting services delivered. Two notable examples are described below, the Poverty Alleviation Fund (PAF) and the Rural Water Supply and Sanitation Fund. In addition, box 4.1 reviews the experience in education and box 7.1 in the forestry sector.

The Poverty Alleviation Fund (PAF) supports small projects to create infrastructure, employment, and income-generating opportunities in poor communities, particularly for socially excluded groups. Since 2004, the PAF has impacted over 314,000 Nepalis in six conflict-affected districts. PAF has been successful on several fronts in achieving its objective of providing direct and indirect benefits to the poorest people who have been excluded for reasons of gender (women), ethnicity (Janajatis), or caste (Dalits).

First, targeting of the disenfranchised has been quite successful. Of the PAF beneficiaries, 43 percent are Dalits and 35 percent are Janajatis, although these groups only account for 15 percent and 23 percent of the population in the targeted districts. There are also indications that PAF has been successful in avoiding elite capture.

Second, empowerment of these two groups and women is also evident in their high participation rates as members and leaders of the community-based organizations. For example in PAF, women account for one-third of chairpersons, 43 percent of secretaries, and 60 percent of treasurers of these organizations.

Third, the subprojects themselves have demonstrated evidence of high returns. Livestock purchase, the most common subproject selected by communities, is estimated to have led to sustained increases in household income of 10–12 percent, translating to a 20–25 percent rate of return. Given that informal credit markets charge 30–40 percent, these subprojects have given poor Nepalis access to highly productive investments. Anecdotal evidence suggests that infrastructure subprojects can also lead to substantial rates of return. For example, a water project in Murma, a very remote village, saved the village women several hours daily spent collecting water, time that is now devoted to farming. Based on the average agricultural wage for women, this suggests a subproject rate of return well above 70 percent. In another example in the remote district of Darchula, electricity subprojects provided households with electricity at a cost far lower than GoN standards. Moreover, they also opened the way for irrigation and increased food availability and security.

Two Rural Water Supply and Sanitation projects (RWSSP I and II) provided financing through the Rural Water Supply and Sanitation Fund Board for the improvement of water and sanitation services in participating communities. As of November 2006, the program has impacted nearly 4.7 million beneficiaries, and another 6.0 million are expected to be reached in subsequent phases.

This demand-driven approach through an inclusive, participatory process empowers communities to make informed decisions about their schemes. Community ownership is proving to yield much more sustainable water supply and sanitation services, as these services are also operated and maintained by the same communities that play the lead role in their planning, design, and implementation. Three years after installation, about 85 percent of the schemes were found to be institutionally, socially, financially, and technically sustainable. This is in stark contrast to the sustainability of traditional schemes, where 10 percent of the completed schemes require rehabilitation and 50 percent require major repairs.

The participating communities have not only benefited from an improved water supply but have also gained time savings averaging three hours per day, now that women can fetch water closer to home. The project also supports activities and technical support for women, so they are able to put the time saved toward income-generating activities and even attend nonformal education classes. Sanitation coverage is also increasing with the availability of a community-managed Sanitation Revolving Loan Fund to provide funding for materials needed to construct latrines.

Source: World Bank 2007a.

4. Education

Key Messages

- Nepal has made remarkable progress in raising enrollment, especially at the primary level. However, the education system still falls short of expectations; in particular, it does not produce enough students with professional skills.
- Despite some realignment of public expenditures with the sector strategy, a more effective allocation of expenditures could be reached by benchmarking allocations to the number of students in the school area, improving the financing of secondary education, developing a means-tested system of scholarship, and encouraging private sector participation.
- Early results, supported by Nepal's own history, suggest that community management helps improve school performance. The impact of this reform now needs more detailed evaluation.

4.1 This chapter reviews public programs and public expenditures in the education sector, focusing on primary and secondary education. Section A assesses progress and challenges in the sector and outlines the government's sector strategy. Section B reviews the allocation of public expenditures, and section C examines planning and implementation issues. Section D sums up with a series of recommendations.

A. Education in Nepal: Progress, Challenges, and Strategy

Primary Education

4.2 **Progress in primary education in the past decade is striking.** The net enrollment rate (NER), which expresses the percentage of children who are enrolled at an age-appropriate level of schooling, increased from 57 percent to 72 percent between 1995/96 and 2003/04.[13] Nepal can attain the MDG of universal primary education if this pace of progress is maintained. Nepal's primary school enrollment is higher than that of most South Asian countries (it is lower only than the 96 percent NER in Sri Lanka).

4.3 **Disparities across groups remain large but have decreased somewhat** (table 4.1). Gender disparities are significant, but a 20.4 percentage point increase in the enrollment of girls in primary school between 1995/96 and 2003/04 has helped narrow the gender gap in school participation. At this rate of progress, Nepal could achieve gender parity in primary education by as early as 2010.[14] Primary enrollment rates have also increased sharply in the least developed regions of the country (the Mid-western and Far-western regions); this has reduced the enrollment gap between regions, although the gap remains large. Enrollment gaps between income and caste groups have also narrowed. The poorer 60 percent of the population has achieved larger gains in net enrollment than the richer 40 percent, although the gap remains large

[13] Flash Report I—2006 has an NER of 87.4 for primary education in FY 2006.
[14] The Demographic and Health Survey for 2006 reports a gender parity index of 0.95.

between enrollment of the poorest quintile (56 percent) and of the top quintile (84 percent). The NER among Dalits, Terai middle castes, and other Janajatis has also increased.

4.4 **However, other indicators raise concerns about the quality of education.** Nepal has high repetition and dropout rates. Between 1995/96 and 2003/04, the primary school completion rates increased among the richest three quintiles but stagnated for the poorest 40 percent of the population. The only consolation is the increase in the primary school completion rate for girls in all income categories. High school fees, poor academic progress, and the need to work at home are among the main reasons that children drop out. The relative importance of these reasons varies across regions (especially with urban/rural disparities) and income groups.

4.5 **Nepal's vision is to enable all children to complete primary education of good quality, irrespective of their ethnicity, gender, religion, disability, and geographic location.** The sector strategy is embedded in the "Education for All" policy that was finalized in 2001. However, since the government runs 70 percent of schools, overcoming inefficiencies in public sector management remains the main challenge for attaining the goals. Low educational achievement in public primary schools is strongly correlated with inadequately trained teachers, high student and teacher absenteeism, delays in delivery of textbooks and learning materials, and inadequate funding.

Table 4.1: Education Profile of Nepal (%)

	Pop.	Primary net enrollment		Secondary net enrollment		Primary completion		Secondary completion	
	2003/04	1995/96	2003/04	1995/96	2003/04	1995/96	2003/04	1995/96	2003/04
National	**100**	**57**	**72**	**9**	**15**	**29**	**37**	**3**	**7**
Boys	51	67	78	13	17	31	38	2	7
Girls	49	47	67	6	13	26	36	3	7
Poorest	20	38	56	2	1	13	13	0	1
2	20	48	68	5	7	22	21	0	1
3	20	62	81	7	9	28	37	2	5
4	20	70	82	10	22	33	50	3	5
Richest	20	77	85	21	33	41	60	5	21
Urban	15	72	83	37	47	44	54	9	21
Rural	85	56	71	18	26	28	34	2	4
Mountains	7	47	77	17	29	30	36	0	5
Hills	42	65	80	21	31	28	37	3	8
Terai	51	51	66	18	27	31	38	3	7
Eastern	25	59	74	17	19	34	38	1	6
Central	37	51	62	10	14	33	42	6	10
Western	19	70	85	8	14	25	37	1	7
Mid-Western	12	52	80	2	13	26	26	2	3
Far-western	8	47	74	0	15	18	32	2	5
Brahman/Chhetri	26	71	85	13	24	32	49	4	12
Terai middle caste	3	43	62	7	25	45	29	5	4
Dalits	7	55	84	2	3	16	19	4	0
Newar	8	69	89	17	21	36	53	6	22
Hill Janajatis	20	56	71	4	10	23	30	0	2
Terai Janajatis	8	47	74	8	10	23	26	0	1
Muslim	7	38	48	0	0	9	18	3	0
Other minorities	22	48	62	10	17	39	38	1	6

Sources: NLSS I and II; staff estimates.

4.6 **The government is trying to overcome these problems by engaging local communities in managing primary schools.** Local management of primary schools is expected to improve the ownership, accountability, and efficiency of education services. Considerable progress has been made in handing over schools to community management (box 4.1). It is too early to judge whether this initiative has made an impact on education quality. Some surveys point to higher enrollment rates, greater mobilization of local resources, and less teacher absenteeism after communities begin managing the schools. Three main challenges have dampened the effectiveness of the new policy, however. First, the legal framework needs further refining to allow more efficient implementation. Second, the relationship between school management committees and local government institutions needs to be clarified. And third, the primary-level scholarships need to increase to attract more underserved ethnic and female students (see below).

4.7 **For grades 1 to 10, while the government remains the largest provider of education, the nongovernment sector has contributed greatly to the growth in enrollment.** By the end of 2004, more than 6 million children were enrolled in schools, over 80 percent of them in public schools (table 4.2). Private and community schools together account for less than 19 percent of total enrollment and less than 35 percent of teachers. However, between 2002 and 2004, more than 43 percent of the increase in enrollment happened in private and community schools. This reflects a 40 percent increase in their numbers and a 4 percent increase in their teaching staff. Nevertheless, given the predominance of public schools, the responsibility of attaining the planned educational outcomes (universal primary education and literacy) still rests largely on the public sector, especially in Mountain areas and in the Mid-western and Far-western regions.

Table 4.2: Schools, Teachers, and Enrollment (grades 1-10)

	Distribution (% of Nepal total) of					Share of community and private schools in		Per capita public expenditures (Rs.)	Student to teacher ratio		
	Population (5-14 years old)	Enrollment	Schools	Teachers	Public expenditures	Number of schools	Enrollment		Public	Private / Community	Total
Eastern	22.7	23.5	22.6	21.1	21.2	27.4	20.7	1,758	50	34	46
Central	33.4	30.4	30.7	33.9	34.9	38.0	20.7	1,961	52	17	37
Western	20.2	21.9	23.9	26.0	21.8	25.7	20.9	2,024	42	20	35
Mid-western	13.6	14.4	13.2	10.9	12.7	26.3	14.3	1,748	60	35	54
Far-western	10.0	9.9	9.6	8.0	9.4	31.7	15.8	1,751	52	43	50
Mountain	7.3	8.0	11.5	9.3	11.7	17.6	12.5	3,012	35	44	36
Hill	44.0	52.2	59.3	56.5	58.3	32.8	21.7	2,491	47	22	38
Terai	48.7	39.8	29.2	34.3	29.9	31.0	17.7	1,153	60	24	48
Nepal	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**30.5**	**19.4**	**1,878**	**50**	**23**	**41**

Sources: Department of Education, School-Level Educational Statistics; staff estimates.

Note: Community and private schools include all nonpublic schools, including "unaided schools," which have no GoN-employed teacher but receive a grant to hire teachers. All community schools benefit from grants such as scholarships.

Secondary Education

4.8 **Net enrollment at the secondary level increased from 9 percent to 15 percent between 1995/96 and 2003/04; among girls, it increased from 6 percent to 13 percent.** The fastest increase in enrollment took place in the Far-western region. However, even though the geographic disparity in enrollment has narrowed at the secondary level, the gains have been limited to the middle- and upper-income quintiles of the population. Secondary school enrollment is also low compared to the primary NER, and there are significant inequalities across geographic regions, castes, and income groups. In terms of household welfare quintiles, NER in the richest households is 25 times that in the poorest. There has also been an increase in completion rates, especially for girls and especially in the Mid-western and Far-western regions. However, the overall completion rate remains very low: only one in four children complete lower secondary schooling and one in seven complete the secondary level.[15]

4.9 **The national objective is to enable children to complete secondary education of good quality and acquire appropriate skills and knowledge to enter the labor market**

[15] Currently, secondary education comprises lower secondary education (grades 6 to 8); secondary education (grades 9 and 10, leading to the school-leaving certificate); and higher secondary education (grades 11 and 12, equivalent to proficiency certificate level). The government intends to merge these components to reorganize schooling into one complete and integrated system, make secondary education opportunities available to a larger group of students, and relieve crowding in higher education. Once this change is complete, Nepal would have an education system consisting of basic education (grades 1 to 8) and secondary education (grades 9 to 12).

or prepare for higher education. Despite progress in enrollment, quality remains very low. More than half of primary students do not continue to secondary level, and among those who do, quality problems are reflected in the poor success rates of public school students in examinations for the school-leaving certificate. This is a concern for economic growth. The transfer of public secondary schools to communities could bring about management efficiencies, but the issue of education quality needs immediate attention.

4.10 **A major shift in service providers from public to private is taking place in secondary education.** Nonpublic providers account for 30 percent of enrollment at this level and 50 percent of schools. This shift may result from a combination of several factors, including a policy emphasis on primary education, the high opportunity cost for those continuing their education beyond primary education, fewer public lower and secondary schools, and a higher pass rate for school completion in private schools. Given the cost to households of secondary education (see below), this raises concerns of affordability.

4.11 **In summary, the education system has seen very significant progress and has a sound sector strategy, but challenges remain high.** Compared to other countries, Nepal has made remarkable progress at the primary level (see annex A.5). However, the education system is still not producing a sufficiently skilled labor force, and adult literacy rates remain below 50 percent. Even at the primary level, completion rates are low: of all ever-enrolled children 11–13 years old, only 37 percent have completed primary school, and only 13 percent of the poorest children complete. The large share of "over-age" children enrolled in school also raises concerns about the quality of education and suggests large needs to improve public expenditures in the sector.

4.12 **While public intervention and financing in education is often taken for granted, it is useful to review the grounds on which the use of public resources in the education sector can be justified.** Conventionally, the arguments of both economic efficiency and equity have been used. First, public intervention is justified on efficiency grounds when reliance on private markets would be socially disadvantageous because of externalities, public goods, noncompetitive markets, and lack of information for "consumers." Indeed, in addition to the positive benefits captured by the individual (e.g., higher wages, higher social status), education has positive externalities for the society, such as better health practices that limit the spread of infectious diseases and decrease maternal and child mortality, higher voter participation, contributions to research and development, and so forth. These larger benefits are typically underestimated by individuals. Second, in helping people who otherwise could not afford to send their children to school or university, public intervention can also be justified on grounds of equity in distribution of services. Nevertheless, each of these cases for public intervention needs to be made carefully. Neither justifies the complete subsidization of services. Therefore, in addition to the question of *why* the government should intervene, there is the equally important question of *how* it should do so—that is, the form of public intervention.

B. Education Expenditures

4.13 **Public expenditures in education have been increasing over the last decade** (table 4.3). The GoN target of allocating more than 15 percent of all expenditures to education has been met throughout the Tenth Plan period. At around 3.5 percent of GDP, public spending on education is in line with the average across countries (see annex A.5). Within the sector, spending was reallocated toward primary education, which increased from 1.4 percent to 1.7 percent of GDP between the Ninth and Tenth plans. Allocations to secondary education as well as to tertiary and technical education remained stable, 0.6 percent to 0.7 percent and 0.5 percent to 0.4 percent respectively. These efforts to promote primary education and community management of schools drove an increase in the proportion of "pro-poor" spending in the sector to above 80 percent.

4.14 **The distribution of expenditures highlights the public policy priority given to primary education as well as affordability concerns regarding secondary education.** The incidence of public expenditure is even across consumption deciles. However, public expenditures per child of the corresponding school age are 2.5 times lower for secondary education than for primary education (figure 4.1), although expenditure per student is similar because enrollment is much more limited in secondary education. Households have to supplement public expenditures for secondary education by paying for fees, uniforms, textbooks, and so on. At around US$12 per student, expenditure per capita is slightly higher than in other countries in primary education, but significantly lower in secondary education (annex A 5).

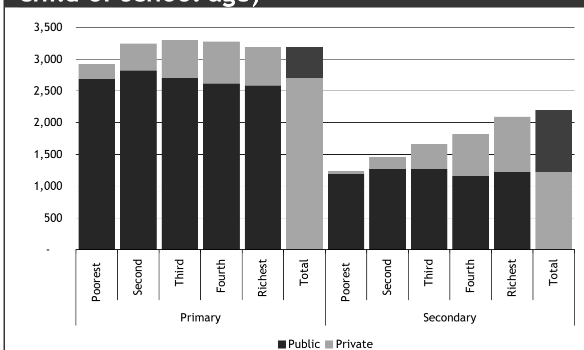
Table 4.3: Public Education Expenditures

	9th Plan					10th Plan					Average of	
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 (E)	2006/07 (B)	9th plan	10th plan
Education (Rs. billion)	**7.8**	**7.6**	**9.3**	**11.0**	**13.0**	**13.2**	**14.3**	**17.1**	**19.1**	**22.8**	**9.7**	**15.9**
in real terms (2003/04 Rs. billion)	10.3	9.1	10.7	12.3	14.2	13.7	14.3	16.4	16.8	19.0	11.3	15.3
as % of all expenditures (GFS definition)	15.3	14.5	15.8	15.3	18.1	18.1	18.6	19.5	19.6	17.8	15.8	19.0
as % of GDP	2.6	2.2	2.4	2.7	3.1	2.9	2.9	3.2	3.3	3.5	2.6	3.1
Composition by Program	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Monitoring and Administration	1	2	3	3	4	5	5	4	5	6	3	5
Primary Education	51	50	50	54	54	58	58	55	55	55	52	56
Secondary Education	23	24	20	22	22	23	22	24	24	24	22	23
Educational Development	4	3	7	5	4	1	2	5	4	2	5	3
Higher and Technical Education	21	21	21	17	15	12	13	12	11	13	19	12
Pro poor expenditure (% total)	**78.1**	**77.4**	**76.8**	**80.3**	**80.5**	**82.5**	**81.5**	**83.9**	**83.4**	**83.2**	**78.6**	**82.8**

Sources: GoN; staff estimates.

4.15 **Salaries account for almost 90 percent of public expenditure.**[16] This proportion, which includes direct salary payments and grants to unaided schools, has decreased slightly, from 95 percent in 2000 to 87 percent in 2004, even though grants to unaided schools have been increasing in recent years. This trend has created space for non-wage recurrent expenditures (scholarships and grants for textbooks are among the major programs) and capital expenditures. Teacher absenteeism does not seem to be a major problem, although "moonlighting" is frequent (GoN 2006b).

Figure 4.1: Education Expenditure (Rs. Per child of school age)



Sources: GoN; NLSS II; staff estimates.

4.16 **Across regions, public expenditures are largely aligned with school-age population, with higher-than-average per capita allocation for Mountains and Hills and lower than average for the Terai** (table 4.2). The higher allocation for Mountains probably reflects the geographic constraints of this region, which requires a greater density of schools and higher remuneration of staff through the remote area allowance. The higher allocation for Hills might reflect a combination of good returns to investment in these districts (especially given good connectivity) and the predominant role of this region in national politics. Student-teacher ratios in public schools mirror this distribution with ratios ranging from 35 in Mountains to 60 in

[16] FY 2006

Terai: the national average, at 50, is twice the target set in the Education Act directive.[17] These patterns also reflect difficulties in allocating teachers across districts, with more teachers than necessary available in some regions and fewer in others. A government report suggests that about 12,400 teachers in primary and secondary education could be redeployed (GoN 2006b).

4.17 **The large role of private expenditures makes evaluation of the impact of public expenditures more difficult.** As noted above, enrollment has surged in non-public schools. Even for community schools, which are largely funded by public spending, 18 percent of their income comes from fees, funding from nongovernmental organizations (NGO), and own sources (GoN 2006b). The impact of the central government's capital spending is also difficult to establish, given that it accounts for only 22 percent of the cost of new classroom construction. A simple regression analysis does not identify any statistically significant impact of district-level public spending on educational outcomes.

4.18 **Achieving universal primary enrollment and expanding secondary enrollment will require a further increase in resources.** For instance, the MDG Needs Assessment concludes that the resources for education would have to reach Rs. 22 billion today (slightly above the existing budget) and Rs. 41 billion in 2015 to make the MDGs attainable (GoN 2006). However, as recognized by this assessment, this amount includes the cost of delivering universal *public* education: a key driver of the budget allocations will therefore be the capacity of the private sector to continue expanding its role in the provision of education services. Another important driver will be the modalities of service delivery, discussed below.

C. Planning and Implementation Issues

4.19 **A major development in the education sector has been the adoption of a robust sector strategy.** Among other things, this has allowed the alignment of donor funding behind this strategy through a SWAp arrangement (box 9.3). The budget implementation ratio has consistently been around 90 percent, a much more satisfactory outcome than in several other sectors. However, as in other sectors, central government budget allocations are rather disconnected from local-level plans such as School Improvement Plans, Village Education Plans, and District Education Plans (GoN 2006b).

4.20 **The second major development in terms of planning and implementation has been the reintroduction of community management of schools** (box 4.1). Although it is yet to be fully evaluated, this reform initiated in the early 2000s appears to be delivering important outcomes. On the other hand, the process of devolution—primary education is one of the sectors for which a full devolution to districts was initiated in 2002—does not seem to lead to similar impact, for reasons discussed in chapter 11.

4.21 **A scholarship program exists but is poorly targeted and implemented in practice.** More than a third of primary-level students are receiving scholarships, mainly from the government (GoN 2006b). In particular, 5 percent of the total Education for All budget is allocated to scholarships for all Dalits and for 50 percent of girls enrolled in primary schools. With respect to the latter, the scholarships are supposed to be provided to poorer girls, and the responsibility for identifying poor students lies with the School Management Committees (SMC). While some schools have borne this responsibility remarkably well, many others are facing serious problems. Those schools that are not able to identify the poorer girls have been distributing scholarships to all girls, spreading the funds over a pool twice the intended size and giving the poorer beneficiaries only half the scholarship help they would otherwise receive. As a

[17] The number of students per teacher ranges from 9 in the Manang district to 189 in the Dhanusa district.

result the scholarship program is not producing the intended academic and enrollement results. In addition to this issue of mistargeting individual beneficiaries, the scholarship program is underfunded at the national level, and due to poor targeting of districts, some districts are more underfunded than others. Because of this, some schools distribute either the full scholarship to a subset of the intended beneficiaries or a partial scholarship to all beneficiaries. Finally, there is evidence of delays in disbursements (see chapter 10). These flaws weaken the effectiveness of the scholarship policy, and there is evidence that the high dropout rates can be partly explained by gaps between expected and actual scholarships.

4.22 **Textbook printing and distribution is open to the private sector since 2007.** Improvements in the quality of education and in the completion rate, among other outcomes, depend on timely availability of textbooks. In spite of resistance from the public sector, printing and distribution of textbooks in the Eastern region is now open to private sector participation. This initiative needs to be monitored and rolled out nationally. In parallel, the disbursement of funds to schools to buy textbooks should be improved to ensure the availability of textbooks.

Box 4.1: Community-Managed Schools

People's participation played an overriding role in education management until the 1970s. The role and responsibility of the government in support of those institutions was limited at that time, with government's financial contribution at only 20 percent to 25 percent of their recurring cost. Schools were nationalized in 1972, minimizing the role of communities. This led to poor educational delivery of teaching and learning activities, weak institutional management, and, ultimately, degradation of educational quality. As a result, since the 1980s private schools have emerged to meet people's aspirations for better education.

The concept of devolution in school education gathered momentum around 2000. The 7th Amendment to the Education Act introduced the concept of "management of schools by communities and financial support by the government." The Tenth Plan then included a target of transferring 8,000 public schools to community management between 2002 and 2007. The revived Parliament endorsed the concept of community management of schools in the new Education Act in 2006.

Notwithstanding resistance from the teachers' union, the Maoist-affiliated student union, and also to some extent the bureaucracy, about 2,600 schools out of about 23,000 public schools have been transferred to community management as of 2007. A survey of 30 schools covering over 10,000 households recorded significant improvement in enrollment from disadvantaged communities. The share of out-of-school children of primary age (5–9 years) has decreased from 41 percent to 15 percent, including for girls (42 percent to 15 percent), Dalits (50 percent to 18 percent), and Janajatis (44 percent to 15 percent). Other studies have reported qualitative changes toward sustainable reforms in the community-managed schools: (a) increased management initiatives and ownership of communities through more frequent participation in School Management Committee meetings and parent visits to schools, (b) physical transformation through increased resource generation, (c) improved teaching-learning environment and transfer of children from private schools to community-managed schools, and (d) reduction in teacher absenteeism. In a striking example, a community in the Kaski district decided to use a grant allocated to its community school as a financial instrument, creating a sustainable financing flow: the interest payments from lending the grant generate sufficient cash flow to pay an additional teacher.

During the period of high insurgency, most of the SMCs engaged Maoists in dialogue and often were able to convince them of the value of community management of schools as a means of devolution and of people's empowerment in education. The transparent management system and the dedication of the committee members were evident, and the Maoists in principle were compelled to support the concept of community management as it was in line with their ideology — empowerment of communities.

4.23 **Financial management issues are numerous**, as revealed by a public expenditure tracking survey. Funds are often disbursed to schools with delays and their amounts are found to differ from one district to the other (GoN 2006b). This reflects issues of poor record keeping at the school level, poor coordination and reconciliation of accounts between schools and District Education Offices, and frequent, confusing changes in guidelines (e.g., merging the textbook fund with the fund for block grants). Audit compliance is weak at the local level.

4.24 **Finally, the conflict has created a number of additional implementation constraints**, including closing of schools, migration of students and teachers to secure areas, and so on. (GoN 2006b). Some community-managed schools were able to dialogue with insurgents (box 4.1).

D. Summing Up

4.25 **This review of public expenditures in education highlights five potential options for reform:**

- *Review allocation formula and ensure adequate deployment of teachers*. The allocation of teachers across the country needs to be reviewed to reduce the disparities across regions. One option would be to budget through a per capita formula known as per-child funding, with some transition mechanism to smooth reallocations over a few years.
- *Ensure adequate funding to secondary education*. Over time, the priority currently given to primary education will have to be balanced with the need to increase access to secondary education, especially for the poorest.
- *Continue devolution of school management to communities*. This policy appears to be delivering results and should be encouraged. To maintain its legitimacy and increase its effectiveness, regular processes of record keeping, monitoring, and audit should be improved. In addition, the policy needs to be thoroughly evaluated to fine-tune its implementation.
- *Revamp the scholarship system*. One option would be to pilot a system whereby schools would rank girls according to their welfare score (a tool for that purpose was developed for higher education). Schools will be given the choice of using scholarship funds in different ways as they deem most effective. Alternatives include: (i) distribute the prescribed amount to the poorest half of girls; (ii) distribute the girls' scholarship fund among girls in the way the school deems most equitable. The number of beneficiaries, amount of scholarship to each beneficiary, type of assistance (in cash or in kind) will be determined by SMCs. The experience of scholarship distribution in this manner funded from school sources already exist in some schools; or (iii) distribute the girls' and Dalit scholarship fund among students in the way the school deems most equitable. Number of beneficiaries, amount of scholarship to each beneficiary, and type of assistance (in cash or in kind) will be determined by SMCs. This is especially relevant for the government because of the recently passed Scholarship Act, which specifically calls for targeting poor students.
- *Implementation issues*. The proposed policy of resource allocation on a per-student basis will ameliorate many implementation issues. Before the implementation of this policy, however, steps should be taken to ensure that annual work programs with procurement plans are approved before the new fiscal year, and to require trimesterly reporting of progress against agreed trimester indicators (chapter 10).

5. Health

Key Messages

- Nepal has made significant progress in improving health outcomes. There is evidence that government expenditures have contributed to this achievement, but health expenditures remain largely funded by out-of-pocket expenditures and donor assistance.
- Nepal faces a number of challenges to further improve health outcomes. While the sector strategy is sound, its implementation requires renewed efforts. Increased expenditures might not be the priority, but policies to encourage devolution and good management should be the way forward.
- Given the role of out-of-pocket expenses and given the poor targeting of public resources, issues of equity and demand need attention. First, budget resources should gradually be allocated on the basis of population, accessibility, and performance, instead of being driven by the existing distribution of facilities. This should be accompanied by measures to encourage health workers to serve in remote areas. Second, schemes to improve the demand for health services, especially on the part of the poorest, should be explored.

5.1 This chapter reviews public programs and public expenditures in the health sector. Section A assesses progress and challenges in the sector and outlines the government's sector strategy. Section B reviews the allocation of public expenditures, and section C examines planning and implementation issues. Section D concludes with a series of recommendations.

A. Health in Nepal: Progress and Challenges

Health Status

5.2 **Nepal has made significant progress in improving health outcomes in the last decade.** From 1996 to 2006, according to the Demographic and Health Survey (DHS) for 2006, the maternal mortality ratio declined from 538 to 281 deaths per 100,000 live births; the infant mortality rate fell from 79 to 48 per 1,000 live births; the under-five mortality rate fell from 118 to 61 per 1,000 live births; and the total fertility rate declined from 4.6 to 3.1 live births per woman of childbearing age. Immunization and vitamin A are likely to have played a significant role in the reduction of infant mortality. The share of children 12 to 23 months of age that were fully immunized against the six major childhood diseases rose from 43 percent to 83 percent between 1996 and 2006 (DHS 2006), and an estimated 81 percent of children 6 to 59 months of age were covered in 2001 by the vitamin A program (DHS 2001).

5.3 **At the current rate of progress, Nepal is likely to meet the MDG target for reducing under-five mortality, but not the target for infant mortality.** Progress to date has probably resulted from substantial improvements in the availability of good water, sanitation, and immunization.[18] However, Nepal is unlikely to meet the goals of reducing by two-thirds the infant mortality rate. Reducing infant mortality will be much more difficult than reducing child mortality. In addition to increasing immunization coverage and improving prevention and treatment of infectious disease, Nepal will have to improve the nutritional status of young children and of mothers and increase the numbers of prenatal and postnatal visits and deliveries assisted by skilled birth attendants in institutions.

5.4 **Nepal's maternal mortality ratio seems to be the highest in the region** (see annex A. 5). But data are inconsistent,[19] making it difficult to know whether Nepal is on track to meet the MDG. Lack of data also makes it difficult to analyze the determinants of maternal mortality. Nevertheless, global evidence indicates that maternal mortality ratios tend to be higher when mothers are poor, too young or too old, malnourished, or anemic, when they have low levels of education, and when they fail to space their births. Maternal mortality is also higher when fewer women use temporary contraception techniques or when expectant mothers deliver without the assistance of a trained health care professional. All these risk factors are present in Nepal, and they suggest that a steep decline in maternal mortality is unlikely, particularly given the continued high rate of births at home (the 2006 DHS found that only 19 percent of births were delivered with the assistance of a health care professional, up from 11 percent in 2001).

5.5 **The level of child malnutrition is among the highest in the world.** During 1995–2002, Nepal ranked last among 177 countries (tied with Bangladesh) in terms of the proportion of children classified as underweight. It ranked third to last, above Ethiopia and Burundi, in terms of the proportion of children classified as stunted (UNDP 2004) The most recent estimates reveal that, in 2006, 43 percent of all children younger than five years of age were moderately to severely stunted, and 45 percent were moderately to severely underweight (DHS 2006).

Table 5.1: Comparison of Deaths by Cause and Disability-Adjusted Life Years (DALY) Lost by Cause

Causes of Death	Cause-specific deaths as % of all deaths	DALYs lost as % of all DALYs lost
Group I: Infectious diseases and maternal, perinatal, and nutritional problems	49.7	68.5
Group II: Noncommunicable and congenital problems	42.1	22.8
Group III: Injuries and accidents	6.9	8.7
Unclassified	1.0	0.0

Source: World Bank 2000.

[18] The proportion of households with piped water in the dwelling increased from 26 percent in 1995/96 to 34 percent in 2003/04. During the same period, the proportion of the population living in a home with no flush toilet declined from 79 percent to 62 percent.

[19] The 1996 Nepal Family and Health Survey reported maternal mortality at 539 per 100,000 live births. Estimates by the World Health Organization put the figures at 1,500 per 100,000 in 1990, 830 in 1995, and 740 in 2000. The Tenth Plan projects 415 maternal deaths per 100,000 live births in 2001/02, though this government estimate has not been validated by survey data. The 2006 DHS was complemented by a Maternal Mortality Survey carried out by the Ministry of Health and Population and the Central Bureau of Statistics.

Table 5.2: Infant and Child Mortality Rates (per 1,000 live births)

	1996			2001		
	Infant mortality	*Child mortality*	*Under-5 mortality*	*Infant mortality*	*Child mortality*	*Under-5 mortality*
Urban	61	23	82	50	17	66
Rural	95	53	143	79	35	112
Eastern	79	36	113	78	30	105
Central	86	56	138	77	36	111
Western	84	38	119	60	25	84
Mid-western	115	71	178	73	41	111
Far-western	124	62	179	112	42	149
Boys	102	46	143	79	28	105
Girls	84	57	136	75	40	112
Nepal	**79**	**43**	**118**	**64**	**29**	**91**

Source: DHS.

5.6 **Infectious and parasitic diseases, nutritional disorders, and maternal and perinatal diseases—the so-called Group 1 causes—dominate the overall pattern of morbidity in Nepal** (table 5.1). Noncommunicable diseases such as diabetes, hypertension, cancers, and cardiovascular diseases—linked in part to lifestyle changes—are beginning to increase in relative importance, though not yet to the same extent as in other low-income countries in the region. At the same time, the emergence of Japanese encephalitis, HIV/AIDS, malaria, kala-azar, and tuberculosis, along with the population growth and aging and risks of avian influenza, will affect the demand for health care services (both preventive and curative) in the future.

5.7 **The highest risk groups are children under five (particularly girls) and women of reproductive age.** Children represent only 16 percent of the population but over 50 percent of DALYs lost from all causes, and 80 percent of their deaths are due to infectious diseases and other Group I causes (table 5.1). Women 15–44 years old experience a 26 percent higher loss of DALYs than men in the same age group. Much of this excess loss is explained by risks in pregnancy. There are also gaps in child mortality rates, with 28 boys and 40 girls per 1,000 live births dying between the ages of one and five in 2001 (infant mortality rates for boys and girls were roughly comparable, with 79 boys and 75 girls per 1,000 live births dying before age one in 2001). Girls under five account for 52.5 percent of all female deaths. Internationally, gender disparities in under-five mortality are attributed to the fact that girls receive less attention, less curative care in case of illness, and less nutrition than boys as a result of cultural preferences for male children. It seems that in Nepal these factors are also at play, the fact being corroborated by the worse nutritional outcomes among girls.

Health Service Providers

5.8 **Physical access to health care facilities has improved.** The median commute time to a rural health facility fell 50 percent, to 50 minutes, between 1995/96 and 2003/04, according to the second Nepal Living Standards Survey (NLSS II). Both improvements in roads and the increased number of public and private health establishments contributed to the decline. Despite overall improvements in access, however, a large proportion of poorer households continue to live far from health facilities.

5.9 **Better access to health care services reflects the expansion of the number of government health facilities.** Until recently, health services were available primarily in urban areas. In the 1990s the number of health care institutions quadrupled, rising from 1,098 in 1991/92 to 4,439 in 2001/02 (MoHP 2004). Public health facilities also expanded at the subnational and community levels, with the establishment of over 3,000 sub-health posts, 750 health posts, and 180 primary health care centers as of 2006. In addition, there are more than 15,000 primary health care outreach clinics, which are run by health posts, sub-health posts, or primary health care centers two or three times a month in a prearranged place within these posts' areas. Female volunteer health workers contribute to these clinics. Reliable estimates of the number and distribution of private facilities are unavailable, but there is an increasing reliance on private practitioners for curative health care: 56 percent of all 2003/04 health consultations took place in private facilities.

5.10 **The shortage of doctors in Nepal remains severe.** Nepal has five physicians for every 100,000 people—one-fifth the ratio in Bangladesh and one-tenth the ratio in India. There are similar shortages of nurses and midwives. Shortages of health professionals are particularly acute in remote regions (table 5.4). The Central region (including the Kathmandu valley), where 34.5 percent of the population lives, has 70.0 percent of the country's doctors. In contrast, the Far-western region, where 9.5 percent of the population lives, has just 2.0 percent of the country's doctors. Under a recent initiative, over 100 doctors from recent batches of medical graduates were appointed and distributed among all primary health care centers.

5.11 **Progress in the use of family planning and other primary health care services has been mixed.** The use of modern contraceptive methods and prenatal care increased markedly between 1996 and 2006. Use of modern contraceptive methods among currently married women of reproductive age reached 44 percent in 2006, up from 26 percent in 1996. Among pregnant women, 44 percent received antenatal care from a health professional in 2006, up from 34 percent in 1996 (DHS 2006). The use of delivery assistance by a trained health professional has also increased but remains low at 19 percent. Rates of treatment of children with symptoms of acute respiratory infection or fever have also exhibited improvements in recent years, but remain low (43 percent and 34 percent respectively).

Health Sector Strategy

5.12 **The government has a sound sector strategy.** The 2003 health sector strategy (HSS) focuses on attaining the MDGs and is based on wide-ranging stakeholder consultations over three years. Key elements of the strategy are (a) ensuring the provision of essential health care services, especially to marginalized populations; (b) decentralizing the management of service delivery; (c) promoting public-private partnerships; and (d) improving sector management and the provision, deployment, utilization, and efficiency of inputs. To implement the strategy, the GoN developed the Nepal Health Sector Program. It has been endorsed as the framework for development assistance to the health sector by all external development partners.

5.13 **There are a number of justifications for government to intervene in the sector, not necessarily by providing services for all, but by financing them and establishing regulations to ensure quality of care.** First, certain components of public health, such as vector control, sanitation, health education, or programs to provide clean water, are public goods: it is unlikely that the private sector will provide them. Second, many health goods are "merit goods": individuals would not invest enough in vaccination, family planning, or specialized treatments, for example, because their value for the society is larger than for any individual (i.e., they have positive externalities). Third, government intervention can be justified on equity grounds, since the poor often cannot afford health care. However, these arguments should be weighed against the record of government performance in the health sector, as there is, in Nepal and many other countries, evidence of misallocation of public resources—resources not reaching the poor, use of non-cost-effective treatments, investment in unutilized hospital beds, and so on.

5.14 **The focus of the health sector strategy—financing a basic package of cost-effective services that have a strong rationale for government subsidization or free provision, using both public and private providers—is appropriate, given Nepal's health system challenges.** The substantial socioeconomic disparities in health outcomes and utilization rates that have persisted in Nepal can be alleviated if the GoN is successful in its objective of ensuring essential health care services for the poorest sections of the society. This calls for increasing the efficiency of existing modes of delivery, as well as identifying and implementing measures that strengthen equitable allocation of human and financial resources. The HSS aims to improve the effectiveness and efficiency of health facilities by developing public-private partnerships, devolving managerial functions to local service users, and directing attention and resources toward essential and primary health care services and away from tertiary care, where the private sector is active. The strategy's focus on demand, care seeking, and client satisfaction appropriately recognizes that supply-side improvements will be insufficient to achieve the MDGs.

5.15 **However, the GoN strategy for multisectoral coordination to improve health outcomes is not explicit.** Coordination between the health sector and other sectors is essential for accelerating progress toward the MDGs. For example, malnutrition is a complex problem that stems from inadequate food intake, disease, and poor health-seeking practices both inside and outside the home; some of these factors relate to traditional practices and attitudes, especially in relation to women's health. To combat malnutrition, the use of a multisectoral approach, involving the health, education, water, women's and children's welfare, and agricultural sectors, is essential.

B. Public Health Expenditures

5.16 **The GoN's contribution to health expenditures is small but growing.** Government expenditures in health, both in real terms and as a share of the total budget, have been slightly increasing in recent years (table 5.3). As part of public expenditures, donors play a large role in public health spending: in 2002 and 2003, 25 percent to 33 percent of public health spending came from external partners (Ministry of Health 2004). A large part of this amount is directly executed by the donors through NGOs. An additional unknown amount is channeled by donors through NGOs working on various aspects of the sector in various districts. Between 4 percent and 12 percent of public health expenditures come from public enterprises and local bodies. Finally, household out-of-pocket payments are estimated to make up as much as three-quarters of total health expenditure in Nepal.[20]

Table 5.3: Public Health Expenditures

	9th Plan					10th Plan					Average of	
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 (E)	2006/07 (B)	9th plan	10th plan
Health (Rs. billion), Central Gvnt	**3.1**	**2.8**	**3.5**	**3.5**	**3.9**	**3.7**	**4.0**	**4.7**	**5.8**	**9.3**	**3.4**	**4.5**
in real terms (2003/04 Rs. billion)	4.1	3.3	4.0	3.9	4.2	3.8	4.0	4.5	5.1	7.7	3.9	4.3
as % of all expenditures (GFS definition)	6.1	5.3	5.9	4.9	5.4	5.0	5.2	5.3	6.0	7.3	5.5	5.4
as % of GDP	1.0	0.8	0.9	0.9	0.9	0.8	0.8	0.9	1.0	1.4	0.9	0.9
Composition by Program	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Essential Health Care Services	41	52	52	59	62	72	65	65	62	54	53	66
Beyond Essential Health Care Services	59	48	48	41	38	28	35	35	38	46	47	34
of which												
Private Sector/NGO Sector Dvpt	25	9	9	12	12	7	6	6	4	3	14	6
Sector Program Management	3	4	3	3	2	3	2	2	4	2	3	3
Health Financing Resource Mngt	15	14	17	6	1	0	6	5	5	4	10	4
Logistic Management	9	13	11	12	14	11	7	8	10	19	12	9
Human Resources Development	2	2	2	3	2	2	2	1	3	2	2	2
Integrated MIS	1	1	1	2	2	1	1	1	1	1	1	1
Pro poor expenditure (% total)	**50.0**	**60.5**	**62.2**	**57.8**	**55.5**	**68.7**	**69.0**	**67.2**	**68.0**	**75.4**	**57.2**	**68.2**

Sources: GoN; staff estimates.

20 There is no recent study of the sources and uses of health funds in Nepal. The most recent estimates from 1995/96 suggest that 70 percent of all health spending was from private sources (World Bank 2000). An analysis of curative outpatient health care expenditures in 2003/04 suggests that households are the source of over 80 percent of health spending on these services (Hotchkiss and Silvestre 2007).

5.17 **Nepal's public health expenditure levels are above those of most of its South Asian neighbors relative to GDP.** Over 2000–5, public health expenditures by the central government, donors, and local bodies are estimated at 1.5 percent of GDP (World Development Indicators). Sri Lanka is the only South Asian country with a higher public health share of GDP (see annex A5). However, in terms of the absolute amount spent on per capita public health expenditure, Nepal ranks below its neighbors (US$3.4 against US$3.6 in Bangladesh and US$5.8 in India).

5.18 **Public expenditures were significantly reallocated to essential health care services (EHCS) until 2003, but the trend has been reversed to some extent since then** (table 5.3). EHCS include communicable disease control, child health services, and reproductive health services, including trained delivery assistance. Spending on EHCS rose steadily to reach 72 percent of GoN health spending in 2002/03 as a result of funding secured to improve the availability of primary health care services to the poor under the Nepal Health Sector Program. The trend has been reversed to some extent in recent years, in part because of constraints on the implementation of EHCS in conflicted-affected areas. Even so, the share of GoN health spending devoted to EHCS increased from an average of 53 percent under the Ninth Plan to 66 percent under the Tenth Plan.

5.19 **The share of public resources devoted to recurrent expenditure has been increasing in recent years.** Almost 60 percent of these expenditures are on salaries and allowances of health staff, with only 5 percent left for capital expenditures.

Table 5.4: Geographic Distribution of Health Care Professionals and Public Expenditures

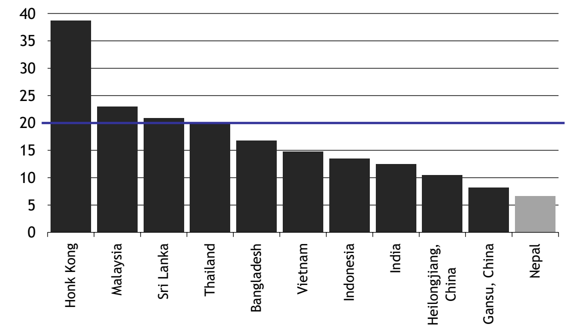
Region	Distribution across regions (%)					2000/04 public exp. per capita	
	Population	Doctors	Nurses and ANM	Retail pharmacies	Health service centers	Level (Rs.)	Average annual growth (%)
Eastern	23	14	23	17	23	83	0.9
Central	35	70	40	64	31	151	-7.4
Western	20	11	26	13	22	88	1.6
Mid-western	12	3	8	4	15	99	0.7
Far-western	10	2	3	3	10	98	2.3
Mountain	7				14	159	-0.7
Hill	44				52	152	-6.4
Terai	49				35	66	4.7
Nepal	**100**	**100**	**100**	**100**	**100**	**111**	**-3.1**

Sources: Ministry of Health (2005) for professionals; GoN and staff estimates for expenditures and health service centers.

5.20 **Despite its commitment to develop and apply a needs-based formula, the GoN allocates resources based mainly on the number and type of facilities rather than on population and need.** As a result, per capita public health spending is substantially higher in the Central region than in other regions, reflecting a higher concentration of health professionals and facilities there: per capita health spending in the Central region is Rs. 151, which is 36 percent above the national average of Rs. 111 (table 5.4). Spending is substantially lower than average in the Terai, although the disparities are being corrected since per capita spending is decreasing in Hills and increasing in Terai. In turn, there are important disparities in outcomes across regions (table 5.2). In 2001, under-five mortality rates ranged from 84 deaths per 1,000 live births in the Western region to 149 in the Far-western region; nationwide, rates in rural areas were almost twice those in urban areas. Infant mortality rates varied similarly. Rural-urban gaps in malnutrition are large as well: moderate to severe stunting rates among children less than four years of age are about 15 percentage points higher in rural areas than in urban areas. Underweight, stunting, and wasting ranged from 31 percent to 64 percent, 27 percent to 61 percent, and 4 percent to 20 percent respectively across Nepal's 15 regional and ecological groups.

5.21 **Public spending tends to disproportionately benefit richer households.** A recent study of nine Asian countries suggests that Nepal has the strongest pro-rich bias in public health resource allocations in the region (figure 5.1). The poorest 20 percent of the population received less than 7 percent of public health care subsidies (this is, however, based on the 1995/96 NLSS). More recent data confirm this bias for acute health care services: for example, in 2003/04 average per capita public expenditures for the top wealth quintile was 89 percent higher than for the bottom expenditure quintile (61 percent on a per-user basis). Despite this bias, richer households still contribute a large share of the cost of the health care services they use: the top quintile pays 91 percent of the total cost, versus 54 percent for the bottom quintile (Hotchkiss and Sylvestre 2007).

Figure 5.1: Share of Public Health Care Subsidies Received by Poorest Quintile



Source: O'Donnell et al. 2007.

5.22 **This bias is likely to reflect demand-side issues, as revealed by the pattern of utilization of health services** (table 5.5). Recent international evidence suggests that demand-side barriers may be as important as supply factors in deterring patients from obtaining needed health care services. These barriers, which include the costs of access, lack of information, and cultural constraints, are likely to be more important for the poor and other vulnerable groups. To the extent that they do not access care, these groups benefit less from public health spending, thereby limiting health system effectiveness. Some services are free, including immunization, behavior change and communication programs, integrated management of childhood diseases, communicable disease treatment, family planning, and nutrition programs. Primary-level consultations and basic drugs are free of charge for prenatal visits, for children under five, and for the elderly. However, there are registration fees for outpatient care for curative services and the cost of drugs, tests, and consumables is charged. Looking forward, although the Nepal Health Sector Program envisions that local cost recovery will make an increased contribution to financing curative health care, the government has not yet produced national guidelines for user fees, and community health insurance has been limited to small pilot schemes. The community drug program in 25 districts charges fees for drugs, and revenue has increased modestly, but the program was sporadically disrupted by the conflict.

Table 5.5: Health Care Utilization

	% accessing public / private facility 1995/96		2003/04		% delivering in facility		% ever immunized	
	Public	Private	Public	Private	1995/96	2003/04	1995/96	2003/04
Poorest	62.1	37.9	60.0	40.0	2.4	5.0	51.8	89.9
Second	60.6	39.4	46.1	53.9	4.2	6.6	58.0	92.8
Third	58.1	41.9	50.0	50.0	5.6	11.2	58.8	93.2
Fourth	59.9	40.1	39.9	60.1	7.1	25.8	57.6	92.8
Richest	54.1	45.9	36.4	63.6	22.6	57.5	53.9	98.1
Total	**58.3**	**41.7**	**44.4**	**55.6**	**7.3**	**16.0**	**56.0**	**92.6**

Sources: NLSS I and II; staff estimates.

5.23 **Although the role of public health expenditures is difficult to establish, there are some signs of a positive link with improved nutritional outcomes.** A simple district-level multivariate regression analysis suggests that, in districts outside Kathmandu, public expenditures per capita on essential health care services are significantly associated with lower prevalence of childhood stunting, after controlling for other factors (see annex A. 9). Other variables that were found to predict child nutritional status were the number of hospitals, the distance to the closest facility, and the availability of a proper toilet.

C. Planning and Implementation Issues

5.24 **Weakness—including lack of realism—on the planning side is evidenced by the consistent gap between budgets and actuals.** This gap averages 20–30 percent, one of the highest across sectors. As a result, despite increases in allocation (such as the planned increase of 50 percent in real terms in 2006/07, table 5.3), expenditures have not significantly picked up. Reasons for this discrepancy include poor capacity in the Ministry of Health and Population (MoHP) planning division, lack of consideration of district plans, persistent problems in financial management systems, low compliance with procurement procedures, conditionality in aid agreements to increase the share of the health allocation in the budget, and continuation of the long-standing problem of delayed reimbursement requests. These issues are further compounded by weak program monitoring during the year. They help explain why donor disbursements have been lower than budgeted, although it is unclear whether funding shortfalls reflect disbursement problems or donors not fulfilling their commitments (Foster and Regmi 2006).

5.25 **Health sector strategy, which calls for an integrated and decentralized sectorwide approach, may be in conflict with objectives of more vertical and centralized service delivery programs**. Perhaps because of the success of vertical health programs in Nepal, such as the immunization program and Directly Observed Treatment Short-Course (DOTS) to treat tuberculosis (Das 2005), support for the HSS is low among government program managers and donor staff (although the integration is reportedly much better below the district level). They may be concerned that health sector reform has been imposed upon them and that reforms could lead to setbacks in service utilization rates and health outcomes (Foster and Regmi 2006). This also highlights a limited capacity to pursue the HSS agenda. Examples of human resource capacity problems include the loss of key health economics and financing staff, a scarcity of senior managers in other divisions who have a clear understanding of the sectorwide approach, the inability to procure local consultants, and the MoHP's reliance on a limited number of individuals to take forward the HSS.

5.26 **Although promising, devolution has not yet delivered its expected benefits.** This may reflect the fact that devolution is at the local government level (chapter 11) as opposed to the community level (as in education, chapter 4). Over 1,430 health facilities in 28 districts have been handed over to local health management committees. This has led to an increase in service utilization and in the responsiveness of care providers.[21] Nevertheless, a number of problems constrain the performance of decentralized health care facilities: a complex flow of funds (see figure 11.1); lack of pre-established targets to assess health provider performance; limited managerial capacity and accountability at the local level; a lack of clarity on the division of responsibilities regarding procurement and other functions between the central level and the local level; local managers not having the authority to shift funds across budget line items; staffing shortages in rural areas; ambiguities surrounding roles and responsibilities at different tiers; and limited or no use of evidence-based management practices (Foster and Regmi 2006). In addition, the conflict had a number of impacts on the sector, including interruption of supply and drug chains, withdrawal of government staff from health care facilities, and limited ability to carry out supervisory functions. Continued uncertainty in the political situation also affects the

[21] For example, a study of 24 sub-health posts that were handed over in four districts found evidence of an 18 percent increase in utilization following the handover to local communities, along with some modest increases in staff attendance, although utilization by Dalits appears to have fallen (Shrestha 2005).

government's willingness to press ahead with decentralization, cost recovery, restructuring of the MoHP, and involvement of the private sector (Foster and Regmi 2006).

5.27 **Quality of services has been hampered by problems in logistics management.** Procurement of drugs, supplies, and equipment is overly centralized, leading to low disbursements, shortages and surpluses, and wastage. A recent MoHP study confirms that supplies reaching districts are based on central norms rather than local needs. Such ineffective processes are likely to have a negative influence on service quality and utilization rates.

5.28 **Finally, a more effective partnership with donors is recognized as critical for the performance of the health sector.** Many donor-assisted projects, while successful vertical programs, lack clear linkages with national-level strategies, despite calls for harmonization (Foster and Regmi 2006). Although efforts to pool funding under a SWAp are very positive (box 9.3), efforts are still necessary to avoid isolated and fragmented initiatives, streamline donor assistance, and improve outcomes.

D. Summing Up

5.29 **As acknowledged by the GoN, Nepal must make progress on multiple fronts in order to improve the health system's performance.** The government has made a commitment to improve the availability and quality of essential health care services by implementing its comprehensive HSS. While much progress has been made, much more rapid implementation of the strategy is needed, especially decentralized mode of health sector service delivery to cover wider geographical coverage. Improvements outside the health sector are also needed, as evidence from Nepal and elsewhere suggests that increases in income, literacy, access to roads, and access to water and sanitation have a significant impact on health outcomes.

5.30 Key recommendations are as follows:

- *Realign public health expenditures*. First of all, the priority given to EHCS needs to be emphasized. Second, service utilization rates of many EHCS remain very low, even in areas characterized by poor health outcomes and should be increased. The sector strategy currently includes plans for equity-based resource allocation, but little progress has been made to date. These plans should receive top priority to ensure that scarce resources are put to best use by allocating them to regions and populations lagging in health outcomes, with an emphasis on the prevention and treatment of diseases that account for the largest share of the burden of disease.
- *Strengthen incentives to encourage trained medical practitioners to serve in remote areas*. Such incentives can be both financial and non-financial, the latter including, for example, opportunities for training, improved physical infrastructure of rural health facilities and residential buildings, and a staff transfer mechanism to ensure fair deployment to remote areas. The recent innovation of posting to remote areas the fresh medical graduates who have received GoN scholarships should be continued, properly monitored, and assessed, and possibly extended to in-service training as part of fulfilling their degree requirements.
- *Strengthen the availability and use of routine health information at the local level, and over time, assess the possibility of introducing performance-based financing*. Nepal has a routine health information system, but given that the decentralization process aims to increase financial and managerial autonomy at the local and facility level, steps should be taken to strengthen the capacity to produce and use data for local-level management. Currently, reliable time-series data at the subnational level are not readily available, making it difficult to quantify the effectiveness of health interventions and undertake rigorous and frequent evaluations. Such data should be

made available to the community in order to improve accountability to citizens by informing them about the performance of health care providers. Improved information on provider performance could also open the possibility for performance-based financing interventions, either on the supply side (through the introduction of provider incentives like modeling payment based on outputs), or on the demand side (through transfer mechanisms such as vouchers).

- *Address demand-side barriers to health care utilization.* Possible interventions include vouchers and other performance-based community interventions, as noted above; exemption of the poor from user fees; strategies to combat the practice of under-the-table payments; behavior change and communication programs; and community-based programs that increase contact between trained workers and households most in need.
- *Develop public-private partnerships.* This area is particularly important given that private providers are playing an increasing role in the health sector, albeit in a poorly regulated way that raises questions about quality. For instance, there are well-established medical colleges, and partnerships with their hospitals could be established for emergency life-saving clinical services to poor people. Progress has been hampered by the inability of public and private stakeholders to agree on initial steps, the inability of MoHP to procure the necessary expertise in contracting, and legal aspects of negotiating partnership arrangements. The GoN could experiment with the contracting out of health care services. Experience from other countries, including India and Afghanistan, suggests that contracting out primary health care services to NGOs can substantially impact access to services, equity, efficiency, and service quality (Loevinsohn and Harding 2005). However, for contracting to be effective, a number of preconditions must be met: the GoN needs adequate capacity to procure and manage contracts, monitoring systems to track utilization and service quality must be available, and private providers must have capacity to deliver services of sufficient quality.[22]
- *Address causes of low disbursement.* Low disbursement should be further examined at every stage of the planning, budgeting, fund release, disbursement, reporting, and accounting cycle. These issues are further reviewed in chapters 9–11.
- *Address bottlenecks to devolution.* Efforts should be made to simplify the flow of funds; clarify roles and responsibilities; ensure clear autonomy and accountability, with the appropriate training, of health facility managers; and develop monitoring and evaluation systems.
- *Further coordinate donor spending.* Despite the SWAp, many externally funded programs remain poorly coordinated. This weakens policy coherence, increases transaction costs, and undermines MoHP staff commitment to the integrated approach. While this situation in part reflects the effects of the conflict, this practice of donor activities outside purview of MoHP should be phased out—while at the same time addressing implementation constraints of the SWAps in order to reduce staff's incentives to rely on funds directly managed by donors.

[22] An alternative to contracting out is to mobilize private financing through community-based or social pooled revenue collection. This would seem promising in Nepal given that households are the most important source of health sector financing, even among clients who receive services from public health care facilities. However, the government's strategy includes measures to extend community-based health insurance with subsidies to the poor, but little has been achieved beyond two small pilot experiences (Foster and Regmi 2006). In addition, international experience with community-based insurance is mixed.

6. Local Roads

Key Messages

- Local roads are a critical component of Nepal's development strategy, through their impact on the delivery of goods and services throughout the country, on rural development, and on good communication in the polity. Progress in expanding the network has been strong in the 1990s and early 2000s and has been an important driver of improved social outcomes. However, it has slowed down in recent years, leaving many gaps and important disparities across the country.
- Issues with network coverage are compounded by poor maintenance, which weakens the quality of roads and requires additional investments for rehabilitation. The Roads Board Nepal was established to address this issue, but its expected impact has not yet been achieved. International experience suggests that such an institutional solution does not reduce the need for the GoN to make a commitment to funding maintenance work.
- Fragmented planning, weakly anchored in strategic plans, along with delays in fund releases and problems with procurement lead to significant gaps between budgets and actuals, seriously weakening the quality of expenditures.

6.1 Nepal is faced with a difficult terrain that rises steeply from the plains of the Terai in the south to the middle hills and the Himalayan range in the north. As a result, transport costs are very high, hindering the development of markets and access to essential services. Given high costs, a varied density of population, and diverse geography, the provision of road infrastructure, particularly local roads, remains a critical challenge. The conflict situation over the past 10 years further increased the difficulty of expanding and maintaining local roads. This chapter first reviews the status of the sector and the government's strategy. Section B assesses the levels and composition of expenditures, and section C focuses on implementation issues.

A. Local Roads in Nepal: Status, Issues, Strategy

6.2 **The importance of local roads has been recognized and highlighted in several national plans and strategies.** The importance of roads and infrastructure more broadly is well documented (box 6.1). The Agriculture Perspective Plan (APP), aimed at generating rural employment with increased agricultural product diversification and improved access to markets (chapter 7), identifies provision of infrastructure in rural areas as a strategic factor for creating a virtuous circle of pro-poor growth. Both the Ninth and Tenth plans have fully endorsed the investment priorities for rural infrastructure underlined by the APP. Analytical work confirms that, between 1995/96 and 2003/04, rural infrastructure had a significant poverty reduction impact and was pro-poor at the margin (World Bank 2006a).

6.3 **Despite expansion in the 1990s, the road network remains underdeveloped.** In 2004/05, the network consisted of 17,000 kilometers of roads, of which 7188 kilometers was the Strategic Road Network (SRN) comprising 15 national highways and 51 major feeder roads and 10093 kilometers was local roads (table 6.1), bringing the total road network in Nepal to 28,000 kilometers inclusive of rural and agriculture roads[23]. The road network expanded by 5 percent a year over the last decade, with faster growth until 2002. The recent slowdown is due partly to the impact of the conflict and security problems, but it also reflects the marked decline in the allocation of resources to the road sector and the attendant degradation of existing roads. By international standards, the road network is poor (annex A 5).

[23] Inclusive of rural roads.

Box 6.1: Public Expenditure and Growth

Public expenditure on infrastructure influences growth through a number of channels. The traditional growth-enhancing effect comes from the impact on the productivity of private inputs and the return on capital. This effect is likely to be significant given the current low stock of infrastructure, notably in roads and power (see below). Public infrastructure can reduce adjustment costs for private capital (e.g., by increasing capacity to move production) and improve the durability of private capital (e.g., by protecting a firm's vehicle fleet through better-quality roads). It also has an important impact on education and health outcomes (e.g., by improving access to facilities, improving water quality, etc.), which in turn have an impact on economic growth.

	Nepal	Afghanistan	Bangladesh	India	Pakistan	Sri Lanka	Burkina Faso	Cambodia	China	Guatemala	Kyrgyz Republic	Rwanda	Sierra Leone	Tanzania	
Transport															
Roads (km per million sq km of area)	106	53	1,661	1,154	315	1,483	..	68	174	..	94	..	158	83	2
Roads, paved (% of total roads)	54	24	10	..	60	81	..	..	80	..	..	..	..	9	
Telecom															
Phone subscribers (fixed and mobile; per 1,000 people)	22	23	37	85	63	165	37	40	499	350	106	18	27	32	
Telephone average cost of call to US (US$ per 3')	2	..	1	1	1	2	1	3	3	1	n/a	2	n/a	3	n
Energy															
Electric power consumption (kWh per capita)	68	..	128	435	408	325	..	..	1,379	397	1,647	..	..	54	
Water and sanitation															
Internal freshwater resources per capita (cubic meters)	7,454	..	754	1,167	345	2,575	975	8,738	2,170	8,882	9,121	1,070	29,982	2,232	1,4
Irrigated land (% of cropland)	47	34	56	33	91	39	1	7	35	6	79	1	5	4	
Access to improved sanitation (% of population)	35	34	39	33	59	91	13	17	44	86	59	42	39	47	
Access to improved water source (% of population)	90	39	74	86	91	79	61	41	77	95	77	74	57	62	

These arguments have particular validity in rural Nepal. Data from the NLSS show that isolation (measured by the average travel time to the nearest market) has significant and large negative effect on income and subjective well-being. Conversely, where local roads exist and are reachable in a short time, they help rural areas integrate with the national and global economy by providing a link to the Strategic Road Network and other long-distance traffic facilities. Calculations for a recent World Bank-funded project in Nepal suggested that the investment for a representative road would have a 28 percent economic rate of return: at that rate, an additional 1 percent of GDP devoted to properly designed and implemented public investment in infrastructure would raise the growth potential by 0.3 percentage point. One should note, however, that the provision of sustainable local roads is only one aspect of rural transport development. Experiences in Nepal and other countries suggest that without corresponding rural transport services, the benefit of investment in local roads will not be fully realized. Therefore, in parallel with the development of the local road network, government and donors should also pay attention to the provision of adequate, affordable, and efficient rural transport services using vehicles such as buses and trucks.

6.4 **The quality of the road network is low, in particular because of expensive and poorly resourced maintenance.** Nearly 85 percent of local roads have an earthen surface, and most of them are operational only during the dry season. Of the 21,000 kilometers of local roads, only 3,600 kilometers meet the all-weather standard. Given its steep and fragile mountainous terrain, varied climate, and unstable geographic structure, Nepal has one of the most vulnerable environments for natural disasters. Even the roads that are of standard quality are frequently subject to damage from slips, landslides, run-off cuts, scouring of side slopes, and uneven settlements. Often huge amounts of sediments and debris carried out by flood waters block the cross-drainage structures, resulting in a complete washout of structures as well as damage to road formations. This results in extremely high maintenance costs, in particular for fair-weather roads. Given insufficient resources, it is not surprising that

Table 6.1: Road Network (kilometers)

		1995/06	2004/05	Annual growth (%)
Strategic Road Network	National highway	2,831	3,339	1.9
	Major feeder road	1,679	3,849	n/a
Local Roads	Minor feeder road		347	n/a
	Urban road	1,415	2,260	5.3
	District road	4,799	6,803	4.0
	Other roads	n/a	684	n/a
Total		**10,724**	**17,281**	**5.4**
Black top		3,533	5,273	4.5
Gravel		2,662	4,613	6.3
Earthen		4,529	7,394	5.6

Sources: GoN, Department of Roads (2004).

maintenance has been neglected, for local roads even more than for the SRN. The backlog of road maintenance is constantly increasing, rendering the present local road network unserviceable.

Table 6.2: Distribution of Expenditures and Outcomes

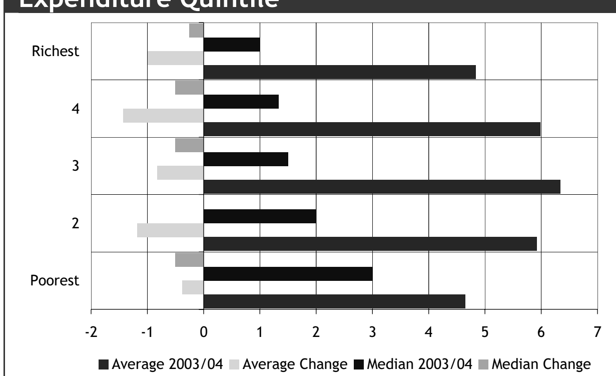
	Population (%)	Walking time to Nearest All-Season Road, Rural			Status of roads (% of total length)					2000-04 Expenditures Per Capita (Rs.)
		Less than 2 hours	2-4 hours	More than 4 hours	Motorable Roads	Highways	Strategic Road Network	Rural Roads	of which % of earthen roads	
Nepal	**100**	**58**	**11**	**31**	**100**	**100**	**100**	**100**	**100**	**100**
Districts without SRN	7	1	2	97						
Mountain	7	22	6	72	5	8	9	3	3	3
Hills	44	36	15	49	46	49	52	41	37	37
Terai	49	90	7	3	49	44	39	56	38	38
Eastern	23	56	8	36	21	22	18	22	18	18
Central	35	78	13	9	39	26	26	36	26	26
Western	20	55	13	32	18	16	19	26	21	21
Mid-Western	13	31	5	64	14	19	22	10	9	9
Far-Western	10	37	14	49	9	17	14	5	4	4

Sources: GoN, Department of Roads (2004); staff estimates.

6.5 **The distribution of the local road network is uneven.** Accessibility remains a major constraint, especially in rural areas, where 86 percent of the population lives. More than 60 percent of the road network is concentrated in the 20 districts of the Terai area, and less than 4 percent in the most remote 20 districts of the country, all in the Mountains and Hills. Fourteen of the 75 district capitals are inaccessible by motorable roads. Only 30 percent of households, mostly living in urban areas, have access to a paved road within 30 minutes. For rural households, the average walking travel time in 2003/04 was more than five hours to the nearest paved road and about three hours to vehicle-passable dirt roads. An estimated 31 percent of the population lives more than a four-hour walk from the nearest all-season road where public transport services may be available (table 6.2). There is also a stark regional disparity in road access. The Central region has the best access while the Mid-western and Far-western regions are the least connected, with more than 60 percent of their population living more than a two-hour walk to the nearest all-season road. The accessibility situation is worst in districts not connected to the SRN.

6.6 **Access is worse for poor households, with small but increasing disparities.** The estimates shown in figure 6.1 indicate that median travel time to the nearest paved road decreases with per capita expenditure: three hours for the poorest quintile against one hour for the highest expenditure quintile. But disparity in average times to access rural roads between different expenditure levels is small. Rural households across the distribution have benefited from improved access between 1995 and 2003, although richer households have benefited more; in other words, the expansion of the rural road network has not been pro-poor.

Figure 6.1: Travel Time in Hours to Reach Nearest Paved Road in Rural Areas, by Expenditure Quintile



Sources: NLSS I and II.

Note: Change is calculated between the 1995/96 and 2003/04 surveys based on panel data.

6.7 **The GoN has adopted accessibility targets, seeking to bring the entire Hill population within a four-hour walk to an all-season road and the Terai population within two hours.** This objective is formulated in the 2004 Local Infrastructure Development policy, which in turn is based on the 1997 National Strategy of Rural Infrastructure Development. The policy also commits the GoN to a decentralized governance system for development and operation of rural roads in districts. The policy is linked to a Priority Investment Plan developed in 1997 as a master plan for the road sector. In 2005, the Nepal Rural Transport Business Plan, covering three five-year periods, was established to attain the minimum accessibility in deprived areas and enhance accessibility levels in districts that are currently served by roads. About 2,200 kilometers of new rural roads are required to meet the accessibility target in districts already connected to the SRN; the Department of Roads plans to build about 1,600 kilometers of SRN in these districts. For non-connected districts, upgrading of 1,000 kilometers of existing fair-weather roads may suffice to meet the target.

6.8 **The GoN's policies also recognize the significant returns of rural road maintenance.** The 1998 Rural Roads Maintenance Plan sets yearly maintenance targets from 1999/2000 to 2006/07 and lays out the financial implications of executing the plan, as well as the expected resource contributions from different stakeholders. An autonomous roads board, the Roads Board Nepal (RBN), was established in 2002, making Nepal the first country in South Asia to attempt to establish a "second-generation" road fund. The Rural Road Maintenance Manual offers a unified approach to the DDCs for maintenance planning, resource mobilization, prioritized fund allocation, and monitoring and evaluation of repair and maintenance. The maintenance manual is also a technical guidebook for implementation of maintenance work, describing the types of maintenance and implementation modalities for each type. But since its introduction in May 2005, very few of the 75 districts are applying it. Preparation of an Annual Road Maintenance Plan (which should be an integral part of a District Transport Master Plan and submitted to the RBN) should be made mandatory before any GoN grant is allocated to the DDCs for local roads.

6.9 **Institutional responsibilities in the sector are fragmented.** The Department of Roads (DoR) used to be responsible for the entire classified network, from programming work to undertaking the works. Now, however, many more national and local entities are involved in the road sector:

- The DoR and its parent ministry, the Ministry of Physical Planning and Works (MPPW), are responsible only for the SRN.
- The Ministry of Local Development (MoLD) has the mandate to monitor, assist, and guide the development activities of local bodies. It formulates policies for local infrastructure including local roads. Based on the recommendation of the APP, the Department of Local Infrastructure Development and Agricultural Roads (DoLIDAR) was established in 1998 under the MoLD to facilitate and coordinate the process of rural road infrastructure development. It also provides technical support (e.g., an environmental and social assessment manual) and norms to local bodies.
- Local bodies—the DDCs and VDCs—are responsible for all development activities, and they have assumed more responsibilities for developing and maintaining rural transport programs. District Technical Offices were established in 1998 under DDCs to carry out all local-level infrastructure-related works by the same agency, and they have focused mostly on local roads. These offices are the focal point for program preparation and implementation, including (a) preparation and updating of District Transport Master Plans, three-year rolling plans, annual investment, and maintenance programs and budgets; (b)

procurement and management of local contractors; and (c) mobilization of community groups and beneficiaries.

- The primary objective of the Roads Board Nepal is to generate and allocate funding for road maintenance and oversee its execution by road agencies. The 13-member board includes representatives of the public sector, the private sector, and road users.

B. Local Roads Expenditures

6.10 **Expenditures on rural roads have been stable at around 1.5 percent of the budget** (table 6.3). While spending on the whole road sector has been declining, spending on rural roads has been largely protected. Spending on local roads occurs through four channels, reflecting the institutional complexity of the sector:

- *Direct tied grants by the GoN to DDCs*. Based on local revenues and the DDCs' capacity to mobilize matching funds, the MoLD authorizes a budget to provide the DDCs with additional resources for developing and managing local roads programs. The ministry stipulates what percentage of the budget should go to VDCs and DDCs to carry out village-level and district-level projects respectively. DDCs, in collaboration with district line ministry departments, prepare annual action plans that include projections of resource requirements for rural transport. Periodic reviews of these plans by the MoLD help determine the amount of the annual lump-sum grant to be allocated to the DDCs for local transport in line with the MTEF.

Table 6.3: Road Sector Expenditures

	9th Plan					10th Plan					Average of	
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 (E)	2006/07 (B)	9th plan	10th plan
Roads (Rs. billion), Central Gvnt	**9.9**	**9.3**	**7.8**	**7.7**	**7.0**	**5.8**	**6.0**	**5.6**	**5.6**	**7.2**	**8.3**	**5.8**
in real terms (2003/04 Rs. billion)	13.1	11.0	9.0	8.6	7.6	6.0	6.0	5.4	4.9	6.0	9.9	5.6
as % of all expenditures (GFS definition)	6.1	5.3	5.9	4.9	5.4	5.0	5.2	5.3	6.0	7.3	5.5	5.4
as % of GDP	3.3	2.7	2.1	1.9	1.7	1.3	1.2	1.0	1.0	1.1	2.3	1.1
Composition by Program	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Road (administration)	2	2	3	3	4	5	4	4	5	3	3	4
Highways	15	7	14	20	27	29	28	16	14	7	17	22
Rural roads	18	23	31	35	30	23	26	28	27	38	27	26
o/w Dpt of roads	12	11	16	17	16	8	12	10	7	13	14	9
o/w M. of Local Devpt	6	11	14	18	14	15	14	19	20	25	13	17
Bridges	6	6	12	11	9	5	7	9	7	7	9	7
Rehabilitation	40	44	26	17	17	14	16	25	32	35	29	22
Road maintenance	18	17	13	11	9	9	14	15	14	10	13	13
o/w rural roads	-	-	-	0	0	0	1	1	1	0	0	1
Others	2	1	2	3	4	16	4	2	2	1	3	6
Rural roads (Rs. Billion)	**1.8**	**2.1**	**2.4**	**2.7**	**2.1**	**1.4**	**1.6**	**1.6**	**1.5**	**2.7**	**2.3**	**1.5**

Sources: GoN; staff estimates.

- *DDCs' own resources*. In addition, DDCs spend an estimated US$19 million from their own revenues and block grants on local roads (World Bank 2005). Resource mobilization remains weak at the local level, and most local bodies still depend heavily on various forms of central government grants for local road construction (chapter 11).

- *Spending by the Roads Board Nepal*. The RBN funds come from road user charges, including fuel levies, road tolls, and vehicle registration charges. Road agencies prepare the ARMP and submit it to the RBN for approval. The RBN prepares an Integrated Annual Plan, taking into account the available budget in the Road Fund and the level of traffic for setting priorities. The RBN spends about 30 percent of its total budget on local roads. In 2006/07, it had budgeted Rs. 160 million for the maintenance of local roads from its funding, up from Rs. 95 million in 2004/05, its initial year of operation.

In addition, the GoN has also provided Rs. 40 million direct maintenance fund to DDCs through the MoLD.

- *Donor contributions*. The local road network depends heavily on foreign sources, which account for over 40 percent of the rural roads budget. Donor assistance is also provided to local bodies based on agreements with individual donors for active programs. These "off-budget" funds make the actual donor contributions an even higher percentage of the budget.

6.11 **Public expenditures are mostly directed to expansion of the network in rural areas.** More rural roads are constructed than highways and strategic feeder roads combined; rural roads accounted for 85 percent of total new kilometers of road construction in 2003/04. Rehabilitation of existing roads and maintenance lag behind, with 35 percent of total expenditure in the Tenth Plan and 42 percent in the Ninth. The distortion in the initial budget is further aggravated by the practice of diverting resources allocated for maintenance to new road construction and road upgrading, as well as by high sunk costs of incomplete road construction activities.

6.12 **Rural investments are concentrated in the Hills and are mostly earthen roads** (table 6.2). To achieve the sector objectives for road access (two and four hours' walking time), road sector investment should target areas with high population density and poor road connectivity. Toward this end, the Priority Investment Plan identifies 7,900 additional kilometers of roads by 2010 and 1,800 more by 2016 to achieve walking times to the nearest road of two hours in Terai and four hours in Hills and Mountains.

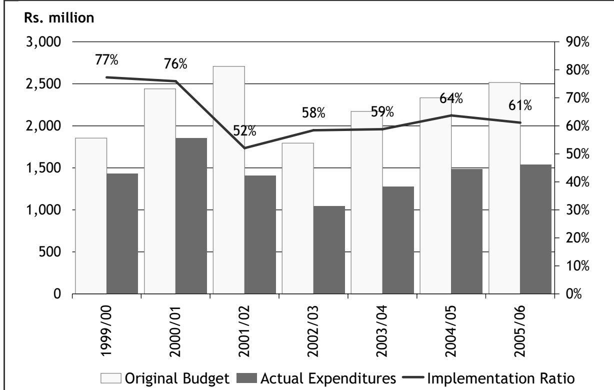
6.13 **An expected financing gap could jeopardize implementation of the Nepal Rural Transport Business Plan.** The plan assumes an approximate yearly expenditure of Rs. 2–2.5 billion—more than twice the Rs. 1 billion spent in recent years. Assuming donor assistance to the local road sector remains at about Rs. 4 billion for each five-year period, local resource mobilization is crucial to fill the funding gap. Otherwise, the rural transport plan needs to be scaled down to include only priority tasks.

6.14 **The potential for resource mobilization from road users through the RBN is underutilized.** International experience shows that road boards are not a panacea; they require government to give priority to road maintenance (Gwilliam and Kumar 2003). An effective way to achieve resource mobilization is to require road users rather than taxpayers to pay for improved road maintenance, as has been done in some other countries. Although the RBN was established to capture such additional revenues, it is still in its infancy and is widely perceived as ineffective. Tapping its potential would require GoN commitment and support to ensure that the fuel levies and other revenues generated by the road sector are fully and efficiently transferred to the Road Fund. The Roads Board in return needs to improve its organizational capacity to ensure that it manages the Road Fund efficiently, allocates resources in an effective manner, monitors the outcomes from Road Fund disbursements, and maintains an objective advocacy for the resource needs of the sector.

C. Planning and Implementation Issues

6.15 **Significant gaps between budgeted and actual expenditures and insufficient maintenance are the key planning and implementation issues.** Between 1999/2000 and 2005/06, actual annual expenditure on local roads averaged 64 percent of the budgeted amounts (figure 6.2). The gap has been particularly large since 2001/02, probably as a result of project implementation interruptions caused by the Maoist insurgency. However, gaps between allocations and expenditures of 25 percent even before the insurgency suggest a need to address underlying issues.

Figure 6.2: Budgeted and Actual Expenditures on Local Roads



Sources: GoN; staff estimates

6.16 **First, there are concerns regarding the budget planning and allocation process in the road sector.** There is no strategy to guide planning and investment in the local road network. Many local roads were built without any priority plans or engineering standards in the 1990s. Local initiation in building unplanned intra-village roads is still a problem, and the GoN has no inventory of such unplanned roads or expenditure records on them. Unsustainable and environmentally damaging roads were built, and many kilometers were built without much utilization as the road was either not connected to the network or there were no vehicles operating in the area. Moreover, the local road sector focuses on discrete project interventions led by the requirements of each funding agency. When plans exist, they often use a project-based approach rather than a policy-based strategy. In this context, rural road sector investments have often been influenced by ad hoc decisions rather then planned systematic operations.

6.17 **Progress can be made by strengthening the District Transport Master Plans (DTMP).** The basic approach of a DTMP entails (a) preparing and finalizing an indicative development potential map of the district, (b) preparing a district inventory map of the local road network, (c) collecting demand through formal requests for new transport linkages from VDCs, and (d) preparing a five-year rural road master plan of the district (World Bank 2005). Such an approach ranks projects using predefined criteria based on identified existing and potential development areas, takes into account all possible financial resources of the DDC and concerned VDC, and projects expenditures for each year. While a positive step, the submission of the DTMP and annual program and budget by DDCs should be advanced to an earlier point in the year, for instance, before March 15 (especially as the MoLD/DoLIDAR approval process takes considerable time). In addition, the quality of these plans, in terms of strategic prioritization, and their enforcement, notably by donor projects, should improve. Finally, the central government should ensure that these local plans feed into national plans (chapter 11).

6.18 **Budget fragmentation and over-programming also create implementation issues.** The budget currently has more than 10 budget head categories to transfer central government funding to districts to implement road investment and maintenance programs. These schemes not only lead to resource fragmentation, but also limit DDCs' flexibility to optimize the use of resources among competing needs and allocate resources to an approved rural road investment and maintenance program. Similarly, over-programming leads to spreading resources too thin across these budget lines and across districts, at the expense of strategic targeting.

6.19 **Second, procedural, regulatory, and administrative constraints have led to delays in releasing funds.** The budget release process is reviewed in chapter 10. Budget authorization from the MoLD to DDCs is often delayed, which in turn leads to project implementation delays (World Bank 2006b). This is partially due to late submissions of the DTMP by DDCs and a time-consuming approval process by the MoLD. Two potential areas for streamlining are the tied GoN direct grants to the DDCs and the Road Fund: these could be released as cash grants, with DDCs and the RBN ensuring monitoring of implementation in their respective areas.

6.20 **Third, there are issues with contracting capacity and procurement methods.** Contractors' capabilities are poor. This is compounded by severe procurement issues in the sector, with participation in bidding processes often limited to a very small number of firms. Using area-based term contracts that move toward output-based rather than input-based specifications could be a way to facilitate participation of non-public sector actors, especially in the execution of routine maintenance.[24] For instance, road user groups (including transport service operators) could be involved in road execution, and community-based organizations in project monitoring. Compared with local contractors, these groups have the potential to be more cost-effective and to deliver resources more directly to the poor by creating local employment and off-farm income-generating opportunities. Involving community based organization can allow local labor to develop useful skills in construction methods that can last long after a project is finished. It can also foster participation and ownership of local communities in road improvement and monitoring and improve the transparency of investment in rural roads and have strong support from DDCs (World Bank 2003).

6.21 Fostering the participation of non–public sector actors will require a framework for greater participation by all nongovernment stakeholders in overall policy formulation (in an advisory capacity) and in the governance of implementing agencies. Allowing private stakeholder groups to have representation on the RBN was a good way to develop a viable partnership between the public and private sectors. In addition, the GoN could consider putting in place public monitoring systems—for instance, through road user satisfaction surveys—to collect, disseminate, and debate data showing progress against established output indicators. An effective system (for instance, as part of DoR's Rural Transport Infrastructure Management Information System) is needed to monitor the performance of consultants and contractors and keep non-performing ones from winning future jobs. As for the community-based organizations that offer a viable institutional option for carrying out small civil works, they too require technical support—as well as substantial lead time and upfront mobilization—to ensure timely delivery of high-quality outputs.

6.22 **Finally, development of institutional and human capacity, especially in DoLIDAR and at the local level, is vital.** Capacity-building activities need to shift focus from projects to sustainable sectorwide performance outcomes. The capacity of local governments should be increased through targeted and practical training programs in order to strengthen the DDCs' technical and managerial capabilities (chapter 11). Capacity-building efforts will be driven by the quality of institutional coordination. Although implementation takes place in decentralized local government agencies, central government plays an indispensable role in setting up the policy and institutional framework and providing technical backstopping. Planning and implementation performance in the sector have not been strong. The four main government entities, MPPW, MoLD, DoLIDAR, and DDCs, have mostly pursued separate planning and

[24] Although the GoN promulgated a Build, Operate and Transfer Act in 2003 to promote private sector participation in the sector, the low volume of traffic is unlikely to attract much private sector interest in exploring concession arrangements in the short term.

implementation processes. Achievement of planned targets has not been effectively monitored, and there has not been an effective performance incentive framework (World Bank 2005). There is a greater chance of duplication of works under different funding sources by the local bodies. The central agencies should closely monitor the DDCs' transport policy, strategy, and plan in line with GoN strategy. In this context, their respective roles need to be further clarified and reconsidered if needed—for instance, the role of DoLIDAR in coordinating local road agencies' ARMP and implementation; the role of MPPW in RBN; MoF's role in monitoring implementation progress for fund release, and so forth.

7. Agriculture

Key Messages

- Agriculture has the potential to be one of Nepal's dynamic sectors and to contribute much to poverty reduction. Recent experience has not met these expectations, however: while agriculture growth has picked up since the early 1990s, diversification, commercialization, and exports remain limited.
- The Agriculture Perspective Plan provides a sound vision for the future of agriculture in Nepal. But it needs to be complemented by better sector strategies that, based on a clear understanding of demand and incentives, would delineate well the role of the public sector in relation to the private sector.
- Despite the Tenth Plan's commitment to the agriculture sector, public expenditures have been declining. This, however, in part reflects implementation constraints on large surface irrigation schemes and a phasing-out of subsidies for fertilizers and shallow tube wells.
- Expenditure priorities and possibly the overall envelope for the sector need to be reviewed, based on a clearly defined sector strategy.

7.1 This chapter reviews public programs and public expenditures in the agriculture sector.[25] Section A assesses the structure of the sector and constraints to growth, and outlines the government's sector strategy. Section B reviews the allocation of public expenditures, and section C examines planning and implementation issues. Section D concludes with a series of recommendations.

A. Agriculture in Nepal: Importance and Strategy

The Agriculture Sector

7.2 **Agriculture is a critical sector of Nepal's economy.** It still accounts for almost 40 percent of total GDP. In rural areas, where 85 percent of the population lives (the highest share in the region), 93 percent of households are engaged in agriculture, and agriculture accounts for some 59 percent of total income. Approximately 95 percent of the poor live in rural areas (in 2003/04), and poor Nepalis in rural areas have less diversity in their sources of income, relying overwhelmingly on agriculture. Improvements in the sector could therefore have a major impact on poverty. Agriculture growth could also help address Nepal's nutrition problems (chapter 5).

[25] This chapter highlights preliminary findings, building on the agriculture sector performance review (GoN/ADB 2005) and the 2006 poverty assessment (World Bank 2006a). Initial findings from the expenditure review were presented at the "APP: From Vision to Action" workshop in November 2006 in Kathmandu. Further work on reviewing expenditures in the sector is ongoing. In this chapter, the agriculture sector includes agriculture, irrigation, forestry, and land survey and management. The role of the Nepal Food Corporation is not reviewed.

7.3 **Nepal's agriculture is focused on crops.** Crop production continues to be dominated by cereals (table 7.1). Three major crops account for 80 percent of the total cropped area and 66 percent of the gross crop output. Paddy is the dominant crop across the country. Wheat and maize follow in the Terai, while maize is more important than wheat in the Hills and Mountains. Production of other crops has increased in recent years, with some rapid growth in high-value crops such as citrus, apples, mango, vegetables, and tea. Livestock rearing is also an important—and more dynamic—source of income, with a recent shift toward poultry and small ruminants (sheep and goats) at the expense of cows and buffalos. Forestry also provides a substantial renewable resource in rural areas in the form of timber, fuelwood, and so on. Commercialization of agriculture has increased in recent years, even though agriculture remains largely oriented toward subsistence: the value of agriculture that is sold increased from 16 percent to 25 percent of the gross crop output between 1995/96 and 2003/04. Exports have also been increasing, from less than 5 percent of agriculture GDP in the early 1990s to over 35 percent around 2000.

7.4 **Nevertheless, agriculture has not been very dynamic.** Since the early 1990s, agriculture has been growing at 2 percent per year in nominal terms, against 4 percent for the rest of the economy. Diversification has been slower than expected, and the share of land cultivated with high-value crops is still limited. Domestic and export commercialization remains weak for most products. As a result, despite the potential noted above, the assessment of the poverty decline over the last decade suggests that agriculture has played a very small role, mainly because of the poor performance of the crop sector.

Table 7.1: Agriculture Production

	Area, 2005/06 (million ha.)	Annual growth, 1992/93 - 2005/06, % p.a.		
		Area	Production	Yield
Cereals	**3.4**	**0.9**	**3.2**	**2.2**
Paddy	1.5	1.1	3.3	2.1
Maize	0.9	0.9	2.5	1.6
Wheat	0.7	0.6	4.4	3.7
Barley	0.0	(2.9)	(1.5)	1.4
Millet	0.3	1.5	1.4	(0.1)
Cash Crops	**0.4**	**2.2**		
Sugarcane	0.1	4.0	5.3	1.3
Jute	0.0	0.1	2.5	2.4
Oil Seed	0.2	0.6	2.5	1.8
Tobacco	0.0	(6.8)	(5.7)	1.1
Potato	0.2	4.3	8.0	3.5
Vegetables	**0.2**	**2.3**	**4.9**	**2.6**
Spices	**0.1**	**2.6**	**6.3**	**12.6**
Cardamom	0.0	2.3	3.8	1.4
Ginger	0.0	6.2	11.2	4.7
Garlic	0.0	13.0	19.2	5.5
Turmeric	0.0	12.6	17.6	4.4
Chilies	0.0	11.5	16.3	4.3
Pulses	**0.3**	**(0.1)**	**2.8**	**2.9**
Fruits	**0.1**	**3.4**	**3.3**	**(0.0)**
Citrus	0.0	5.8	6.7	0.9
Winter (Deciduous)	0.0	2.5	2.6	0.1
Summer (Tropical)	0.0	2.8	2.4	(0.4)
Other crops	**0.0**			
Cotton (92/93-04/05)	0.0	(35.2)	(36.4)	(1.9)
Tea	0.0	23.4	20.3	(2.6)
Coffee	0.0	20.6	25.9	4.4
Livestock products				
Milk			3.1	
Meat (Net)			3.0	
Egg			4.2	
Wool			(0.4)	

Source: Statistical Yearbook 2001 and 2005.
Note: Growth calculated through regression trend.

7.5 **Numerous constraints lead to low productivity in the sector.** Indeed, despite a considerable increase in the use of modern inputs, yields have increased only modestly. At 2,200 kilograms per hectare, cereal yields are the lowest in the region (annex A.5). Progress needs to be made on two fronts. First, on the supply side, modernization and diversification are essential, as the Green Revolution that changed the agriculture of neighboring India has not impacted Nepal. This would include increased use of fertilizers, irrigation, and extension services. In particular, the very large natural water resources of Nepal are not being used to their potential. Second, on the demand side, a focus on commercialization—including exports—would drive demand up. Efforts at marketing, rural access (see chapter 6), and quality control will be crucial.

7.6 **Most constraints to higher productivity and commercialization bear particularly on poor households.** Access to irrigation (notably groundwater schemes) and use of fertilizers and improved seeds are lower for the poorest households. Access to markets, as noted in chapter 6, and access to land are also lower for poor households.

The Agriculture Perspective Plan

7.7 **The Agriculture Perspective Plan is a 20-year plan approved in 1995.** This is the main policy document for the sector, designed to accelerate agricultural growth. A National Agriculture Policy was approved in 2004. The APP lays priority on the production of cereal crops, livestock, horticulture, and high-value commodities such as fruits, off-season vegetables, sericulture, and community forestry. It puts the emphasis on inputs, including availability of fertilizer, farmer-controlled year-round irrigation, generation and dissemination of appropriate technologies, and development of rural infrastructure, especially roads and electricity.

7.8 **The APP seeks to differentiate a technology-driven strategy for the Terai (with a focus on food crops) from a demand-driven strategy for the Hills and Mountains (with a focus on high-value commodities).** The objective is to build on the synergies between complementary inputs, taking into account the different potential of each region (table 7.3). The APP posits that the Terai offers the greatest agro-ecological scope for a green revolution. Thus it supports the development of groundwater based on shallow tube well schemes, which in turn require rural electrification. Conversely, the Hills and Mountains were found to have a comparative advantage in horticulture and livestock. For these regions, the APP puts the emphasis on technology and commercialization. Through the Prioritized Pocket Program, the APP focuses on packaging priorities to enable complementarities between inputs.

7.9 **The APP remains a valid vision and strategy.** It adequately emphasizes the need to develop the use of technology and provide infrastructure to increase productivity. It also puts the right emphasis on synergies between inputs, through the Prioritized Pocket Program, to concentrate efforts in key areas with high potential. However, through its heavy focus on plans and on detailed, quantified targets, it underestimates the role of incentives and the demand side of the agriculture market—even though it recognizes that the market will determine priorities.

7.10 **As a result, the APP as an implementation plan has not worked well.** Its design as a "plan" has led to an overemphasis on specific inputs and outputs, as opposed to focusing on outcomes and facilitating choices by the private sector. In particular, a good business plan should clarify the respective roles of the public and private sectors and the institutional responsibilities in the public sector.

Role of the Public Sector

7.11 Indeed, the role of the public sector in agriculture deserves debate. On the one hand, given the potential impact of the sector on poverty, there seems to be a strong rationale for the government to intervene. On the other hand, many of the important decisions (on the use of technology, irrigation, fertilizer, crop selection, commercialization) are made by the private sector, and there is evidence that the public sector is not well placed to substitute for the private sector in making these decisions.

7.12 This leaves the public sector with a role that focuses on areas with clear externalities and involves facilitating private sector decisions (as opposed to making them, for instance by imposing special technologies or manipulating prices through subsidies to distort private sector decisions). Basic research and many aspects of adoptive research are clearly public goods, deserving priority attention by the government. Extension services, by disseminating information, present positive externalities that can justify public intervention. There are also market failures with respect to irrigation services, although it might not be necessary to subsidize these services given that access to water has a high rate of return for farmers. A number of quality control and veterinary services also have a public-good dimension, although they do not necessarily need to be delivered by public institutions. For instance, in the delivery of livestock services, certain key functions—managing national systems of disease surveillance, undertaking disease eradication campaigns, supporting basic research and extension, as well as playing a regulatory role for drug, vaccine, and feed safety—are clearly public sector responsibilities. But private sector participation should be encouraged in the provision of animal health services, herd improvement, and research and development, keeping in mind that evidence from other countries indicates that remoteness and poor roads may sometimes limit the feasibility of viable private sector delivery of these services in some locations. Similarly, while there are crucial regulatory, research, and management functions for food safety, the private sector also has an important role to play in setting standards and ensuring actual compliance with food safety requirements. Finally, as discussed in chapter 6, there is a role for the government in facilitating the expansion of rural infrastructure. On the other hand, input subsidies (e.g., fertilizers, credit) and output subsidies (e.g., on specific products) have little rationale. They tend to distort production decisions, are often poorly administered with large leaks, and tend to be pro-rich, benefiting mainly large farmers.

B. Agriculture Expenditures

7.13 **Expenditures in the agriculture sector have been declining in relative terms**, from 2.0 percent of GDP during the Ninth Plan to 1.4 percent during the Tenth Plan (table 7.2). This decline seems inconsistent with the Tenth Plan's vision of high priority to agriculture. As a share of agricultural GDP, expenditures amount to less than 5 percent, which is slightly below the proportion in Africa and half the proportion in Asia—even though the agricultural sector in Nepal accounts for a larger share of overall GDP (Fan and Rao 2003). But agriculture accounts for 8–9 percent of all expenditures, above the proportion in Africa (5.0 percent) and Asia (7.4 percent). The decline in expenditures is mirrored by a decline in donors' commitments to agriculture, from 25–30 percent in the 1980s and early 1990s to 10–15 percent in recent years, based on data from the Organisation of Economic Co-operation and Development's Development Assistance Committee (OECD/DAC). It is, however, offset by an increase in farmers' expenditures on all inputs (fertilizers, seeds, irrigation, land rents, and hired labor).

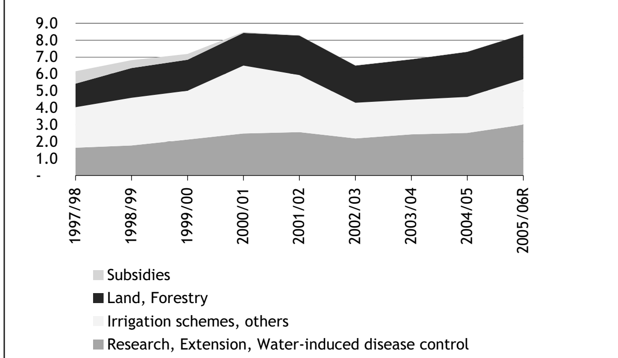
Table 7.2: Agriculture Expenditures

	9th Plan					10th Plan					Average of	
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 (E)	2006/07 (B)	9th plan	10th plan
Agriculture (Rs. billion)	**6.2**	**6.8**	**7.2**	**8.5**	**8.3**	**6.5**	**6.9**	**7.3**	**8.3**	**10.7**	**7.4**	**7.3**
in real terms (2003/04 Rs. billion)	8.1	8.1	8.2	9.5	9.0	6.8	6.9	7.0	7.3	8.9	8.6	7.0
as % of all expenditures (GFS definition)	6.1	5.3	5.9	4.9	5.4	5.0	5.2	5.3	6.0	7.3	5.5	5.4
as % of GDP	2.0	2.0	1.9	2.1	2.0	1.4	1.4	1.4	1.4	1.7	2.0	1.4
Composition by Program	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Agriculture, of which	36	30	31	29	33	30	29	32	34	37	32	31
Agriculture	20	15	16	11	14	13	14	14	14	12	15	14
of which subsidies	n/a	n/a	3	0	0	0	0	n/a	n/a	n/a	1	0
Livestock services	9	7	7	8	9	9	7	7	9	9	8	8
Research institution	5	6	6	7	8	6	5	6	8	8	6	6
Agricultural Development Bank	4	2	1	1	2	2	2	6	1	15	2	3
Irrigation, of which	41	45	44	48	38	36	36	32	34	37	43	34
Large surface irrigation	21	22	21	26	21	15	12	10	10	9	22	11
Ground water and non conventional	1	3	1	2	1	2	1	3	4	6	2	3
Small and Hill area irrigation	13	15	16	15	11	10	9	9	10	13	14	10
Land reform and survey	7	8	7	7	8	8	9	9	9	7	8	9
Forest	15	18	18	15	20	25	26	27	22	18	17	25
Pro poor expenditure (% total)	**52.2**	**47.9**	**48.8**	**43.5**	**45.8**	**47.5**	**46.0**	**46.4**	**43.9**	**49.3**	**47.7**	**45.9**

Sources: GoN; staff estimates.

7.14 **There have been important shifts in the composition of spending** (figure 7.1). The share of public goods like research, extension, and waterborne disease control has increased from 27 percent in the mid-1990s to 35 percent in the mid-2000s. At the same time, subsidies on fertilizers and shallow tube wells were reduced from over Rs. 700 million in 1997/98 (10 percent of total expenditures on agriculture) to around Rs. 10 million in 2005/06. Expenditures on irrigation schemes have decreased, while spending on the forestry sector has been increasing, notably for parks.

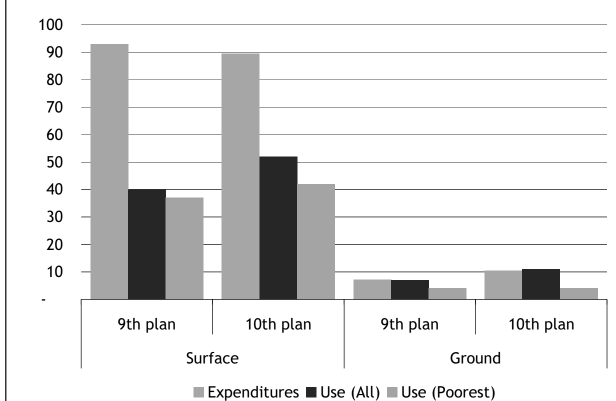
Figure 7.1: Expenditures in the Agriculture Sector (Rs. billions)



Sources: GoN, staff estimates. **[[Change water-induced to waterborne]]ok**

7.15 **Expenditures on irrigation have been declining in recent years.** A major development has been the elimination of the subsidy for shallow tube wells (STW). This seems to have caused a decline in the demand for these schemes, even though economic rates of returns indicate that they would be profitable to many farmers without subsidy (the decline in numbers of shallow tube well installed could indicate an expectation that the subsidy would be reintroduced). Demand has shifted to deep tube wells (DTW), which remain subsidized. As a result, the proportion of rural households using STW and DTW increased from 7 percent to 11 percent between 1995/96 and 2003/04 (figure 7.2).[26] Poorer households have not benefited from this increase in access. Surface schemes (canals) remain the largest expenditure item and the most widely used systems. Although investments in large surface schemes have been declining, together with investment in infrastructure, access to these schemes increased from 32 percent to 47 percent of rural households between 1995/96 and 2003/04. Finally, a major and persistent issue is the weakness of cost recovery for operation and maintenance, despite a policy of joint management of irrigation schemes by farmer groups.

Figure 7.2: Irrigation Spending and Access (%)



Sources: GoN; NLSS; staff estimates.

Note: Surface refers to canal schemes and ground to STW/DTW schemes. Expenditures are % of total sector spending . Access is shown as % of rural households.

7.16 **A variety of providers offer extension services**. They do so mainly through the Department of Agriculture for crops (61 percent of public spending for extension) and the Department of Livestock Services (39 percent). Extension accounts for about 14 percent of public expenditures on agriculture. But this represents only half a percentage point of agriculture GDP, and only 20 percent of all farmers have access to extension.

[26] One constraint in this area in the need for electrification in rural areas, which is not reviewed in this chapter. Among other things, a review of the sector should evaluate the innovative policy of subsidizing 80 percent of the cost of community electrification, with the community providing the other 20 percent.

7.17 **Expenditures on research remain weak,** at around 3 percent of expenditures in the sector. The National Agriculture Research Council, an autonomous body created in 1991, is the main institution in charge of research. Its funding is highly dependent on the budget and on donor funding. In 2001, the National Agriculture Research and Development Fund (NARDF), a system of competitive grants, was introduced.

7.18 **Public spending on fertilizer declined as the subsidy was phased out and the sector opened to competition.** As a result, the role of the public entity, the Agricultural Inputs Corporation, has become a minor one. The reforms have had their intended effect of unleashing the demand for fertilizer, with the proportion of farmers using fertilizers increasing from 55 percent in 1995/96 to 63 percent in 2003/04 (although there are some concerns about quality). Nevertheless, the use of fertilizer in Nepal is a fraction of that in neighboring countries (see annex A 5).

7.19 **Public sector institutions expected to provide rural finance are not effective** (see World Bank 2007b). There are four such institutions: the Agriculture Development Bank Nepal, the Nepal Bank Limited, the Rastriya Banijaya Bank, and the Regional Rural Development Bank . As noted in chapter 2, they in fact contribute to the significant risks of Nepal's financial situation. There are plans to substantially increase the activities of the Agriculture Development Bank, as evidenced by the planned budget increase in 2006/07.

7.20 **In forestry, the growth in expenditures is related to the National Parks and Wildlife Conservation program.** Forestry is an important sector, given that forests cover almost 30 percent of Nepal's land area, but forest cover has been shrinking at almost 2 percent per year (World Bank 2007c). The main program in the forestry sector relates to protected areas, which cover 18 percent of Nepal's land. On the other hand, despite the successes of community forestry (box 7.1), spending on these schemes has not been dynamic.

7.21 **Expenditures on land reform and survey have been largely stable in real terms.** They are equally divided between land reform and land survey.

7.22 **There are important differences in agricultural characteristics, strategies, and spending patterns in the different parts of Nepal** (table 7.3). The most striking feature is the low public spending in the Terai, given that agriculture in this region is much more input-intensive, diversified, and productive. This notably reflects the influence of in-put policies in northern states of India, which is significantly subsidized and operating in an open border.

Table 7.3: Agriculture Inputs and Outputs by Region

	Characteristics					Expenditures				Output			Inputs (% farmers using:)				
	Pop.	Area	Elevation	Density	Poverty	Share	Per cap (Rs.)	Per cap (index)	Growth	Diversification 1/	Sales as share of GCO	Gross Crop Output per ha	Irrigation	Fertilizers	Purchased Seeds	Extension Services	Accessibility (2/)
Eastern	23	19	1,348	188	31.3	18	98	80	-11.9	0.43	27	21,088	65	54	38	18	34
Central	35	18	1,469	297	27.9	40	141	115	1.4	0.42	25	37,470	70	82	37	23	58
Western	20	20	1,961	155	34.6	17	107	87	-3.0	0.36	27	22,730	60	63	48	17	48
Mid-Western	13	29	1,789	72	46.1	16	147	120	-2.6	0.27	21	31,863	66	46	38	17	24
Far-Western	9	13	2,184	112	46.0	9	120	97	-1.0	0.29	23	21,333	82	47	45	22	33
Mountains	12	35	2,901	54	35.1	15	151	123	-4.2	0.28	20	19,424	75	48	26	13	13
Hills	46	41	2,193	179	35.6	57	151	123	-2.5	0.32	23	27,200	60	58	33	17	30
Terai	42	24	674	279	32.1	28	84	68	-2.8	0.46	28	30,818	72	72	51	23	62
Nepal	**100**	**100**	**2,759**	**158**	**34.1**	**100**	**123**	**100**	**-2.8**	**0.38**	**25**	**28,046**	**67**	**63**	**41**	**20**	**43**

1/ Herfindael index (high index => low diversification; 2/ % farmers with nearest paved road at less than 10 km

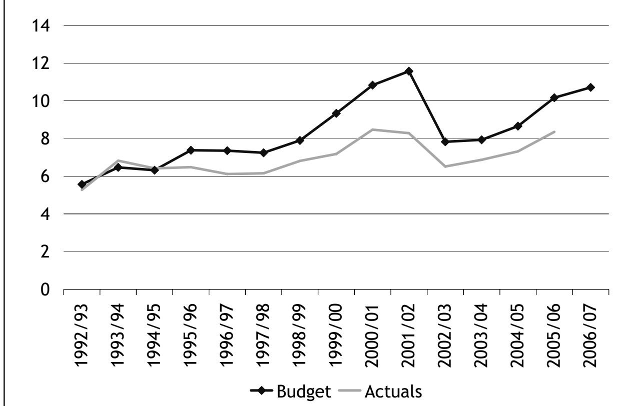
Sources: GoN; staff estimates.

C. Implementation Issues

7.23 **A review of budgets and actuals highlights important implementation bottlenecks** (figure 7.3). Part of the gap observed in 2000/02 reflects implementation constraints with respect to large surface irrigation schemes.

7.24 **The agriculture sector has also demonstrated the potential of community-managed schemes.** The example of the forestry sector is the best known (box 7.1). In the irrigation sector, schemes are managed by farmer groups as well. The potential role of farmer groups should be further explored.

Figure 7.3: Budgeted and Actual Expenditures in Agriculture Sector (Rs. billions)



Sources: GoN; staff estimates.

Box 7.1: Forest User Groups

Over 13,000 "forest user groups" (FUG) have been established in Nepal and now manage over a quarter of the country's forest land. The process was initiated with the 1993 Forest Act, which transferred nationalized forests from state control to local communities, and accelerated during the late 1990s. FUGs are composed of households residing near a forest, which typically rely on the forest for a variety of products (fuelwood for energy, timber and poles for construction, fodder and grass for livestock feed). Communities can create community funds supported by forest user fees and penalties, auctions of surplus forest products, as well as donor assistance.

Forest management can be a typical example of the "tragedy of the commons," whereby natural resources are poorly managed because of problems of free-riders and lack of coordination. This indeed was a major problem in Nepal a decade ago.

The experience of forest user groups in Nepal shows that community management of forests can improve consumption, especially of low-income households. In particular, the presence of FUGs increases per capita consumption expenditure, on average, by around 6 percent, with a higher gain for the asset-poor and the land-poor. The presence of FUGs has no impact on consumption expenditure of the asset-rich, but for the asset-poor households, the presence of FUGs increases household welfare by about 7 percent. FUGs have also been able to generate resources for community development activities (e.g., paying the salary of a local school teacher, building a road or a bridge, etc.). However, community forestry does not have a significant effect on fuelwood extraction.

Sources: World Bank 2006 ; Bandyopadhyay, Shyamsundar, and Kanel 2005.

7.25 **Weak institutional coordination and capacity seems to be an important constraint.** As noted in the previous section, there are many institutions involved in the sector, but their roles and responsibilities seem fragmented. This is evident in particular for monitoring: initially the National Planning Commission was in charge of monitoring the implementation of the APP (through the Independent Analytical Unit), but when it was discharged from this function, no alternative mechanism was set up. This is also evident for extension services, which were devolved to districts in 2002: however, as in other sectors (chapter 11), coordination between DDCs and the central departments remains weak.

D. Summing Up

7.26 There are six key recommendations in the agriculture sector:

- *Define an implementable business plan, based on a clear definition of the role of the public sector*. The APP continues to provide an adequate strategic anchor and vision for the sector. However, it needs to be transformed into an implementable plan, one that will focus less on specific quantified targets of inputs and outputs and more on ensuring an adequate role for the public sector. A clear monitoring framework (including the institutional framework) should be put in place for this business plan.
- *Review expenditures on the basis of this business plan and reorient spending toward public goods*. In a context of limited fiscal resources, public expenditures should focus on research and extension and on rural infrastructure, given their importance to agricultural productivity and the clear rationale for funding those public goods. With respect to rural infrastructure, the role of rural roads was discussed in chapter 6. There is some evidence that the provision of irrigation services has high private returns and hence should receive limited public subsidies. Issues of rural electrification were not discussed here and deserve further review. Finally, research and extension is insufficiently funded. Not only is this function an important public good, it can also help mitigate the impact of phased-out subsidies (e.g., research and extension can help raise the rate of return of water supply and to use of different fertilizer use trials). While the public sector has a role in expanding this function, private sector participation should also be encouraged, for instance based on the NARDF.
- *Improve incentives for irrigation*. The phasing out of the subsidy on STW has led the demand for irrigation schemes to shift toward DTW and surface schemes, although these are not necessarily more cost-effective. Incentives should be further reviewed to avoid distorting the demand.
- *Expand the role of communities and user groups in the sector*. Given the development potential of these groups in forestry and other sectors, the potential role of farmer groups and producer organizations should be harnessed, especially to enable small farmers to take advantage of scale economies. More generally, the issue of public-private partnerships should be further explored once the implementable plan is defined.
- *Consider programs to help poor farmers cope with risks*. Poor farmers tend to be very vulnerable to a variety of shocks. This has often been the rationale for some subsidies, but as noted above, subsidies are not an effective way to help poor farmers mitigate risks. Means-tested transfers or schemes like the Poverty Alleviation Fund (box 3.1) can provide a better response. Some investment, for example in roads, can also be targeted at poor areas.
- *Further analyze the sources of growth in the livestock sector and the price dynamics in the agriculture sector*. There remains a need for further analytical work to better understand the constraints of the sector and the potential directions for public policy.

8. Financing the Budget

Key Messages

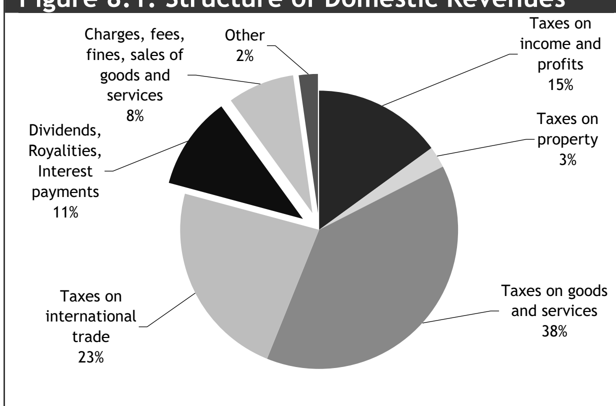
- Some additional domestic revenue mobilization should be expected in the medium term, but in the short term, the focus should be on administrative measures to improve revenue collection (possibly with the exception of a small VAT rate increase) and, at the margin, some additional domestic borrowing.
- External assistance is expected to increase as part of the peace process, but in the coming years the budget should be based on realistic projections of aid.
- Setting the total resource envelope needs to take into account a number of parameters, including (on the financing side) the macroeconomic implications, the sustainability of the sources of financing, and the risks associated with alternative sources of financing.

8.1 In light of expenditure prospects (chapter 3), and even after expenditure reallocations, a funding gap is likely. This chapter reviews prospects for expanding the resource envelope from both domestic sources (section A) and external sources (section B). Section A also relates to indicators 13–15 of the PFM performance assessment (see table 2.4 for a list of the indicators). Section C wraps up the analysis of budget financing by analyzing the key trade-offs.

A. Domestic Resources

8.2 **Although improving, domestic revenue mobilization is weak.** Collecting 12–13 percent of GDP places Nepal near the low end of the range achieved in low-income countries (see annex5). Around 80 percent of these revenues come from taxes, mainly indirect taxation, both domestic (VAT) and international (import duties) (figure 8.1). Customs management is particularly important since a large part of consumption taxes, in addition to import duties, is collected at the border on imports. Compared to other countries, Nepal relies less than average on income tax and—despite joining the World Trade Organization (WTO) and liberalizing trade—more on import duties, even though this pattern was slightly altered in recent years.

Figure 8.1: Structure of Domestic Revenues



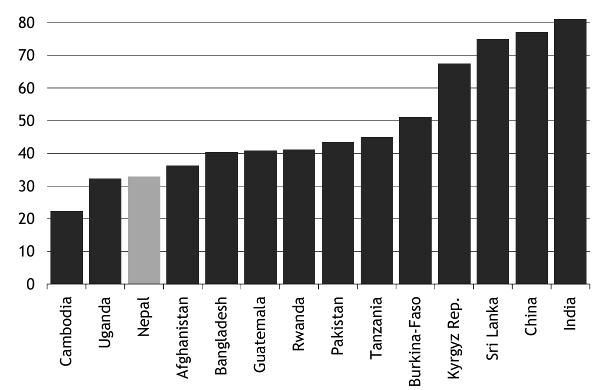
Source: GoN.
Note: Central government only.

8.3 **Various evaluations, notably by the IMF, suggest that tax policy is appropriate, with a reasonably large tax base and reasonably low tax rates.** For instance, at

32.8 percent of profits, the effective tax rate on firms is not high in comparison to other developing countries (figure 8.2). Customs duties, which account for a large part of Nepal's tax revenues, have been reduced to an unweighted average rate of 14 percent, with a plan to further rationalize tariffs in 2007 to meet Nepal's commitments to the WTO.[27] In addition, it does not seem appropriate to pursue any significant increase in tax rate in a context of feeble economic growth, compounded by the fact that taxpayers in some areas continued in 2006 to face additional informal taxation from Maoists. The main policy change could be the lifting of the myriad of VAT exemptions (it is noteworthy that, despite a nominal rate of 13 percent, the effective rate—measured as a ratio to total consumption—is only 4 percent). Another could be elimination of the local development fee, which replaced the "octroi" and finances local governments; it is not a good instrument for financing local governments and is contrary to Nepal's commitments to the WTO. Other adjustments will be necessary as decisions on decentralization and revenue assignments are made. If necessary, an increase in the VAT rate would be the most neutral way to mobilize additional revenues in the short term: a 1 percentage point increase would generate around Rs. 2 billion per year.

8.4 **There is, however, significant room for additional revenue collection by tightening revenue administration.** By some measures, the tax gap between actual and potential tax collections could be as high as 40 percent—almost 5 percent of GDP.[28] Indicators 13–15 of the PFM assessment suggest a number of weaknesses, notably in transparency and effectiveness of collection mechanisms, with allegations of pervasive corruption in the sector. The Auditor General's reports also note significant arrears (Rs. 28 billion in 2005, although this is a cumulative figure with some old arrears that should probably be written off). This calls for more frequent reconciliation of revenue accounts (PFM indicator 22). The proportion of non-filers at the VAT has also been increasing in recent years. In fact, such administrative improvements could be growth-enhancing as they level the playing field for private entrepreneurs. It should be noted, however, that this is a long-term endeavor that should not be expected to generate significant additional revenues in the short term.

Figure 8.2: Tax as Percentage of Profits



Source: Doing Business.

8.5 Key measures in several areas can reduce the tax gap and improve governance:

- The *customs* side is critical as the Department of Customs is responsible for the collection of all taxes on foreign trade. These include import duties but also VAT, excise, and other duties on trade, accounting for over 50 percent of all tax revenues. A reform strategy was recently adopted and progress has been made in the operations of several Inland Clearance Depots, including in Birgung, Biratnagar, and Bhairahawa. However, the cost of importing and exporting remains very large by regional standards (see annex A 5). In addition to other trade facilitation measures, administrative reform in customs could seek to: (a) simplify documentation clearance; (b) further reduce exemptions and monitor them; (c) expand implementation and usage of the Automated System for Customs Data (ASYCUDA), with

[27] While tariff rationalization has an immediate adverse impact on revenues collected, it can help curb smuggling, thus increasing the volume of recorded imports with an impact on both import duties and VAT.

[28] See estimates in B. Ghimire (2006).

linkage to the central Department of Customs in Kathmandu and selective implementation of the inspection module; and (d) build capacity for customs valuation.

- With respect to *other tax revenues*, the management of excises is generally considered weak, with significant leakages. Several technical measures have been proposed to strengthen it, including by operationalizing the excise sticker and flow meter regime in the liquor and cigarette industries. The functioning of the Large Taxpayer Office (LTO) could also be improved. The GoN plans an audit of all large taxpayers, further computerization, better data communication, and expanded services to taxpayers (e.g., to allow electronic tax deduction at source). The audit function is in need of significant improvements for the VAT.
- Significant progress has already been made on the *organizational* side, with the amalgamation of several departments into the Internal Revenue Department in the early 2000s. The LTO was created and made operational in 2004, but it has not delivered on its objectives, with only a small proportion of revenue managed through this office. The GoN is now considering introduction of performance-based incentive schemes in the LTO and customs administration to improve collections, but there are implementation difficulties related to design of the schemes and resistance from other parts of the civil service. Stronger reporting system (e.g., on exemptions, audit) are also needed to enable management to improve its performance and to ensure accountability. A more radical solution would be the creation of an autonomous revenue authority or board, but international experience provides mixed evidence (box 10.2).

8.6 **Non-tax revenues have been used in recent years to offset uneven performance in tax revenue collection.** They have generated significant resources, more than 2.5 percent of GDP in some years. They include (a) duties and administrative fees, notably with a rapid growth of passport fees in line with remittances growth; (b) dividends and interests, mainly from the central bank and from Nepal Telecom; (c) royalties and sales of property and services, including forest and electricity; and (d) miscellaneous other revenues (M. P. Ghimire 2005). However, given the overall situation of public enterprises, this is not a sustainable source of revenue. At best, these revenues could be expected to grow as nominal GDP.

8.7 **In summary, while it is important to target higher domestic revenues through the immediate implementation of a series of measures, the fiscal framework cannot count on a significant short-term increase.** A possible exception is a VAT rate increase. The longer-term increase is important both to improve governance and to reduce dependence on aid. In fact, an increase in revenues can have a positive spillover effect on donors' willingness to support Nepal, and it certainly has an impact on government's borrowing capacity. This long-term increase requires immediate actions to tighten revenue administration management—but without unrealistic expectations about a short-term impact on domestic revenues.

8.8 **Domestic borrowing has largely been the residual of the fiscal equation and, as such, has been quite volatile** (table 8.1). Beginning in the mid-1990s, some increase in domestic borrowing was undertaken to mitigate the decrease in available external financing. However, the government entered a new strategy in 2002 with the Tenth Plan and the subsequent initiation of a Poverty Reduction and Growth Facility, and domestic borrowing was reduced. Now, as per the NRB Act of 2058 (2002), the central bank can finance government only up to 10 percent of the previous year's revenues (and the limit is 5 percent for overdraft). This trend toward a reduction in domestic borrowing has been somewhat reversed since 2005.

8.9 **The cost of domestic borrowing is more than twice as high as the cost of external borrowing.** The effective rate, defined as interest payments over debt stock, is about 5 percent (and declining) for domestic debt, and about 1 percent (and slightly increasing) for external debt. The GoN uses—in increasing order of nominal interest rate in 2006—91-day Treasury Bills (3.5 percent), development bonds (3.0–7.0 percent), national savings certificates (6.5–8.5 percent), and commercial loans. However, in recent years interest rates have been going down, reaching negative levels in real terms, because of the lack of demand for private investment and the significant liquidity available. In addition, exchange rate risks cannot be fully ruled out when considering the cost of external borrowing.

Box 8.1: Coordinating Fiscal, Monetary, and Exchange Rate Policies

Coordinating macroeconomic policies is critical for stability and growth. In a closed economy, the priority is to ensure consistency in the policy mix (fiscal and monetary) to achieve high growth and low inflation. The key interlinkages between the two policies are through financial markets, as domestic borrowing is part of money supply and interest rates have an impact on the fiscal costs of domestic borrowing. In addition, public expenditures can either crowd in private investment (e.g., if public infrastructure is a complement to private investment) or crowd it out (e.g., if there is a financing constraint).

In a small open economy like Nepal, with significant inflows of foreign currency in the form of aid and remittances, this coordination takes on another challenge. Without cautious management, these inflows would lead to a "Dutch disease," that is, appreciation of the real exchange rate. This is an important risk to assess in a country where manufacturing accounts for only 10 percent of GDP and has been stagnating at that level for more than a decade.

The impact of an increase in aid flows on the exchange rate and on competitiveness depends on several factors. First, it depends on whether aid is (a) *absorbed* (i.e., whether the non-aid current account deficit widens or not; alternatively foreign currencies are used to build up reserves) and (b) *spent* (i.e., whether the government lets its non-aid fiscal deficit widen or not; alternatively it can also build up reserves). When aid is spent faster than it is absorbed, some appreciation of the real exchange rate is needed. Second, pressures on prices might be dampened if there is unused capacity in the economy to absorb the higher demand (which is likely the case in Nepal today). Third, the impact depends on the import intensity of aid-financed expenditures. Finally, the impact on competitiveness depends on whether policy decisions (such as easing the labor law) and expenditure priorities (such as infrastructure) are implemented in parallel to increase firm productivity. A simulation in the case of Nepal suggests that a 20 percent increase in foreign grants would generate a 1 percent increase in domestic prices, hence in the real exchange rate – a small effect reflecting in particular the relatively low levels of grants (see Guimbert and Tiwari 2007).

The need for coordination applies at the operational level as well. Toward this end, institutionalizing relationships between the NRB (monetary and exchange rate), the MoF (budget formulation), and the Financial Comptroller General Office (budget implementation) is critical. Recent IMF reports have noted the operational challenges of managing large liquidities in the banking system.

8.10 **Is there room to expand domestic borrowing?** A number of criteria can be used to address this question.[29] The first is the risk of crowding out credit to the private sector, which is very much needed to accelerate growth. This risk does not seem critical in the short term given the large private savings available and the many other constraints on private investment. However, this will be an important consideration in the medium term. The second criterion is to look at the need to coordinate the fiscal, monetary, and exchange rate policies. This issue, which is at the core of the Poverty Reduction and Growth Facility framework, is briefly reviewed in box 8.1. Hence some additional domestic borrowing is possible, at least in the short term. A final answer to the question depends on the rate of return on expenditures and the cost of alternative sources of financing, an issue further discussed in section C.

8.11 **Finally, government could consider one-time sources of financing, such as the sale of assets** (e.g., public enterprises, land, or telecom licenses). In recent years the restructuring of state-owned enterprises has been moving very slowly, although it should be noted that in 2007 the GoN decided to sell 15 percent of the shares of Nepal Telecom, worth

[29] Another question would be whether printing money to increase seignoriage is an option for financing the deficit. This is, however, ruled out given the current inflationary pressure on prices and the peg on the Indian rupee, both requiring a tight management of monetary policy.

around Rs. 2 billion. Another resource would be for Nepal to benefit from debt relief, which would generate significant resources (over Rs. 4 billion a year) in a short time frame (box 8.2).

B. External Resources

8.12 **External grants account for around 1.5–2.5 percent of GDP and external loans, on a net basis, for around 0.5–1.5 percent of GDP** (table 2.1 and table 8.1). The level of grants has been very stable over the last decades, with a temporary increase in the early 1980s, while net external financing has been on the decline since its peak around 1990. In Nepal, unlike many low-income countries, grants are in fact slightly less volatile that domestic revenues. Hence, the large gaps between budgets and actuals in terms of grants and loans (figure 9.1) largely stem from unrealistic expectations about external financing.

Table 8.1: Level and Volatility of Financing Sources

	Volatility (% GDP)				Level (% GDP)			
	1972-2006	1972-1984	1987-1996	1996-2006	1972-2006	1972-1984	1987-1996	1996-2006
Revenues	0.64	0.57	0.75	0.48	9.1	7.2	9.1	11.4
Grants	0.54	0.63	0.44	0.48	2.1	2.5	1.8	2.0
Total Revenues and Grants	1.07	1.10	1.01	0.87	11.2	9.7	10.9	13.4
Domestic Borrowing	1.25	1.55	1.11	0.71	1.7	2.0	1.9	1.5
External Loans	1.63	1.00	1.10	1.17	2.1	1.4	4.1	1.6
Grand Total	**2.44**	**2.93**	**1.71**	**1.11**	**15.0**	**13.2**	**16.9**	**16.5**
of which external	*1.60*	*1.39*	*1.20*	*0.88*	*4.2*	*3.9*	*5.9*	*3.6*

Sources: GoN; IMF; staff estimates.
Note: Volatility is defined as the standard deviation (after adjusting for trend).

8.13 **Net external borrowing shows a clear downward trend since the early 1990s.** This reflects the maturing of the structure of external debt, with the grace periods of loans contracted in the early 1980s now expiring. This explains the significant increase in principal repayment in recent years, with external debt service increasing from 5 percent of GDP in the mid-1990s to 10 percent in the last few years. External borrowing is largely on concessional terms—notably from the International Development Association (IDA) and the Asian Development Bank (ADB)—with effective interest payments around 1 percent of the amount borrowed. External borrowing shows little sign of volatility in recent years, once the downward trend is taken into account. Access to international financial markets is very limited. Nepal could also have access to international debt relief initiatives (box 8.2).

8.14 **The turnaround in the political situation might create some opportunity for higher external assistance.** In February 2007, the GoN announced that it had received pledges from nine donors and an international agency, amounting to Rs. 18 billion in the form of grants since the events of April 2006 (and Rs. 7 billion in the form of loans). In addition, debt sustainability analysis suggests that contracting additional debt, on concessional terms, is possible, particularly if Nepal takes advantage of the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative.

8.15 **However, a conservative approach to estimating external assistance is important.** First, Nepal has a long history of overestimating foreign aid flows. This has several adverse consequences, including weakening the credibility of the budget (for strategic and macroeconomic purposes) and undermining the credibility of the government as promises are not delivered. Second, while significant—and based only on an incomplete survey of agencies—the recently announced pledges will materialize only over time, given the lag between pledges, commitments, and actual disbursements. In fact, these pledges remain lower than the commitments made in 2005 (Rs. 26 billion) and in previous years (e.g., Rs. 40 billion in 2004, based on commitments declared by donors to the OECD/DAC). In conclusion, as important as the amount of external assistance will be its effectiveness, a topic discussed in the next chapter.

Box 8.2: Debt Relief Options

The Heavily Indebted Poor Countries (HIPC) Initiative promotes debt sustainability. Eligibility is based on income criteria, indebtedness criteria, the existence of IDA and IMF programs, and a track record of reforms. Once eligibility is confirmed, the boards of the IMF and IDA review a "decision point" document that sets the path toward reaching the "completion point." At decision point, temporary debt service relief is granted, bringing the ratio of indebtedness to the HIPC thresholds. A country reaches completion point when the triggers agreed at decision point are met. At that time, debt service relief becomes irrevocable. In addition, the Multilateral Debt Relief Initiative (MDRI), an initiative launched in 2005, then becomes possible, allowing debt service relief on the remaining debt owed to IDA and IMF (with some limited offsetting on IDA envelope).

On the basis of an analysis of external debt at end-December 2004, Nepal does qualify for the HIPC and MDRI. This is because at that time, the ratio of the net present value of its external debt over its exports was above the threshold of 150 percent (in part reflecting the depressed value of exports during the conflict). On average, IDA net cash flows to Nepal in the first five years of debt relief would increase by around Rs. 4 billion per year. While this effect would be somewhat offset in the outer years by lower IDA allocations, the net present value of IDA flows would increase overall by Rs. 9–10 billion.

C. Financing Options

8.16 **What then are the most appropriate sources of financing?** To design the best financing mix, the GoN can take three main approaches:

- *Assess relative financial cost and macroeconomic impact.* As discussed above, the financing terms are quite different for domestic revenues, grants, external borrowing, and domestic borrowing. The cost of external borrowing is also affected by exchange rate fluctuations. The macroeconomic impacts of these options differ (box 8.1). External assistance has an impact only on the balance of payments, and therefore possibly on the exchange rate. Domestic borrowing can have a negative crowding-out impact on private investment. An increase in tax or customs rates can have a negative impact on productive activities, while a tightening of tax or customs administration might level the playing field and thus support the private sector.
- *Manage the transition to self-reliance.* Higher borrowing creates debt sustainability concerns (chapter 2), but higher revenues reduce aid dependence and generate a more stable long-term fiscal position. It is important for Nepal to plan on a scenario in which the country becomes gradually self-reliant. This requires in particular a cautious assessment of the impact of expenditure and financing on economic growth, factoring in the risk that the impact is often weaker than expected.
- *Avoid risks of significant adjustments.* The financing mix must have some degree of predictability, since major downward adjustments have an adverse impact on the quality of expenditures. An example is the lack of capital investment in recent years, in part due to unrealistic expectations of external aid. Domestic borrowing and changes in revenue policies can quickly mobilize revenues that are somewhat predictable (but not fully predictable because of the economic impact). On the other hand, the impact of tax and customs administrative reforms is more difficult to predict. External assistance has its weaknesses: although it is not more volatile than domestic revenues (table 8.1), projections are often unrealistic (figure 9.1), and the aid often does not come in the form of fungible cash.

8.17 **Nepal's fiscal policy is currently anchored in a domestic borrowing target (or ceiling),** a variant of targeting a fiscal deficit. An anchor is useful for setting targets that will ensure sustainability and solvency in the fiscal policy. Targeting the fiscal deficit is effective from a macroeconomic and sustainability point of view. For an aid-dependent country, targeting domestic borrowing is easier to implement and largely achieves the same purpose: if expected foreign assistance does not materialize, then the budgeted expenditure is just not implemented, leaving the fiscal deficit unchanged, with apparently no fiscal cost. But this approach can have adverse consequences. First, it invariably leads to unrealistic expectations about the levels of foreign assistance and to large gaps in implementation. Second, as a consequence, it weakens prioritization: in essence, the prioritization has ex post nothing to do with expected returns or strategic priorities of the government, only with the uncertainties of projecting external assistance. Third, letting expenditures adjust fully to changes in foreign assistance could have adverse consequences if the adjustment leads to a buildup of recurrent costs beyond sustainable levels.

8.18 **This suggests that expenditures should be used as the anchor for fiscal policy** (see Heller et al. 2006). The expenditure path would have to take into consideration issues of sustainability, prioritization, sequencing, and capacity, suggesting a gradual increase with due attention to the mix of expenditures (see chapter 3, section C). On this basis, the financing targets would be set. As discussed above, a modest but steady increase should be targeted for domestic revenues. External assistance should be targeted at an ambitious but realistic level. The rule applied in Uganda, for instance, of discounting donors' disbursement projections by 30 percent, could be a good guide. The GoN should also be prepared to provide financing for projects with high rates of return when donor funding is not forthcoming.

8.19 **In this approach, domestic borrowing is the residual and should be expected to fluctuate around a target.** Of course, the constraints related to the macroeconomic implications of such borrowing—both crowding-out of private sector credit and medium-term fiscal sustainability issues—are still present. Hence, despite its benefits, this approach has risks that need to be mitigated. First, there is a risk of dispensing with fiscal discipline. The budget should not assume large increases in both domestic borrowing and external assistance because (a) both are unlikely to materialize at the same time and (b) the capacity to spend effectively is unlikely to increase so sharply. Second, the expenditure path might not lead to the expected growth outcomes (box 6.1). Therefore, close reviews of expenditure impact and progress in PFM performance are important mitigating measures. Periodic reassessments of the policy will be warranted.

8.20 Summary observations (see also fiscal scenarios in chapter 12):

- In the short term, it is difficult and undesirable to increase domestic revenues too aggressively. Administrative measures could lead 1–2 percentage points of revenue to GDP growth.
- External assistance could well be assumed to increase. However, it will respond not only to political developments but also to the quality of public expenditures. In addition, even if commitments increase, actual disbursements will increase only with improved implementation and might not even be on the budget. The HIPC Initiative could give additional fiscal space to this framework. While recognizing the need for a rapid increase in aid, the analysis in this chapter also highlights the need for good aid management and realistic planning.
- On the other hand, it is assumed that the space to increase domestic borrowing beyond 1–1.5 percent of GDP is limited but not null. In particular, in the very short term, especially given the position of economy in the cycle, there should be some exceptional space for financing the deficit with domestic borrowing.

- Finally, the GoN could consider anchoring its fiscal policy in a well-conceived, steadily growing expenditure path, with some tolerance for ex post adjustment to domestic borrowing. Over time, the GoN could get back to targeting the fiscal deficit, a fiscal anchor that served it well in the past.

9. Formulating the Budget

Key Messages

- Nepal's accomplishments in the area of planning and budget preparation have been remarkable over the last few years, notably with the roll-out of a Medium-Term Expenditure Framework.
- Yet ownership at the operational level and the quality of political engagement around this process are uneven. Progress in formulating more effective plans requires boosting the demand for budget information (physical and financial), in particular to monitor and evaluate past achievements.
- The weaknesses of the planning framework are compounded by a long list of development boards and funds that have independent monitoring mechanisms, and by the fact that half of external assistance is outside the budget framework. The priority in this area is to improve oversight through timely reporting, while the medium-term objective is to better integrate these components of public expenditures into the budget.

9.1 Chapters 3 and 8 made a strong case for realistic resource envelope projections and rigorous expenditure prioritization: this is the role of the budget formulation process, which is reviewed in this chapter. Section A assesses the quality of budget formulation, with an emphasis on the strong achievements of the Medium-Term Expenditure Framework. Section B assesses the management of fiscal risks in light of their potential implications discussed in chapter 2. Finally, section C discusses progress and gaps in making aid more effective. This chapter relates to indicators 1–12, 27, and D-1 through D-3 of the PFM performance assessment (table 2.4).

A. Budget Preparation

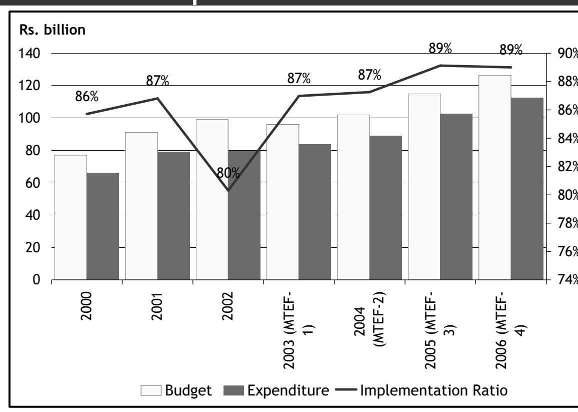
9.2 **The budget process has a number of "best practice" characteristics** (table 9.1). These include the initiation of the budget process through a "strategic phase," the alignment of the budget with the development strategy, some integration between recurrent and capital budgets, and a well-established medium-term perspective (box 9.1). Importantly, this translates into a number of positive PFM outturns as evidenced by PFM indicators 1 and 3.

9.3 **A parallel improvement has been the adoption of Immediate Action Plans (IAP), an innovative way to focus attention on priorities and create a track record of reform implementation.** IAPs are adopted by the Council of Ministers to help focus on key reforms. The first IAP was adopted in June 2002: it focused on three areas—prioritizing public expenditures, improving service delivery, and fighting corruption—and all of its 19 actions were successfully implemented. Five IAP cycles have been completed, supporting the PRSP process and facilitated by a joint GoN-donor task force (the Reform and Development Group).

Table 9.1: Budget Preparation		
Step	**Timing**	**Comment**
1. Top-down, strategic part		
Midyear review Resource Committee Budget ceilings sent to ministries Development projects approved as part of MTEF	End-December End-January Mid-February Mid-June	The first part of the budget, in theory scheduled around October–November, is often postponed to later in the year. It is not unusual that the budget process starts before key decisions on the MTEF have been made.
2. Bottom-up budget preparation and review		
Bottom-up budget preparation in ministries and submission to MoF/NPC	Early March	With the first part postponed, the timeline for line ministries to prepare their proposals and complete their submissions is often delayed.
Discussions with MoF (recurrent) and NPC (specific lines/capital) about budget submission	April–June	Given the late discussion, work programs and Form #2 (chapter 10) are often finalized in the new fiscal year, delaying implementation.
3. Budget review and approval		
Submission to Parliament Budget speech Budget approval by Parliament	End-July August-September	Budget speech is often delayed to late the last week of the fiscal year (mid-July), pushing budget approval well into the new fiscal year (with implications for budget execution).

Sources: GoN's budget guidelines; staff assessment.

Box 9.1: Introducing and Institutionalizing a Medium-Term Expenditure Framework



In October 2000, during the Ninth Plan, the GoN's Public Expenditure Reform Commission made recommendations for improving public resource management to address poor plan performance. One of these recommendations was to improve budget performance. Consequentially, formulation and implementation of the Tenth Plan has increased expenditure performance from a low of 80 percent during the Ninth Plan to 88 percent during the Tenth. Budget fragmentation has been reduced by the merging or dropping of some 200 projects, almost a third of the projects.

Behind these achievements was the Medium-Term Expenditure Framework. The MTEF was introduced and rolled out incrementally, an appropriate sequencing given capacity, leadership required for complex institutional change, including donor support, and demonstration effect of early successes. First, five large-spending ministries, accounting for 70 percent of the development budget, were selected for MTEF formulation, linking annual plan to periodic plan through the budget. In the first year of the Tenth Plan, all ministries prepared medium-term estimates for development expenditures. The second year, the whole budget was covered (all ministries and both regular and development expenditures). This pragmatic approach initially focusing on fiscal discipline and allocative efficiency favored the internalization of the reform.

The MTEF succeeded in revitalizing credibility of the plans by (a) linking annual programs and budget with the periodic plan; (b) prioritizing programs and expenditures in relation to the periodic plan's outcomes (see chapter 3); (c) ensuring resource availability by dictating adjustment of annual expenditure with guaranteed funding for priority activities (box 10.1); (d) focusing on unit costs of major activities; and (e) maintaining macroeconomic stability (chapter 2). These are not small achievements, given the mixed experience with medium-term expenditure frameworks in other countries (Le Houerou and Taliercio 2002).

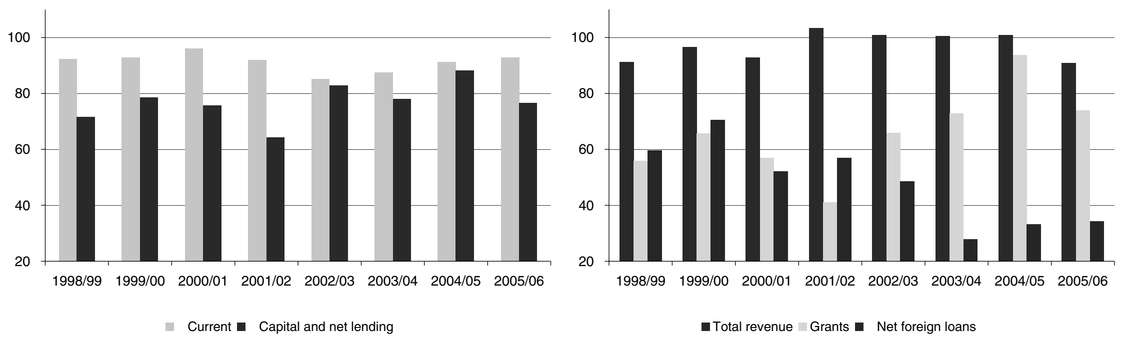
Although the achievements of the MTEF are impressive, the process is far from complete. There is a need to deepen and widen principles of medium-term planning within line ministries; strengthen political engagement in making strategic decisions on policy and budget; prioritize new initiatives within agreed fiscal limits, giving due recognition to ongoing commitments; and extend the MTEF to local government planning, programming, and budgeting (chapter 11).

9.4 **Budget formulation has, however, a number of weaknesses.** First, there is a lack of *budget realism*, with chronic under spending of capital expenditures (figure 9.1; box 2.1).

Second, there are significant *deviations between budgets and outturns* (PFM indicator 2), although deviations between revenue targets and outturns are small (PFM indicator 3). Both these flaws weaken the credibility of the budget as a policy instrument and its usefulness as a strategic allocation tool. This weakness was much attenuated between 2002/03 and 2004/05, thanks to the MTEF, but large deviations since then raise concerns about the quality of the fiscal framework underpinning the budget. These weaknesses reflect three main issues.[30]

9.5 **First, the degree of ownership of the MTEF is uneven** (PFM indicators 11 and 12; see box 9.1). Tellingly, the MTEF is often finalized and published after the budget. Lack of meaningful discussion at the political level constrains the degree of engagement of line ministries, while lack of ownership at the operational level weakens the alignment of the budget with sector strategies and budget implementation. This translates into unrealistic projections and lack of prioritization. For instance, in the feeder road sectors, budget allocations typically cover a few kilometers of road per year, leading to very long completion time (chapter 6).

Figure 9.1: Budget Realism (actual expenditures/resources as % of original budget)



Sources: GoN; staff estimates.

Note: Part of the shortfall in capital expenditures in recent years has been due to implementation problems with two large projects, the Melamchi drinking water and Marsyangdi hydropower projects.

9.6 The priority is to restructure the *annual budget timeline* to ensure that the MTEF precedes the budget process. This should be complemented by a stronger engagement of the political leadership (Cabinet and possibly Parliament) early in the process to define the broad parameters of the MTEF. The MTEF should then be published with the budget. The IAP process, which has lost some momentum due to wavering political focus on reform implementation (e.g., the 2006/07 IAP was finalized at midyear), should be revived and integrated into the MTEF/budget process. Finally, the budget should be presented to Parliament one to two months before the end of the fiscal year, as was done in 2000/01, to ensure timely budget approval. Second, and more structurally, *institutional reforms* might be considered to ensure that a single institution—the Ministry of Finance—manages both the budget and the MTEF process (box 10.2). In Nepal, the ownership of the MTEF still rests with the NPC and the ownership of the budget with the MoF, a problematic disconnect.

9.7 **Second, as experienced in many countries, the focus on performance has been elusive.** Attention to performance is an important ethic for the state. It brings focus to strategies and priorities, it supports measurement, and it helps internal management and external accountability (Schick 2003). The introduction of the MTEF and associated monitoring

[30] In addition to the issues discussed below, deviations also result from adjustments made to the budget during the year. The financial regulations authorized the executive to make changes to the budget during the year without Parliament's approval. While reallocation of budget may be necessary, the details of the rules might need review to ensure that line ministries do not create an incentive to weaken the initial planning knowing that budgets can easily be later adjusted.

framework has been an important step. But while performance-based fund releases have indeed been introduced (box 10.1), the MTEF itself has not achieved a significant focus on performance. The use of past performance is still very limited, prioritization criteria led to more than 90 percent of budget lines being classified as "priority 1," and the implementation of performance-based fund releases is weak. Similarly, while the MTEF documentation reviews past performance, the document is not presented to Parliament or widely circulated; on the contrary, the budget speech has little analysis of past performance and focuses on a long list of detailed measures. This unfortunately echoes difficulties encountered by other countries. International experience indeed shows that "it is futile to reform budgeting without reforming first the overall management framework" (Schick 2003). Hence the debate about budget and performance has to be linked to the performance orientation of the whole bureaucracy, including the political system (box 9.2). Performance-based budgeting is linked to managerial changes by which line agencies get discretion to achieve their objectives: in Nepal's tightly controlled environment, this is a distant prospect.

9.8 **Recognizing the difficulty of "performance-based budgeting," the government could focus on using and improving its monitoring and reporting systems toward a practice of "*evidenced-based budgeting*."** First, the priority is to use *existing information* (like Form #2) to its potential, improving its accuracy and updating frequently through computerized systems (chapter 10). Second, budgeting could be more *program-based*: the MTEF has allowed some focus on outputs, but the continued fragmentation of the budget into small projects, in part driven by aid requirements, upholds a focus on inputs through line-item budgeting. Programs would be based on clearly defined sector strategies (or business plans). Project costing also should be based on programs; the GoN's plan of developing "activity-based costing" could prove counterproductive as it could reinforce the trend to plan at a too-detailed level, which increases budget fragmentation. Programs should include clear project screening and selection criteria. A focus on programs would entail some progress on budget classification, which still does not meet international standards (PFM indicator 5).[31] Third, more systematic *ex post evaluation* would improve the focus on evidence. For example, MTEF assumptions should systematically be reviewed ex post, a rolling series of sector expenditure reviews could be introduced, and significant deviations between past performance and budgets should be identified and justified. Finally, while these changes will by themselves generate new demand for information, other options for *building the demand for evidence-based policy-making* should be considered. These include both soft options (develop demand by politicians in Cabinet, the Parliament, and the public at large) and hard options (use prior year's implementation track record in the budgeting preparation process and mandate the MoF's Budget Department to report in the budget document on how such evidence has been used). In addition, over time, other reforms will be required to further deepen the focus on performance, including civil service and institutional reforms, progress in capacity to cost programs, and streamlining of controls (box 9.2).

9.9 **Finally, the external oversight on budget preparation is weak.** Obviously the absence of Parliament between 2002 and 2006 was the prime cause of this. However, the delays in the budget process also leave inadequate time for debate in the Parliament, leading to delays in capital budget implementation as the budget is approved one to two months into the fiscal year

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[31] One gap is the formulation of the budget on a "gross" basis (i.e., repayments of loans are counted as expenditures, as opposed to the internationally recognized convention of including them as a negative financing item). Another potential improvement would be to introduce reporting with distributional analysis. At a minimum, the distribution of expenditures by main regions should be reported. Such reporting forms the background of chapters 3–7. However, while the trappings of such data are available in government's systems, they are not used, and there are important quality issues (see annex A).

(PFM indicator 11). An option would be to introduce a discussion of fiscal policy objectives early in the budget cycle, possibly in the winter session (currently there is no debate on fiscal policy in Parliament). In addition, the MTEF should be tabled in Parliament, possibly in summary form, as part of the budget document. More generally, the budget documentation needs an upgrade in quality (PFM indicator 6).[32] Gaps include the lack of explanation of key policy changes (which is replaced by a long catalog of measures) and the weakness of data on fiscal risks, discussed below. The budget speech provides some information, but not in a systematic or tabular form—and, as discussed above, without a multi-year perspective. It is therefore impossible to assess budget realism, relate policy proposals to the budget, understand the multi-year prospects, or get an analysis of the implementation of earlier policy proposals. An interesting experience comes from the introduction in Kenya in the mid-1990s of a user-friendly summary budget disclosed when the budget was being debated. This document showed that 90 percent of the education budget was going to salaries, provoking a healthy debate that led to correction of this misallocation (Stevens 2004).

B. Monitoring and Managing Fiscal Risks

9.10 **Despite progress in recent years, the management of fiscal risks is weak.** There are significant uncertainties about the actual level of expenditure payment arrears (PFM indicator 4): while the measured stock of arrears is small, existing systems do not allow a proper assessment. Progress has been made in managing debt (PFM indicator 17). An office has been created in the Financial Comptroller General Office (FCGO) that regularly updates domestic and foreign debt, although MoF/Foreign Aid Cordination Division, FCGO, and NRB still have distinct responsibilities in debt management. But reporting on debt remains weak (PFM indicator 6). The extent of unreported government operations seems high (PFM indicator 7), reflecting the large number of revolving funds, development funds, and boards (chapter 2). Transparency of intergovernmental fiscal relations (PFM indicator 8) and of fiscal activities of local government (chapter 11) is weak. Finally, oversight of the aggregate fiscal risk of the public sector, including SOEs, is limited (PFM indicator 9). Despite progress in monitoring SOEs and introducing a definition of contingent liabilities (in the "Yellow Book"), there is a large backlog of audits for funds, committees, and SOEs.

9.11 **These features have a number of adverse implications.** While such fragmentation) is usually the rationale for these dedicated funds (e.g., the Road Fund was created to ensure funding for road maintenance), this rationale should be compared to potential costs. First, lack of monitoring itself creates a *fiscal risk*. Second, *lack of comprehensiveness* in budgeting and reporting and *fragmentation of resources* (including earmarking tax to special funds) weaken the government's capacity to make strategic trade-offs and maximize synergies across funds. Third, these features also make *accountability diffuse*: Is central government responsible if resources in these funds are poorly used? Are these funds responsible if they cannot deliver because central government does not take complementary actions? In turn, this negatively affects government's legitimacy because the government is viewed as responsible for lack of delivery, without getting credit for delivery.

9.12 **A simple way forward is to develop reporting requirements.** By ensuring better monitoring through comprehensive reports, this will generate demand for more analytical oversight and accountability and initiate a virtuous cycle. Such requirement could be established through a Fiscal Transparency Act, although amendments to existing legislation or

[32] See also the Open Budget Index at http://www.openbudgetindex.org.

implementation of existing legislation (e.g., the Procurement Act) might be sufficient. It is important that to ensure that such a reporting system is made public and is discussed in Parliament—for instance, by including a list of these extra budgetary activities in the budget document. Such transparency would not be at the cost of the autonomy of these funds—when they are well-funded—but would greatly improve accountability and management of fiscal risks. In addition, there is need for a clear policy identifying cases that deserve a dedicated fund and modalities to carry out activities funded by dedicated fund. With respect to debt management, building on recent achievements, a clarification of responsibilities should help improve the quality and timeliness of data for better management.

Box 9.2: Performance Management in the Civil Service

While important, the establishment of performance-oriented PFM devices (such as the MTEF) has limited value unless placed within a broader framework of organizational reforms aimed at creating systems for managing results. Critical to this is the establishment of an ethos of performance across the bureaucracy. Many of the problems that plague Nepal's administration, from weak implementation to a "culture of impunity," can be attributed to managerial failures. Often there are a host of obstacles that prevent managers from effectively managing their staff, ranging from political interference to poorly defined performance targets and monitoring to a weak system of sanctions and rewards.

While establishing a performance ethic in any bureaucracy requires an enormous cultural shift, Nepal could begin by taking some critical steps toward creating better performance accountability. These would include (a) clearly defining roles and responsibilities of different levels of civil servants and (b) setting achievable targets with monitoring and evaluation systems in each delivery unit to track progress. This would need to be underpinned by a support system of human and financial resources to deliver results.

The first step is to *delineate the roles and responsibilities of civil servants* at different levels and between civil servants and politicians and to establish a human resource management system that is politically "neutral." This is particularly important in cultural contexts where informal rules and patronage determine human resource management — transfers, postings, promotions — and incentives *other than performance* exert a more important influence than performance over an employee's career. Performance evaluation is grossly underutilized as a management tool, and it has virtually no role in any human resource function beyond promotion, such as placement, transfer, compensation, and career development. Removing disincentives that demotivate civil servants from performing and inhibit bureaucratic accountability is an important starting point (these include frequent transfers, allegedly related to political networks). Nepal has made some progress on this issue and has drafted a Governance Act that attempts to formally delineate responsibilities between ministers and senior civil servants, particularly in the area of transfers and postings. The passage of this act will provide a better legal framework to protect human resource management within the civil service from arbitrary decisions based on the politics of patronage and will create an environment for competency-based management.

Creating the institutional capacity within each department to *set targets and monitor and evaluate implementation* is the second critical task. Each delivery unit needs to clarify its mission and strategy and ensure monitoring and evaluation. A significant challenge is to make employees realize that they are accountable for their performance to their clients and stakeholders. While a beginning has been made through the establishment of citizen charters in key departments, these have generally not resulted in changes in accountability structures. The charters are largely ignored and do not play the role of reinforcing a performance culture based on delivering to clients. If Nepal is to make citizen charters work, these will have to be accompanied by better systems of grievance redressal, and they will have to be better linked with each individual civil servant's annual performance targets.

Yet even if these systemic and procedural problems are rectified — and some have been, at least formally — progress will not be forthcoming unless managers actually use the tools at their disposal to achieve better performance from their staff. This involves not the grand task of articulating sweeping visions and strategies, but the mundane effort of ensuring that daily administrative decisions, some significant and others quite small, point in a consistent direction and reinforce common messages of performance and accountability. PFM systems can make an important contribution to this agenda, using the budget to set objectives and monitor achievements, fostering accountability and focus on performance, and enabling transparency (which can be complemented by report cards and surveys).

Over time, the management of human resources and budgets will then be able to move toward clear performance agreements, requiring greater flexibility in managing resources together with decentralized managerial autonomy.

9.13 **On the SOE side, a number of corporate governance improvements are necessary**. Beyond increased reporting, a priority is for the Auditor General to issue directives to SOEs to adopt Nepal Accounting Standards and applicable international standards, and to clear the backlog of audits. This should be followed up by the government departments responsible for SOE oversight, with, for example, the MoF creating a financial review committee to review SOEs' financial statements, ensure compliance with laws, and assess audit opinions.

C. Aid Coordination

9.14 **As noted in chapter 2, aid is an important feature of the PFM system of Nepal.** Its importance includes its fiscal dimension (to finance the deficit), its impact on governance and financial management, and its political implications.

9.15 **There are, however, a number of issues hampering the effectiveness of aid** (PFM indicators D-1 through D-3). First, while aid has not been particularly volatile (table 8.1), there is a recurrent gap between plans and actuals (figure 9.1 and PFM indicator 2). This indicates a combination of poor budgeting and poor donor indications on projected disbursements. Second, the quality of financial reporting from donors is poor, which weakens the GoN's capacity to coordinate aid with its own programs. Third, the proportion of aid using national procedures remains below 50 percent, stretching the GoN's capacity to manage various sets of procedures. This is evident in the multitude of Project Implementation Units, despite the GoN's policy to phase these out. Fourth, aid remains fragmented and somewhat rigid, with a large number of projects and a high proportion of tied or non-cash budget, also a drag on the GoN's capacity and a constraint on budget trade-offs. In 2005, there were new donor commitments for 449 projects, 80 percent of aid was tied, only 57 percent of aid was on budget, and 64 percent of this was not in cash to government (sources: OECD/DAC and GoN). This fragmentation is also a sign of poor ownership of these projects by the GoN. Finally, aid channeled outside the GoN often finances NGOs, for which the accountability framework also needs to be strengthened.

9.16 **Aid effectiveness is particularly relevant in today's historical moment.** The "open moment" in Nepal's history could be seen as a reason to bypass the GoN's systems and seek to deliver quick-impact aid projects. However, while short-term results are important, the perception that they have nothing to do with the GoN would further weaken the government's credibility and legitimacy. All countries need governments that are accountable, capable, and responsive to their people—an objective that requires effective aid delivery—and this issue is paramount in Nepal today. Finally, while poor financial management and poor capacity are valid concerns for donors, these issues are at the core of the institutional change that needs to happen in Nepal.

9.17 **There have been significant positive developments since 2000.** First, as the issue of aid effectiveness was increasingly recognized, the government adopted in 2002 its Foreign Aid Policy, which clearly laid out the constraints on aid effectiveness and the GoN's policies to improve it. Further discussion was held in the 2004 Nepal Development Forum. A number of these policies are being implemented. Sectorwide approaches have been introduced in education and health (box 9.3), and business plans have been developed in five sectors. The MoF has undertaken more thorough monitoring of aid. The practice of annual portfolio reviews with donors was deepened, and in 2006 the GoN took leadership of a joint ADB/IDA/JIBC portfolio performance review that focused on systemic issues ("Budget Implementation and Improving Portfolio Performance"). In 2007 a modern Procurement Act was enacted, which several donors have pledged to use to manage their funds, while other efforts are under way to bridge the gap between national and international accounting and auditing standards (chapter 10).[33]

[33] The creation of the Peace Trust Fund in 2007 is only partially aligned with this approach, since the fund is managed off-budget but with clear leadership from government. This is a pragmatic solution that brings comfort to donors who cannot directly support the budget, while ensuring clear fiduciary standards for these expenditures, use of financial management procedures similar to government's, and clear government leadership.

9.18 **Moving forward, the principles of the Foreign Aid Policy remain valid.** In the long term, developing enduring partnerships, moving toward the use of country systems and budget support, and agreeing to joint accountability mechanisms are the right direction. However, in view of the difficulties and uncertainties ahead, the priority might be to take confidence-building measures, short of a full integration of aid into the budget. On the government side, this includes a number of actions to strengthen PFM performance. The performance assessment done for this review is expected to provide a solid baseline for donors' assessments. In particular, a more realistic approach to projecting aid flows is necessary. On the donor side, renewed efforts should be made toward transparency and reporting, using to the extent possible government's formats and timelines to allow consolidation and analysis. Donors should also consider using the new Procurement Act, as the ADB, the IDA, and the UK Department for International Development (DfID) have already committed to do.

Box 9.3: Sectorwide Approaches: Lessons from Education and Health

The sectorwide approach (SWAp) involves a different partnership between government and donors and a change in the ways the partners interact. It allows government to take ownership of a sector by defining policies and programs built into a sector strategy and to improve the effectiveness of public expenditures through strategic coherence, lower transaction costs, and more predictable funding. For donors, the SWAp allows for greater development impact, giving them a voice in the elaboration of the overall sector strategy (not only in their own project) and ensuring that the impact of their financial support is maximized through synergies with other funds. Expected benefits include (a) less focus on projects, avoiding the drawbacks of a project-focused approach (salary top-up, focus on donor-specific processes, lack of strategic coherence); (b) more focus on policies and implementation (using country systems, hence promoting capacity building); and (c) clear accountability.

In 2004, SWAps were set up in education (to achieve education for all) and health (to provide essential health care services, covering almost the entire sector). These programs have generated predictable funding for good sector strategies. They have also led to a different relationship between the GoN and donors in these sectors, with more donors joining the arrangement as a result. Some early results are described in chapters 4 and 5. Based on this experience, several lessons can be learned; overall they are positive, suggesting the benefits of the approach for other sectors.

- *A well-designed sector strategy* fully owned by the government and its partners is key. Some consensus is necessary between the sectoral ministry, the MoF, the overall Cabinet, and international partners. For instance, continued support for the devolution of school management to communities has been an essential feature of the education strategy. Support has been strengthened by quick wins, such as the feedback from communities in the community-managed schools that started receiving grants. It is important that the strategies focus not only on service delivery, but also on strengthening the institutional framework.
- A *simple financial management and reporting system* is necessary to ensure accurate, timely reporting, in turn an essential piece of the management and accountability system. In both sectors, development partners have been willing to develop a system of block grants to community-managed schools and to sub-health posts. While this could raise fiduciary concerns if not mitigated by actions to ensure transparency, notably public posting of all financial accounts and social audit, the block grants did simplify the flow of funds (otherwise based on "imprest accounts," which require clearing advances before replenishing). In both sectors, also, the FCGO has extended the financial information from its computerized system to facilitate financial reporting, although there are questions about the design of the program structure in health. However, in the education sector, monitoring systems for some grants (scholarship, school improvement plan fund, incentive grants, school physical facility improvement grants) are insufficient. In addition, fund releases are often late, with some funds reaching schools and sub-health posts only in the last month of the fiscal year. Finally, in both sectors, timeliness of reports has been an issue.
- A robust *system of internal controls* is absolutely critical in order to maintain donors' willingness to use country systems. For instance, in health, there are concerns with the monitoring of medicines distribution and the management of inventories, both raising reputational risks for donors. In health also, there are concerns that only a few vendors get contracts awarded.
- *Incentives* have to be compatible with objectives. For sector ministries, it was critical that the SWAps provided resources to avoid a likely decrease in funding (see chapter 3). From the standpoint of the MoF and the NPC, SWAps are a natural way to institutionalize MTEFs and budget processes while ensuring smooth disbursements from donors. However, notably in the health sector, important staff turnover has weakened the incentives and the expected benefits in terms of capacity building.
- *Coordination among donors* is also critical. An important feature in both sectors has been IDA's fund management — an upfront commitment for multi-year disbursements, while many other agencies have to secure annual commitments. This has allowed IDA to substitute for other partners when necessary. This was a critical factor in maintaining the credibility of the arrangement amid volatile donor commitment (at odds with the SWAp approach). Nevertheless, coordination is not automatic. In health, for instance, most of external assistance remains outside the SWAp, thwarting most of the benefits of harmonization.

10. Executing the Budget

Key Messages

- A reasonable control and accounting framework is in place, enabling good aggregate control of fiscal trends, basic transaction-based controls (especially on payroll), and robust annual financial accounts. The new Procurement Act will further strengthen this framework. External accountability, although weakened while the Parliament was dissolved, is well supported by the work of the Auditor General (and a few other constitutional bodies).
- However, the implementation of this framework is uneven, and at times the framework itself detracts attention from results on the ground. A renewed focus on performance therefore requires (a) strengthening demand for high-quality information, (b) better monitoring across the board, and (c) simplification at times. Internal audit and financial management information systems are particularly in need of a good vision and a well-sequenced reform strategy.
- Implementation of the new Procurement Act is now a priority given the expected benefits in terms of value for money, good governance, transparency, and reduced corruption.

10.1 After assessing the way the budget is financed (chapter 8) and prepared (chapter 9), we turn in this chapter to budget execution, which is in many ways the core of PFM challenges in Nepal. The first section reviews issues related to financial management, from fund release to payments, accounting, and reporting (PFM indicators 10, 16–18, and 20–25). Section B relates to procurement (PFM indicator 19), and section C reviews issues of external accountability (PFM indicators 26–28). Cutting across these areas is the issue of corruption, which is discussed in section D.

A. Financial Management

10.2 **Nepal has a reasonably advanced PFM system for a developing country, but it is not implemented as intended.** The financial management system is by and large similar to those in Anglophone countries, with responsibilities for maintaining accounts decentralized at the agency level. Nevertheless, the system is hybrid, as it also ensures a significant degree of centralization for fund releases (recent changes in this area, described in box 10.1, have further reinforced this), payments (done by the FCGO), and internal audit (which focuses on pre-audit of transactions). The result is a financial management system with well-crafted regulations providing for an effective control framework, but weak implementation. This weakness may be due to a narrow focus on compliance with rules, an unbalanced relationship between centralized and decentralized systems, and too much complexity, given the capacity constraints. This section reviews this system and these issues in detail.

10.3 **An important positive feature of financial management is the capacity to control aggregate spending.** This owes to a robust top-down system of fund releases defined by the Financial Procedures Act and the Financial Administration Regulations (FAR). After the budget is approved and allocations are finalized, the secretary of finance issues authorizations to spend to the secretaries of line ministries and heads of constitutional bodies, who in turn issue authorizations to spend to the respective heads of spending units under them. The Financial Comptroller General Office then releases funds on the basis of approved budget allocations to nearly 4,000 paying offices in 75 districts through its District Treasury and Controller Offices (DTCO).[34] Another important feature is the existence of a "Consolidated Fund" mandated by the Constitution to receive all government revenues (although there are exceptions; see chapter 9 on extrabudgetary funds and non-cash aid). PFM indicators 16 and 17 highlight positive features, such as the existence of reliable aggregate information on cash flows and cash availability (notably the "Weekly Treasury Report," although the report does not include all extrabudgetary funds; see chapter 9) and a fairly light and transparent process of budget reallocations.

10.4 **In addition, robust cash controls have not been traded off against allocative efficiency.** While there was some cash rationing in the 1990s, leading the top-down controls to redesign the budget on a "first-spent/first-served" basis, this has stopped with the introduction of prioritization in fund release. Indeed, since the introduction of the MTEF, high-priority projects receive a preferential treatment that guarantees funding. In addition, fund release is related to progress in physical implementation (box 10.1). This has greatly improved the predictability of funds at the agency and project levels.

Box 10.1: Monitoring Implementation and Managing Fund Releases

The 1990 Constitution and the 1999 FAR require tying all budgets and cash releases to forecasts of, and reports on, goals for physical achievements, or outcomes resulting from public expenditures. Progress in implementing this requirement on the budgeting side has come from the MTEF (chapter 9).

For budget implementation and monitoring, the GoN uses Form #2. This is an annual work program linking trimester-based expenditures to trimester-based expected outputs (or outcomes) for each activity. This form is captured in the NPC's Project Performance Information System (PPIS). The first trimester fund release is prioritized toward high-priority ("P1") projects in the MTEF: when the authority to spend is given at the beginning of the year, one-third of the budget is released for the P1 project, against one-sixth for other two categories – "P2" and "P3" budget lines. The second- and third-trimester fund releases are then contingent on the satisfactory implementation of work plans agreed in Form #2.

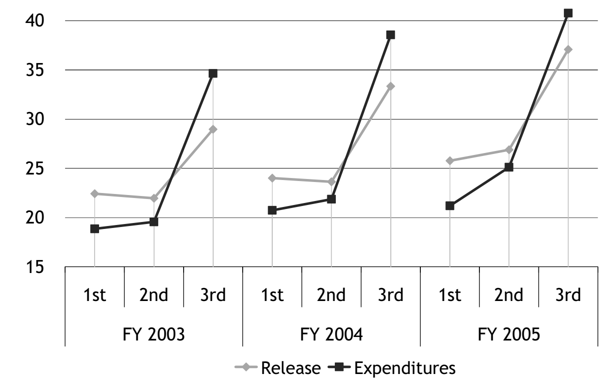
However, implementation of this system is weak. These work programs are often prepared late in the process, often after the start of the fiscal year, delaying budget implementation. Furthermore, PPIS is not linked to the FCGO's financial system (table 10.1). And finally, there is very little physical verification of the data, usually only a certification from the head of office. This translates into serious data quality issues, a quasi-absence of monitoring during the year, and limited use of this information for budgeting or evaluation.

10.5 **However, the pattern of expenditures is heavily bunched toward the end of the year, a sign of weakness in budget implementation** (figure 10.1). This pattern is even more accentuated for capital expenditures. A first issue is related to the *release of funds*, which is low the first trimester (figure 10.1; see also box 9.3 for anecdotal evidence in health and education). A Public Expenditure Tracking Survey in education showed that some of the bottlenecks in fund release were at the local level, for example, from District Education Office to schools. This results from a combination of factors, including (a) conservative cash management (which on the other hand contributes to fiscal discipline); (b) weak prioritization criterion (the share of high-priority "P1" projects in the budget allocation has been increasing and reached 81 percent in 2006/07); (c) delays in approving the budget and finalizing the

[34] The FCGO is also responsible for ensuring that accounts are properly maintained; for collecting, monitoring and recording revenues; for maintaining records of inventories, expenditures, and unsettled irregularities; and for managing accounting personnel and internal audit across the GoN. It consolidates monthly cash flow information, and upon completion of the financial year, submits for auditing to the Office of the Auditor General the national statement of receipts and expenditures.

appropriations (chapter 9); and (d) a complex flow of funds, notably at the local level (figure 11.1).[35]

Figure 10.1: Fund Release and Expenditures (Rs. billions per trimester)

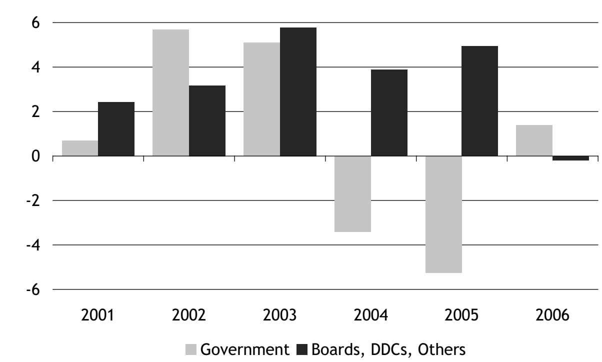


Sources: GoN; staff analysis.

10.6 Second, there are issues with *procurement planning*, which is not done before budget approval (see next section). This calls for a change in the project selection process to ensure that projects in the budget are ready for implementation. Similarly, *work program planning* (box 10.1) often starts after budget approval, that is, with the fiscal year already under way. A broader issue is that of *incentives* in the bureaucracy to focus on implementation: the introduction of new processes has changed the paperwork, but not the mindset. Part of the problem has to do with excessive political interference at key points of the project cycle, an important rationale for a better delineation of roles between the bureaucracy and the politicians (box 9.2). This also raises the need for more focus on reporting and on ex post reviews.

10.7 Finally, two *physical elements* contribute to this bunching in spending: (a) the remoteness and inaccessibility of some parts of the country, and (b) the calendar, with the beginning of the fiscal year (July 15) followed by the monsoon and the festival month, and the winter soon after. One option to address the second issue would be to change the timing of the fiscal year, as has been done in several countries and is being considered in others. However, the logistical implications are complex, and the timing of budget decisions should mesh with timetables for other decisions (including decisions on tariffs in other countries).

Figure 10.2: External Audit's Net Irregularities (Rs. billions)



Source: AG's annual reports; staff analysis.
Note: Net irregularities include additions net of irregularities settled during the year.

10.8 **There has been good progress toward establishing a control framework.** Progress is evidenced by the reports of the Auditor General (AG), summarized in figure 10.2. In 2004 and 2005, more irregularities were settled than new ones added for the central government (see chapter 9 on extrabudgetary activities and chapter 11 on DDCs). This progress is based on a good regulatory framework, the FAR in particular. Further progress has been made recently in payroll control (PFM indicator 18) with the creation of an Electronic Personnel Information System; however, it covers only a third of the payroll so far, with teachers and police

[35] Revenue inflows are also somewhat biased toward the end of the year (ADB 2005), although the use of domestic borrowing should keep this from being a constraint on expenditures. The Asian Development Bank also documents a number of other recent improvements in cash management, including a reduction in the float (and resulting carry-over from one year to the next) and some progress in getting timely reimbursement from donors.

being gradually added, while the security sector should be considered for future addition. Audits found very few cases of ghost workers.

10.9 **There remain, however, five critical weaknesses in the control framework.** (An additional issue is related to procurement, where AG reports note frequent violations of rules; see section B). In fact, although "net irregularities" have been reduced, the AG still identifies new irregularities amounting to around Rs. 7–13 billion per year—almost 10 percent of total expenditures.

10.10 **First, record keeping is insufficient.** "Documentary evidence not submitted" accounts for 45 percent of all irregularities in the 2005 AG report. In education, for instance, District Education Offices do not maintain proper records of block grants disbursed to schools.

10.11 **Second, the fragmentation of bank accounts and lack of automation make reconciliation difficult.** The FAR stipulates that each office should submit its monthly financial statements to the FCGO/DTCO (and its line ministry) within seven days after the end of the month. Reconciliation of the major expenditure accounts, which are held at the NRB, works well. However, the fragmentation of bank accounts makes reconciliation very difficult and resource-intensive (especially at the local level, chapter 11). The GoN maintains 12,000 bank accounts in 124 banks, some of them producing manually written bank statements. In particular, the reconciliation of revenue accounts is very weak and is done only at year-end. One option would be to simplify the system and streamline accounts. In addition, banking information could be included in the computerized system with a view to moving toward automated reconciliation.

10.12 **Third, despite its stated importance in the control framework, physical verification is weak.** The regulations stipulate that fund release and payments should be based on physical verification of actual progress (box 10.1). However, DTCOs lack technical capacity and manpower to do such verification, they have monitoring and control systems that are disconnected (table 10.1), and as a result they often accept fund release requests without any verification, even on a sample basis. Hence the accuracy, timeliness, and reliability of implementation reports are limited. These results are interrelated with the fact that such reports are not used for budget formulation: since their accuracy is doubtful, they are not used, and since they are not used, no effort is made to improve them. There are several options for reform. One can (a) focus verification on only a fraction of the capital budget (say 25 percent, possibly with risk-based sampling) and simplify verification; (b) involve communities, building on the existing practice of "social audits"; (c) adjust the budget formulation process to make evidence of progress a condition for subsequent budget allocation; and (d) clarify roles of various institutions (e.g., line departments responsible for certification, FCGO for sample-based verification of outputs, internal and external audit for testing the system, and NPC for monitoring outcomes and development impact).

10.13 **Fourth, there is no commitment control or encumbrance monitoring** (PFM indicator 20). This explains the lack of data on arrears. Poor reconciliation of advance accounts (PFM indicator 22) in a system that treats advances as expenditures further weakens the control framework. According to AG reports, unsettled advances reached Rs. 9 billion in 2005, or 1.6 percent of GDP. The solution is twofold. First, "advances" that do not require reporting back should be explicitly converted into cash grants. For instance, for the education and health SWAps, payments to schools and sub-health posts are considered as grants, with a requirement for the local organization to maintain accounts, report on them, and get them audited—but no requirement to settle the advance (box 9.3). Second, for genuine advances, the current system of imprest accounts (which conditions new advances on the settlement of earlier advances) and arrears reporting ("Form #18") should be tightened. The existing system of commitment monitoring for large transactions could be better enforced and used.

10.14 **Finally, internal audit (IA) is an area in need of reform** (PFM indicator 21). Its role first needs to be clarified between two options:

- The current role is largely limited to pre-audit transactions, and in this sense IA is very much part of the internal control framework. The IA function is centralized. In this model, the large backlog of IA (as noted by AG reports) and the limited follow-up on IA report findings show a significant weakness in the control framework. There are structural reasons for this backlog. Internal auditors are managed centrally, hence they undermine the discretion of the line ministry and, necessarily, are a source of conflict. Moreover, they add an extra layer of control that might be redundant in the existing "dual-key system" (payments are authorized jointly by the line ministry and the DTCO).
- An alternative is to move toward a more standard approach to IA, whereby IA is used by the management of each agency to assess the quality of its control framework (see Diamond 2002). In that model, audit activity would focus on identifying weaknesses in the implementation of the control framework, as opposed to irregularities, and would become risk-based. The system could remain centralized or could be decentralized, with centralization having benefits in a low-capacity environment. As external audit has greatly improved in recent years, this option, which reflects developments in many other countries, might now be appropriate for Nepal.

10.15 While the second option appears preferable, any IA reform should start from the development of a commonly agreed approach. On this basis, a number of steps will be necessary, as summarized in the 2005 AG report: (a) prepare an audit plan and field an IA team under the leadership of a gazetted officer to carry out IA; (b) review the positions of IA staff and ensure that they are filled with qualified personnel; (c) ensure the quality of IA by developing the expertise of in-house staff or by contracting out this function; and (d) institutionalize the IA training program. Complementary reforms would include the creation of internal audit committees, possibly creating a cadre of internal auditors.

10.16 **There are several gaps in reporting,** despite systematic data reporting from line departments to DTCOs and to the FCGO (18 DTCOs are not connected to the computerized network, but they account for only 5 percent of transactions). First, in terms of *coverage and classification*, many funds are left out of reporting, and the usefulness of reports for management is compromised by classification issues (chapter 9). Second, the *content and frequency of consolidated analytical reporting* are deficient, even though reports from departments are submitted internally on time. While a weekly aggregate internal report is prepared for cash management, no analytical within-year report is prepared (even less made public), with the exception of a midterm review. Third, there is a *lack of information received by service delivery units* (PFM indicator 23). The issue is compounded by the lack of information at the local level about commodity grants and other in-kind external assistance. These points highlight two structural issues: the FCGO needs to become a client-oriented information provider, hence developing its supply of reports, while efforts should be made to stimulate the demand for reports (chapter 9).

10.17 **The preparation of annual financial statements is sound, although there are gaps in accounting policy** (PFM indicator 26). The FCGO, based on submissions from line ministries, prepares annual financial statements in a timely manner (six months after year-end, as per the FAR). The accounting policy is on a cash basis, which is appropriate given existing capacity, but a few changes are needed toward the cash-based International Public Sector Accounting Standards (IPSAS)—for example, on the treatment of advances, discussed above.[36]

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[36] The IPSAS standards have been set by the International Public Sector Accounting Standards Board of the International Federation of Accountants. See "Gap Analysis of Public Sector Accounting and Auditing Standards" (Word Bank 2006c).

These changes would improve the control framework and help with macroeconomic management by providing a clearer picture of cash transactions. The FCGO makes an attempt to include in these statements not only the Consolidated Fund but also direct payments and commodity grants from donors, although these donor-related transactions are not reflected in line ministries' accounts, hence weakening reconciliation. However, other funds have separate accounts (see chapter 9, section B). In addition, as noted above, there are reconciliation issues, notably for the revenue account and for advances. Public sector accounting standards should be set, and consolidated financial statements and annual revenues and expenditure statements should be based on them. Finally, the law should be amended to reflect the requirement to use international standards (Sri Lanka provides a good example of moving to these standards), and a public sector accounting board could be created to set specific standards.

Box 10.2: Institutional Capabilities for Public Finance Management

Weak PFM performance is often simplistically attributed to "poor capacity." This claim is valid, but training alone is not enough to bring about better performance. Capacity must be developed at three levels.

First, capacity is largely driven by the *institutional environment*. This includes the policy environment, and therefore a key theme of this PFM review is to identify ways to simplify the regulatory system. A second element is the demand for good performance: capacity will only develop if the PFM institutions can feel a demand for it. For instance, internal audit will develop only if managers demand feedback about their units' performance. Another element is the political environment and the clear delineation of roles between civil servants and politicians. The institutional environment also depends on the capacity of a computerized management system (see text in this section) and on the content of multiple donor requirements for the management of donor funds (e.g., in Project Implementation Units), which can be a drag on capacity.

Second, *organizations* have to be set up to support good performance. To begin with, accountabilities within organizations have to be clear. In the PFM area, the absence of a clearly designated chief financial officer needs to be remedied to ensure clear accountability. The chief of the finance administration unit should be made the chief financial officer, with a clear definition of roles and duties and with dual accountability, within the ministry to the secretary and outside the ministry to the financial comptroller general. There are also three radical organizational changes that are often raised. First is the question of co-management of the budget by the NPC and the MoF (similarly, the budget and planning divisions of these two ministries are separate). While a joint team might make sense today, given the NPC's expertise with development issues, international experience clearly suggests the benefits of having one institution manage an integrated budget; this could be a medium-term objective for Nepal. Second, there are projects to make the FCGO independent from the MoF in order to focus on accounting issues. Experience in other countries highlights the risk that such reform may further weaken the coordination between budget preparation and budget implementation; even today, the FCGO is insufficiently focused on its role of providing within-year reports. Third, the GoN on several occasions has considered the option of setting up an autonomous revenue agency. However, a recent review of international experience provides no evidence that such an approach has improved revenue administration in countries that have adopted it (Kidd and Crandall 2006).

Finally, and more traditionally, *individual capacity* must be built. Training is important, and may include such activities as courses, on-the-job training, mentoring, and study tours. For instance, accounting skills are scarce in the public sector and must be adequately nurtured, for example, with support from the Institute of Chartered Accountants of Nepal. Curricula need to be more attuned to international standards of accounting. Auditing skills should be expanded from a focus on transaction-based irregularities to a capacity to assess internal control systems. Training in the procurement area has already been scaled up to allow implementation of the new Procurement Act. Equally important is a practice of civil service management that makes the job attractive and that recognizes performance (box 9.2). For instance, it can be argued that the absence of a well-managed cadre of internal auditors is one reason for the weak performance of internal audit.

10.18 **Cutting across these issues is the role of a computerized Integrated Financial Information Management System (IFMIS).** A quick summary of existing systems (table 10.1) reveals a severe fragmentation and lack of connectivity, and at times consistency. There is also a lack of comprehensiveness (19 non-connected districts and two have manual systems; extra budgetary funds with independent system, etc). This structure contributes to the issues raised in this section, including poor bank account reconciliation, accounting gaps, and weak reporting.

10.19 **A more effective IFMIS would improve the timeliness and accuracy of information, enabling stronger controls and better reporting.** The recently defined IFMIS development strategy rightly focuses on developing an integrated system that would build on existing systems (IMCL 2005). An approach based on expanding the system to off-line districts and connecting existing systems together is in line with international experience, which supports a phased approach to connecting systems rather than introduction of a new integrated system (Diamond and Khemani 2006). However, international experience warns against rolling out an integrated system without reviewing business processes first. Given the existence of duplication in the control system, leading to multiple entries in various systems, a more ambitious reform of the IFMIS should be preceded by a review, and simplification, of business processes. For instance, it has been proposed that a new district accounting system become the single point of entry of transactions. International experience also suggests that the proposed reform should offer compatible incentives: it should have clear ownership, bring benefits for users (e.g., simplification of tasks) but without overpromising, and respond to demands from stakeholders (e.g., better reporting). Finally, international experience highlights that such reform should be managed as a project, with a design and planning phase, adequate resources, and careful project management, especially given the specific complexities of a decentralized system like Nepal's.

Table 10.1: A Fragmented Information Management System

System	Owner	Content	Issues
Budget Management Information System (BMIS)	MoF	Budget data to prepare the Red Book and around 70 reports	No interactive link with FMIS
District Expenditure Control System (DECS)	FCGO/ DTCO	Accounting system for releases and expenditure transactions	Insufficient as accounting system (DECS duplicates accounting by paying offices)
Financial Management Information System (FMIS)	FCGO	Based on data from DECS received on a monthly basis; records expenditure (releases and actuals), virements, revenues	Not designed as accounting and financial reporting system; does not capture physical information
Tax and VAT Revenue Management System Customs Systems	MoF	Dedicated systems for the Inland Revenue Department and for the Department of Customs	Little interaction with DECS and FMIS, reducing scope for reconciliation
Line Ministry Budget System (LMBS)	Line ministries	Stand-alone system in pilot ministries (agriculture, education, health), to prepare budget and link with BMIS	Needs integration with BMIS and PPIS
Other line ministry systems	Line ministries	Ad-hoc (e.g., Education and Health Management Information Systems)	Not connected to other systems
Project Performance Information System (PPIS)	NPC	Work program and achievements (financial and physical) for MTEF P1 projects	Needs to be rolled out to line ministries to collect data; lack of budget data
Poverty Monitoring Analysis System (PMAS)	NPC	Combines short-term monitoring and poverty evaluation	Not connected to other systems

Sources: GoN; staff assessment.

Note: Other systems include a debt and revenue management system, a personnel information system, and systems in the Ministry of Local Development.

B. Procurement

10.20 **Significant improvements have been made in the public procurement system in Nepal in the last few years.** These include (a) adoption of a modern Procurement Act with provisions generally in line with the UNCITRAL model law; (b) plans to create a Public Procurement Monitoring Office (PPMO) with responsibility and authority for setting procurement policy, monitoring practices, and reporting on overall system performance; (c) initiation of training programs to establish core competencies in the area of procurement; and (d) amendment of anti-corruption legislation to enable the imposition of harsher penalties (such as blacklisting) for acts of fraud and corruption and to allow bidders to report acts of corruption by other bidders or government officials.

10.21 **The procurement system is in transition.** The enactment of the 2007 Procurement Act is bringing significant institutional and regulatory improvements in each of the four main areas of the OECD/DAC baseline indicators: the legal and regulatory basis for procurement, the institutional architecture of the system, the operation of the system and competitiveness of the national market, and the integrity of the procurement system (table 10.2). However, advances these still have to translate into concrete improvements in procurement outcomes. The implementation of the new Procurement Act is the core challenge, requiring the dedication of significant resources if the act is going to successfully improve procurement practices across the public sector.

Table 10.2: Procurement Assessment

Pillar / Indicator	Score
I. Legislative and regulatory framework	
1: Procurement legislative and regulatory framework complies with applicable obligations deriving from national and international requirements	3
2: Availability of implementing regulations, documentation, and tools to support implementation of the framework	2
II. Institutional framework and management capacity	
3: The public procurement system is mainstreamed and well integrated into the public sector governance system	1
4: Functional management of procurement by a public procurement policy body	2
5: The country has institutional development capacity	2
III. Procurement operations and market practices	
6: The country's procurement operations and practices are efficient	2
7: The country's public procurement market functions well	1
8: The country has contract administration and dispute resolution provisions	3
IV. Integrity of the public procurement system	
9: The country has effective control and audit systems	2
10: The country has an efficient appeals mechanism	2
11: The public has broad access to information	2
12: The country has ethics and anti-corruption measures	2

Sources: GoN; staff estimates.

Note: Based on OECD/DAC baseline indicator methodology. A score of 1 means that the trigger is not achieved, with serious procedural deficiencies; 2 means the trigger is partially achieved, with procedural deficiencies but benchmarks partly met; 3 means the trigger is substantially achieved, with some procedural deficiencies but most benchmarks met; 4 means the trigger is fully achieved.

10.22 Delays in budget implementation and perceptions of corruption (especially collusion in works contracting) highlight four key interrelated gaps in public procurement. First, *poor procurement planning* is a source of delays in budget implementation (see above). The new Procurement Act mandates proper procurement planning, a requirement that needs to be enforced through the budget process. Second, *weak capacity* remains a constraint (box 10.2). At the individual level, there is a shortage of properly trained officials, with a perception that competency is declining. This is beginning to be addressed through a procurement faculty created at the Nepal Administrative Staff College. At the organization level, the soon-to-be established PPMO will enable better oversight and support to public procurement, including through a monitoring system. Third, there is a sense of *fear*—partly related to issues of capacity—that paralyzes procurement decisions. This results from (a) significant influence and involvement of politicians in the process; (b) excessively cumbersome review processes in some areas (the new act itself contains some provisions that may be difficult to implement, such as the provision that contract variations of more than 15 percent require the approval of the Cabinet); and (c) fear of scrutiny and unnecessary probing by oversight bodies such as anti-corruption agencies (see below). Finally, the *public procurement market* is weak, with limited competition on many bids. The fact that often only 10 percent to 20 percent of potential bidders actually submit bids reveals issues of weak capacity to bid and potential collusion (see also chapter 6 on rural roads).

C. External Accountability

10.23 **With respect to external accountability, there are a number of issues at the policy and budget formulation stage** (PFM indicator 27). While the Tenth Plan was prepared with thorough consultations, annual budget preparation would benefit from additional transparency and time for debate, notably with the Parliament. Chapter 9 flagged the need for higher quality documentation, an early discussion on strategic directions, and more time for Parliament to review the budget.

10.24 **Important progress has been made with external audit.** PFM indicator 26 has a low rating because of delays in submitting AG reports to the legislature, which were due to the political context. The 2007 Interim Constitution and the 1991 Audit Act guarantee the independence of the AG. Audits are conducted according to standards based on recommendations of INTOSAI (International Organization of Supreme Audit Institutions). Their coverage has been extended to all extrabudgetary funds. The content has also been extended, including to technical audit which is carried out by the National Vigilance Center. Although there have been delays in the past, in particular while the Parliament was dissolved, and there is no legal requirement about timeliness, which is a gap, audits are now submitted in a reasonably timely manner to the chairman of the House of Representatives. Audited entities are required to respond to audit findings within 35 days. Capacity of the AG is being built through revised manuals, training, and twinning with the Malaysian AG, including for peer review.

10.25 **External audit is not yet used to its full effectiveness, however.** First, the AG report still focuses largely on compliance with laws and on irregularities, rather than on *systemic issues*. Progress has been made in classifying irregularities, but more analytical classifications are not available—for example, procurement versus lack of documentation, or payroll versus goods and services. It is difficult to gauge the level of fiduciary risks through AG reports: a financial audit should be conducted to provide an audit opinion on the complete set of financial statements instead of commenting on the deficiencies found in the scrutinized transactions. Similarly, the AG report needs to become more user-friendly, with a summarized version for the public that communicates clear objectives, addresses relevant problems, and makes effective recommendations. Second, the *follow-up* to audit recommendations is weak, in part because of the absence of Parliament for four years. As a result, the same recommendations and irregularities are repeated year after year. The Irregularities Clearance and Central Monitoring Committee chaired by the chief secretary was established to recover irregularities, but follow-up on systemic issues is weak. Finally, clearing the backlog of *audits for SOEs and extrabudgetary funds* is also important (chapter 9, section B).

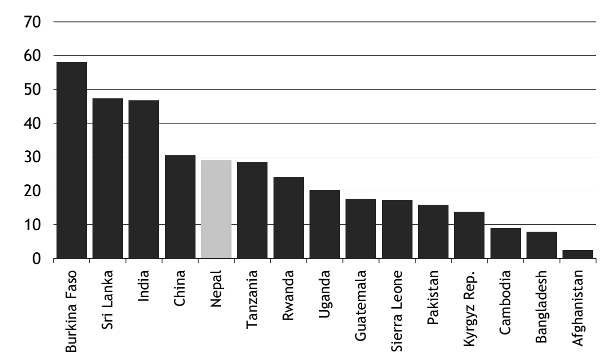
10.26 **The Public Accounts Committee (PAC) has a key role to play in external accountability.** After the reconstitution of the Interim Parliament, a 22-member PAC was formed that included Maoists, but it has yet to play an active role. This committee should provide a good system for monitoring follow-up to the AG's recommendations. However, the PAC will require significant capacity building if it is to exert this role fully. Like the AG, its work will need to focus on systemic issues rather than on an indiscriminate review of all irregularities. In addition, a cross-country review of more than 50 PACs suggests additional criteria for their success, including the behavior of committee members, the availability of independent sources of information, and the media's interest in scrutinizing government accounts (Pelizzo et al. 2006).

10.27 **Significant information is publicly available,** even though publication is not a legal obligation. However, earlier sections of this report noted a number of deficiencies in the available information, including incomplete coverage, classification issues, weakness of within-year reporting, lack of reporting on achievements, and lack of user-friendliness. Combined with weak demand and lack of expertise, this explains why most media cannot sustain a story on the budget or the PAC for more than a few days.

D. Fighting Corruption

10.28 **There are indications of widespread corruption in Nepal.** The governance indicators from the World Bank Institute suggest that Nepal is around the 30th percentile in the ranking of countries with most corruption (figure 10.3). A household survey from Transparency International Nepal suggests that land administration and customs are perceived as the most corrupt sectors, with police and justice ranking immediately after (the latter two areas are also where almost 50 percent of the service users experienced corruption). The survey also point to corruption in education and health, such as bribes to get admitted to facilities and irregular fees. As in most countries, the survey found that corruption was hurting lower-income groups most.

Figure 10.3: Corruption Indicators



Source: Kaufmann, Kraay, and Mastruzzi 2006.
Note: Corruption is measured by combining a number of surveys. The Y-axis measures the percentile ranking of each country (29 for Nepal in 2006). Countries with higher ranking have less corruption.

10.29 **The GoN has adopted a number of steps to fight corruption.** The Commission for the Investigation of Abuse of Authority (CIAA) was created in 1990 as an autonomous body with a mandate to prosecute cases of corruption. In 2002, the Prevention of Corruption Act was adopted, the powers of the CIAA were extended, and another anti-corruption agency, the National Vigilance Center, was created.[37] The number of cases filed by the CIAA and the proportion of convictions in these cases has increased, and the CIAA has shown a lot of

[37] The Royal Commission for Corruption Control (RCCC) was created by the king in 2005 to investigate matters of prosecution, with powers of the special court. The commission has been controversial given its mandate, which conflicted with the functions other institutions and was seen as politically motivated. The RCCC was later found unconstitutional by the Supreme Court and disbanded.

independence and commitment to fulfill its mandate. The vigilance center has conducted awareness-raising campaigns and more than two dozen technical audits. In 2002 also, an Impeachment Act was enacted and a high-level Property Investigation Judicial Commission was established to examine the property of politicians and bureaucrats. An anti-corruption strategy was prepared in 2003 to be supervised by the chief secretary. A number of acts help define important issues such as conflict of interest, asset declaration, human resource management practices, disclosure requirements, and so on.[38] While corruption remains a major concern, these various steps are a significant achievement.

10.30 **Progress in PFM performance will be an important component of the anti-corruption strategy.** As discussed in this report, a number of gaps exist, including in account reconciliations, application of the control framework, procurement, revenue collection, audit, quality of disclosed financial information, and external oversight. Many reforms made in the PFM area will contribute to tightening the systems toward better governance and thus will reduce vulnerability to corruption. Finally, incentives are important. Some internal measures—such as establishing codes of conduct, with clear disciplinary measures for noncompliance, in the areas of revenue collection, accounting, and auditing—will be necessary to complement incentives provided by transparency and external oversight.

[38] See the Global Integrity report at http://www.globalintegrity.org/reports/2006/nepal/index.cfm.

11. Local-Level Public Finance

Key Messages

- Irrespective of the decisions made with respect to local governments, decentralization, and federalism, public finance management at the local level must be sound. At the moment, local public finances are a small part of total public finances.
- For local governments to manage public finance well, a stronger commitment from the center is needed to (a) reduce the reliance on earmarked grants; (b) develop use of local-level planning for national planning purposes, for example for rural roads; (c) clarify the control framework and provide better support systems (information technology as well as processes); and (d) supply better budget reports to local government to support good management.
- Such stronger commitment from the center should create the framework and incentive for local government capacity to increase faster. In addition, the local accountability framework needs significant tightening to ensure that citizens' voices are heard — including before local elections can be held.

11.1 This chapter reviews PFM issues at the local (mainly district) level. Decentralization is a major feature of Nepal's history and institutions, and it will remain so as Nepal becomes a federal state (box 11.1). Irrespective of the exact structure of the state, a good PFM system at the local level is essential to ensure good local planning, an appropriate flow of funds, implementation, and accounting, and good accountability, all of which are expected benefits of decentralization. After outlining the structure of local finances in section A, the chapter reviews issues of planning in section B, execution in section C, and accountability in section D.

A. Structure of Local Finances

11.2 **Local government resources amount to 1.3 percent of GDP** (table 11.1). A quarter of this comes from the District Development Committees, a third from the Village Development Committees, and two-fifths from municipalities.

11.3 **Local bodies mobilize a third of their resources, with the balance coming from the central government.** They have access to five major types of resources. First, local bodies have some taxation power, as prescribed by the Local Self-Governance Act (LSGA).[39]

[39] VDCs and municipalities can collect house tax, land revenue, market shop tax (temporary bazaar tax), vehicle tax, entertainment tax, rent and tenancy tax, advertisement tax, business tax, commercial video tax, and natural resources utilization tax. They also have authority to levy service charges and fees and dispose of public property. Additionally, the municipalities can levy enterprise tax, property tax, and parking charges. They also receive a share of the local development fee levied on imports (1.5 percent of import value) at customs entry points. DDCs are authorized to impose taxes on roads, paths, bridges, irrigation, and ditches and ponds built or maintained by them, as well as taxes on resources such as wool, turpentine, herbs, recyclable scrap,

Second, vertical revenue-sharing arrangements are in place with the central government and between local bodies.[40] Horizontally, DDCs share revenue on hydroelectricity generation. Third, the central government provides grants, a major source of income for local bodies. These include (a) annual block grants, which are unconditional; (b) conditional grants, including for devolved activities; (c) administrative grants for financing administrative and operational expenditures such as salary and allowances of centrally deputed staffs and office operating costs; and (d) special grants, which are matching central contributions to programs implemented by local bodies and community groups.[41] Fourth, local bodies can borrow, based on collateral or central government guarantees. Borrowing from foreign governments and international institutions requires prior approval from the central government. In effect, only municipalities have any access to borrowing, as low creditworthiness remains an obstacle. Finally, donors contribute directly to local development activities, but the level of direct financing by donors and NGOs is largely unknown.

11.4 A review of local bodies' resources highlights the following issues:

Table 11.1: Local Finances (Rs. millions, 2004/05)

	DDCs	VDCs	Municip.	Total (net)	% GDP	% central govt revenues
Revenues	**1,823**	**2,546**	**3,106**	**6,786**	**1.3**	**9.7**
Gov grants	766	1,590	308	2,663	0.5	3.8
DDC grants	-	298	390			-
Other grants (*)	-	122	8	129	0.0	0.2
Own source revenue	518	537	943	1,998	0.4	2.8
Revenue sharing	539	-	-	539	0.1	0.8
Local Dvpt Fee	-	-	990	990	0.2	1.4
Other income (**)	-	-	466	466	0.1	0.7
Expenditures	**1,498**	**2,405**	**2,726**	**5,941**	**1.1**	**8.5**
Balance	**325**	**140**	**379**	**845**	**0.2**	**1.2**
Distribution across level of local Governments						
Revenues	24	34	42	100		
Expenditures	23	36	41	100		

(*) inc. Town Dvpt Fund for municip.; (**) inc. loans, balance carry-forward

Sources: GoN; staff estimates.

- *Narrow tax base*. Although they can tax land and property (rent), the rates are low. Other sources such as such as entertainment tax, enterprise tax, natural resource utilization tax, fees, service charges, fines, and penalties have low returns. The major taxes such as VAT, income tax, and excise duties are still under central government jurisdiction. The problem is exacerbated by the fact that many people suffer double taxation: they not only pay normal taxes, but are also taxed by the rebels.
- *Overlapping revenue assignments*. The revenue responsibilities of DDCs, municipalities, and VDCs are similar, generating tensions over resources.
- *Autonomy*. Local bodies lack discretion in taxation as the central government assigns revenue responsibilities. Similarly, grants—including block grants that are supposed to be unconditional—are governed by detailed central government guidelines, which prescribe priorities and reduce local bodies' discretion. The lack of predictability of government grants further weakens the autonomy of local bodies. The high proportion of grants in local

construction aggregates, etc. They can also levy different types of service charges and fees and dispose of public property.

[40] There are vertical revenue-sharing arrangements (a) between the central government and DDCs (50 percent of royalties from mining, 10 percent of forestry products, 50 percent of hydroelectricity fee, and 30 percent of tourism entrance fee); (b) between central government and municipalities for the local development fee; (c) from VDCs and municipalities to DDCs (about 25 percent of land revenue); and (d) from DDCs to VDCs and municipalities (35 to 40 percent of income from charges on commercial use of raw materials, recyclable waste, construction aggregates and timber swept by rivers, etc.).

[41] Block grants to DDCs are based on weighted criteria: Human Development Index (50 percent), population (20 percent), geographic area (10 percent), and cost index (20 percent). VDCs received Rs. 500,000 as block grants until 2005; the amount was raised to Rs. 1 million in 2006. They also receive an additional Rs. 500,000 that has to be spent on designated areas.

bodies' resources generates a high dependence and weakens autonomy; this is particularly true for VDCs.

- *Revenue management capacity.* Local bodies lack organizational capacity, technical know-how, and skilled staff for revenue administration and management. Capacity to assess their revenue potential is also limited.

Box 11.1: Decentralization in Nepal: Framework and Issues

Nepal's local governance structure has two tiers: the 75 District Development Committees are the upper level, and 58 municipalities and 3,915 Village Development Committees are the lower tier. The DDC electoral constituency comprises nine to 17 "ilakas," a VDC has nine wards, and the number of municipal wards varies from nine to 35 based on population, geographic coverage, development level, income, and need for services. All three units of local government are autonomous in terms of functions. The DDC has a supervisory role over the municipalities and VDCs. The government grant to VDCs is channeled through the DDC, which is also responsible for supporting the VDCs through internal resources.

The 1990 Constitution launched the process of decentralization in Nepal. Successive enactment of the DDC Act, the VDC Act and the Municipality Act in 1992 provided the basis for forming local governments. However, real decentralization began only in 1999, following the enactment of the Local Self-Governance Act (LSGA). The LSGA provides a framework for managing local bodies, including provisions to make them accountable to the people. The law led to the formulation of the Local Self-Governance Regulations and the Local Bodies (Financial Administration) Regulations. But the process was slowed down by the conflict, which, combined with the reluctance of the central government to give up decision-making powers, resulted in confusion and poor coordination during implementation.

Nepal made some progress in empowering local bodies by providing them fiscal and decision-making authority, accompanied by clear assignment of expenditure and local revenue generation functions. However, the LSGA and its associated regulations have yet to be fully implemented. The local bodies were dissolved in July 2002, after which successive governments, failing to hold elections, appointed officials to run local bodies.

Decentralization remains relevant to Nepal, even in the context of a federated structure, which is a major demand of excluded social groups and some major political parties. The following commitments have been articulated in the Interim Constitution 2007: (a) progressive restructuring will be done to end the centralized and unitary structure of the state; (b) local self-governing bodies will be managed to promote the public interest and to provide service at the local level through decentralization/devolution of authorities to the local level; (c) roles and responsibilities of the center and local bodies will be clearly delineated, based on which expenditure and revenue assignment will be done; and (d) special attention will be given to ensuring equitable and balanced development of the state while allocating resources and sharing revenue with special emphasis for uplifting the socioeconomic status of excluded communities.

Source: Adapted from "Decentralization in Nepal," in World Bank 2007b.

11.5 **The LSGA sets expenditure responsibilities,** assigning 10, 11, and 16 functional expenditure categories to the municipalities, VDCs, and DDCs respectively.[42] Local bodies can also exercise some judicial powers. This assignment remains centrally driven rather than based on principles of subsidiarity and local demand. In fact, despite a gradual increase in their responsibilities (primary education and health services, agriculture and livestock extension, and local infrastructure were devolved to local bodies in 2001/02), spending by local bodies has not been increasing (table 2.1). Most devolved functions remain centrally funded and executed.

B. Planning and Budgeting

11.6 **Each DDC is required to formulate periodic and annual development plans.** Anchored in district periodic plans, annual district development plans cover programs relating to

[42] Expenditure responsibilities include agriculture, water supply, construction and transport, education and sports, irrigation and river control, physical development, health, forestry and environment, language and culture, tourism and cottage industry, social welfare, labor wages, women and children, disabled people, hydropower, land management, and rural settlements.

agricultural extension, irrigation facilities, livestock raising, road repairs and upgrading, mini and micro hydropower and alternative energy, forestation, environmental protection, skills for employment, sports, promotion of tourism, education for all, essential health care services, water supply and sanitation, gender sensitization, social welfare, and strengthening of institutional capacity. The plans are based on budget ceilings and on various guidelines and plans, including directives from the NPC and line ministries, district-level goals and policies set on the basis of national goals and policies, and plans received from VDCs and municipalities. Annual work plans are also prepared, even for donor-assisted projects handled through NGOs.

11.7 **Despite the absence of elected members, participatory planning processes are in place.** The District Implementation Plan process begins with a seminar to share ideas about functions of the various local offices of central ministries, guiding policies at both national and district levels, and their budget ceiling for the next fiscal year. Key participants are VDC chairpersons, line agency chiefs, NGO representatives, authorities of the DDC, and DDC staff. Program proposals are formulated at the ward level and then reviewed in the village council with the participation of the VDC chairperson, VDC members, user group chairpersons, social workers, and representatives of political parties, NGOs, community-based organizations, and so forth. Then, under the leadership of the concerned line agencies, these program proposals are reviewed and their priorities are set at the ilaka-level workshop. For the purpose of scrutinizing program proposals in light of the available means, committees convened by DDC members are formed for various sectors. These committees include the representatives from the related line agencies and NGOs, and their recommendations are reviewed by the Integrated Planning Committee before being submitted to the district council for approval and reporting to the NPC.

11.8 **Programming and budgeting exercises are carried out after circulation of policy guidelines and budget ceiling from the NPC.** The DDC finalizes both programs and budgets before the onset of a new financial year. Programs approved by the DDC are incorporated in the annual district development plan and sent to the NPC for budgetary approval. Once the budget is sanctioned, programs are implemented by line agencies.

11.9 **In 2005, three districts piloted a district-level MTEF.** DDC Morang has been a pioneer in framing such a framework for FY2006/07, 2007/08, and 2008/09, with DDC Kaski and DDC Bhaktapur following. The rationale for this initiative was to overcome some of the limitations of existing processes (fragmentation, weak connection between budgets and plans, lack of medium-term perspective) and also to build on lessons learned with the central-level MTEF. The exercise produced two major findings. The first was the lack of predictability of resources: grants from the center are communicated late in the process and often change during the fiscal year, capacity to project revenue collection is limited, and donor resources are also highly uncertain. The second finding was the high level of constraints imposed on resources provided by the center and by donors—hence defeating the purpose of an integrated MTEF that seeks to make trade-offs across sectors.

11.10 **The experience with DDC budgeting and planning is largely positive, but the process has not been used to its potential.** Despite a number of concerns about capacity and predictability of resource flows, these planning processes do bring value, and medium-term development plans can serve as a platform for popular participation and integration of all development activities in the district. Local-level budget management also allows more flexibility to make reallocations during the year (the DDC also has authority to make transfers from one budget head to another up to 20 percent of the annual budget for this budget line).

11.11 **However, four issues need to be addressed.**[43] First, with limited predictability in available resources and detailed guidelines imposed by the center (combined with sector staff accountability to their line ministries, discussed in section D), planning often does not lead to an articulated local development vision. Instead it produces a compilation of micro-projects, with little coordination and integration between DDC/VDC projects and line ministry programs and excessive control by line ministries. Better support from the center—more predictability during budget preparation *and* implementation, simpler guidelines disseminated on time—and greater clarity in terms of sectoral responsibilities are required. Also, the budget formulation cycle should be formalized, with clarification of timing and responsibilities of all the actors involved in the process.

11.12 Second, local-level planning is undermined by the weak use of these plans by the central government. In some cases, the annual program and budget authority, which are devolved at the local level, turn out to be quite different from the DDC proposals. In part, this reflects the fact that devolved sectoral agencies are more loyal to their respective authorities and prefer to follow program guidelines irrespective of local needs (section D). The central government should commit to use local plans as inputs to national plans and budgets, for example in the road sector (chapter 6).

11.13 Third, the previous two concerns—lack of vision and weak use of local plans—have been compounded by the absence of elected local representatives after July 2002. Since then, government-appointed politicians and the local elite have been playing major roles in the local bodies, further eroding the legitimacy of their plans and their capacity to make trade-offs.

11.14 Finally, the technical soundness of the plans suffers from two weaknesses. First, the lack of clarity in the distribution of service delivery responsibilities between DDCs, VDCs, and line agencies (combined with the absence of a well-defined village development program) potentially leads to duplication or gaps. The nature of projects that should be included in the village development plans because they can be handled by VDCs individually should be specified. Second, weak prioritization of projects and lack of reliable feasibility studies and cost estimates need to be addressed through improved planning tools. Finally, a practice of simple midterm reviews could be established to evaluate the effectiveness of periodic planning.

C. Budget Implementation

11.15 **At the district level, the budget is implemented through District Development Funds (DDF) operated by DDCs.** Each DDC establishes a DDF and deposits all its resources into it, including funds released by the DTCO on behalf of line ministries. Funds are then released by the DDC secretary to agencies. Both inflows and disbursements must be recorded. The DDC also has a monitoring and supervisory role as well as a control role.

11.16 **A major feature of this system is its complexity.** As shown in figure 11.1, the flow of funds must pass through many layers before funds reach service delivery units, and the path is not even uniform.[44] This often generates delays. In fact, partial devolution has made the

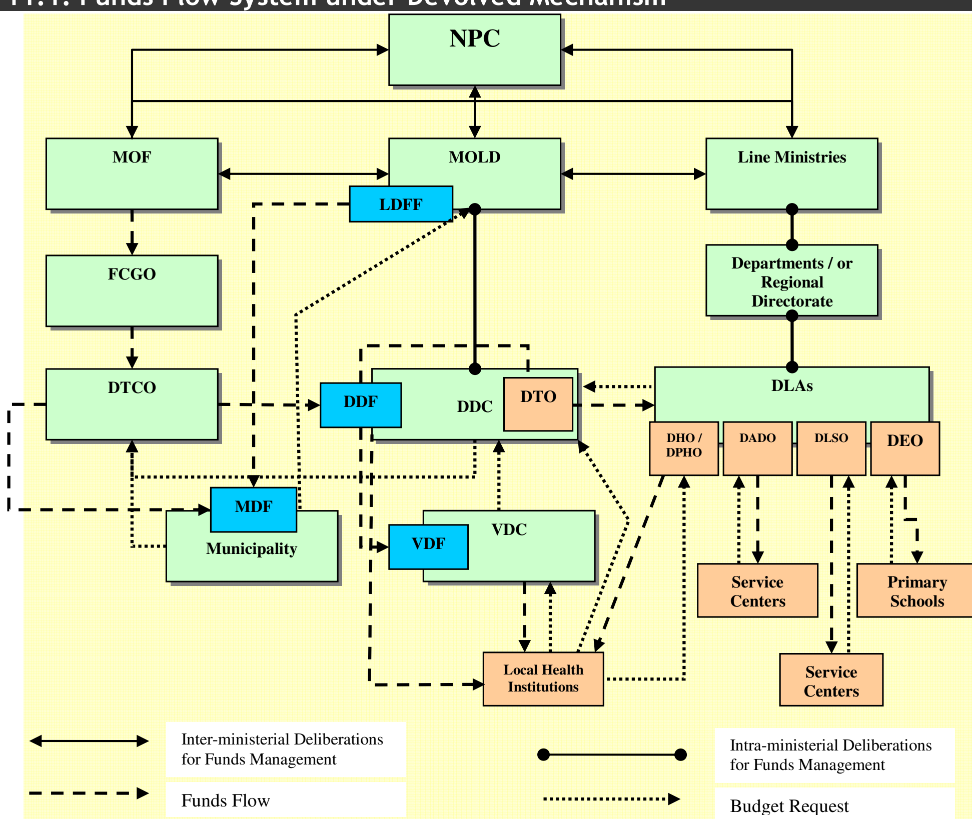
[43] Although there are similarities, some of these issues do not apply to community management, as discussed in chapter 4, either because the scale is different (e.g., school communities have fewer trade-offs to make and a smaller constituency) or because innovative solutions have been implemented (e.g., simplified flow of funds to schools).

[44] Funds for primary schoolteachers, agriculture extension workers, and livestock service personnel are transferred to the respective district agencies. For basic health services, in some districts funds are released from DDF to VDF, from where the VDCs make them available to local institutions, but in most districts the DDCs send the funds to the District Health Office.

DDC a "financial intermediary" that is supposed to make funds available to the concerned sectors without exercising any authority over how resources are planned or managed, or how service delivery modalities are decided. Rather than making DDCs more autonomous, this change has merely made the disbursement process more time-consuming by adding one more step (routing the funds through the DDF). This complexity is compounded by the lack of monitoring of funds channeled through the DDF. Line agencies also feel that, in the present situation of partial devolution, they must expend double effort in tracing budget releases—from the DTCO as usual, and for devolved programs. Adding to the complexity are donor-funded programs for which funds flow through the DDF to project-dedicated local offices. A clear-cut fund flow and control mechanism needs to be established. Since funds will be channeled through the related DDCs, there is an immediate need for an appropriate database system to capture DDCs' electronic data in the MoLD and ensure an effective coordination and their onward linkage with central-level offices.

11.17 **Issues in budget implementation and controls are highlighted by AG's audit reports** (figure 10.2). Common weaknesses identified in these reports include spending beyond the budgetary limit, holding back unexpended balances, unclear advances, poor accounting, incomplete submission of statements of income and expenditure, pending audits, failure to maintain assets records and the list of completed projects, excessive recruitment of staff, adoption of write-off measures for the adjustment of advances and pending taxes, delays in preparation of budget and plan, delays in implementation, and poor monitoring and evaluation.

Figure 11.1: Funds Flow System under Devolved Mechanism



Source: GoN.

11.18 **There is no coherent control policy.** Some basics are in place. The accounts of the VDCs and DDCs follow a double-entry cash-based accounting system, while the municipalities can maintain accounts using either the cash basis or accrual basis of accounting.[45] A few accounting formats prescribed under the Local Bodies (Financial Administration) Regulations (LBFAR) are missing and should be completed as soon as possible.[46] As for the central government, commitments are not recorded and advance payments are treated as expenditures. Accounting is done manually, although many DDCs and municipalities are equipped with computers to share data processing internally, and the MoLD has recently updated an accounting software package to be used in DDCs. However, there is no coherent internal control policy. Control rules remain scattered over several sets of regulations: for example, the Local Self-Governance Regulations prescribe the planning, budgeting, and monitoring framework, while the LBFAR provide financial guidelines for local bodies. Nor is there any document providing for clear delegation and segregation of duties. Clear definitions of responsibilities and lines of accountability across the DDC structure, effective planning and budgeting, and a mechanism for monitoring and evaluation of performance need to be established.

11.19 **DDCs need to pay more attention to the monitoring of financial and physical progress.** A reporting system is in place.[47] But regulations lack standard formats for reporting on programs and activities, work done until the previous year, the current year's target, allocations and trimester breakdown, and cumulative progress, which would be comparable to the annual target. In line with the experience at the national level (box 10.1), a simple management control mechanism should be developed to set targets and monitor actual achievements (financial flows and physical outputs) against targets. Given the limited capacity at the local level, this should be very simple and should be facilitated by the center (DTCOs in particular).

11.20 **Existing internal audit practices raise concerns similar to those surrounding the central government audit** (chapter 10). Internal audit sections have been created in all DDCs. However, recruitment of permanent internal audit staff has not yet taken place in all DDCs. The MoLD, which is responsible for training audit staff, has provided internal audit guidelines, but they are outdated. An average-sized DDC handles 8,000 transactions per year, a heavy workload if two persons (one internal auditor at officer level and one assistant) are to perform pre-audit of transactions. The devolution policy has created additional uncertainties about the units in charge of this function. As for the central government, a rethinking of the overall function, in the context of a review of the control framework, might be appropriate.

11.21 **Procurement practices show weaknesses similar to that of the central level** (chapter 10). Although mandated by the LBFAR, the preparation and use of a comprehensive procurement plan is not yet established in local bodies. Even more than at the central level, there

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[45] Regulations require that accounting shift to an accrual system in the next three to five years for municipalities. In light of the fact that there is no clear action plan to accomplish this, the government might want to reassess the desirability of this target.

[46] They include, at VDC level, the budget ledger, bank reconciliation statement, statement of outstanding advances, and irregularities register; at municipality level, the budget ledger; and at DDC level, the budget ledger and bank cash book.

[47] DDCs are required, within seven days after the end of the month, to submit to the MoLD and also to DTCOs the statement of income and expenditure, along with details of pending advances and the bank reconciliation statement. DDCs also report on grants in kind, direct payments, assistance on turnkey basis, technical and other assistance, and reimbursable amounts. VDCs also are required to submit such statements to DDCs every trimester. VDCs and municipalities, within 35 days after the year-end, submit the yearly statement of income and expenditure and a progress report to DDCs, which in turn prepare a summary statement for submission to the MoLD. Each DDC submits the statement of income and expenditure of the amount sanctioned to it and the amounts of its own resources to the MoLD and the concerned DTCO within 35 days following the end of a fiscal year. Line ministries also compile information in their respective sectors.

is a reliance on high-level clearances for procurement, with thresholds requiring frequent references to the DDC chairman. Finally, the absence of clear separation of duties can be problematic: for instance, the procurement function should be kept separate from recording transactions, which in turn should be kept separate from maintaining physical custody of assets. DDCs are not precisely following this policy, since most DDCs do not have staff specified for procurement. The implementation of the Procurement Act should address a number of these issues.

11.22 **Cutting across these issues is the institutional capacity of DDCs** (see also box 10.2). Monitoring and controlling of financial functions for devolved sectors are inadequate, because the accounting staff of DDCs are overburdened. DDCs are using their regular staff for handling treasury functions. The chief of accounts section in DDCs is deputed from the FCGO, possibly with mixed accountabilities (municipalities appoint their own accounting staff and, in VDCs, the secretary alone handles the records). The lack of elected bodies led DDCs to rely on the leadership of local development officers, who are exercising the authority of DDC chairmen. Once roles and responsibilities are clarified, the DDC capacity should be strengthened in line with the district functions and internal control requirements. Toward this end, steps should be taken to (a) revise the DDC organization chart to clearly establish PFM functions (planning and budgeting, monitoring and evaluation, support to and supervision of VDCs); (b) prepare job descriptions clearly defining the accountability limits; (c) introduce a system of staff performance assessment (this raises the broader issue of creating a local body service cadre); and (d) strengthen DDC staffing, especially in respect to manager positions, and professional skills (planning, project design and supervision, financial management).

11.23 **A number of initiatives are under way to improve DDC performance.** The Danish aid agency, DANIDA, through its Decentralisation Advisory Support Unit, (DASU) supports the Local Body Fiscal Commission in its efforts to strengthen the institutional capacity and fiscal position of local bodies (setting parameters for allocation of grants, analysis of effectiveness of local investments, auditing, collection of land and property tax, preparation of a framework for devolution of resources and responsibility, preparation of a manual for revenue estimation in local bodies, preparation of revenue-sharing mechanisms among local bodies, and preparation of a manual of planning and budgeting). UNCDF/DfID supports the Decentralized Finance and Development Program, which supports the districts in carrying out local-level demand-driven projects run through the user groups and requires that an internal audit mechanism be established in DDCs. Funding from this program is based on a mix of implementation performance and minimum conditions (such as periodic plan, inclusion of program in the annual plan, and due approval from district council to continue to fulfill performance measuring conditions). The MoLD hopes to replicate this model in carrying out more development programs at the local level. The United Nations Development Programme/Norway supports the Decentralized Local Self-Governance Support Program in 66 districts; this program provides seed money matched with group savings to provide microcredit facilities to group members carrying out income-generating activity at the village level, and also supports the updating of the accounting software used at the district level. Finally, the Association of District Development Committees has assumed an active role in various efforts geared toward strengthening the capabilities of DDCs through training, technical and professional support, and services (preparation of district periodic plans, program guidelines, study reports, and manuals on governance procedures).

D. Accountability

11.24 **Effective accountability mechanisms should be the strength of local bodies.** Proximity to citizens is indeed a traditional rationale for devolution of activities to local bodies. A number of effective accountability mechanisms are theoretically in place:

- *A committee for supervision and monitoring*, under the chairmanship of the member of Parliament from the district, consisting of the DDC chairman, a DDC member designated by the DDC chairman, and the relevant employees. This committee meets normally every four months to determine whether the resources and means estimated in formulating DDC plans have been mobilized, assess whether works have been carried out according to calendar, and recommend actions to address bottlenecks.
- *External audit*. DDCs use the services of the Auditor General. VDC auditors are appointed by the DDCs. The municipal council, on the recommendation of the Accounts Committee, appoints a registered auditor. The external audit's primary focus is on certification of accounts; performance auditing has not been introduced yet at the district level. Several arrangements have been made to audit development programs funded directly by the donors.
- *Accounts Committees*. The local councils constitute Accounts Committees (at the VDC, municipality, and DDC levels), receive their reports, and give direction to local bodies for settlement of irregular amounts.
- *Social audit*. DDCs have adopted various types of social audit process, by organizing public meetings, answering queries, and publishing reports, bulletins, and brochures. In 2006, public or social audit was made mandatory for all community-managed local development activities. Many DDCs have established Information and Documentation Sections that maintain information about socioeconomic development, physical infrastructure, and service facilities within the DDC.

11.25 **Yet the accountability framework for local government is ineffective for a series of reasons.** First, without elections, local authorities may have no incentive to embrace good governance practices or be responsive to citizens' needs. For the same reasons, Accounts Committees are not in place, which weakens both internal and external audit. Key financial officers (DDC secretary and accounts officer) are appointed by the central government and therefore may have dual accountability. Sound monitoring and evaluation of local bodies' performance is yet to be enforced, and little has been done to raise awareness among local officials and staffs about the need for and benefits of improved transparency and accountability. Local civil society organizations have no "teeth" to challenge local authorities' actions. Physical insecurity poses a serious threat to accountability. Finally, information disclosed to the public is not comprehensive and is rarely user-friendly.

11.26 **As interim measures, before local elections, there are several priorities:** (a) tighten monitoring of DDC performance; (b) ensure that transparency measures are enforced, including for procurement processes; (c) encourage local civil society organizations to voice people's demands that DDC decisions and performance be investigated; and (d) create interim Accounts Committees consisting, for instance, of former members of these committees.

11.27 **In the long term, three types of measures would support stronger local accountability.** First, accountability should be clarified through a precise devolution policy. Because devolution has so far been partial, district offices of decentralized ministries have to report to DDCs for the devolved subjects while reporting to DTCOs for non-devolved matters. Sometimes, as in the Cooperative Sector Strengthening Project, a subject or item devolved to the DDC in one year is withdrawn and returned to the ministry's control the next year. Second, some coordination—both to set norms and to learn from experience—would be beneficial. As recommended by the Local Body Fiscal Commission 2000, an apex accounts and audit board should be established to set standards and norms, administer irregularities and recoveries, and monitor the financial issues relating to local bodies. Annual national conferences of representatives of Accounts Committees could be organized to share experiences, best practices, and general information, and also to advocate for transparency and financial accountability. Third, the information held by the Information and Documentation Section needs to be updated, upgraded, and maintained.

12. A Four-Point Agenda for Public Finance

Key Messages

- An agenda for better public finance management should rest on four pillars: a sound fiscal policy, prioritized and effective expenditure policies, stronger PFM performance, and effective aid delivery. The central themes are the need to (a) gradually scale up public expenditures and PFM performance as capacity is built, (b) boost the use of monitoring systems and ex post evaluation as management tools to strengthen efficiency and accountability, and (c) simplify unnecessarily complex systems.
- While external assistance can be expected to increase and domestic borrowing could offer a short-term option, large expenditure needs have to be reconciled with limited financing. Beyond this balance between fiscal versus service deficit, the main constraint is implementation capacity.
- To improve expenditure policies, a priority is to scale up existing successful programs. Accelerating infrastructure expenditures, including by developing a pipeline of projects, is another priority.
- Strengthening public finance management systems requires embracing a holistic but realistic approach to reform management. One option is to define a series of platforms, each around one particular outcome. The series of platforms would provide a way to focus capacity and ensure synergies between reform efforts.
- The quality of aid delivery will be a key outcome of PFM performance — as well as a key driver of the quality of public expenditures.

12.1 This concluding chapter puts forward a four-point agenda to strengthen public finance management and enhance its contributions to Nepal's peace and development process (table 12.1; see also the more detailed table in annex B). It is put forward for discussion with key stakeholders in Nepal. This four-point agenda will support the four blocks of Nepal's development strategy as discussed in chapter 2, section A. It will require appropriate sequencing, piloting, monitoring, evaluation, and adjustments as appropriate. The importance of sequencing cannot be overstated given the complexity of the transition process the country has to go through.

A. Fiscal Strategy

12.2 **As outlined throughout the report, a sound fiscal strategy must take into account three dimensions,** all of them emphasizing the need for a long-term perspective:

- *Fiscal space*. Creating fiscal space seeks to "make available resources for meritorious government spending (or tax reduction)" (see chapter 3, section C). In a sense, the idea is that these additional resources will pay for themselves in the long run through the benefits they are expected to bring—economic growth in particular.

- *Macroeconomic space*. Fiscal policy influences macroeconomic stability (including on inflation and debt), which has a well-documented impact on growth and poverty. Expansion of macroeconomic space, through fiscal policy, need to factor in public expenditures finances which have a negative impact on the investment climate (crowding out of private investment, appreciation of the exchange rate, etc.). Issues of coordination between macroeconomic policies were reviewed in box 8.1.
- *Capacity*. The third dimension is the GoN's capacity to implement its budget. This capacity is driven in large part by PFM performance (chapters 9 to 11), which is a key element and enabler of the overall capacity of the administration (box 9.2).

12.3 **External assistance cuts across the three dimensions.** While it brings fiscal space and foreign currency to expand imports, it can also have a negative macroeconomic impact ("Dutch disease," box 8.1). Its impact on capacity and governance is mixed: while it can support the development of government leadership and capacity, it can also mix incentives and create high transaction costs.

Table 12.1: A Four-Point Agenda for Public Finance Management

Area	Building on achievements…	… with a well sequenced strategy… Short-term	… with a well sequenced strategy… Medium-term	… toward a new Nepal
1. Fiscal strategy	Fiscal discipline	Stable expenditure path as fiscal anchor	Manage away from aid dependence	Macroeconomic stability, self-reliance
2. Expenditure policies	Some realignment with Tenth Plan in recent years	Scale up existing programs Allocate budgets on per capita basis (and performance) in health and education Develop infrastructure pipeline Focus on community management	Develop and refine sector strategies Adjust prioritization across sectors Analyze and improve efficiency of expenditures	Services delivered, growth enabled
3. Public finance management	Well-specified system, MTEF, controls, etc.	Scale up reporting Implement Procurement Act Define PFM business plans around a series of "platforms"	Streamline control framework and internal audit Improve oversight of fiscal risks and extrabudgetary funds	Good governance, capacity for implementation
4. Aid effectiveness	Two SWAps	Improve reporting Quick wins (e.g., use of Procurement Act)	Move toward SWAps and budget support	Predictable financing aligned with the GoN's strategy and systems

Source: Staff assessment.

12.4 On this basis, a number of recommendations can be made. **First, Nepal needs a new fiscal strategy in line with the expectations of the People's Movement of April 2006.** While the current fiscal framework is sound, it is beset by significant fiscal risks and has limited room to address the expenditure needs emerging from the peace process. A robust fiscal policy is also a tool to discipline trade-offs for planning exercises.

12.5 **Second, this fiscal strategy should build on Nepal's track record of fiscal discipline.** Fiscal discipline can be protected by existing arrangements such as the MTEF, the centralized control of fund releases, and so on. But fiscal discipline should not come at the expense of public investment. It should also be placed in perspective, with a medium- to long-term objective of reducing aid dependence and moving toward self-reliance. However, fiscal discipline does not necessarily mean targeting a particular level of domestic borrowing.

12.6 **On the contrary, in the next couple of years, one option would be to anchor the fiscal policy in an expenditure path placed in a medium-term context** (chapter 8, section C). This would entail allowing domestic borrowing to fluctuate around a target to smooth the expenditure path. Such a fiscal policy would be both sustainable and solvent, but the approach is not without risk. Progress with the MTEF will be critical. The approach should be regularly reviewed and assessed. One option could be to task an independent evaluator to audit the fiscal policy, evaluating assumptions of the MTEF and the budgets, monitoring implementation of the fiscal policy, and monitoring and assessing the quality of coordination with donors.

12.7 **The expenditure path could assume a gradual increase, notably in capital expenditures.** On the expenditure side, capacity is likely to be the main constraint. On the resource side, administrative revenue reforms will create some fiscal space but are unlikely to generate major revenues in the short term. External assistance could also be expected to increase somewhat in the short term, though expectations should be realistic. Finally, as discussed in chapter 8, there is some limited room for domestic borrowing, but only in the short term (before additional domestic borrowing becomes costly for the private sector). With the expenditure path as the anchor, domestic borrowing targets should not be set too high, but fluctuations around this target should be expected to smooth the expenditure path.

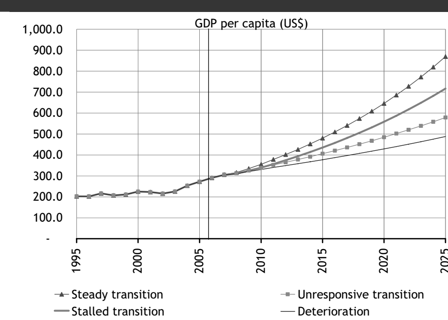
12.8 **The fiscal policy should be well sequenced.** As noted above, recourse to domestic borrowing should gradually be phased out as private sector investment picks up. This suggests a need to quickly implement the revenue administration reform measures that will mobilize revenues only with a delay. In addition, over time, the fiscal policy would need to become anchored in a fiscal deficit target to reduce dependence on external assistance.

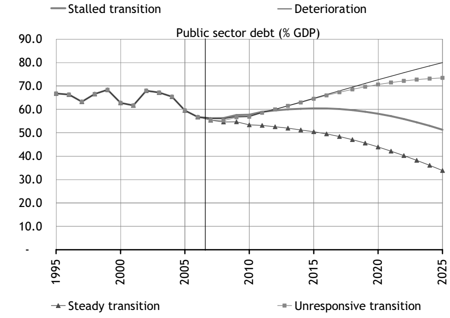
12.9 **Fiscal scenarios highlight the uncertainty of the fiscal situation** (table 12.2).

Table 12.2: Indicative Fiscal Scenarios

	Historical		Steady Transition		Unresponsive Growth		Stalled Transition		Deterioration	
	1990s	2000-06	2007-12	2012-25	2007-12	2012-25	2007-12	2012-25	2007-12	2012-25
GDP growth (real)	5.0	3.2	4.7	5.5	3.0	3.0	3.5	4.5	2.3	2.0
GDP per capita (US$)	196	243	348	608	333	464	335	529	326	415
% GDP										
Revenues	9.6	11.9	13.2	13.8	13.2	13.6	13.2	13.7	12.6	12.7
Grants	1.7	2.1	2.7	2.3	2.7	2.3	2.5	2.3	2.0	1.5
Total expenditures	16.3	16.8	19.4	18.6	19.9	21.3	20.0	19.9	18.4	19.7
Current Exp.	10.1	11.4	12.0	10.9	12.5	13.6	12.5	12.2	12.4	13.7
Capital Exp.	6.4	4.6	6.4	6.7	6.4	6.7	6.4	6.7	5.0	5.0
Net lending	1.1	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Deficit before grants	6.7	4.9	6.2	4.8	6.7	7.6	6.8	6.3	5.7	7.0
Deficit after grants	5.0	2.8	3.5	2.5	4.0	5.3	4.3	4.0	3.7	5.5
Financing	5.0	2.8	3.5	2.5	4.0	5.3	4.3	4.0	3.7	5.5
Domestic (net)	1.7	1.8	1.7	0.7	2.3	3.6	2.8	2.4	3.2	5.0
External (net)	3.3	1.0	1.8	1.8	1.8	1.8	1.5	1.5	0.5	0.5
Memo (% GDP)										
Ext. assistance (net)	5.0	3.0	4.4	4.1	4.4	4.1	4.0	3.8	2.5	2.0
Public Sector debt	65.7	63.0	53.9	45.1	57.1	68.1	57.7	57.8	57.4	70.2
of which domestic	13.9	16.1	17.1	14.5	18.8	31.6	20.3	26.3	22.0	42.8
of which external	51.8	46.9	36.8	30.6	38.2	36.6	37.4	31.5	35.4	27.4

Sources: GoN; IMF; staff estimates.





- In a scenario with a *steady transition*, external assistance is forthcoming and growth picks up in response to improvements in the political and security situation, effective public investments, and complementary policy reforms. Expenditures gradually increase as implementation bottlenecks are alleviated. After a couple of years, the country can initiate its transition toward reducing aid dependence.

- In an alternative scenario of *unresponsive growth*, it is assumed that the political process still moves forward and external assistance is made available as a result. However, because public spending is either not effective or not complemented by supportive policies, growth does not pick up to its potential. In that case, despite some steady increase in expenditures and revenues, Nepal has to defer its transition away from aid dependence. The high reliance on aid for such a sustained period and the lack of a "peace dividend" to sustain the political process make this scenario, especially the debt path, quite unsustainable.
- In a scenario with a *stalled transition*, the political process takes longer than expected. This weakens the prospect for external assistance and the response of growth to public investment. This scenario reveals the fragility of the current fiscal situation.
- Finally, in a scenario of *deterioration*, failures to address the roots of the conflict lead to weak growth performance, low revenue growth, expenditure pressures on security spending, wavering donor support, and pressure on domestic borrowing—and hence on macroeconomic stability.

B. Expenditure Policies

12.10 Using an expenditure path to anchor the fiscal policy is valid only if the composition and quality of expenditures is well managed. Recommendations made in chapters 3–7 are summarized in annex B. The key themes are as follows.

12.11 **The immediate "quick wins" can come mainly from scaling up successful programs while scaling down unsuccessful ones.** Examples include (a) rolling out devolution reforms in health and education; (b) scaling up successful community-based programs that deliver resources to communities, such as the Poverty Alleviation Fund; and (c) aligning rural road spending with district priorities and quality standards. At the same time, the pipeline of infrastructure investments should be built up. Spending on the Strategic Road Network should also be a priority given its externalities on the rate of return of many other investments. Scaling down of less effective activities, like subsidies to SOEs, could also be considered. The GoN already plans to review expenditures in the security sector after the end of the conflict.

12.12 **In some sectors, the use of formula-based allocations could improve the effectiveness of expenditure allocations.** For instance, an important shift in education and health would include an allocation made on a per capita basis (chapters 4 and 5). Similarly, with respect to the funding of local bodies, an increased reliance on block grants, based on objective criteria and performance, could improve the allocation of expenditures (chapter 11).

12.13 **Nepal's experience also highlights the positive role of robust sector strategies.** This has proven its effectiveness in education and health, while the absence of such a strategy seems to be an important constraint in agriculture. Over time, sector strategy anchored by funding plan should become the priority, in part because of its externalities on the modalities of aid (see below).

12.14 **Nepal's experience also underscores the developmental potential of communities and the need to partner with the private sector.** The education sector is a good example (chapter 4). More generally, given the resources at the government's disposal, ambitious, publicly financed programs are unlikely to be viable. Similarly, given the state's capacity and gaps in accountability, many publicly provided programs might not be effective.

This suggests a need to clearly outline for each sector the role of the state in the financing and provision of services, including the medium-term delineation of roles between local governments and communities.

12.15 **Finally, due attention to the efficiency of expenditures is necessary.** The assessment of expenditure efficiency is by nature very complex, as evidenced by the analysis of several sectors in this review. Efforts are needed to improve the quality of the monitoring systems and the demand for them, to enable better informed policy decisions and efficiency analysis. Beyond the analytical side, improvements in efficiency will largely depend on the accountability system; this in turn highlights the role of community involvement (for management or oversight) and the role of PFM institutions.

C. PFM Strategy

12.16 **The review of PFM performance revealed a good formal system with poor implementation.** Several features of this gap point toward the need to adopt a holistic and prioritized approach. In the past, formal systems have improved, but informal practices have not changed much. Moreover, some parts of the systems have been upgraded (e.g., the MTEF), while others have not (e.g., physical monitoring is not captured in the FMIS).

12.17 **Improving PFM performance requires a holistic and realistic approach through the development of a well-sequenced sector strategy.** A promising option is to adopt a "platform approach." The idea is to make consistent progress across all PFM dimensions to reach a particular outcome, which then becomes the platform to move to the next level of reforms. These platforms, and their focus on a clearly identified outcome, will help orient reform efforts and align the objectives of various activities and stakeholders.

12.18 To illustrate this approach, potential platforms, each with its targeted outcome, are identified. These platforms seek to highlight the approach and should be further discussed and refined by key stakeholders (see also key elements of an action plan in annex B):

- *Platform 1: A credible budget that delivers predictable funds to frontline units and basic information for democratic accountability.* Most of the basics for this platform are in place, including innovations such as MTEF, Form #2, the Poverty Monitoring Analysis System, and the Procurement Act. To make it work, a number of simple changes could be introduced: increase technical verification, increase demand for reporting (in budget preparation and budget implementation), and introduce procurement planning as mandated by the Procurement Act. Similarly, at the local level, efforts should be made to improve the quality of reporting, including through better support from the central government. At the same time, a PFM sectorwide approach should be developed to prepare for the subsequent platforms.
- *Platform 2: "Evidenced-based" public finance management and streamlined control processes.* First, some of the changes of the first platform should be implemented (e.g., the Procurement Act). Second, systems should be reviewed to reduce fragmentation, which will help clarify accountability and improve budget implementation. This would in particular involve a clarification of roles and responsibilities at the local level. Finally, further progress should be made in using monitoring, reporting, and evaluation to manage budgets based on evidence; this is likely to entail a redesign of the budget preparation process. At the same time, some design work should be undertaken for the subsequent phase, especially for an FMIS, local-level PFM, and the internal audit function.

- *Platform 3: Stronger management and accountability tools.* In this third platform, systems would be put in place to enable a deepening of the focus on performance. This would likely include rolling out the FMIS to provide more timely and high-quality information, reforming internal audit to create a feedback loop for managers, and enhancing local-level PFM. These efforts would provide the information basis for a deepening of the MTEF and more robust external accountability, especially by focusing more on systemic issues than on irregularities. Improvements in public administration would be necessary in parallel to enable the next platform.
- *Platform 4: Deepen performance-based orientation.* Tentatively, this fourth approach would involve a further shift toward performance-based budgeting. This assumes that the earlier platforms have delivered the necessary environment (in public administration management, information systems, evaluation capacity, etc.). At that stage, initial efforts toward accrual accounting would be made.

12.19 **This is a medium-term agenda that needs to be managed as such.** Although the first platform has almost been reached, each platform would take two to three years: this approach therefore defines a 10-year agenda. Sustaining such an effort requires dedicated stakeholders and coordinated plans. The first platform would include the definition of a PFM sector strategy, which would be used as a tool for coordination of reforms (including coordination of donor support). The PEFA framework could serve as the monitoring framework. The MoF is an obvious locus to lead the effort; however, a broader constituency needs to be created. This could include (a) an internal team of secretaries whose interest in PFM performance should be nurtured and whose demand for good physical and financial information should be developed and met, and (b) an external team including selected parliamentarians, interested donors, and possibly members of civil society such as the media and academics.

12.20 **In parallel, a priority is to improve public oversight over the budget and its outcome.** Important elements are in place, such as the Auditor General and the Public Accounts Committee. However, more needs to be done to hold policy makers accountable, both on the supply side (more informative budget documents, user-friendly within-year and end-of-year budget reports) and on the demand side (at the national, local, and community levels).

D. Aid Effectiveness

12.21 The quality of aid will be an important driver of fiscal policy, sector outcomes, and PFM performance. As discussed in chapter 9, the long-term objectives are to increase predictability, flexibility, and government leadership, while reducing transaction costs.

12.22 **The GoN's Foreign Aid Policy remains appropriate.** A shift toward longer-term partnerships is also desirable, possibly building on the experience of the United Kingdom in establishing long-term partnerships with several countries. Aligning aid to support SWAps should also remain an important goal as more good sector strategies are developed (although in large infrastructure sectors, coordination of projects through sector "master plans" might be an effective approach as well).

12.23 **In the short term, a number of confidence-building measures are desirable.** On the donor side, first and foremost, the quality of reporting needs to improve. Second, the enactment of the Procurement Act is an opportunity to harmonize donors' procurement rules in a way that promotes transparency and value-for-money. Third, donors should find ways to support the GoN's accountability mechanisms. This could mean that in their dialogue with the GoN they (a) emphasize the need to finance existing policies adequately before embarking on new investments (this could translate into joint discussions of fiscal policy objectives); (b) pay more attention to the AG's reports and raise consistently the issue of follow-up; and (c) track progress in PFM performance as a basis to move toward budget support. On the GoN side, more realistic budget projections would create a more trustworthy basis for dialogue with development partners. An effective PFM reform program, with clear leadership, monitoring, and reporting, would also signal the drive toward performing budget systems.

Annexes

A. Statistical Annex

1. **Classification issues for fiscal data.** Throughout this report, fiscal data are reported using internationally accepted standards as defined in the IMF's Government Fiscal Statistics (GFS). There are three main differences between the GFS definitions and those of the GoN:

- Revenues exclude the repayment of loans by public enterprises in GFS data and include them in GoN data.
- Expenditures exclude the repayment of principal for government's debt (domestic and external) in GFS data. In addition, the disbursement of loans granted by the government (usually to public enterprises) is included in net terms in GFS data (net of repayments), but in gross terms in GoN data.
- This in particular results in a somewhat different fiscal deficit—typically lower in GFS data, since the repayment of principal is accounted for "below the line."

2. **District-level database.** The district-level database is built on the following sources: (a) FCGO data for fiscal data (especially expenditures), complemented by some data from the MoLD on local governments; (b) administrative data on outputs (e.g., on roads, enrollment); and (c) survey data on outputs and outcomes, mainly from the Nepal Living Standards Survey. There are three main issues:

- Issues related to fiscal data. The FCGO records expenditures by the payment center. By and large, this allows an analysis of the geographic distribution of expenditures. However, payments for some major infrastructure projects are made from Kathmandu, even though the actual project is not related to Kathmandu. The expenditure data were therefore reviewed to address this issue, although for some programs (e.g., vertical programs in the health sector) the disaggregation was not possible. In addition, while the GoN maintains good aggregate accounts, district-disaggregated data are not used: therefore the quality of data is not as good as aggregate data.
- Issues with survey-based local-level poverty estimates and other indicators. The sampling frame of the NLSS was not conceived at the district level, hence in theory the NLSS cannot be used to derive district-level estimates. However, using the "small area estimate" methodology, an exercise of poverty mapping was done to calculate ward-level estimates of poverty (and a small selection of other indicators). These are the indicators used at the district level.
- Issues of consistency between administrative data and survey data. A recurring issue in Nepal is the frequent discrepancies between these various sources of data. This report gives preference to survey-based data, by and large, but also attempts to document gaps and inconsistencies.

3. **Household data** are mainly based on the 2003/04 NLSS, which was collected between April 2003 and May 2004. The survey covered a sample of about 4,000 households representing 4.2 million households currently residing in Nepal. Detailed analysis of the survey is available in the 2006 poverty assessment.

4. **International data** are also used throughout the report and are summarized in the table below. The quality of international fiscal data is notoriously poor. Data in the fiscal panel of the attached table are based on recent IMF reports, using the most recent year available. Data in other panels include expenditure data (e.g., on education and health); this information is based on other sources and reports a 2000–5 average, explaining some gaps. For instance, in health, WTO data reported in this table attempt to capture all health public spending, not only that of the central government as reported in IMF data.

Table A.3: Macroeconomic Framework

	2001/02	2002/03	2003/04	2004/05	2005/06 Est.	2006/07 Proj.
National Income Accounts (% change)						
Real GDP market prices	(0.6)	3.4	3.7	2.7	1.9	3.7
Real GDP factor costs	(0.4)	3.0	3.5	2.3	2.3	2.8
Agriculture	2.2	2.5	3.9	3.0	1.7	3.5
Industry	(2.9)	3.6	0.8	1.5	3.5	2.0
Manfacturing	(10.0)	2.0	1.7	2.6	2.2	2.0
Services	(1.6)	3.3	4.8	2.1	2.2	2.6
GDP deflator	3.4	4.5	4.9	4.6	7.2	6.5
CPI Inflation	2.9	4.7	4.0	4.5	8.0	7.3
GDP at market prices (US billion)	5.6	5.9	6.7	7.4	8.1	8.7
Financial Accounts						
Money Supply (Money+Quasi Money) (% change)	4.4	9.8	12.8	8.3	15.6	16.0
Domestic Credit (% change)	8.7	12.0	9.8	13.9	8.8	15.3
to Government	24.7	5.6	(1.8)	11.3	14.5	15.9
to Private Sector	3.9	14.9	14.2	12.9	8.3	6.6
Lending rate average (%)	7.0	6.8	7.9	6.5	6.5	..
External Accounts						
Exports of goods (% change in current US)	(20.2)	(13.5)	14.7	11.2	4.0	8.5
Imports of goods (% change in current US)	(15.3)	7.5	15.7	12.3	18.3	16.1
Current account balance (% of GDP)	4.5	2.6	3.0	2.2	2.4	3.9
Foreign Direct Investment (US million)	(3.7)	12.4	2.0	1.9	(6.5)	27.0
Foreign Exchange Reserves (excl. gold) (US million)	1,055	1,184	1,463	1,484	1,780	1,949
Exchange rate End of Period (Rs./US)	78.0	74.8	74.8	70.6	74.4	74.4
Exchange rate Period Average (Rs./US)	75.9	77.8	73.8	72.1	72.3	73.8
Fiscal Accounts (% of GDP)						
Revenue Receipts	11.9	12.0	12.2	12.9	12.2	13.1
Total Expenditure	17.5	16.0	15.5	16.5	16.4	19.9
Fiscal Deficit	4.0	1.5	1.0	0.8	1.8	3.1
Deficit Financing						
Domestic	2.5	1.7	0.6	0.2	1.5	1.6
Foreign	1.5	(0.2)	0.4	0.6	0.3	1.5
Total Debt	69.5	66.5	65.2	59.0	56.2	54.7
Domestic debt	17.5	17.4	17.1	16.1	16.2	16.2
Foreign	52.2	49.1	48.1	42.9	40.0	38.5

Sources: IMF, staff estimates.

Table A.4: Fiscal Framework (Rs. millions)

	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06(E)	2006/07(B)
CENTRAL GOVERNMENT										
Total Revenue (GoN)	**32,740**	**37,051**	**42,667**	**50,951**	**52,335**	**56,230**	**62,331**	**70,123**	**73,500**	**85,376**
Total Revenue (GFS)	31,492	34,809	40,484	48,894	50,445	54,690	60,480	68,875	72,978	84,466
Loan repayment	1,248	2,242	2,183	2,057	1,889	1,540	1,851	1,248	522	910
Total Revenue and Grants	**36,895**	**39,146**	**46,196**	**55,647**	**57,132**	**66,029**	**71,764**	**83,266**	**86,786**	**108,194**
Total Revenue	**31,492**	**34,809**	**40,484**	**48,894**	**50,445**	**54,690**	**60,480**	**68,875**	**72,978**	**84,466**
Tax Revenue	25,991	28,808	33,152	38,865	39,331	42,587	48,173	54,105	59,963	69,932
Taxes on income and profits	4,576	5,774	6,969	8,675	8,222	7,903	9,260	10,160	10,693	12,329
Taxes on property	1,115	1,127	1,134	616	1,134	1,414	-	1,799	3,400	3,911
Taxes on goods and services	11,476	11,992	13,784	16,583	16,634	18,804	21,406	26,138	29,825	35,011
Taxes on international trade	8,502	9,518	10,813	12,552	12,659	14,236	15,555	15,702	15,739	18,328
Non Tax Revenue	5,380	5,905	7,151	9,567	11,043	11,312	11,855	14,206	12,767	12,494
Dividends, Royalities, Interest payments	2,969	3,575	4,458	4,265	4,386	4,576	3,673	7,424	5,691	6,195
Charges, fees, fines, sales of goods and services	2,246	2,130	2,493	3,115	3,130	3,643	4,700	5,210	6,031	6,099
Other	76	103	104	131	1,639	3,093	1,825	1,573	1,045	200
Grants	**5,403**	**4,337**	**5,712**	**6,753**	**6,686**	**11,339**	**11,283**	**14,391**	**13,808**	**23,729**
Total Expenditure (GoN)	**55,920**	**59,379**	**66,047**	**79,606**	**82,158**	**84,006**	**89,443**	**102,560**	**126,885**	**143,912**
Total Expenditure (GFS)	50,741	52,494	58,651	71,858	73,834	72,907	76,797	87,779	112,562	127,834
Loan repayment	1,248	2,242	2,183	2,057	1,889	1,540	1,851	1,248	522	910
Principal payment	3,931	4,643	5,213	5,691	6,435	9,559	10,795	13,533	13,801	15,168
Total Expenditures (Net of lending)	**50,741**	**52,494**	**58,651**	**71,858**	**73,834**	**72,907**	**76,797**	**87,779**	**112,562**	**127,834**
Current expenditure	**27,652**	**32,012**	**36,456**	**45,837**	**48,718**	**52,090**	**55,552**	**61,686**	**75,850**	**83,768**
1. Goods and services	-	-	-	-	-	40,594	46,468	52,690	59,462	67,777
1.1 Wages, salaries and benefits	-	-	-	-	-	29,418	30,576	34,320	-	-
Core Civil Service	-	-	-	-	-	9,423	9,650	10,494	-	-
Police salaries	-	-	-	-	-	5,255	5,260	5,967	-	-
Defense salaries	-	-	-	-	-	5,206	5,739	7,165	-	-
Teacher salaries	-	-	-	-	-	9,534	9,927	10,695	-	-
1.2 Retirement facilities	-	-	-	-	-	3,063	3,274	3,524	5,076	5,416
1.3 Office operation and services	-	-	-	-	-	4,014	4,625	4,520	4,550	4,927
1.4 Other goods and services	-	-	-	-	-	2,981	3,319	4,685	5,387	8,473
2. Interest payments	3,752	4,080	4,820	4,698	5,770	6,622	6,544	6,218	7,416	7,860
3. Subsidies and transfers	-	-	-	-	-	2,572	2,515	2,715	5,767	5,891
Capital Expenditure Net of Lending	**22,548**	**20,819**	**23,298**	**26,250**	**23,853**	**20,816**	**21,245**	**26,093**	**36,712**	**44,066**
Capital expenditure	19,356	19,017	19,358	21,188	20,932	17,572	17,759	21,530	31,052	37,362
4. Acquisition of fixed assets	12,876	13,288	13,130	14,447	13,811	12,141	11,483	12,884	16,044	18,154
5. Purchase of stocks	1,913	1,556	1,315	1,109	1,549	1,701	595	1,583	1,749	2,062
6. Capital transfers (grants)	4,566	4,173	4,913	5,632	5,573	3,730	5,681	7,063	12,161	16,317
Lending minus repayments	3,192	1,802	3,940	5,062	2,922	3,244	3,486	4,563	5,660	6,704
Investment in loans	4,440	4,044	6,123	7,119	4,811	4,784	5,337	5,811	6,182	7,614
Less repayment of loans (income)	1,248	2,242	2,183	2,057	1,889	1,540	1,851	1,248	522	910
Deficit Before Grants	**19,249**	**17,685**	**18,167**	**22,964**	**23,389**	**18,217**	**16,317**	**18,904**	**39,584**	**43,368**
Deficit After Grants	**13,846**	**13,348**	**12,455**	**16,211**	**16,702**	**6,878**	**5,033**	**4,513**	**25,776**	**19,640**
Primary Deficit	**15,497**	**13,605**	**13,347**	**18,267**	**17,619**	**11,595**	**9,773**	**12,686**	**32,168**	**35,509**
Financing (net)	**13,846**	**13,348**	**12,455**	**18,498**	**16,748**	**6,878**	**5,033**	**4,513**	**10,966**	**19,640**
Domestic Financing	5,572	4,693	4,323	10,954	10,553	7,827	3,170	1,200	8,087	10,200
Financing from Abroad	8,274	8,655	8,132	7,544	6,195	(950)	1,863	3,313	2,879	9,440
Total Public Debt	199,615	223,531	245,048	261,595	293,747	308,078	318,913	307,206	312,581	-
Domestic	38,407	49,670	54,357	60,044	73,621	84,645	86,134	87,564	92,946	-
External	161,208	173,861	190,691	201,551	220,126	223,433	232,779	219,642	219,635	-
External debt, total (DOD, current US$ million)	2,646	2,993	2,846	2,716	2,972	3,253	3,251	3,264	-	-
LOCAL GOVERNMENT										
Revenues					**6,267**	**5,751**	**6,482**	**7,101**		
Own revenues					3,613	3,196	3,171	3,620		
Grants					2,654	2,554	3,311	3,481		
Expenditures					**5,389**	**4,912**	**5,514**	**6,629**		
District Development Councils					799	810	816	1,498		
Village Development Councils					2,428	2,334	2,538	2,405		
Municipalities					2,162	1,767	2,160	2,726		
AID										
Total (from donor reporting)	24,879	25,163	25,706	28,403	28,696	31,685	33,374	31,018		
On budget (grants and loans)	13,677	12,992	13,844	14,297	12,881	10,389	13,147	17,704		
Residual	11,202	12,171	11,862	14,106	15,815	21,295	20,228	13,314		
GDP	300,845	342,036	379,488	410,789	422,301	456,675	496,745	533,538	582,948	642,641

Sources: GoN; IMF; OECD/DAC; staff estimates.

Table A.5: International Comparisons

	Nepal	Afghanistan	Bangladesh	India	Pakistan	Sri Lanka	Burkina-Faso	Cambodia	China	Guatemala	Kyrgyz Rep.	Rwanda	Sierra-Leone	Tanzania	Uganda
General background															
Population (million)	25.8	n/a	135.3	1,056.0	146.8	19.2	12.2	13.4	1,284.0	11.9	5.0	8.6	5.0	36.6	26.5
Surface area ('000 sq. km)	147	652	144	3,287	796	66	274	181	9,598	109	200	26	72	945	241
GDP (current US$ billion)	6.1	4.8	51.4	587.8	84.2	18.4	3.8	4.4	1,629.8	24.6	1.8	1.8	0.9	10.3	6.5
GDP per capita (current US$)	235	n/a	379	554	571	956	307	324	1,266	2,061	366	211	186	282	246
GDP per capita (constant 2000 US$)	229	n/a	382	508	550	911	242	318	1,175	1,725	301	242	188	294	256
GDP growth (annual %)	3.4	12.5	5.4	6.4	4.7	4.2	4.5	6.8	9.3	2.7	4.0	5.3	12.3	6.6	5.4
GDP per capita growth (annual %)	1.2	n/a	3.4	4.8	2.2	3.7	1.3	4.7	8.6	0.3	3.0	2.1	8.0	4.5	2.0
Inflation, consumer prices (annual %)	3.3	n/a	3.3	4.0	5.0	9.2	2.5	2.1	1.2	7.2	6.5	6.3	5.3	4.0	4.0
Gross capital formation (% of GDP)	25.2	n/a	23.7	26.0	17.1	24.1	19.6	21.3	35.7	18.6	16.9	18.8	10.7	18.3	20.6
Exports of goods and services (% of GDP)	18.9	n/a	15.0	14.8	15.3	36.5	8.8	57.2	26.9	17.7	39.6	8.9	19.5	16.8	12.7
Current account balance (% of GDP)	0.9	n/a	(0.1)	0.5	2.3	(2.6)	(11.3)	(6.8)	2.4	(5.0)	(3.6)	(4.8)	(10.5)	(4.0)	(5.0)
Poverty headcount ratio at $1 a day (PPP) (% of population)	24.1	n/a	36.0	36.0	17.0	5.8	28.6	n/a	16.6	8.5	2.0	51.7	n/a	57.8	n/a
Poverty headcount ratio at national poverty line (% of population)	30.9	n/a	49.8	28.6	n/a	n/a	46.4	n/a	n/a	56.2	49.8	n/a	70.2	35.7	35.8

Table A.5: International Comparisons

	Nepal	Afghanistan	Bangladesh	India	Pakistan	Sri Lanka	Burkina-Faso	Cambodia	China	Guatemala	Kyrgyz Rep.	Rwanda	Sierra-Leone	Tanzania	Uganda
Public Finances (last year available; % GDP)				[central]											
Economic classification															
Revenues	12.9	5.7	10.5	10.2	9.3	15.3	12.8	10.5	18.3	11.1	18.3	13.5	11.8	12.1	12.6
Taxes	10.1	3.9	8.5	7.3	5.5	13.9	11.8	8.2	16.6	10.3	14.5	12.7	11.1	11.0	11.7
on income, profits, and property	2.2	0.7	1.5	4.2	2.7	1.9	9.5	1.5	4.5	2.7	5.4	3.9	3.1	3.8	3.3
on goods and services	4.9	2.6	4.8	1.3	1.0	9.2	0.2	4.2	12.1	6.0	8.6	6.4	2.9	6.1	7.4
on international trade	2.9	0.5	2.2	1.8	1.8	2.8	2.1	2.3		1.1	0.5	2.4	4.9	1.1	1.0
Non taxes	2.7	1.8	2.0	2.9	3.8	1.5	1.0	2.3	1.7	0.8	3.8	0.9	0.7	1.1	0.9
Grants	2.7	10.1	1.7	0.1	0.3	0.4	4.4	2.0	..	n/a	0.5	8.1	10.0	6.2	11.7
Total expenditures	16.5	14.7	13.9	14.4	13.3	23.5	21.6	13.8	19.5	11.4	23.8	24.1	23.5	19.8	23.4
Current expenditures	11.6	8.9	8.4	12.8	11.0	19.2	10.6	8.2	15.6	8.2	19.6	18.0	17.6	14.8	14.1
Wages	6.4	5.5	2.3	1.1		5.2	4.4	2.8		3.2	6.8	4.9	6.5	4.0	5.2
Interest payments	1.2	0.0	1.7	4.1	4.7	5.9	0.7	0.2	0.5	1.2	1.5	1.2	3.6	1.0	2.0
Capital expenditures (and net lending)	4.9	5.8	5.5	1.6	2.3	4.3	11.0	5.6	3.9	3.2	4.2	6.1	5.9	5.0	9.3
Deficit before grants	3.5	9.0	3.4	4.2	4.0	8.2	8.8	3.3	1.2	0.3	5.5	10.5	11.7	7.7	10.8
Deficit after grants	0.8	(1.1)	1.7	4.1	3.7	7.8	4.5	1.3	..	n/a	5.0	2.5	1.7	1.5	(0.9)
Financing	0.8	(1.1)	1.7	4.1	3.7	7.8	4.5	1.3	..	n/a	5.0	2.5	1.7	1.5	(0.9)
Net foreign loans	0.6	1.5	0.1	0.5	1.7	1.8	4.4	2.8	..	n/a	4.2	2.4	0.8	2.0	2.3
Net domestic financing (inc. adjustment)	0.2	(2.6)	1.6	3.6	2.0	6.0	0.1	(1.5)	..	n/a	0.8	0.0	0.9	(0.5)	(3.2)
Functional Classification															
Total expenditures	16.5	..	..	..	..	23.5	..	..	..	11.4	20.9	19.1	23.5	19.8	23.4
Social expenditures	5.9	..	..	..	..	8.2	..	..	..	6.7	11.0	3.3	5.9	6.7	7.3
Education	3.2	..	..	..	..	2.1	..	..	..	2.4	4.5	2.4	3.9	4.3	5.2
Health	0.9	..	..	..	..	1.7	..	..	..	1.0	2.0	0.8	1.1	2.3	2.1
Economic sectors	4.3	..	..	..	..	4.1	..	..	..	2.3	2.2	1.3	1.4	n/a	1.9
Agriculture	1.4	..	..	..	..	..	..	..	..	0.5	0.9	0.2	0.4	1.2	0.5
Infrastructure	2.5	..	..	..	..	..	..	..	..	1.1	1.2	1.0	0.1	n/a	1.5
Other (inc. interest payments)	6.3	..	..	..	..	11.2	..	..	..	2.4	7.7	14.5	16.2	n/a	14.1
Defense (or security)	2.1	..	..	2.4	..	2.8	..	..	..	0.6	1.5	2.7	1.9	n/a	3.4
Doing Business															
Payments (number)	35	2	17	59	47	61	45	27	48	50	89	43	20	48	31
Time (hours)	408	275	400	264	560	256	270	121	872	294	204	168	399	248	237
Total tax rate (% profit)	32.8	36.3	40.3	81.1	43.4	74.9	51.1	22.3	77.1	40.9	67.4	41.1	277.0	45.0	32.2
Documents for export (number)	7	7	7	5	8	8	9	8	6	9	..	14	7	3	12
Time for export (days)	44	66	35	26	24	25	69	36	18	20	..	60	29	24	42
Cost to export (US$ per container)	1,599	2,500	902	700	996	797	1,215	736	335	1,785	..	3,840	2,075	822	1,050
Documents for import (number)	10	11	16	11	12	13	13	12	12	7	18	20	7	10	19

Table A.5: International Comparisons

	Nepal	Afghanistan	Bangladesh	India	Pakistan	Sri Lanka	Burkina-Faso	Cambodia	China	Guatemala	Kyrgyz Rep.	Rwanda	Sierra-Leone	Tanzania	Uganda
Governance															
Global Integrity															
Civil Society, Public Information & Media	51			75	63					67	67			63	81
Elections	47			78	70					72	60			56	74
Government Accountability	54			68	59					63	64			48	76
Administration & Civil Service	32			75	62					34	56			55	71
Oversight & Regulation	54			70	82					81	78			67	81
Anti-Corruption & Rule of Law	61			83	81					70	57			66	72
Total	50			75	69					64	64			59	76
Governance Indicators (WBI)															
Corruption indicator	29	3	8	47	16	47	58	9	31	18	14	24	17	29	20
Percentile Rank	17	23	16	12	15	16	22	18	12	16	14	25	23	15	15

	Nepal	Afghanistan	Bangladesh	India	Pakistan	Sri Lanka	Burkina-Faso	Cambodia	China	Guatemala	Kyrgyz Rep.	Rwanda	Sierra-Leone	Tanzania	Uganda
Education															
School enrollment, primary (% net)	74.2	..	91.5	83.9	62.2	97.9	37.5	93.5	..	88.5	87.1	74.1	..	72.8	..
School enrollment, secondary (% net)	..	..	47.9	..	..	..	9.1	20.7	..	30.5	..	..	..	..	14.2
School enrollment, tertiary (% gross)	4.8	1.1	6.4	11.0	2.8	..	1.5	2.6	12.9	9.6	39.6	2.0	2.2	0.9	2.9
Ratio of female to male primary enrollment	86.1	29.4	102.0	87.2	69.8	98.4	74.0	89.5	100.2	90.6	98.8	99.3	71.4	97.0	97.9
Ratio of female to male secondary enrollment	76.1	27.8	109.1	74.6	72.1	103.4	66.6	60.7	97.8	89.0	101.1	91.8	86.7	..	79.3
Literacy rate, adult male (% of males ages 15 and above)	62.7	43.1	..	73.4	63.0	92.3	29.4	84.7	95.1	75.4	99.3	71.4	46.9	77.5	76.8
Literacy rate, adult female (% of females ages 15 and above)	34.9	12.6	..	47.8	36.0	89.1	15.2	64.1	86.5	63.3	98.1	59.8	24.4	62.2	57.7
Literacy rate, adult total (% of people ages 15 and above)	48.6	28.1	..	61.0	49.9	90.7	21.8	73.6	90.9	69.1	98.7	64.9	35.1	69.4	66.8
Public spending on education, total (% of GDP)	3.4	..	2.4	3.7	1.9	..	..	1.9	..	..	3.7	2.8	3.7	..	3.8
Expenditure per student, primary (% of GDP per capita)	12.4	..	7.8	11.8	..	..	..	6.4	..	6.3	6.3	7.4	21.5	..	11.2
Expenditure per student, secondary (% of GDP per capita)	11.8	..	12.6	20.5	..	..	..	6.8	..	4.0	11.8	28.4	..	..	33.7
Expenditure per student, tertiary (% of GDP per capita)	100.7	..	38.5	73.0	..	..	..	46.8	..	..	17.5	657.6	..	..	187.5
Public spending on education, total (% of government expenditure)	13.8	..	15.5	11.7	..	..	..	14.6	..	..	18.6	..	..	..	18.3
Primary education, teachers (per 1,000 people)	3.9	..	2.3	2.8	2.9	3.8	1.7	3.6	4.8	5.7	3.7	3.2	3.2	3.2	5.2
Primary education, teachers (% female)	26.9	22.3	36.8	39.1	44.7	78.9	25.5	39.7	52.9	..	95.8	51.1	34.1	46.3	37.0
Trained teachers in primary education (% of total teachers)	39.3	..	62.2	..	..	..	85.6	96.0	96.8	100.0	50.2	72.7	78.9	100.0	80.4
Trained teachers in primary education, female (% of female teachers)	31.9	..	61.9	..	..	..	87.7	..	..	..	50.2	73.5	72.9	100.0	83.1
Trained teachers in primary education, male (% of male teachers)	41.7	..	62.5	..	..	..	84.8	..	..	..	50.3	71.9	82.6	100.0	78.8
Pupil-teacher ratio, primary	38.5	65.5	55.4	40.5	35.0	23.1	47.1	54.1	20.3	30.7	24.3	57.3	52.1	51.8	51.8

Table A.5: International Comparisons

	Nepal	Afghanistan	Bangladesh	India	Pakistan	Sri Lanka	Burkina-Faso	Cambodia	China	Guatemala	Kyrgyz Rep.	Rwanda	Sierra-Leone	Tanzania	Uganda
Health															
Life expectancy at birth, total (years)	61.4	..	62.6	63.3	64.2	74.0	47.5	56.0	70.9	67.0	68.4	43.0	40.7	46.3	47.1
Maternal mortality ratio (modeled estimate, per 100,000 live births)	740	..	380	540	500	92	1,000	450	56	240	110	1,400	2,000	1,500	880
Mortality rate, infant (per 1,000 live births)	63.8	..	61.2	64.9	82.6	14.1	98.4	96.2	29.5	36.2	59.2	118.0	166.2	83.2	82.6
Mortality rate, under-5 (per 1,000)	85.6	..	84.5	89.6	104.4	16.8	194.0	138.2	36.0	49.0	68.8	203.0	284.4	133.5	141.4
Births attended by skilled health staff (% of total)	12.6	13.2	12.7	42.5	23.0	96.0	38.0	31.8	96.5	41.0	99.0	31.3	41.7	46.0	39.0
Health expenditure per capita (current US$)	11.8	7.0	12.8	24.0	13.0	29.5	14.5	32.0	51.3	103.0	13.8	8.5	6.3	12.0	17.3
Health expenditure, public (% of GDP)	1.5	1.4	0.9	1.2	0.8	1.7	2.3	1.8	2.0	2.1	2.0	1.7	2.1	2.3	2.1
Health expenditure, private (% of GDP)	3.8	3.4	2.4	3.7	1.8	1.9	3.0	9.1	3.4	3.3	2.6	2.4	1.5	2.2	5.1
Health expenditure, total (% of GDP)	5.3	4.8	3.3	4.9	2.6	3.6	5.3	10.9	5.3	5.4	4.6	4.1	3.6	4.4	7.2
Immunization, measles (% of children ages 12-23 months)	72.2	47.2	76.6	56.0	60.8	98.4	69.2	64.2	84.0	75.2	98.6	77.2	57.2	88.2	74.8
Physicians (per 1,000 people)	0.1	0.2	0.2	0.6	0.7	0.5	0.0	0.2	1.4	..	2.6	0.0	0.0	0.0	0.1

	Nepal	Afghanistan	Bangladesh	India	Pakistan	Sri Lanka	Burkina-Faso	Cambodia	China	Guatemala	Kyrgyz Rep.	Rwanda	Sierra-Leone	Tanzania	Uganda
Agriculture and roads															
Agriculture, value added (% of GDP)	40.3	..	22.6	21.1	23.6	19.0	31.7	35.2	13.6	22.7	36.0	41.3	48.7	45.0	33.8
Rural population (% of total population)	85.4	77.9	75.9	71.8	66.0	84.6	82.6	81.7	61.9	53.9	64.4	83.4	61.1	76.8	87.7
Rural population density (rural population per sq. km of arable land)	919.4	..	1,261.2	467.3	454.6	1,663.1	217.5	292.0	566.4	443.4	248.2	679.4	571.2	592.7	438.9
Agriculture employment (% of total population)	41.8	..	28.8	25.4	17.3	20.2	44.2	35.1	39.8	16.7	11.1	45.4	21.3	40.0	35.5
Cereal yield (kg per hectare)	2,223	..	3,448	2,367	2,369	3,409	941	2,055	4,937	1,761	2,859	960	1,199	1,463	1,642
Fertilizer consumption (100 grams per hectare of arable land)	333	19	1,738	1,044	1,377	2,862	30	..	2,578	1,427	213	48	5	31	14
Crop production index (1999-2001 = 100)	107.6	..	103.6	99.9	101.3	99.2	115.4	103.6	107.0	102.0	103.3	111.2	107.5	102.7	104.6
Agriculture value added per worker (constant 2000 US$)	206.4	..	306.5	385.5	698.7	742.5	164.8	289.5	362.7	2,280.2	907.9	216.8	..	278.2	227.8
Roads, total network ('000 km)	16	35	239	3,794	250	97	..	12	1,669	..	19	..	11	79	71
Roads, paved (% of total roads)	42.4	23.7	9.5	62.9	58.3	81.0	..	16.2	78.9	..	90.0	..	8.0	8.6	23.0

Sources: World Development Indicators; Global Development Finances; IMF for public finances; Global integrity; WBI Governance indicators; Doing Business.

Note: 2000–5 average except when otherwise noted. See introduction to annex A for comments on data issues.

Table A.6: Fiscal Pressures (Rs. billions per year)

Pressure	Amount	Comment / Source
Post-conflict immediate transition	3	Government's estimate, including cost of establishing and operating special camps and rehabilitating police posts and equipment. GoN has also costed the conflict damage to physical infrastructure at Rs. 2-4 billion.
Demobilization, reintegration	2	There is a large variance in per capita cost of this process. The actual cost will also depend on the strength of Maoist combatants. For illustrative purposes, the estimate assumes 30,000 people at US$1,000 per person.
IDP reintegration	1	Based on an estimated 200,000 IDP (http://www.internal-displacement.org). Government's estimate.
Elections	2-3	-
MDG needs assessment	55	Based on a costing of the number of interventions required to reach selected MDGs as well as rural infrastructure objectives. Total cost is Rs. 115 billion per year over 10 years, of which about Rs. 26 billion would be financed by the private sector and Rs. 33 billion would come from existing government resources devoted to the sector, leaving a gap of Rs. 55 billion per year. The gap is largest for activities targeting the eradication of extreme poverty and hunger (MDG 1), which will include activities in the area of agriculture, irrigation, and so on, as well as activities targeting universal primary education (MDG 2).
Three-year Interim Plan	65	The NPC estimates that the three-year interim plan will cost Rs. 430 billion, with a resource gap of Rs. 200 billion (approx. Rs. 65 billion per year), for which external assistance will be requested.
Infrastructure:		
Roads	6	Based on World Bank (2005). This assumes a target of 2.5% of GDP spent every year on roads, while in recent years spending was on the order of 1% of GDP.
Power	12	Based on World Bank (2001). This includes both generation and transmission needs based on the power master plan hydro-only scenario. This excludes additional funding for export-oriented projects. Some of this requirement should be met by the utility's own savings, but its net profits have turned negative since 2003.
Pensions (over 10 years)	8	Assumes that the unfunded pension liability of 14% of GDP (excluding police and military), which is almost Rs. 80 billion, is funded over 10 years.
Wage bill decompression	10	Assumes an objective of doubling the compression ratio, from the current 2 to 4. The recently introduced partial annual indexation of salaries on inflation will cost an additional Rs. 1.5 billion per year, approximately.
Contingent liabilities of SOEs	14	Based on NOC losses only.

Sources: GoN; staff estimates.

Table A.7: District-Level Regressions of 2000-04 Per Capita Expenditures

Dependent Variable	Total	Education	Health	Local Development	Agriculture[a]	Other
Poverty incidence	-0.03	-0.10	-0.13	-0.26 *	0.05	0.12
Population	-0.61 **	-0.49 **	-0.62 **	-0.64 **	-0.80 **	-0.65 **
Road density	0.95 **	0.82 **	0.96 **	-0.60	0.40	0.26
Share of population in agriculture	-1.03 **	0.03	-1.08 **	-0.38	-3.73 **	-2.51 **
Elevation (max)	-0.46 **	-0.72 **	-0.19	0.21	1.07 **	-1.51 **
Elevation (min)	0.63 **	0.91 **	0.29	-0.16	-0.94	1.74 **
Constant	12.4 **	7.6 **	12.4 **	15.7 **	24.3 **	4.9
R2 (%)	93.0	85.5	84.2	75.7	71.7	74.9
Observations	75	75	75	75	68	75

Sources: Staff estimates, based on data from GoN, NLSS II, poverty mapping, and Census.

Note: All variables in log; * means significant at the 10% level, and ** at the 5% level.
a. Includes agriculture, irrigation, land management, and forestry.

Table A.8: District Characteristics and Total Expenditures

	Nb	Characteristics					Expenditures			
	Districts	Population	Surface	Elevation	Density	Poverty	Share	Per cap (Rs.)	Per cap (index)	Growth
Eastern	16	23	19	1,348	188	31.3	19	819	84	6.6
Central	19	35	18	1,469	297	27.9	37	1,026	106	4.0
Western	16	20	20	1,961	155	34.6	21	1,020	105	5.0
Mid-Western	15	13	29	1,789	72	46.1	14	1,006	104	9.7
Far-Western	9	9	13	2,184	112	46.0	10	974	100	8.3
Mountains	16	12	35	2,901	54	35.1	14	1,156	119	8.7
Hills	39	46	41	2,193	179	35.6	59	1,226	126	4.3
Terai	20	42	24	674	279	32.1	27	630	65	7.7
Nepal	**75**	**100**	**100**	**2,759**	**158**	**34.1**	**100**	**969**	**100**	**5.8**

Sources: GoN; staff estimates.

Table A.9: District-Level Regressions on Education and Health Outcomes

Determinants of child height-for-age outcomes at the district level

Independent variable	Parameter	T
Per capita public expenditures on essential health care	**-2.14E-09**	**-2.14**
Poverty incidence	0.06	0.67
Per capita private health care expenditures	0	-1.39
Number of hospitals	**-0.04**	**-2**
Time to closest facility (in minutes)	**0**	**2.11**
Availability of a proper toilet in the household	**-0.15**	**-3.88**
Constant	**0.64**	**10.04**
Prob>F	0	
R2	0.56	
Root MSE	0.05	

Source: Staff estimates.

Note: Ordinary Least Square regression on 74 districts (excluding Kathmandu). Bold font for coefficient statistically significant at the 0.10 level.

Determinants of primary education enrollment at the district level

Independent variable	Parameter	T
Per capita public primary education expenditures	-1.00E-05	-0.21
Poverty incidence	**4.04**	**2.09**
Per capita private primary education expenditures	-0.00043	-0.45
Number of teachers per student (primary)	15.37	0.91
Number of schools per student (primary)	-98.72	-0.88
Mean time to school	-0.0042	-0.43
Constant	0.11	0.09
Prob>F	0.33	
R2	0.1	
Root MSE	1.3	

Source: Staff estimates.

Note: Ordinary Least Square regression on 75 districts. Bold font for coefficient statistically significant at the 0.10 level.

B. Summary Recommendations

Table A.10: Summary of Recommendations

Area	Recommendation	Measures of progress and impact
Fiscal policy		
(chapters 3 and 8)	Review expenditure prioritization criteria	Reduced fragmentation
	Develop fiscal framework based on stable expenditure path	Expenditure path
	Review assumptions of MTEFs and assess implementation of fiscal policy	PFM indicators 1–3
	Review periodically exchange rate developments	Real exchange rate
	Expand tax base	Reduction in aid dependency
Expenditure allocations		
Geographic distribution	Expand reporting and analytical work on geographic distribution of public spending	Reports including district-level data
(chapter 3)	Explore options for expanded use of formula-based allocations	Distribution of expenditures across districts
Education (chapter 4)	Benchmark allocations to the number of students in the school area; possibly then move to per capita funding; develop mechanisms to address shortages/surplus of teachers	Distribution of expenditures and teachers
	Continue devolution of school management to communities and evaluate impact	Share of community-managed schools and evaluation
	Improve financing of secondary education	Share of budget to secondary education
	Develop means-tested system of scholarship	Evaluation of scholarship system
	Encourage private sector participation and review impact	Evaluation, e.g., of textbook printing and distribution
	Address implementation bottlenecks	Trimesterly reporting of progress against work program indicators
Health (chapter 5)	Explore options to allocate resources on the basis of population, accessibility, and performance	Distribution of expenditures
	Encourage health workers to serve in remote areas	Distribution of health workers
	Strengthen availability and use of routine health information at the local level	Survey of available information
	On this basis, explore options to introduce performance-based financing	
	Address demand-side barriers to health care utilization (e.g., through vouchers and other performance-based community interventions, ensuring that the poor are exempt from user fees; strategies to combat the practice of under-the-table payments; behavior change and communication programs; and community-based programs that increase contact between trained workers and households most in need)	Health care utilization rates of poorest quintile of the population
	Mobilize private financing through community-based or social-pooled revenue collection	Health care utilization rates of poorest quintile of the population
	Develop public-private regulations	Access to health services; quality of health services

Table A.10: Summary of Recommendations

Area	Recommendation	Measures of progress and impact
	Address causes of low disbursements	Gap between budgets and actuals
	Address bottlenecks to devolution	Clarity in roles; increased autonomy, accountability, and performance
	Coordinate donor spending	Clear information and visible progress in harmonization
Local roads (chapter 6)	Reaffirm the GoN's commitment to fund maintenance work (through RBN)	Share of budget for operation and maintenance; backlog of maintenance
	Ensure priority given to Strategic Road Network	Share of Strategic Road Network completed
	Ensure good quality of District Transport Master Plans (including adequate prioritization and quality) and ensure their use in local and national plans and budgets	Review of consistency between DTMP and national plans and between DTMP and budgets
	Reduce overprogramming and fragmentation of resources in the sector	Average budget per road/budget line
	Address implementation bottlenecks (e.g., delays in fund releases)	Trimester profile of spending in the sector
	Implement new Procurement Act and enforce good monitoring to ensure adequate participation to bidding processes and reduce risks of collusion	Number of bidders per bid; unit costs
	Clarify — and if possible simplify — institutional responsibilities in the sector	Definition of roles and responsibilities
Agriculture (chapter 7)	Define an implementable business plan, based on clear definition of the role of the public sector	Business plan
	Review expenditures on the basis of this business plan and reorient spending toward public goods: priorities are likely to include research and extension and rural infrastructure	Share of budget on research and extension (and public goods in general)
	Expand use of competitive grants for research (through NARDF)	Allocation to competitive grants
	Review and improve incentives for irrigation	Increased access to irrigation
	Further expand the role of communities and user groups in the sector	Coverage of community groups and user groups
	Consider programs to help poor farmers cope with risks (including PAF)	Reduced vulnerabilities for poor farmers
	Further analyze sources of growth in the livestock sector and price dynamics in the agriculture sector	Analysis and impact on agriculture sector strategy
PFM performance		
Planning and budget preparation (chapter 9)	Advance budget preparation process and ensure sequencing of MTEF and budget (with appropriate review by political leadership, and early statement and discussion in Parliament of fiscal policy objectives)	PFM indicators 11 and 27
	Introduce a budget document that includes key elements of the MTEF, policy proposals,	Budget document; PFM indicator 6

Table A.10: Summary of Recommendations

Area	Recommendation	Measures of progress and impact
	review of previous years' initiatives, etc.	
	Revive IAP process and make it consistent with the budget process	IAP in budget document
	Make budget document more user-friendly	Use of budget document information in media
	Move focus of budget to programs (with less fragmentation by projects, and better project screening and selection)	Number of sectors structured around programs
	Develop reports on achievements, ex post reviews of MTEFs, sectoral expenditure programs, etc., and ensure budget is based on such information (including through a requirement to report on this dimension)	Report from MoF to Parliament on how such evidence was used
	Provide ex ante comprehensive budget (or plan), including central and local governments, SOEs, and revolving funds	Comprehensive report discussed in Parliament
	Clarify policy on use and implementation of extrabudgetary funds	Number of extrabudgetary funds
	Consider plan to separate institutional responsibilities of MoF and NPC (and similarly of budget and planning divisions in line ministries)	Institutional structure
Budget reporting (chapters 9 and 10)	Bring budget classification to international standards, with clearly identified programs	PFM indicator 5
	Introduce reporting by region or district	Availability of such data
	Increase supply of within-year reporting, both internally (for management) and externally (for accountability), immediately by using existing MIS systems, and soon after by improving connectivity across these systems	
	Introduce requirement to report on autonomous funds, local bodies' fiscal activities, and contingent liabilities	PFM indicators 6–9
Budget implementation (chapter 10)	Consider change in timing of fiscal year	Quality and timeliness of budget implementation
	Simplify release of funds	
	Enforce procurement planning	
Procurement (chapter 10)	Implement Procurement Act, starting with the establishment of the PPMO, enforcement of procurement planning, and initiation of statistical monitoring	PFM indicator 19; procurement performance indicators to be defined (notably timeliness)
	Develop capacity in procurement	
	Ensure adequate protection and penalties for procurement staff	
Control framework (chapter 10)	Review control framework and accounting system, with a view of introducing an IFMIS (structured around District Accounting Systems)	
	Improve record-keeping practices	AG reports
	Review system of bank accounts and simplify to the extent possible with a view to increasing quality of bank account reconciliation	Number of bank accounts
	Focus physical verification on fraction of capital budget	Outcome of physical verification

Table A.10: Summary of Recommendations

Area	Recommendation	Measures of progress and impact
	Clarify role of advances and make them grants when appropriate; enforce monitoring of advances (Form #18)	Amount of irregularities due to advances
	Enforce system of commitment monitoring	Information on commitment
	Develop vision of internal audit as a basis for developing an action plan on internal audit	PFM indicator 20
	Develop integrated plan for IFMIS	IFMIS achievements
	Create public sector accounting standards board and adjust accounting policies to international standards	Accounting standards (e.g., gap analysis with international standards)
	Adopt Nepal Accounting Standards and applicable standards for SOEs	Quality of financial accounts
	Ensure that MoF performs adequate oversight of SOEs (e.g., through a financial review committee)	Size of and trend in contingent liabilities
External accountability (chapters 9 and 10)	Make AG work program more focused on systemic issues; make its annual report also focused on systemic issues; produce a user-friendly summary	Quality of AG reports
	Clear backlog of audits of SOEs and other extrabudgetary funds	AG reports, Yellow Book
	Ensure good functioning of PAC	PAC proceedings
Local level (chapter 11)	Increase predictability in budget allocations from the center and use of block grants; simplify guidelines for use of grants	Increase in share of resources that are untied and predictability from current **[[of what?]]**
	Ensure local plans are used in national plans (e.g., for road sector)	Sectoral reviews of consistency between plans
	Clarify respective roles of local bodies	Definition of roles
	Structure DDCs around clear definition of roles and responsibilities in the PFM area	Higher DDC capacity for good PFM performance
	Increase monitoring of DDC-level activities	Reports from DDCs
	Simplify flow of funds to DDCs and other locally managed entities	Number of steps in flow of funds
	Increase computerized connection of local bodies and ensure adequate flow of information (including reporting from the center to local bodies)	Suite of reports provided to local bodies
	Complete suite of accounting formats for local bodies	Availability of this suite
	Assess feasibility for municipalities to move to accrual accounting in next 3-5 years	Decision on such a move
	Create board to set standards for accounting and audit at local level	Availability of standards
	Encourage civil society participation in planning processes and oversight of local bodies' performance; upgrade and update information in Information and Documentation Sections	Better accountability of local bodies
	Create national conference of representatives of Accounts Committee	
Aid Effectiveness (chapter 9)	Implement the Foreign Aid Policy	Share of aid that (a) goes through the budget, (b) uses national systems, (c) is untied, (d) is

Table A.10: Summary of Recommendations

Area	Recommendation	Measures of progress and impact
		disbursed in cash, (e) is disbursed as budget support.
	Expand adoption of Procurement Act by donors Use PFM Assessment Framework as tool to monitor progress in PFM performance	
	Improve reporting	

Source: Staff assessment.

Background Papers for the PFM Review

Public Finance Management Performance Assessment (based on PEFA framework and led by the Government of Nepal)

Review of Key Issues and Recommendations of Auditor General's Annual Report 2005 and 2006 and Review of Monitoring System of Auditor General's Recommendations

Public Procurement in Nepal

Private and Public Expenditures on Education and Health in Nepal

Household Expenditure on Agriculture in Nepal

Nepal: Issues in Government Payroll

Fiscal Policy Options for Nepal

The report also builds on:

Nepal: Public Sector Accounting and Auditing: A Comparison to International Standards, World Bank report, 2006

Financial Accountability Review Mission, A Joint HMGN/DFID and World Bank Assessment Update, May 2005.

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