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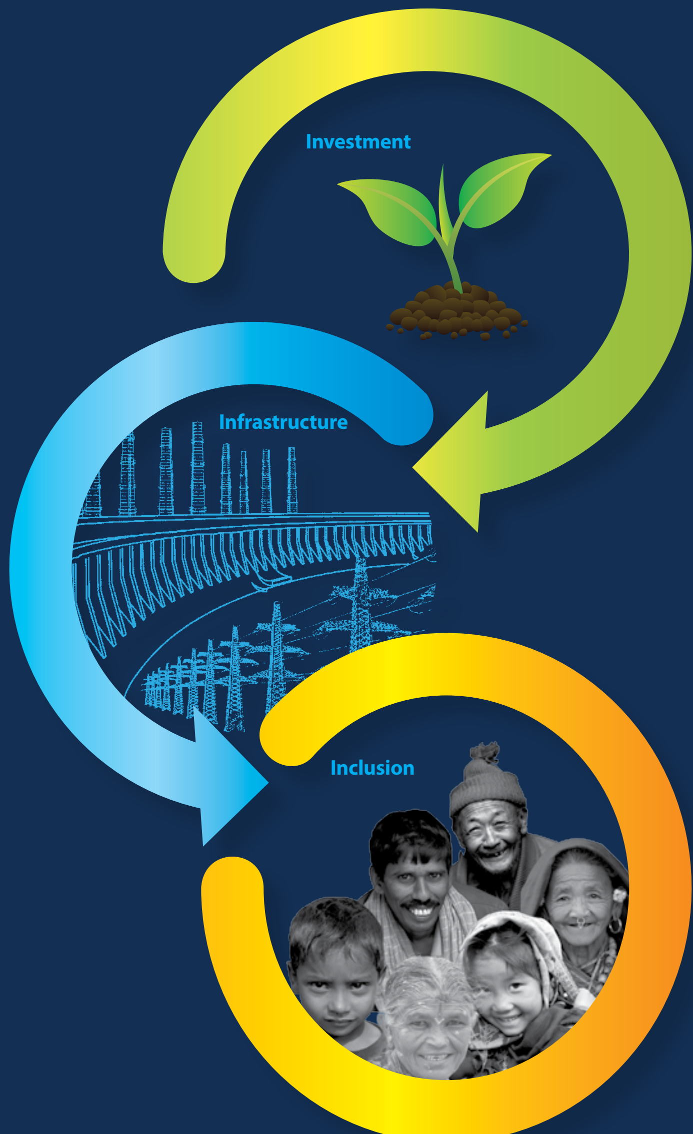
A Vision for Nepal

Policy Notes for the Government

THREE "I"S FOR GROWTH: INVESTMENT, INFRASTRUCTURE, INCLUSION



VOLUME II | SECTOR NOTES

WORLD BANK GROUP

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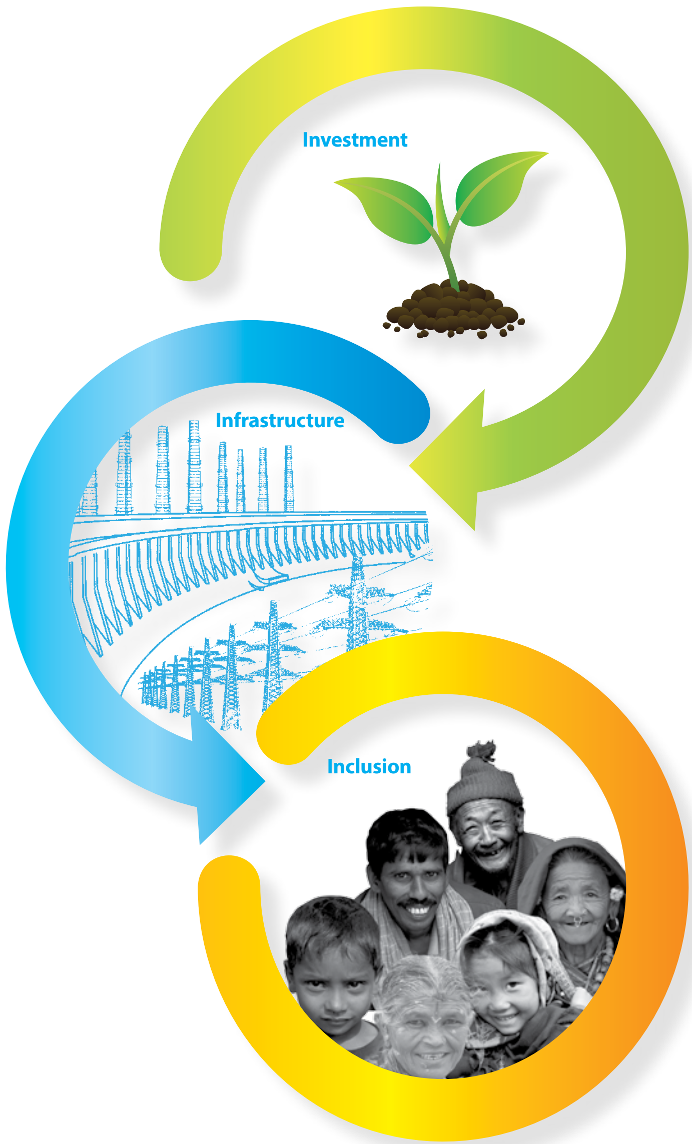

VOLUME II | SECTOR NOTES

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Abbreviations

ADB	Asian Development bank
ADBL	Agriculture Development Bank Limited
ADS	Agriculture Development Strategy
AML-CFT	Anti-Money Laundering – Counter Financing of Terrorism
BAFIA	Banks and Financial Institutions Act
BFI	Banking and Financial Institution
BIS	Bank for International Settlement
BOP	Balance of Payments
CIAA	Commission for the Investigation of Abuse of Authority
CIB	Credit Information Bureau
CIP	Country Investment Plan
CIT	Corporate Income Tax
CSR	Corporate Social Responsibility
DCGC	Deposit and Credit Guarantee Corporation
DCGF	Deposit and Credit Guarantee Fund
DDC	District Development Committee
DfID	Department for International Development
DMLI	Department of Money Laundering Investigation
DOI	Department of Industry
DoLIDAR	Department of Local Infrastructure Development and Agricultural Roads
DOR	Department of Roads
DPC	Development Policy Credit
DWSS	Department of Water Sanitation and Sewerage
EFA	Education for All
EGRA	Early Grade Reading Assessment
EVENT	Enhanced Vocational Education and Training Project
FCGO	Financial Comptroller General Office
FDI	Foreign Direct Investment
FI	Financial Institution
FIP	Foreign Investment Policy
FITTA	Foreign Investment and Technology Transfer Act
FIU	Financial Intelligence Unit
FMIS	Financial Management Information System
FRP	Financial Restructuring Plan
FSMD	Financial Sector Management Division

GA	Government Guarantee
GFCF	Gross Fixed Capital Formation
GFMIS	Government Financial Management Information System
IA	Indemnity Agreement
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
IPP	Independent Power Producer
IRD	Inland Revenue Department
JPM	Joint Monitoring Program
KUKL	Kathmandu Upatyaka Khanepani Limited
LLA	Land Lease Agreement
LPI	Logistic Performance Index
MDG	Millennium Development Goal
MDTF	Multi Donor Trust Fund
MFI	Micro Finance Institute
MIGA	Multilateral Investment Guarantee Association
MoAD	Ministry of Agriculture Development
MoF	Ministry of Finance
MoFALD	Ministry of Federal Affairs and Local Development
MOHP	Ministry of Health and Population
MoPIT	Ministry of Physical Infrastructure and Transport
NARC	National Agriculture Research Council
NASA	National Assessment of Student Achievement
NASDP	National Agriculture Sector Development Plan
NBL	Nepal Bank Limited
NEA	Nepal Electricity Authority
NEGRP	National Early Grade Reading Program
NIDC	Nepal Industrial Development Corporation Ltd.
NLSS	Nepal Living Standards Survey
NMIP	National Management Information Project
NOC	Nepal Oil Corporation
NPC	National Planning Commission
NPL	Non Performing Loans
NRB	Nepal Rastra Bank
NRBA	Nepal Rastra Bank Act
NSNS	Nepal Safety Net Survey
NWSC	National Water Supply Company
OAG	Office of the Auditor General
OCR	Office of Company Registrar
OECD	Organisation for Economic Co-operation and Development
ORA	Operational Risk Assessment
PAC	Public Accounts Committee
PDA	Project Development Agreement
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFMRP	Public Financial Management Reform Program
PPA	Power Purchase Agreement
PPMO	Public Procurement Monitoring Office
PPP	Public Private Partnerships
PRG	Partial Risk Guarantee

RBB	Rastriya Banijya bank
ROSC-A&A	Report on Observance of Standards and Codes – Accounting and Auditing
ROW	Right of Way
SCB	State Controlled Bank
SME	Small and Medium Enterprises
SMLE	Small Medium and Large Enterprises
SP	Social Protection
SPFMP	Strengthening Public Financial Management Project
SSRP	School Sector Reform Program
T&D	Transmission and Distribution
TEVT	Technical Education and Vocational Training
TIA	Tribhuvan International Airport
TIN	Taxpayers Information Network
TSA	Treasury Single Account
USAID	United States Agency for International Development
VDC	Village Development Committee
WHT	Withholding Tax
WUA	Water Users Association
WUC	Water Users Committee

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Consolidating Financial Sector Stability

Executive Summary

Nepal's financial sector is characterized by weak governance and remains vulnerable to potential shocks that could undermine macroeconomic stability and economic growth. The government has limited regulatory tools or sufficient operational capacity to identify and address the weaknesses of the financial sector or to effectively manage and limit the fiscal costs of a potential financial crisis. In addition, the efficient functioning of the financial sector is further distorted by the presence of four state-controlled financial institutions, which have unfair competitive advantages over private banks, mainly in the form of an implicit state guarantee for their liabilities. While Nepal has been successful in recently getting out of the Financial Action Task Force watch list, robust implementation of international standards for anti-money laundering and counter financing of terrorism is warranted to mitigate risks to the financial system and economy. Finally, expanding the reach of the financial system without compromising its stability is critical for developing Nepal's economy and reducing poverty. The policy recommendations below aim to assist Nepal to develop a fully competitive financial sector that is resilient to shocks:

- **Develop a financial sector crisis management toolkit.**
  - Accelerate the enactment of the NRBA Amendments Bill and the DCGT Bill.
  - Complete and enact the BAFIA Amendments Bill ensuring no legal conflict between the BAFIA and NRBA.
  - Build capacity of NRB and FSMD to carry out their functions in the context of a financial crisis

- **Restructure state-controlled banks (SCB).**
  - Complete the restructuring of SCBs, in particular of NBL by identifying alternative sources of recapitalization (including conversion of tax and loan liabilities to the government into common shares).
  - Complete the merger the of RBB with NIDC
  - Build FSMD capacity to manage the divestiture of NBL and define a clear mandate for RBB

- **Implement the anti-money laundering and counter-financing of terrorism legal framework.**
  - Implement laws on Mutual Legal Assistance and Extradition, Organized Crime, Proceeds of Crime, and Amendments to the Asset Laundering Prevention Act
  - Build institutional infrastructure, including capacity of DMLI and the special court

- **Enhance the reach of the financial system**
  - Develop an overall strategy towards access to finance, and ensure that policies are consistent with the strategy
  - Restore the balance in policy between stability and development
  - Enhance the enabling financial infrastructure and credit information
  - Complement improvements in the enabling environment by making markets work better through enforcing enhanced transparency encouraging development of financial products and services to MSMEs and the "missing middle".

Context

1. While Nepal's macroeconomic fundamentals are broadly sound, financial sector weaknesses could –under adverse circumstances- undermine macroeconomic stability and economic growth. Risks to the solvency of financial institutions stem from exposure to the real estate market and possible loss of depositor confidence. While reported real estate exposure and non-performing loans (NPLs) have been decreasing notably in FY13, most observers believe that the risk of a credit quality driven systemic problem is largely concealed by -possibly widespread- under-reporting of NPLs. The government does not have modern legal tools or adequate operational capacity to identify and address the weaknesses of the financial sector or to effectively manage and limit the fiscal costs of a financial crisis, which would have long-term consequences for the economy and poverty reduction.

2. The fall out of a badly managed financial crisis in Nepal could be substantial. Research carried out by DfID shows a very high correlation between credit growth and economic (GDP) growth in Nepal[1], and a high correlation between growth and the numbers of people lifted out of poverty[2]. Analysis performed by the IMF also shows that a major financial sector crisis in Nepal would have serious fiscal and economic impacts (Box 2). Economic costs of widespread FI insolvency fall into three main categories: (i) worsening of the population's well-being following changes in service delivery (education, health, infrastructure) as a result of reallocation of budget resources to finance financial sector restructuring; (ii) losses directly incurred by uninsured depositors and creditors, impacting economic activity and individual well-being; and, (iii) the impact on the supply of credit caused by a reduction of FIs' capital ("deleveraging" or a "credit crunch"). The economic costs described in point (i) above have not been quantified due to the difficulty to predict which sectors will be hit by an estimated budget squeeze of 4¾ % of GDP (as projected by the IMF[3]) following a financial crisis in Nepal; and conclusions as to how exactly service delivery would be affected are equally difficult to derive. However, the aggregate loss of output which the combined impact of points (ii) and (iii) would cause for Nepal would undoubtedly be significant.

BOX 1: Empirical evidence on the link between the financial sector and development

The cost of banking crises in developing countries has been estimated by the IMF (2008): according to the Fund's analysis average fiscal costs amounted to between 22% of GDP, output loss (cumulative loss against trend) ranges between 31% and 98% of GDP; reserve losses and depreciation range between 28% and 32% of GDP (cumulative over the first 2 quarters in the crisis year) respectively.

Source: IMF Staff Report for the 2012 Article IV Consultation

3. Although Nepal's banks appear less vulnerable to direct external financial contagion, solvency risk may be affected by underreporting or volatility in remittance flows. Direct financial links between Nepal and the rest of the world are limited, and thus the risk of financial contagion impacting Nepal's financial sector appears small. Bank for International Settlement (BIS) reporting of banks' total deposits and loans outstanding to all sectors in Nepal only amounted to between $60-85 million over Q1-2010 and Q1-2012. Further, BOP data indicate that while India is the dominant source of trade credit, liabilities to India are only about 7 percent of total imports. Nepalese banks' balance sheets show that loan liabilities to foreign financial

[1] Research conducted by DFID Nepal on the relationship between formal financial sector credit growth and GDP growth (1996-2011 data) gives the following results: Change in GDP/ Change in Credit to Private Sector 0.902 and Change in GDP/Change in Domestic Credit Provided by the Banking Sector 0.931. *Financial Sector Technical Assistance Business Case,* DFID, January 2013.

[2] Research conducted by DFID Nepal gives a growth/percent of population lifted out of poverty coefficient of 0.85 (1% GDP growth results in 0.85% of the population moving above the poverty line). *Financial Sector Technical Assistance Business Case*, DFID, January 2013.

[3] IMF Staff Report for the 2014 Article IV Consultation

institutions amount to less than 0.5 percent of total liabilities of the banking sector. However, it is possible that these figures understate the true depth of financial links, in light of unrecorded transactions over the open border. Volatility in remittances poses a more immediate risk. Nepali banks intermediate and benefit from the flow of inward remittances (around 30 percent of GDP in FY14). A negative shock to remittances, due to a slowdown in India and/or the GCC states could resurrect liquidity stress.

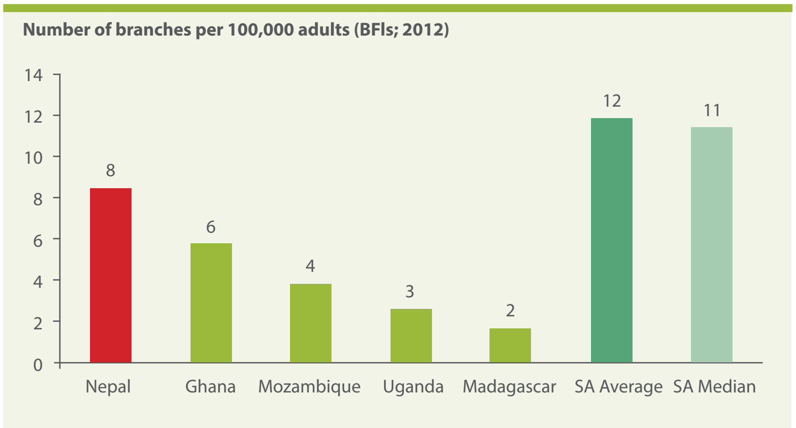
4. While capacity building for banking sector management and oversight is underway, necessary legal amendments remain in a draft stage. In late 2013 the NRB has embarked on a program of special audits of more than 50 banks that will help better assess the extent of problems in the financial sector. Resolution may require the use of strong supervisory measures – and possibly government financial support. Conducting such "deep dive" diagnostics was specifically recommended by the IMF in its report on the 2012 Article IV Consultations. As part of preparations undertaken in 2012-13 to manage possible FI insolvencies identified by routine supervisory activity and which may be corroborated by the special audits, and to put in place the architecture to support a stable and healthy financial system, the government has prepared amendments to the Nepal Rastra Bank Act (NRBA) and prepared a new bill to place the deposit insurance system on a sound legal footing (the Deposit and Credit Guarantee Fund – DCGF - Bill). The NRB is also strengthening its bank resolutions capacity and, the DCGC has started work to build operational capacity for the deposit insurance system. Work is also underway to amend the Banks and Financial Institutions Act (BAFIA) to ensure consistency with the new legislative framework. However, due to the absence of parliament in 2012-13, the NRBA Amendments Bill and DCGF Bill have not been enacted, and the government remains without vital legal powers needed to ensure that the insolvency of specific FIs does not trigger a financial crisis.

TABLE 1: Nepal's banking sector in international perspective

	Nepal (2013)	India (2012)
Market Share (Assets) of State Controlled Banks %	21.6%	73.0%
Market Share (Deposit) of State Controlled Banks %	20.4%	74.0%
CAR of State Controlled Banks %[4]	10 %	
CAR of Total Banks %	12.8 %	6.9%
Total NPLs %	2.5%	3.0%
NPLs of State Controlled Banks %	4.9 %	
Private Credit to GDP %	48.9%	45.5%
Commercial bank branches per 1000 population	6.7	10.6

5. Finally, while access to financial services compares favorably to other low income countries[5] significant gaps remain in the coverage of financial services, both in terms of access and effective use. Access gaps are most acute in the more remote and geographically isolated parts of the country, which as of yet remain underserved by formal financial institutions. Despite the relatively large deposit base, financial services are concentrated among the urban and male population. Of the urban population, 51% has a bank account, compared to 22% of the rural adult population. Similarly, a persistent gender gap exists: while about 30% of Nepali adult males have a bank account, only 21% of females do. Access to finance is a major and worsening constraint for firms, particularly small and medium enterprises

FIGURE 1: Branches per 100,000 adults



Source: Finstats, accessed February 2014.

[4] CAR of SCBs averages 10 % because of high CAR of ADB (18%) although RBB (3%) and NBL (negative) do not comply with NRB norms

[5] with the number of BFI branches per 100,000 adults doubling from 3 in 2004 to 8 in 2012, and growth in deposits and credit to reach 65% and 55% of GDP respectively

(SMEs). Some 40% of firms recently surveyed in the World Bank's Enterprise Survey 2013 considered access to finance to be a major or severe obstacle to their operations, significantly higher than the 5% reported in 2009.

Key Challenges and Recommendations

6. Two out of the four identified key issues (failure to put in place an adequate bank resolution framework and implement the AML-CFT framework) could potentially paralyze the economy and threaten political stability. Restructuring of the state-controlled banks is important for the future development of the financial market as an efficiently functioning mechanism to support productive investment. Expanding the reach of the financial system without compromising its stability is critical for developing Nepal's economy and reducing poverty. A medium term policy framework to address these issues was agreed between the World Bank and the government in the context of the Development Policy Credit (DPC) approved in June 2013 and work has continued towards operationalizing these policies throughout 2013 and 2014. Substantial technical assistance has also been attracted to support capacity building for implementation of the medium-term policy framework. However, major milestones remain to be achieved.

Key Challenge 1: Enacting Legislation to Provide a Financial Sector Crisis Management Toolkit and Effective Safety Net

7. The recent near-financial crisis (2011) has underlined the importance of crisis management capacity. From an international perspective, in response to the global financial crisis, many economies (from the most developed – United States and European Union - to less developed countries such as Nigeria) have recently strengthened their financial crisis management capacity by amending existing laws and regulations and introducing specific crisis management legislation. Examples of such legislation include laws to establish financial stability councils (which have legal authority to coordinate government institutions during a crisis and may include power to use budget resources); establishment of emergency liquidity facilities; and creation of rules covering budget support for financial institutions during a crisis as well as laws to establish special purpose vehicles to acquire good assets and liquidating troubled assets from banks to support the cleanup of balance sheets to facilitate capital-raising.

8. Despite recent efforts, the Government of Nepal still lacks vital legal powers needed to ensure that the insolvency of specific FIs does not trigger a financial crisis and the deposit insurance system lacks a sound legal basis. The current legal framework does not give the NRB sufficient powers to quickly resolve problems incurred by troubled FIs (many actions involve lengthy delays due to the need to seek court approval and there are inconsistencies between the NRBA and BAFIA which may lead to legal uncertainty). In the event of an FI's failure, the DCGC does not have a strong legal basis for action (its current deposit insurance mandate derives from regulations and bylaws rather than law) and its legal standing may be open to question in bankruptcy proceedings. Furthermore, DCGC is not adequately funded and currently has coverage of only 1 % of the insured liabilities.

9. Various efforts are underway but key bills remain short of enactment. Extensive work has been done over the past two years to prepare draft Bills (with IMF and World Bank assistance) to address the weaknesses of the bank resolution framework and to place the deposit insurance system on a sound legal footing. The two draft Bills (the NRBA Amendments Bill and DCGF Bill) are being finalized by the Ministry of Finance and are being processed for submission to the Constituent Assembly. The implementation of the special audits program may result in the need for effective supervisory action to resolve troubled financial institutions and it is vital that the deposit insurance system be strengthened so that it can perform its functions of averting depositor panic.

Recommendation:* *Accelerate the enactment of the NRBA Amendments Bill and the DCGF Bill.

10. Work is also underway to prepare a BAFIA Amendments Bill to conform it to the NRBA and DCGF Act as amended by the respective Bills and to avoid legal conflicts between the amended Acts. In parallel, the NRB has adopted an initial bank resolution framework and has completed drafting of a stronger framework which will be put in place as soon as the requisite legal powers become available on passage of the NRBA Amendments Bill. The internal bank resolution capacity (Problem Bank Resolution Framework) of the NRB is also being strengthened. DCGC should complete the drafting of regulations and bylaws required to implement the DCGF Bill in the first half of 2014, and the internal capacity building process (including installation of the IT systems and payout procedure needed to allow DCGC to quickly honor depositors' claims) is underway.

Recommendation:* *Complete the drafting and enact the BAFIA Amendments Bill ensuring no legal conflict between the BAFIA and NRBA

11. While a new Financial Sector Management Division (FSMD) has been established and staffed, concerns remain regarding the capacity of the FSMD to play its previsioned role in the event of a financial crisis. Thus in order to prevent panic in the financial sector and loss of depositor confidence in the event of a financial crisis capacity building of the FSMD needs to get underway.

Recommendation:* *Build capacity of FSMD to carry out its functions in the context of a financial crisis

Key Challenge 2: Restructuring of the State-controlled Banks

12. State ownership of large banks distorts competition in the financial sector and invites political interference. There are currently four banks with state ownership (NBL, RBB, ADBL, and NIDC), of which three (NBL, ADBL and RBB) are among the ten largest in Nepal. Since the early 2000's, government policy has been to restructure and then divest all of the state-owned banks except RBB, which is to be retained in state ownership for the long term. This policy recognizes that state ownership of such large banks causes various problems: (a) it heavily distorts the competitive environment because the SCBs enjoy an implicit state-guarantee, enabling them to gather deposits at lower rates than private sector banks; (b) the implicit state guarantee of deposits creates very large contingent liabilities for the state; and, (c) state ownership could potentially create the preconditions for political interference in the banks' lending and banking operations, leading to losses which must then be covered by the budget. The decision to retain ownership of RBB reflects its importance in providing financial access and the distribution of social payments such as pensions to a large segment of the population, particularly outside of the Kathmandu valley and urban centres, but at the same time must be matched by vigilance to ensure that the bank is insulated from political forces through strong governance and oversight structures.

13. Significant efforts have been made since the start of 2012 to implement this policy towards state-controlled banks, but further steps are needed. ADBL, RBB and NBL's capital adequacy has been restored to above zero; all these banks are profitable. In the case of RBB the government should allow the bank to continue its approved recapitalization plan. The RBB management team (with the CEO hired under open competition) and the board have been successful during the first phases of recapitalization and restructuring of the bank and it is expected to be fully compliant with capital adequacy requirements by FY-2015 at the latest. While RBB's recapitalization has been undertaken solely using state resources, NBL's recapitalization has involved a combination of public and private funds. As a pure commercial bank (i.e. without the financial access aspects of RBB's operations), NBL significantly distorts the market (because of its implicit state guarantee) and the state transfers significant subsidies to NBL's private shareholders as a result of: (a) possible sales of non-banking assets to government institutions at prices which may not be market-driven; and, (b) the implicit guarantee to NBL's private shareholders in the form of increased profits following bank restructuring initially funded by the state.

14. NBL's capital raising plan is significantly weaker than RBB' and it may be difficult for the Bank to fulfill its recapitalization program as intended without additional state support.. Rather than have NBL remain an undercapitalized bank for a prolonged period, priority should be given to completing recapitalization by converting approximately NRP 2 billion of liabilities to the government into equity capital. This liability should be converted into common shares, bringing NBL into full compliance with the minimum capital adequacy ratio and giving the state a significant majority in ownership. This would then allow NBL's divestiture to proceed and would also have the added benefit of making the bank more attractive to private investors by having a majority stake available for divestiture. The conversion can be accomplished (as was the case for RBB) by approval of a request from the Ministry of Finance to the Cabinet or by including the activity as part of the budget. The conversion of tax liabilities into equity has been agreed in principle with the Ministry of Finance and should proceed. The conversion should be allowed to go ahead, but only if the liability is converted into common shares which can then be sold as part of the divestiture. Following the completion of the credit line liability conversion into common shares, the divestiture process for NBL should be started.

Recommendation: Complete recapitalization of NBL by converting ~NPR 2.3 billion of tax and loan liabilities to the government into common shares

15. ADBL is undergoing restructuring with a view to divestiture of a controlling stake with assistance from the Asian Development Bank. NIDC (which is 99% state-owned) was slated for merger with RBB in 2012, but change of government's end-game plan for NIDC (as an infrastructure bank) prevented completion of what should be a straightforward merger process.

Recommendation: Complete merger of RBB with NIDC

16. In order to manage the divestiture process and provide long term oversight over the remaining state-controlled banks, the NRB's Financial Sector Management Division (FSMD) needs to build capacity in these areas. Donor support for the divestiture process and to strengthen FSMD's capacity to manage the process has already been pledged.

Recommendation: Build FSMD capacity to manage the divestiture of NBL and provide long term oversight for RBB

Key Challenge 3: Anti-Money Laundering and Counter Financing of Terrorism

17. Nepal will be at the risk of being put back into watch list with the possibility of being blacklisted for failure to fully implement the agreed international standards for the prevention of money laundering and counter financing of terrorism (AML-CFT). Blacklisting would cut off the Nepali financial system from the rest of the world, with potentially catastrophic impacts on the flow of remittances, trade, the banking system, and the economy as a whole. Since the beginning of 2012, with cross-party support, ordinances on Mutual Legal Assistance and Extradition, Organized Crime, Proceeds of Crime, and Amendments to the Asset (Money) Laundering Prevention Act have been issued to provide the legal framework required by international standards. Given the broad cross-party support for the ordinances, the Constituent Assembly has approved the ordinances into law.

18. Implementation will be key. The focus of international regulators (with the Financial Action Task Force of the OECD in the lead) has now turned to satisfactory implementation of the AML-CFT measures in the new laws, and the government will face continuous pressure to demonstrate measurable and substantial progress unless effective implementation and adequate institutional infrastructure is in place.

Recommendation: ***Building capacity and institutional infrastructure of regulatory agencies to effectively implement laws on Mutual Legal Assistance and Extradition, Organized Crime, Proceeds of Crime, and Amendments to the Asset (Money) Laundering Prevention.***

19. Institutions will require strengthening with appropriate resources. A special court has been established to handle AML-CFT cases, the Ministry of Finance has established a Department of Money Laundering Investigation (DMLI) and the NRB has strengthened its Financial Intelligence Unit (FIU). However, the DMLI's capacity constraint and lack of resources remain a major concern. In order to make the required progress on the implementation of the AML-CFT, the capacity and performance of DMLI and the special court must be quickly developed. Building capacity – covering everything from training to adequate information technology - in the DMLI and the special court will require prioritizing the allocation of budget resources for this purpose (the NRB FIU receives technical assistance from the IMF). Urgent efforts should be made to seek donor support for capacity building but, given the severe risks posed by being "listed" by FATF, the government should be prepared to use budget funds to pay for capacity building.

Recommendation: ***Build capacity of DMLI and the special court***

Key Challenge 4: Expanding the reach of the financial system

20. The Government of Nepal and the Nepal Rastra Bank strongly recognize the importance of the financial sector in advancing economic growth and poverty reduction. The authorities have been actively promoting access to financial services through a wide range of institutions, programs, policies, as well as enabling financial infrastructure. This has included (i) assuming ownership in a variety of financial institutions (SCBs, Regional Rural Development Banks, etc); (ii) introducing several new policies aimed at reallocating banking credit towards underserved productive sectors, and lowering the cost of credit (productive sector lending, interest rate caps, deprived sector lending targets, branch licensing policies, caps on fees and commissions, etc.), and (iii) establishing a number of funds and schemes to support subsidized credit (Youth Self Employment Fund, Rural Self Reliance Fund, Credit Guarantee scheme, etc.). Over time, the strategic direction of the policy package has undergone marked changes. In recent years, the Nepali authorities have moved away from a strategy centered on liberal licensing policies toward more interventionist administrative measures to address gaps/weakness.

21. There is a lack of an overall strategy and coherent approach towards access to finance. Although GoN and NRB have initiated many programs and policies, the ad-hoc nature and inconsistency of some of the policies and regulations have resulted in confusion in the banking community. Policies, regulations and laws introduced to enhance access to finance do not seem to be founded on strong evidence-based analysis of the problems, nor an understanding of best practices. There is also no analysis or monitoring of whether these policies and regulations have achieved their intended purposes.

22. The current set of policies raises several serious concerns in terms of effectiveness, and distortionary side effects. The combination of deprived and productive sector targets with the envisaged introduction of the cap on the deposit-lending spread imply restrictions on banks' room to maneuver through both prices and quantities. Of particular concern is the channeling of large amounts of funding through deprived sector lending, which may discourage eligible MFIs from developing products and targeting clients beyond those specified in the policy, leaving a segment of the market unserved by formal financial institutions. In addition, the interest rate spread cap could also prove counterproductive, as it likely induces banks to reduce their exposures to sectors that carry a higher interest rate. Among the sectors likely to be affected are SMEs and long term finance – precisely two segments that are currently underserved by the banking system. Lastly, restrictions on banks from charging fees in mobile banking will likely dissuade them from investing in innovative delivery channels, due to the inability to recoup their investment costs.

23. Current policies are also associated with a series of stability risks. To comply with the deprived sector requirements, class A, B and C banks are building up a significant exposure to not only class D financial institutions, but also to the largely unregulated cooperative sector which is known to be problematic, leading to an oversupply of credit to the bottom of the pyramid. In addition, the introduction of a fixed intermediation spread could squeeze profitability at a time when there is a likely need to rebuild capital through earnings, as the capital of many banks may be understated due to under-reported exposure to the real-estate sector.

24. The numerous administrative measures implemented thus far target the amount and cost of credit to the underserved sectors, but do not address the root causes of the lack of access to finance. These root causes include the challenging physical and technological infrastructure, and weak enabling environment and credit culture. The structural weaknesses in the overall lending environment exacerbate information asymmetries between lenders and borrowers. The policies in place so far try to solve the problem of lack of access by increasing liquidity to the system, but increased liquidity alone is not sufficient nor effective when the deeper structural weaknesses are not resolved.

25. The difficulties that Nepal is experiencing in terms of limited reach of the financial system and the high cost of finance are, to a large degree, typical for low income countries. At a fundamental level, the lack of depth and the high costs of finance reflect a series of structural weaknesses in the overall lending environment that exacerbate information asymmetries between lenders and borrowers. The sectors that are typically underserved by the financial system, particularly SMEs and households, are among the most impacted. Administrative measures to influence the amount and cost of credit to underserved sectors do not address the root causes.

The following recommendations seek to address these root causes:

- ***The GoN and NRB should develop an overall strategy towards access to finance, and ensure that policies are consistent with the strategy***
- ***NRB should restore the balance in policy between stability and development by developing a strategy for consolidation in class D, considering phasing out the deprived sector lending requirement over time (and lowering the thresholds during the transition), reconsidering the productive sector lending and the cap on the intermediation spread***
- ***MoF and NRB should enhance the weak enabling financial infrastructure and address the issue of weak credit information (see Investment Climate Policy Note for details of these recommendations)***
- ***NRB should complement improvements in the enabling environment by making markets work better through enforcing enhanced transparency in the disclosure of the effective cost of financial services, and encouraging BFIs to provide financial products and services to MSMEs and the missing middle.***

Toward a More Effective Investment Climate

Executive Summary

Nepal's long transition from autocratic rule to multiparty democracy has not provided the private sector with the stability and predictability it needs to take long term investment positions in the country.

With the prospect of improved political stability, Nepal can finally reap the dividend of peace if it acts strategically to provide key building blocks for private sector activity. In other words, the country needs to capitalize on the proven link between investment, development and growth by addressing the binding constraints to investment.

The recommendations below aim to assist Nepal to develop an effective investment climate to foster greater economic growth. Specifically it focuses on constraints which are both binding for the private sector and within the scope of the GoN to address effectively in the short run:

- **Increase access to finance to SMEs (without threatening financial stability) by enhancing the weak enabling financial infrastructure and addressing the issue of poor credit information.**
- **Alleviate regulatory burden on firms by simplifying bureaucratic procedures and making laws and regulations clear – especially in the areas of licensing and taxes**
- **Promote professional skill development and reduce non-wage costs of labor by increasing flexibility for employers and improve monitoring for better labor relations and greater productivity.**
- **Improve terms of trade through targeted interventions, revamping export subsidies and enhancing trade finance.**
- **Attract foreign direct investment (FDI) by updating Nepal's investment legislation and investment procedures to increase transparency and predictability of outcomes. This should include reviewing the regulatory framework in high potential industries – e.g. hydropower.**

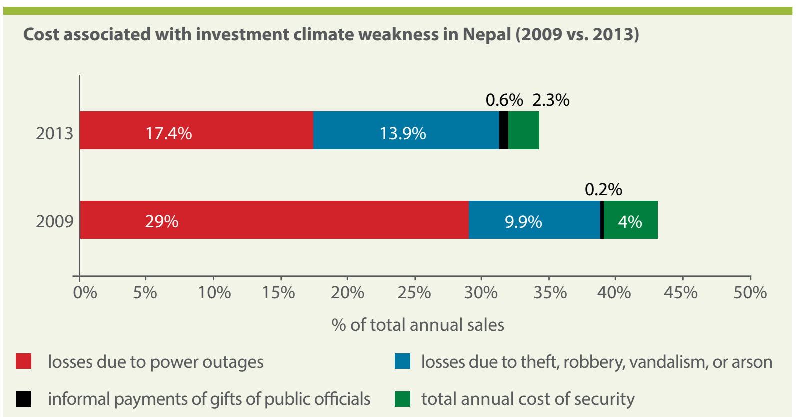
Context

1. Nepal's transition to peace, following the civil war, has been complex and prolonged with a direct detrimental impact on businesses activity. Political uncertainty and policy unpredictability continue to adversely affect private sector development, which is otherwise severely constrained by (i) poor infrastructure, (ii) limited access to finance, (iii) poor labor relations, and (iv) burdensome regulations.[1]

2. Political instability, labor action and power outages are the key constraints for firms to do business in Nepal. In 2013, industrial action (much of which is led by labor unions affiliated with political parties) resulted in an average of 20-day loss in productive activity, while poor access to electricity and costs associated with vandalism or arson (emanating from weak security and law and order) resulted in losses up to 35% of annual sales (figure 1). In such a business environment firms have poor incentives to invest, operate, grow and create jobs.

3. The weak business environment creates disincentives for new firms to enter the market and forces existing ones to remain small in size and more "conservative" than innovative. Small manufacturing firms currently dominate the spectrum of small, medium and large enterprises (SMLEs). Very few (and mostly large in size) firms are internationally certified - the percentage of firms having an internationally recognized quality certification is, on average, 0.08% (very low) and is mainly concentrated among the larger and older firms. The majority of registered SMLEs (85%) are small in size (employing 5-19 employees), and most firms are "middle-aged" (13 years on average) indicating that few new firms enter or survive in the market in Nepal.

FIGURE 1: Sales loss due to investment climate weakness



Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

4. Currently, the private sector invests less and generates fewer jobs than in the past. Among surveyed enterprises, employment growth slowed down to 5.7% per year between FY10-FY12, from 6.5% for the period FY06-FY09, which is worrying given the need to create more employment for the large number of new entrants into the job market every year[2]. In 2009 the majority of firms surveyed made investments to improve their competitiveness, either by upgrading their classification (60.6%), improving facilities (81.6%), or upgrading services (94.4%). In 2013, only 50% of surveyed firms made similar investments to improve their competitiveness. R&D activity in Nepal also remains very limited – only 7% of the firms (mostly larger and older) introduced formal R&D activities (in-house or contracted) in 2013. This clearly points to the failure of new entrants to push the innovation and technology frontier and spur competition.

5. Nepal ranks 105 worldwide in the 2014 Doing Business ranking, slightly worse than in 2013 (103), with improvements in starting a business, but continuing difficulties in trading across borders, enforcing contracts, paying taxes, resolving insolvency and dealing with construction permits.

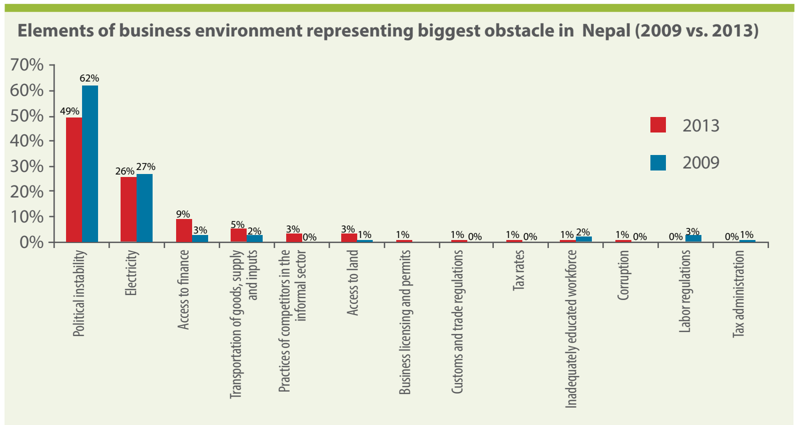
[1] This policy note is based on the empirical evidence and findings of Nepal's Enterprise Survey ES for 2009 and 2013, unless stated otherwise. The ES for 2009 and 2013 had a sample size of 482 firms, of which 240 were panel firms for the 2013 survey.

[2] Many young entrants into the labor force choose to migrate as the growth in number of jobs created by the private sector in Nepal is failing to keep pace.

6. From a policy standpoint, the most binding constraints –political instability[3] and poor infrastructure- are not amenable to easy fixes. Greater political stability and commensurate declines in perceived country risk will only come about as the state building process matures and Nepal's politics gradually shifts its focus towards economic policy. Also, while much can be done in a short period of time to ensure that Nepal adequately leverages its huge hydro potential and improves connectivity, the payoffs will materialize only in the longer run.

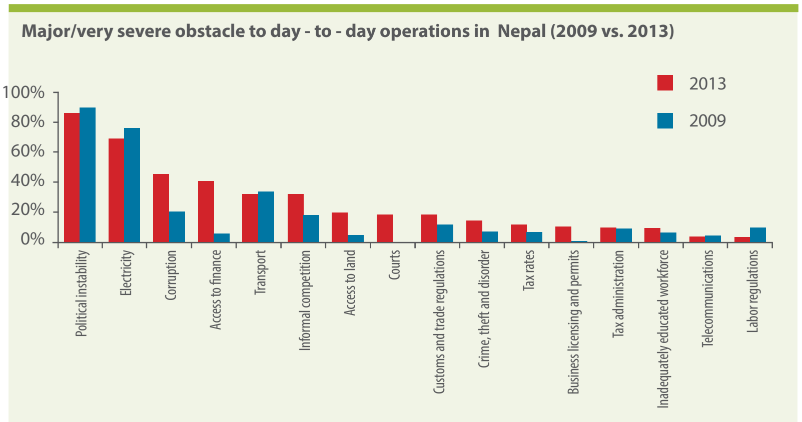
7. At the same time, there are many options for the authorities to begin implementing business friendly policies –strategically and incrementally- and signal that Nepal is serious about promoting private sector-led growth. There are low hanging fruits, from a policy standpoint, that could provide such signaling, in areas such as access to finance, informal competition, export promotion, and regulatory complexity.

FIGURE 2: Biggest obstacles to business (ranking)[4]



Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

FIGURE 3: Biggest obstacle to day-to-day firms' operations[5]



Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

Key Challenges and Recommendations

KEY CHALLENGE 1: INCREASING ACCESS TO FINANCE TO SMES

8. Despite the large number of players in Nepal's financial sector, firms' access to finance remains limited. Although the percentage of firms with checking or savings account has increased from 74% to 86% between 2009 and 2013, the proportion of firms with a line of credit or loan has decreased over time (figure 4). Nepalese firms continue having difficulty to obtain funding through debt.

9. Given such limited availability of debt financing, firms have to rely on internal funds to finance the bulk of their investment and working capital needs.[6] Very few firms use formal banks as a way to finance their investments (13%), which is lower than in 2009. Un-surprisingly, registered SMLEs consider access to finance through debt as the third biggest general obstacle to business in Nepal, while up to about 40% of firms (from just 5% in 2009) perceive it to be a major or very severe constraint to their day-to-day operations (figure 4).

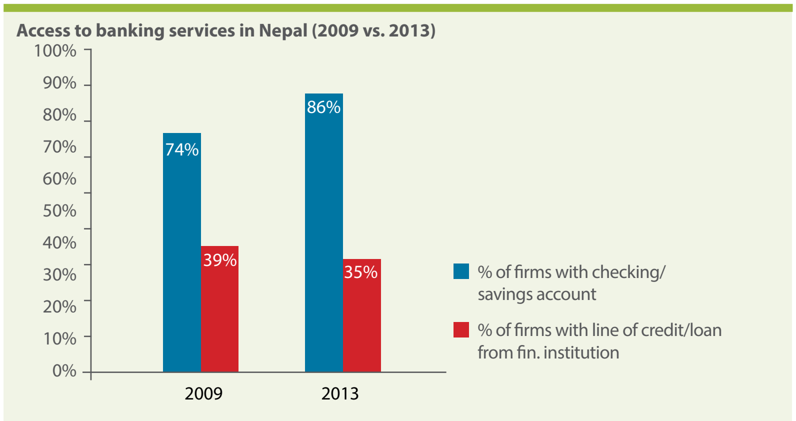
[3] Political instability is currently perceived by half of Nepalese firms, and in all sectors, as one of the biggest business environment impediments in general. Even though this portion is down from 62% in 2009, political instability continues to be the number one reported obstacle to business in Nepal (figure 3). Interestingly, among the firms that participated in both the 2009 and 2013 Enterprise Survey, the results remain in general the same. A remarkable 86% of the firms consider political instability to be not just an obstacle, but rather a major or very severe obstacle to their day-to-day operations (figure 4). Among the firms that participated in both the 2009 and 2013 Enterprise Survey, the results remain in general the same. As in 2009, political instability remains the top obstacle across all the sectors covered by the Enterprise Survey in Nepal, across all the firm sizes, with large enterprises being most affected.

[4] Firms choose one – the biggest – obstacle from a list of 15 business environment obstacles presented to them.

[5] Firms assess (one by one) the particular obstacles as major or very severe to their day-to-day operations.

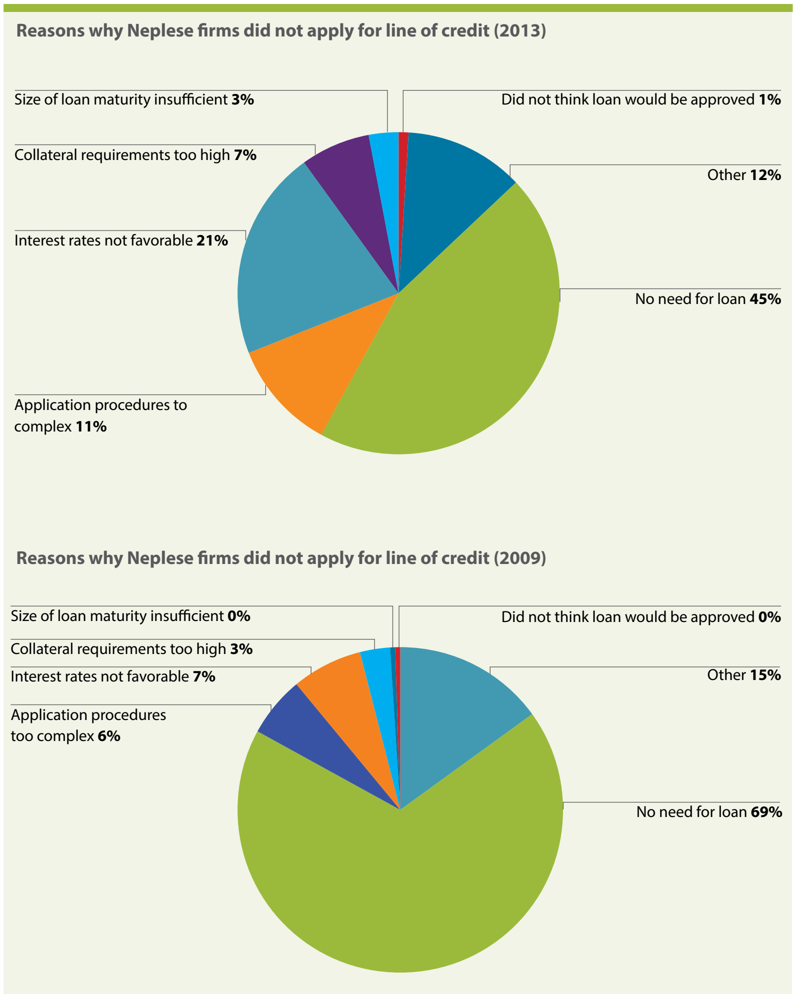
[6] Oftentimes, using retained earnings to finance capital outlays is a preferable choice by firms as (a) managers retain flexibility and control over their businesses, and (b) internal equity tends to be less costly than both external equity and debt financing. However, firms in Nepal have difficulty to generally accumulate retained earnings as they struggle to earn income in a consistent way due to political instability and high operational costs. Therefore, their capital structure implies cash deficits instead of sufficient retained earnings, and thus, exposes them to serious liquidity problems in case of an economic downturn.

FIGURE 4: Banking services over time



Source: Enterprise Surveys, World Bank.

FIGURE 5: Line of credit: reasons not to apply



Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

10. Getting credit is cumbersome (especially for SMEs). Nepal ranks low on ease of 'getting credit' (55/189) in the *Doing Business* survey.[7] Low levels of credit can be mainly linked to market inefficiencies in the banking sector that make it (i) hard for SMEs to obtain credit, and (ii) risky for the banks to extend loans as they face problems of imperfect information regarding the potential client's creditworthiness. High interest rates and cumbersome application processes are key constraints to apply for a loan or line of credit (figure 5). Around 40% of Nepalese firms face a serious difficulty to access financing – a proportion among the highest in the South Asia region.

11. Much can be done to make credit markets work better. Reforms to enhance the weak enabling financial infrastructure, address the issue of poor credit information, and make finance markets work better would be critical to decrease firms' reliance on physical collateral and reduce information asymmetry about SME's credit worthiness. When coupled with more bankable proposals and better record-keeping by MSMEs, they would go a long way to enhance access to finance for these enterprises. Specifically the authorities could consider the following initiatives:

Recommendation:

- ***Improve the financial infrastructure and reduce information asymmetries that constrain access to credit and raise the cost and risks of financial intermediations:***
  - *The authorities should broaden the range of assets acceptable as collateral by operationalizing the secured transaction registry as envisaged by the Secured Transaction Act and create a registration database to keep public records of obligations secured by moveable property;*
  - *The Credit Information Bureaus (CIB) should be allowed (through the enactment of its own statute) to accept reporting from multiple sources and to give borrowers access to information;*

[7] World Bank Doing Business 2014, country report for Nepal (www.doingbusiness.org).

- *The minimum reporting threshold for CIB should be removed (eventually, reporting should cover all lending by all institutions);*
- *The GoN and NRB should address weaknesses in the recovery process. This can be done by setting-out uniform enforcement procedures in BAFIA, limiting the borrowers' scope to request stays, and improving the Debt Recovery Tribunal procedures and enforcement mechanisms;*
- *The NRB can establish an SME database. This data can be used by BFIs to make informed lending decisions to SMEs, and will help guide the GoN and NRB policy on SMEs;*
- *The GoN should revamp the Credit Guarantee scheme to introduce new and larger portfolio-based products, targeting MSMEs with a rapid and streamlined settlement mechanism.*

- ***Encourage Banking and Financial Institutions (BFIs) to develop products and services tailored to MSMEs and to lend based on the value of the project proposal and not the collateral.*** *Many countries have launched initiatives that address this market gap, including India, Turkey and China.*
- ***Introduce initiatives to enhance financial literacy (by MoF, NRB, and financial sector institutions).*** *For example, assisting MSMEs with producing financial reports and helping entrepreneurs in preparing business plans.*

KEY CHALLENGE 2: ALLEVIATING THE REGULATORY BURDEN

12. Starting operations and obtaining business licenses remains cumbersome. Since 2009, the average number of days to obtain an operating or import license has decreased (figure 6), but it remains high. Moreover, the average number of days to obtain construction-related permits has been increasing.

13. According to the IFC's 2011 *Business License Inventory Study*, the licensing process in Nepal remains needlessly complex. In particular, 130 different licenses of various kinds were issued by 41 institutions. More than half of those business licenses (67 out of 130) were just pre-operational, resulting in unusually long periods of time that firms needed to wait in order to start operating, burdening both the government and the private sector. Government officials spent around 2.5 million processing days a year to process 167,000 licenses (table 1).

14. Tax compliance requirements have improved, but continue to burden businesses in Nepal. According to the *Doing Business* report for 2014, an average registered firm in Nepal makes 34 tax payments per year and the average tax payer spends 326 hours in order to meet all the tax requirements. A *Tax Compliance Cost Survey*, conducted by the IFC in 2012/13 showed that over 50% of Nepalese businesses find it difficult to calculate and pay taxes such as the Corporate Income Tax (CIT), VAT and withholding tax (WHT), with VAT being the most difficult of all. Due to the complexity involved in paying VAT, many tourism firms prefer to stay small and informal. Hence, improving tax regulations could reach the twin objective of (a) giving the incentive to informal firms to register, and (b) making the tax administration more efficient.

FIGURE 6: Procedural and regulatory burden

Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

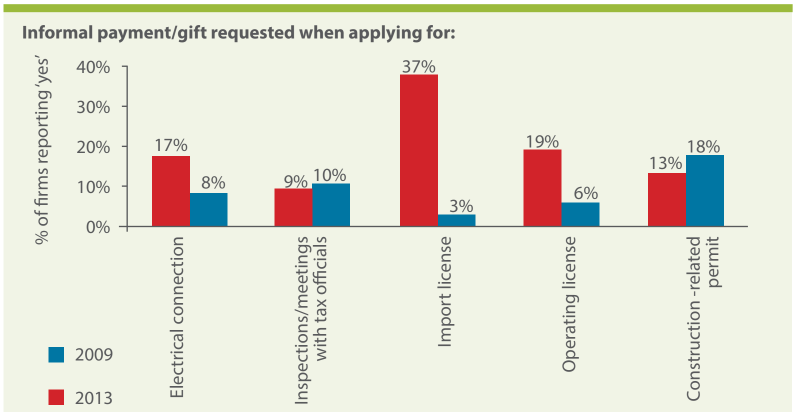
15. Lack of clarity over exact requirements to obtain a business license enables the licensing authorities to treat the firms with discretion and creates opportunities for informal payments. A main source of opacity resides in the ineffective system of monitoring compliance with license requirements that relies primarily on licencing renewal (61 of 130 business licenses in Nepal have a license validity period of one year or less). Although only 1% of firms identify corruption as the biggest obstacle to business, some 45% see it as a major or very severe obstacle to day-to-day operations, a proportion much higher than in 2009. Informal payments or "gifts" requested from firms for basic services or regulatory requirements are becoming more common (figure 7). Informal payments as a percentage of total annual sales increased from 0.15% in 2009 to 0.57% in 2013.

TABLE 1: The Licensing Process in Nepal

Types of license	No. issued / year	Total Processing days	% of Total Processing days	Mean processing days	Range Processing days
Business and Tax Registration Licenses	103,895	957,948	38.5%	9	2 to 120
Conditional/ Restrictive Licenses	40,615	932,675	37.4%	23	1 to 180
Pre Operational Approval	22,523	599,855	24.1%	27	1 to 390
All Enterprise licenses	167,033	2,490,478	100.0%	15	1 to 390

Source: Business License Inventory Survey, 2011, IFC

FIGURE 7: Informal gifts to acquire basic services or complete regulatory requirements



Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

16. Poor governance affects small firms disproportionately and it is difficult to capture the extent to which investments actually fail to materialize because of that. The majority of firms that perceive corruption as a very severe obstacle to day-to-day operations in Nepal are small in size. At the same time, medium-size firms allocate the highest proportion of annual sales to informal payments or gifts (0.8% on average), and pay the highest proportion of the contract value to secure a government contract (5.8% on average, up from 3.1% in 2009). Nepal only scores better than Pakistan, Bangladesh and Afghanistan in the region in perceiving corruption as a major or very severe obstacle to day-to-day firms' operations.

Recommendation:

- ***To streamline licensing:***
  - ***At the Office of the Company Registrar (OCR):***
    - *Eliminate the requirement to obtain a stamp to be attached to the registration form*
    - *Abolish the practice of obtaining a company seal or stamp*
    - *Consolidate government approvals (company registration, tax registration and Provident Fund registration) at one access point.*
  - ***At the Department of Industry (DOI):*** *further simplify the foreign investment approval process and industry registration process*[8]
  - ***Across government agencies: improve coordination to issue particular licenses which involves multiple agencies to review and make decisions (such as sector licenses on tourism, building construction permit etc.).*** *This problem could be addressed by, for example, sharing data across agencies. One example of data sharing and connectivity that has been implemented already (and can be replicated elsewhere) is between the OCR and Inland Revenue Department (IRD);*
- ***To facilitate tax compliance:*** *As part of the efforts of the Inland Revenue Department (IRD) and the Ministry of Finance to implement Taxpayers Information Network (TIN), business taxations should be improved, particularly in two strategic areas:*

[8] Currently it takes about 15 steps and 1-2 months to obtain foreign investment approval

- *Amending the legal framework to (i) ensure legal validity and eliminate any possibility of legal challenge for implementing the TIN, (ii) enable IRD to prescribe documents and transactions where it would be mandatory to quote PAN, and (iii) facilitate the introduction of the new tax payment system,*
- *Streamlining and automating business tax process.*

KEY CHALLENGE 3: PROMOTING PROFESSIONAL SKILL DEVELOPMENT AND REDUCING NON-WAGE COST

17. Despite improvements since 2009, Nepalese firms still lose an average of 21 working days a year to labor issues such as trade union action, civil unrest or employee absenteeism (figure 8). Much of the employed labor is unionized and unions, in turn, are highly politicized; politically motivated industrial action is frequent. It typically involves strikes (every second exporting firm considers strikes as the biggest obstacle to road transportation) and lockouts. Politically motivated industrial action might be one of the reasons why Nepal's labor productivity growth remains negative (-3.8%) and is among the weakest in the South Asia region.

18. Firms have little scope to link compensation of employees to their productivity. Firms (especially large firms) in Nepal find it difficult to match the minimum wage requirement given the existing labor productivity.[9] Even though fewer workers are being employed.[10] putting upward pressure on labor productivity (measured as total sales per worker), instability has a negative impact on sales and access to production inputs which brings the overall labor productivity ratio down.

Recommendation:

- ***Review the Bonus Act 1973 to***
  - *Provide additional flexibility to employers in hiring and firing workers*

FIGURE 8: Losses due to labor action

Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

  - *Relax mandatory requirements so that employment contracts provide employers with more options to formally employ workers based on, for example, higher wage differentiation, while discouraging employers to hire workers informally with no appointment letters*

- ***Consider independent (private/NGO) inspections to resolve labor disputes.*** *Better dialogue with workers could help de-link labor-relevant and politically motivated actions. Emphasizing the concept of "no work, no pay," would be especially helpful as currently many workers can expect full salary payment despite high levels of absenteeism.*
- ***Create new Labor Court branches to better address labor cases.*** *Opening new branches of labor courts in industrial towns is important as workers face difficulties to travel to Kathmandu frequently for judicial proceedings*
- ***Provide broader access to professional training and skills development opportunities.*** *Increasing the access to training in small firms, for example, could lead to increased returns on education in terms of wage increase and higher productivity.*

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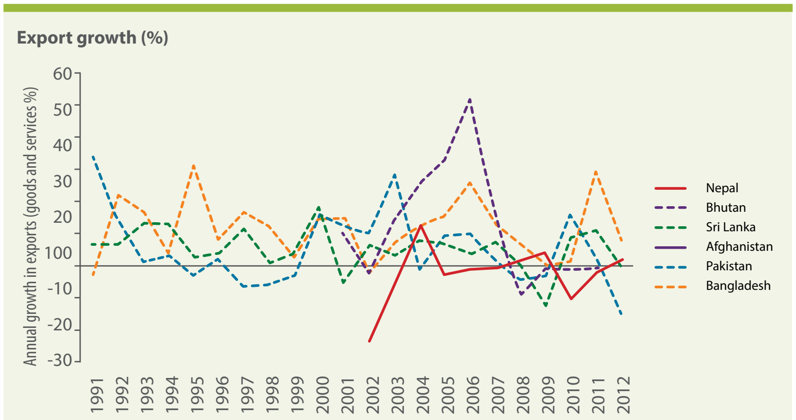
[9] Over 10% of the large firms still consider labor regulations as a major or very severe obstacle to day-to-day operations compared to 3% of overall SMLEs (Enterprise Survey for Nepal, 2013, the World Bank).

[10] While the proportion of skilled workers employed in the production process had increased from 57% in 2009 to 75% in 2013 (possibly as a result of low-skilled workers being priced out of the labor market due to the minimum wage requirement), the pace in which firms generate employment has slowed down.

KEY CHALLENGE 4: REMOVING THE BARRIERS TO EXPORTS

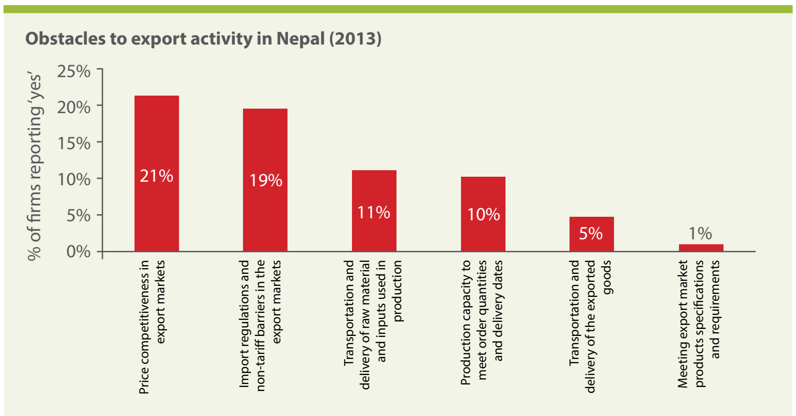
19. Export growth has been particularly slow in Nepal compared to other South Asian countries (figure 9). Although export growth has picked up since 2010 – reflecting catch up after negative years and the effect of the rupee's depreciation-, the performance of export-oriented sectors has been poor over much of the past decade. Nepal is losing export competitiveness, with merchandise export growth slowing down from an average of 19% a year in the 1990s to just 0.67% in the following decade. The past decade has been associated with significant growth in imports and declining export. Also, exports have been concentrated in a narrow range of agricultural and low value-added manufacturing products, in globally declining market segments, and in a handful of export destinations (mainly India). Less than 6% of the SMLEs in Nepal export their main product and the percentage of firms importing material inputs and supplies went down from 67% in 2009 to 45% in 2013. Even within manufacturing, exporters currently account for just 10% and they are small in size.

FIGURE 9: Export growth over time



Source: World Development Indicators, World Bank.

FIGURE 10: Obstacles to exporting



Source: Enterprise Survey for Nepal 2013, World Bank

20. Strikes remain the biggest obstacle to road transportation[11], while price competitiveness in the destination markets is perceived as a major or very severe obstacle for firms in Nepal to export, closely followed by import regulations (figure 10). High operational costs such as the price of fuel, electricity, and raw materials hinder exporters' current operations. Since retail traders (who account for about 70% of the exporters) import 50% of their production inputs, rising input prices also have a negative impact on overall exporting activity in Nepal.[12]

21. Lack of trade finance seems to seriously constrain Nepali firms that seek to increase exports in sectors with growth potential. In particular, only 0.03% of collateral for credits are covered by export bills and 0.8% by import bills (L/C).

Recommendation:

- ***Encourage the development of trade finance instruments and revamp the export subsidy and export finance scheme to better target new, smaller and third country exporters.***
  - *Establish a centralized asset register that promotes non-conventional forms of working capital such as inventory and equipment finance.*
  - *Encourage commercial banks to offer export credits to unlock the Nepal Rasta Bank (NRB) trade facility and increase firms' access to affordable export credits.*
  - *Develop a legal and regulatory framework conducive to the development of specialized insti-*

[11] Which when coupled with the bad quality of roads and the limited road network continue possibly explain why exporting through air transport has picked up

[12] Nepal's Investment Climate 2009, the World Bank.

tutions such as factoring companies, discount houses, and credit agencies to increase the competition between those institutions and commercial banks as well as complement commercial banks' services

- ***Reduce the cost of export facilitation (especially due to the challenges of Nepal's distinct geography, poor transportation system and theft) through localized support for both existing and new (niche) export products.***
  - *Provide firms with access to information on peculiarities of the destination markets to reduce the cost of exporting.* [13]
  - *Carry-out targeted investments aimed at export facilitation, such as laboratory facilities tailored to specific local export products and located in specific production regions.* [14]
  - *Create a decentralized export promotion office to lower the costs associated with the export activity in Nepal.*

KEY CHALLENGE 5: REMOVING THE BARRIERS TO FOREIGN DIRECT INVESTMENT

22. FDI has been stagnant and extremely low in Nepal. While many developing countries have seen FDI to increase recently, investment flows into Nepal have barely reached $100 million in FY13 (0.53% of GDP). This figure is low given the size of Nepal's economy and population. Most developing countries attract four times that amount relative to the size of their economy (figure 12). UNCTAD's analysis also confirms that Nepal's performance in attracting FDI is significantly below potential.

23. Nepal's FDI regime is outdated. The Foreign Investment and Technology Transfer Act (FITTA) – the key law of Nepal's FDI regime-was passed in 1992 and no longer meets the expectations of investors. Recently the Foreign Investment Policy 2014 (2071) has undergone a series of consultation with the Ministry of Industry (MoI) soliciting feedback from stakeholders (including development partners). The policy draft could be improved. In particular:

- Market access provisions are restrictive, including increased minimum capital requirement and FDI limits in many sectors;
- Investor rights are incomplete and not prominent enough;
- The institutional set-up is not very efficient, and further complicating already complex arrangements;
- Requirements for administrative procedures are too control-oriented and discretionary;
- The investment incentives regime is overly generous and discretionary.

24. The problem of Nepal's outdated investment legislation is also exacerbated by weak implementation. The lack of clarity in assigning responsibilities and accountabilities together with limited technical capabilities and overly bureaucratic procedures have a negative impact on investors' risk taking in Nepal. In particular:

- Obtaining an FDI approval in Nepal can take several weeks to months as opposed to most of the countries worldwide, where FDI approval is either not required or comes as simple reporting;
- Receiving clearance from the Nepali authorities for repatriation of dividends and other foreign exchange transactions associated with cross-border business can take several months, whereas in most of the countries worldwide such clearance is not even required;
- The issuance of expatriate work permits and visas remains opaque - the validity period of the permits is unpredictable as is the time needed to process the permits and visas.

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[13] In Nepal, evidence suggests that the amount of information available in the market about exporting a particular product is valuable for firms, as it is systematically and positively associated with the likelihood of surviving in export markets.

[14] For instance, tea is mainly produced in eastern Nepal. Where until now India has not accepted Nepal's laboratory test report for tea exports, this has meant additional time and costs for Nepali exporters who instead need to go to laboratories in Kolkata, Sunauli or Lucknow in order to obtain the necessary certification. Nepalese laboratory facilities in the eastern region could reduce this additional time and costs.

On that score, making administrative procedures less complicated and more aligned to investment needs should be a priority in order to reduce corruption and increase transparency.

25. Investment incentives are critical to attract foreign investments, especially in strategic sectors. However, the incentive regime outlined in the proposed Foreign Investment Policy (FIP) remains severely flawed. First, it is good international practice to address fiscal incentives in the tax legislation and not in the investment law. Second, the incentive regime is complex with many different fiscal and non-fiscal incentives. Third, the incentive award decision is not based on clearly stated requirements. Fourth, they are mostly available only to foreign investors, creating an unfair advantage over domestic competitors. Fifth, some of the incentives are export contingent and may not be WTO compliant.

Recommendation:

- ***Improve incentives regime (see Annex 1).*** *The best practice suggests incentives regimes with the following characteristics: Affordable, Transparent, Efficient, Targeted, Simple, Non-discretionary, Positive in the cost-benefit relation, and Periodically-reviewed.*

- ***Streamline Nepal's investment (administrative) procedures to increase transparency and predictability of outcomes:***
  - *Automate. Expand the use of online registrations and clearances to all key business processes (e.g. trade licenses, key sector-specific licenses, etc.);*
  - *Introduce silent consent/deemed approval. Introduce time limits in approvals, and enforce them;*
  - *Follow clear guidelines and standard process maps to increase the predictability of administrative processes and uniformity across different government departments;*
  - *Assign clear roles and responsibilities to allow investors to readily identify the public official responsible to advise them or approve their application;*

TABLE 2: Foreign direct investment (FDI) overview, selected years

(Millions of dollars and percentages)

FDI flows	2005-2007 (Pre-crisis annual average)	2009	2010	2011	2012	as a percentage of gross fixed capital formation: 2005-2007 (Pre-crisis annual average)	2010	2011	2012
Nepal									
Inward	1	39	87	95	92	-	2.4	2.4	2.5
Outward	-	-	-	-	-	-			
Memorandum									
Bangladesh									
Inward	768	700	913	1 136	990	5.0	3.8	4.3	3.4
Outward	9	29	15	13	53	0.1	0.1	-	0.2
India									
Inward	17 766	35 657	21 125	36 190	25 543	5.4	3.9	5.9	4.3
Outward	11 501	16 031	15 933	12 456	8 583	3.5	2.9	2.0	1.4
South Asia									
Inward	25 631	42 438	28 726	44 231	33 511	5.8	3.9	5.3	4.1
Outward	12 015	16 507	16 383	12 952	9 219	2.8	2.3	1.6	1.1
Asia and Oceania									
Inward	296 342	327 174	403 626	438 182	408 924	11.6	8.3	7.6	6.6
Outward	162 585	211 609	284 673	311 537	308 742	6.4	5.9	5.4	5.0
Developing economies									
Inward	452 023	530 289	637 063	735 212	702 826	13.3	10.2	10.1	9.0
Outward	238 224	273 401	413 220	422 067	426 082	7.1	6.7	5.9	5.5
World									
Inward	1 490 966	1 216 475	1 408 537	1 651 511	1 350 926	13.3	10.2	10.6	8.3
Outward	1 534 429	1 149 776	1 504 928	1 678 035	1 390 956	13.8	10.9	10.8	8.6

Source: UNCTAD, World Investment Report 2013

- *Develop clear action plans (specifying existing broadly-phrased policies) to ensure that the policies are properly implemented;*
- *Introduce fast-track procedures at added cost. This is a common practice in many countries; yet such a process is nearly completely absent in Nepal.*

- ***Update Nepal's investment legislation to align it with international best practice, and implement an investment strategy focused on strategic sectors in order to leverage FDI for local development:***
  - *Remove the threshold on the initial investment. Investment projects of all sizes should be welcome. Investors often prefer to start small, and grow their project over time. US$ 200,000 seems too high for many services sectors; and US$ 2mil too high for agribusiness and all export-oriented manufacturing;*
  - *Shorten the 'negative' list – the list that outlines all the sectors where FDI is prohibited AND where FDI is restricted;*
  - *Remove the requirement of approval that foreign companies need to meet in order to start their business in Nepal. With the exception of strategic industries, foreign companies should be treated in the same way as domestic companies;*
  - *Create a single regulator overseeing foreign investments. With multiple regulators, investors can "game the system" and structure their investments in a way to get the easiest approval;*
  - *Different types of investment should adhere to different legal instruments. More specifically, portfolio investment should be covered by securities/capital markets legislation rather than the future foreign investment law (or FITTA).*
  - *The regulatory framework of high potential industries (e.g. hydro-power) should be reviewed as to ensure they offer private investors reasonable risk/reward opportunities.*

ANNEX 1:

Good international practice: recommended investment incentive policies under various country scenarios

Scenario	Short-term policy	Long-term policy
Countries with weak investment climates	Investment incentives are ineffective and therefore a waste of tax revenues. Such revenues should instead be used to provide public goods. Reforms should also be introduced to clean up the tax system.	Such countries should reduce barriers to investment by, for example, simplifying investment procedures.
Countries facing tax competition	Incentives can be used in the short-term to ensure that countries are not at a disadvantage relative to their neighbors.	Such countries should work on regional pacts to stop tax competition and promote their substantive differences (labor skills, infrastructure, and so on).
Countries seeking to diversify their economies	Such countries can use incentives linked to investment growth (investment allowances, accelerated depreciation), but for a limited period based on clear prioritization of sectors in line with FDI competitiveness.	Broader industrial policy strategies have to be followed, including a focus on sector targeting and promotion to attract investments.
Countries with unique advantages (natural beauty, natural resources)	General investment incentives to attract investments that exploit such advantages waste revenue unless they kick-start investment.	Barriers should be lowered for investments designed to exploit natural resources, improve access to land, and so on.

Source: Providing Incentives for Investment: Advice for Policymakers in Developing Countries, World Bank Group.

Building PFM systems to Deliver More and Better Spending

Executive Summary

Building sound and effective Public Financial Management (PFM) systems is key to boosting spending –particularly investment- and to achieving greater value for each rupee spent. While Nepal's PFM framework is overall well designed, there is a significant gap between intention and implementation. In particular, the budget process does not currently translate into effective spending either in terms of aggregate amounts or intended allocation.

Transparent public finances are also necessary for accountability and to generate public consensus around development priorities. While Nepal has made some progress in recent years to upgrade its oversight mechanisms, critical gaps in budget execution and monitoring processes have resulted in heightened concerns over the spending of public money and, ultimately, the ability / commitment of the state to improve the level of service delivery to the people.

Nepal is at a point where it can articulate a new vision for PFM. The completion of the first phase of the Public Financial Management Reform Program (PFMRP) coincides with the advent of the new government and the second Public Expenditure and Financial Accountability (PEFA) Assessment and Report on Observance of Standards and Codes – Accounting and Auditing (ROSC-A&A) assessments. The PEFA offers an opportunity to take stock of PFM reform progress to date and to set new strategic directions while the ROSC-A&A report will provide recommendations to strengthen corporate accounting and auditing practices in Nepal. The recommendations below aim to assist the GoN to improve its PFM systems and practices in a way that supports increased, more efficient, transparent and accountable public spending:

To improve the GoN's capacity to implement PFM reforms

- Leverage the second PEFA assessment and ROSC-A&A to develop a vision for PFM reform
- Carry out a PFM competency audit and develop a capacity building plan

To improve the allocation and utilization of resources

- Reform the budget process
  - Restructure the budget calendar with clearer separation between planning, formulation and execution phases and adhere to such restructuring in practice
  - Advance the date of budget submission to allow for speedy implementation and adhere to the budget calendar
  - Respect expenditures ceilings to better link budget allocations to policy priorities
  - Include in the budget only projects with finalized and approved feasibility studies, work plans and procurement documents
  - Impose limits on virements / reallocations
- Improve capital spending quality
  - Develop national norms for project costing and minimum standards for contracted works
  - Provide technical and institutional support to local governments (LGs) to enhance their monitoring and supervisory capacity

To increase transparency and performance of public spending

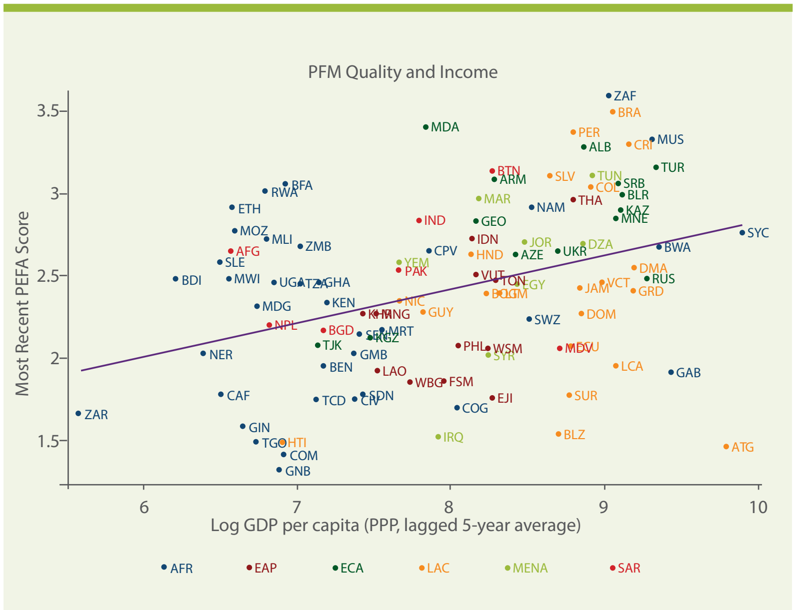
- Scale up the TSA system into a credible Financial Management Information System (FMIS)
- Strengthen formal institutions of accountability including internal and external audit
- Strengthen accountability practices of local governments.

Context

1. Sound PFM systems are particularly important in Nepal given the magnitude of the need for greater and more efficient public spending – especially capital investment. Remarkably, Nepal has managed to maintain healthy fiscal balances and to limit the need for external or internal borrowing. Instead, the main challenges have been to (i) use available resources to boost sorely needed public investment, (ii) achieve allocative efficiency across competing uses, and (iii) achieve/track quality of spending and ensure service delivery efficiency. Nepal's overall PFM performance, as measured by the PEFA benchmark, is at the lower range of the spectrum though on par with that of countries of similar income levels (Figure 1).

2. As in many other developing countries, there is a significant gap between the design of PFM systems (which is largely sound) and their effective use in the process of expenditure planning, allocation, execution and oversight. Even where formal PFM systems and processes are well defined through acts and rules, informal practices continue to prevail. This means that the reform emphasis should switch from legal and regulatory upgrading to institutional clarification (who does what), capacity building of PFM practitioners and the political economy of reform.

FIGURE 1: Relation between income level and PEFA performance



3. The budget process requires enhancement. While budget preparation is formally well governed by detailed guidelines and procedures, there are lapses in practice. The annual budget preparation guideline specifies a clear annual calendar, but there are often delays at each stage of the process resulting in last day of the fiscal year closing in budget submission to Parliament. Moreover, each distinct phase of budget execution encroaches on the other creating overlapping patterns of simultaneous and disconnected activities. In practice, capital and program budget negotiations continue well after the presentation/adoption of the budget: there is no hard deadline for inclusion of new capital projects and budget holders have substantial powers to reallocate funds across uses (virement rules are extremely flexible, resulting in a large amount of re-budgeting throughout the year); bunching increases the pressure (and the freedom) to reallocate funds. Even after the budget is approved, the project approval/authorization process takes an unduly long time (typically over 3-4 months) due to delay in initiating procurement process and decision making processes. In turn these processes can be manipulated to gain freedom to expedite procurement and 'slice' projects in chunks with weaker safeguards. These observations from the 2007 PEFA were also confirmed by the recently concluded Operational Risk Assessment 2013 (Box 1).

4. Capital spending has been more directly and negatively affected than recurrent spending. Under-spending of the capital budget is a continuing challenge, and is compounded by interference in decision making, which causes fragmentation of the capital budget. Dysfunctional aspects in the PFM system combined with weak technical capacity for proper procurement planning has resulted in reports of loss and leakage of funds and weaknesses in contracting has resulted in undue delays and cost overruns in development projects.

5. Although some progress has been made in PFM practices at the central level, these improvements have yet to trickle down to the local level where significant spending occurs. Significant improvements in PFM practices have begun to emerge at the level of central agencies (through computerized information systems, introduction of the treasury single account (TSA), strengthened audit practices etc.), but progress has been much slower in line ministries and at the local government level in the areas of budget discipline, budget execution, monitoring and reporting.

6. The gap between planned expenditure and effective use –both in volumes and allocation- is compounded (and to some extent enabled) by weak accountability and oversight. The accountability framework of audit and oversight has been eroded by the vacuum in political governance and is constrained by outdated audit legislation and practices. The external audit function is circumscribed by legislation that provides the Auditor General with insufficient independence as compared to the independence provisions called for by INTOSAI and endorsed by the United Nations. Internal audit is also weak, in part because of insufficient separation of responsibilities between the internal audit and treasury functions within the FCGO.

7. While the GoN and Development Partners (DPs) have developed a common understanding around priorities for reform, the framework for implementation –and follow up- could be improved. In 2010, the GoN adopted PFM reform strategy (Public Financial Management Reform Plan (PFMRP) Phase I), that prioritized a set of six reform interventions. The PFM Multi-donor Trust Fund (MDTF) was set up in 2011 which helped the GoN modernize payment processes through the introduction of a Treasury Single Account (TSA) system in all the 75 districts of the country and to upgrade audit systems and processes at the Office of the Auditor General. To support the reform agenda, the GoN set up a PEFA Secretariat, which functionally reports to the PFM Steering Committee chaired by the Finance Secretary - an innovative approach to coordinate PFM reforms through "one window". While this ensures a coordinated and harmonized approach to dealing with PFM reforms, there are serious handicaps in several policy and implementation aspects of PFM reforms. The engagement on PFM reforms has been entirely at the technical level with little support from the political leadership of the country. Moreover, frequent turnover of staff at critical positions both at the policy and operating levels leads to the risk of lack of continuity in the implementation of reform actions.

BOX 1: Key Observations of the Operational Risk Assessment (ORA) Report 2013

- Aggregate fiscal discipline has been stable based on a sound preparation of the medium term macro-fiscal framework that has supported the introduction of conservative revenue forecasting and provided a framework for multiyear contracting of P1 public investment projects.
- The formulation of a coherent PFM reform strategy and action plan through the PFM Reform Program (PFMRP, 2010) and its subsequent implementation with donor supported Multi-donor Trust Fund (MDTF) has resulted in some significant improvements in PFM systems.
- Credible and consistent scores on fiscal transparency in the Open Budget Indices.
- Critical weaknesses in the budget execution process in terms of bunching of expenditures, weak linkages between the MTEF and expenditure ceilings for line ministries as well as between the budgets and sector strategies and the pervasive political interference that undermines the formal processes of planning and budget allocations.
- Weak systems and processes for capital expenditure planning and execution resulting in fragmentation, delay and under execution
- Weak internal controls for public spending and the absence of an effective system of internal audit.
- Absence of a stable system of Parliamentary oversight over public finances in the absence of a functioning Parliamentary Committees like the Public Accounts Committee.

Source: Krause et al (2013)

Key Challenges and Recommendations

KEY CHALLENGE 1: DEVELOP A MEDIUM TO LONG TERM VISION FOR PFM REFORM WITH PROPER SEQUENCING AND CAPACITY BUILDING

8. Given Nepal's rocky transition from conflict and autocracy to multiparty democracy, the resulting weak focus on development-promoting policies, PFM reform programs have been deliberately opportunistic. Recognizing that complex long term plans were unlikely to gain traction in such an environment, the reform strategy has been one focusing on quick wins and the PFMRP has promoted a set of "technical fixes" to get the system running in an efficient, transparent and accountable manner. However, as the country conditions are now changing with increased stability and an empowered government, the time is probably right to begin formulating a more structured and long term agenda for PFM reform. The ORA and the ongoing PEFA and ROSC-A&A will provide the needed information base upon which such PFM reform strategy can be formulated.

9. The ongoing technical upgrading of PFM systems and processes needs to be continued in the short term while the stage is set for longer term reforms. Though the PFMRP as well as the ongoing PFM reform initiatives supported by the MDTF have been guided by the short term goal of technical feasibility, these technical interventions have resulted in strengthening some of the basic building blocks of the country's PFM system. In the short term, the ongoing initiatives need to be implemented efficiently and the current momentum of PFM reforms continued as that would provide the necessary foundation for a long term PFM reform strategy.

10. Key gains need to be amplified and rolled-out. The successful implementation of the Treasury Single Account (TSA) system in the 75 districts of the country will enable the GoN to maximize efficiencies in processing financial transactions especially at the budget execution level as well as benefit from efficient cash management and reliable reporting on budget expenditures. The strengthening of the Office of the Auditor General by introducing the AG's staff to modern audit techniques and practices will improve the quality of the audit and oversight function. Similar initiatives need to be scaled up and replicated across the GoN as well as at the local level, if their benefits are to become sustainable - otherwise they will result in creating a few islands of excellence with low impact on the overall country system.

11. Upgrading the TSA to a full-fledged credible Financial Management Information System (FMIS) would bring tangible benefits in terms of budget planning, execution and tracking. (Box 2). An FMIS can be broadly defined as "a set of automated solutions that enable governments to plan, execute, and monitor the budget by assisting in the prioritization, execution and reporting of expenditures, as well as the custodianship and reporting of revenues". This could be either off-the shelf solutions or a locally developed one and the choice would depend upon the country circumstances and capacity. Computerized FMIS platforms help governments comply with domestic and international financial regulations and reporting standards and support decentralized operations through centralized web-based solutions, providing access to a large number of authorized budget users at all levels. More recently, open budget initiatives have led to an increase in the provision of public sector financial information for the general public, and FMISs facilitate such information exchanges. During the next two years along with completion of the roll out of the TSA system in 75 districts, steps could be taken to make sure that the TSA systems develop linkages with other government systems, such as those of the National Revenue Board as well as with the budget execution processes and systems of the sectoral ministries. This would require to move towards an integrated architecture with seamless interfacing between various system, enhancing the networking/hardware and developing additional functionalities. This will lay the ground work for moving into a full-fledged credible FMIS in future that will enhance the quality and efficiency of governmental accounting and reporting significantly. To achieve this, the bank is working with the GoN on additional financing for the component 1 of the Strengthening Public Financial Management project (SPFMP).

12. Systems are only as good as those using them and competency gaps are significant in the civil service. The ongoing efforts to strengthen PFM systems as well as future plans on PFM reforms will depend to a large extent on the capacity of the officials operating and managing the PFM system. As PFM systems are being modernized and strengthened, a sustainable framework for training and skill building of staff needs to be put in place. Considering the frequent turnover of civil servants, it is necessary that base levels of PFM skills are developed across the public sector. Therefore, training needs relating to PFM competencies have to be assessed and suitable institutional structures -such as a specialized training institute for PFM- could be considered. Also suitable policies and processes need to be put in place that would ensure that key staffs at the management and operating levels have greater stability of tenure.

Recommendation:

- ***Leverage 2013 PEFA assessment findings to develop a Vision for PFM reform and action plan for the period FY2015-2019***
- ***Scale up the TSA system into a credible Financial Management Information System (FMIS).***
- ***Carry out a PFM competency audit and develop a capacity building plan.***

KEY CHALLENGE 2: LOW, DELAYED AND INEFFICIENT EXPENDITURES, PARTICULARLY INVESTMENT

13. Weaknesses in budget preparation and execution are resulting in low capital spending and inefficient utilization of budgetary resources. The approved budget is not a predictor of actual spending. Instead it is in some ways the beginning of a new set of budget negotiations and a constant stream of reallocations and virements that continue throughout the budget year. The first and second trimesters often see a continuation of planning and negotiations (with the exception of salary expenses) and much execution typically occurs in the third and final trimesters of the year. The result is poor budget utilization rates, specifically for investment (with actual expenditure on average at 75% of plan in the last three years) with massive bunching of expenditures at the end of the fiscal year. In the last three fiscal years, more than half of total expenditures occurred in the last trimester (more skewed towards the last month of the year) with more that 70% of the capital budget spent in the last four months of the fiscal year.

14. The budget calendar is not binding in practice. Although it is governed by detailed

BOX 2: Scaling up of a Treasury Single Account (TSA) system into a FMIS – the experience of Mongolia

The PFM reform in Mongolia began in 1993. The main objectives of reform were to maintain aggregate fiscal discipline, allocate public resources in accordance with strategic priorities, promote the efficient provision of services and strengthen financial transparency and accountability. In addition to policy reforms such as the introduction of a Medium Term Budget Framework, a key piece of the reforms was to introduce a TSA system and improve reporting. The World Bank supported these reforms through three consecutive projects totaling around $27.2 million. The Government Financial Management Information System (GIFMIS) included (a) establishment of the TSA (b) development of a unified chart of accounts (c) adoption of software to the Mongolian environment in budget controls, language, and financial management setup (d) training of staff; and (e) assistance in change management. The GIFMIS implementation started in 1998 and was implemented over six years with a cost of $5.3 million. Subsequent projects (with a total outlay of $21.9 million) were designed to expand the core treasury system towards a core FMIS solution by adding a budget preparation module, procurement and performance monitoring functions as well as Human Resources information system (HRMIS). The GIFMIS improved the budget execution and accountability, enabled accurate and timely reporting, strengthened budget oversight and monitoring, and improved budget accounting. Vendor payments are made reliably and promptly, the proliferation of bank accounts was reduced and aggregate cash balances and flows are more accurately reported and controlled.

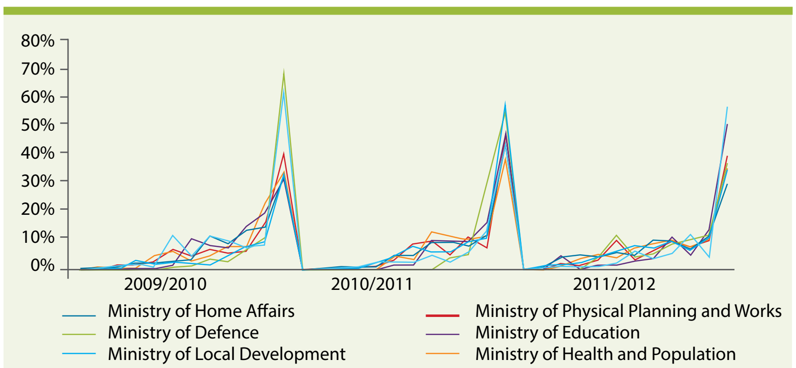
Source: Adapted from Dener et al (2011)

formal guidelines and procedures, the calendar is rarely adhered to in practice. The budget ceilings approved by the MoF in January and presented to line ministries and agencies constitute the basis for each ministry (following a bottoms-up approach) to submit their budgets by the end of March. Not only does this not typically happen until May but the ceilings are typically not adhered to (sometimes with wide divergences). This in turns requires a round of evaluations and negotiations by the MoF and NPC, which stretches up to the beginning of the fiscal year (although the Budget Circulars specifies March-April). Program and sector discussions on the budget estimates are held between MoF/NPC and the concerned ministry or agency to reconcile the proposals within the constraints imposed by the aggregate ceiling for the central government. The negotiated budget requests are compiled by the MoF at the end of June when a draft annual budget is prepared. The budget is then presented to the parliament, usually mid-July for approval.

15. The presentation and adoption of the budget does not put an end to budget negotiations. While the ceilings outlined in the budget document (Red Book) are binding, the inclusion / exclusion of activities –within these limits- is subject to ongoing discussions. Line ministries, departments and local bodies complain that the NPC and the MoF change the budget at the last minute, by including programs or projects not previously planned for in their budgets. Typically political pressures drive new projects included after the formal preparation stage.

16. In-year budget revisions and reallocations are frequent. Virement rules are extremely flexible, allowing line ministries to reallocate up to 25% of any particular line item within each budget heading. In turn, the high level of virements during budget execution weakens the credibility of the budget preparation process. Moreover, there is no central level monitoring mechanism to track changes made to the budget and neither the Budget Division at MoF nor the FCGO keep budget allocations updated (i.e. there is no further control after the budget is approved) and line agencies can incur spending within the budget envelope with generous powers of virements.

FIGURE 2: Timing of capital expenditures for selected ministries (2009-12)



Source: Krause et al (2013)

17. The authorization for development projects remains highly centralized and bureaucratic, causing major delays in project implementation. While execution of salary payments may start on issue of the authorization letter by MoF, line ministries and the NPC must further assess other expenditures –notably from the development budget- before project implementation can start. The approval of capital projects (strictly "priority" or P1 projects, which however account for some 80% of the total) requires the adoption and vetting of feasibility studies, work plans and procurement plans by the NPC, *following* approval of the annual budget (rather than *ex ante*). Typically the line ministries become aware of these changes only after the budget is approved: the departments, division offices and local bodies must then readjust their work-programs, re-write project implementation plans and develop new procurement plans. These revised work plans are again sent to the respective ministries and the NPC for approval (many are rejected requiring further modifications). This approval process can take an additional 3 to 4 months and sometimes rolls into the last trimester.

18. Weak fiduciary capacity at the level of line ministries and agencies, further slow-down capital projects implementation. While cumbersome approval processes and budget release procedures are partly to blame, delays are also the result of insufficient preparedness on the part of implementing agencies which devote insufficient attention to feasibility studies and other elements of project preparation. As unspent balances increase at the end of the fiscal year, budget holders gain additional freedom to expedite spending causing fragmentation of the capital budget into multiple small projects (with weaker procurement and oversight constraints). Approved projects are often unfinished, resulting in wastage of resources and ineffective development outcomes.

19. Budget process bottlenecks are compounded by implementation and procurement weaknesses, particularly for investment and at the local level. Significant local-level discretion by user committees over contractor selection and the financial terms of contract awards has frequently been associated with leakage and inefficient use of expenditure. There are reports of loss and leakage of funds through the inflation of user costs of construction as well as over-charging by user-committees which then subcontract. Procurement and contracting are weak in terms of both competition among contractors and technical capacity for proper procurement planning. Entry points for reform –short of changing the roles and responsibilities of user committees- include (i) technical and institutional support to local government monitoring and supervisory capacity (ii) developing national norms and rates for project costing (to replace the current district-by-district regime for norm setting) and (iii) enforcing technical standards for contracted works through technical monitoring.

Recommendation:* *Strengthen budget execution of line ministries to enable efficient service delivery

1. ***Strengthen the credibility of the budget and link between allocations and policy priorities***

a. *Advance the budget preparation phase so that a full budget can be presented to Parliament two months prior to the start of the fiscal year*

b. *Include in the budget only projects with finalized and approved feasibility studies, work plans and procurement documents, and*

c. *Launch a joint consultative review of inter-ministerial arrangements in budget planning, formulation and execution to establish a clearer division of* roles between the NPC, the MoF, the FCGO and line ministries.

2. ***Improving procedures and capacities for procurement planning and management***

a. De*velop national norms and rates for project costing (to replace the current district-by-district regime for norm setting),*

b. *Establish minimum technical standards for contracted works and enforcing them through technical monitoring, and*

c. *Provide technical and institutional support to local government monitoring and supervisory capacity*

d. *Empower Public Procurement Monitoring Office (PPMO) in effectively delivering its role of procurement monitoring and developing and disseminating procurement tools (manuals, guidelines, directives, technical notes, etc) for effective procurement management.*

KEY CHALLENGE 3: WEAK ACCOUNTABILITY AND OVERSIGHT

20. A clearer separation is needed between treasury and internal audit functions. Though the internal audit function has been established as part of the FCGO's responsibilities, the absence of clear separation of duties between the accounting and the internal audit wings has resulted in a conflict of interest. Instead, the role and functions of internal audit need to be redesigned with a formal organizational structure that would separate the internal audit function from accounting as well as with arrangements for clear reporting and quality assurance arrangements. In addition, internal audit standards and procedural methodologies need to be upgraded to align with modern good practices in internal audit, and a concerted effort needs to be made to upgrade the capacities and professional accreditations of internal auditors.

21. Internal audit systems are compliance oriented and are weak in practice. The internal audit function is compliance oriented focusing on merely identifying irregularities rather than addressing systemic issues. FCGO has recognized the need to reform the internal audit function and has already prepared a concept paper which needs to be followed up on with action.

22. External audit credibility has been weakened in the absence of oversight bodies, by outdated standards and procedures at OAG and outdated audit legislation. Over time, weak audit practices and audit follow up have increased fiduciary risk. The delays in the audit process along with the lack of timely follow up of audit recommendations have reduced the effectiveness of the external audit. The large number of audit queries outstanding and the persistent number of irregularities identified through audits both at the central and local government levels have increased the fiduciary risk for the utilization of budgetary and donor resources. The recent appointment of an AG and a CIAA Chief Commissioner has empowered staff to pursue their work with a measure of non-political legitimacy and backing that had been hitherto eroding. Likewise, with the election of a new Parliament, the Public Accounts Committee (PAC) will resume its work and provide much needed external scrutiny. In the medium term, the OAG could invest in upgrading its audit skills to enable a shift from the current detailed tests of transactions for compliance with government rules, to risk-based financial statement audits and performance or value for money audits. To complement the ongoing reforms in external audit, technical and administrative support needs to be provided to the Commission for the Investigation of Abuse of Authority and to any financial oversight committees that may be constituted under the new Parliament. In addition, updated audit legislation is required in order to respond to a 2011 resolution of the United Nations General Assembly calling on all member countries to provide their audit institutions with the independence provisions specified by the International Organization of Supreme Audit Institutions. Until the Office of the Auditor General is provided with such independence, improvements at the procedural level can be expected to result in only marginal impact.

23. Financial management practices are particularly poor at the local level. Financial management systems and practices of local governments are extremely weak. The absence of elected local councils combined with weak systems and practices at the local government level (VDCs, DDCs and municipalities) have resulted in weak accountability. This is reflected in the large number of audit queries and irregularities detected at the local governments. Since local governments are responsible for providing a range of basic services and with the increasing discussion in the country of moving towards a federal model of governance, it is important that the PFM systems and accountability practices of local governments are strengthened. Participative planning and budgeting, transparent accounting and reporting systems and independent audit systems will provide a strong institutional platform for local governments to provide efficient and accountable service delivery. The ongoing strengthening of PFM systems at the Central Government level need to be extended to local governments.

Recommendation:

- ***Separate internal audit and accounting functions at FCGO with administrative reorganization, separate cadres of staff and clear reporting structures***
- ***Prepare internal audit manuals and roll out training to move from compliance verification to strategic risk-based audits***
- ***Strengthen the capacity of the new Parliament to carry out its financial oversight functions***
- ***Strengthen PFM systems and accountability practices of local governments***
- ***Amend the audit legislation (Audit Act) to provide the Office of the Auditor General with the powers and independence of a modern Supreme Audit Institution.***
- ***Continue to support the Office of the Auditor General to scale up improvements in financial and performance auditing and to implement its Strategic Development Plan 2015-2019.***

Private Sector Accounting and Auditing practices; An assessment of the Accounting and Auditing practices in the country will be taking place under the ROSC-A&A program. The main purpose of the ROSC-A&A is to provide findings and recommendations in support of the strengthening of corporate accounting and auditing practices, in order to foster the quality and reliability of corporate financial reporting. As an output, the assessment will provide policy recommendations for necessary actions towards implementation of international corporate accounting and auditing standards; strengthening the profession and improving the capacity of professional bodies; introducing appropriate mechanisms for ensuring compliance with corporate accounting and auditing requirements; and developing arrangements for high quality accounting and auditing education and training. The policy recommendations from the ROSC- A&A review will provide a framework for preparing an Action Plan for the reform of accounting and auditing practices in Nepal.

Unlocking Nepal's HydroPower Potential

Executive Summary

Even though the country has a large hydropower potential, the population of Nepal has been experiencing severe power supply shortfalls. Poor sector policy and financial performance holds back investments needed to scale up power production to meet demand.

Implementing the recommendations below would improve the performance of the power sector and attract private investments in power production:

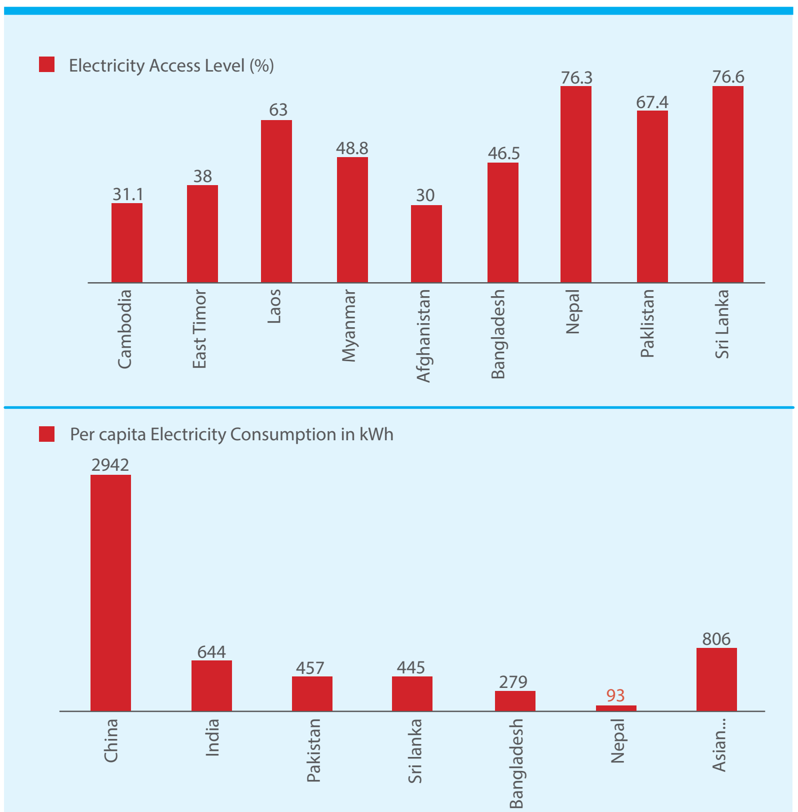
- **Tariff reform aimed at full recovery of costs and generating a positive return on NEA's assets, suitably revalued.**
- **Publication of a corporate development plan that outlines:**
  - technical and financial performance improvements
  - transmission and distribution loss reduction targets and actions.
- **Finalization of a template Project Development Agreement (PDA) to:**
  - provide reasonable coverage of country risks through guarantees for obligations of government entities
  - allow Partial Risk Guarantees from multilateral development banks.
- **Formulation of a transmission line Right Of Way compensation policy that provides reasonable site-specific compensation for restricted land use within the legal framework of Nepal**
- **Preparation of a Corporate Social Responsibility policy to address social impacts, livelihood restoration and enhance benefits of the local community affected by transmission lines.**

Context

1. Nepal has huge hydropower potential but is experiencing an energy crisis of unprecedented severity. The grid connected capacity is very low. Nepal has 43,000 MW of economically exploitable hydropower potential. Yet the country's installed hydropower generation capacity was merely 746 MW as of November 2013, of which 704 MW is grid-connected. Since most of the hydropower plants are of run-of-river type, the available generating capacity is low during dry seasons (472 MW in November 2013) when the system demand is high (1,203 MW in November 2013). In 2012, the supply-demand gap was recorded to be around 1,228 GWh, which was resolved through load shedding of up to 18 hours in the dry season (Feb to May)[1].

2. Nepal has achieved a reasonable level of access to electricity; however the service is not of sufficient quality. According to the 2013 Census, about 75 percent of the population in Nepal is estimated to have access to electricity (grid and off-grid), with a significant disparity between access levels in urban (around 90 percent) and rural (around 30 percent) areas. However, service often unavailable due supply shortages, with load shedding of up to 18 hours per day in grid-covered areas in the dry season; and average annual consumption remains very low, at about 93 kWh per capita.

FIGURE 1: Electricity access vs. per capita electricity consumption



3. Lack of access to reliable electricity services has become a major barrier for growth in Nepal. First, energy shortages come at a significant fiscal cost, as fuel-based alternatives remain significantly subsidized. Second, they also impose a significant burden on consumers and firms.

4. Unreliably electricity continues to be perceived as one of the biggest impediments to business in Nepal. Almost 26 percent of Nepalese firms identify electricity as the second biggest obstacle to the general business environment in Nepal and it is the top obstacle for small and medium-size firms. Some 70 percent of SMLEs consider electricity to be a major or very severe obstacle to their day-to-day operations (Figure 2). Reflecting the supply-demand gap, the percentage of electricity coming from captive generators (owned or shared) has increased from almost 25 percent in 2009 to over 41 percent in 2013. The real cost of the electricity problem in Nepal becomes evident once looking at the percentage of annual sales (17 percent on average) lost due to power outages. By some estimates, load shedding is costing Nepal some one billion dollars in revenue per year[2].

5. Expanding the supply and distribution of electricity is hampered by the poor financial health of the Nepal Electricity Authority (NEA). NEA, a vertically integrated government-owned utility, owns 66 percent of the generation capacity in the country and has a monopoly over power transmission and distribution. Power generation is opened for private investment – independent power producers (IPPs) own about 34% of the total power generation capacity in the country – but the NEA is the single buyer. NEA suffers from severe financial losses and can neither

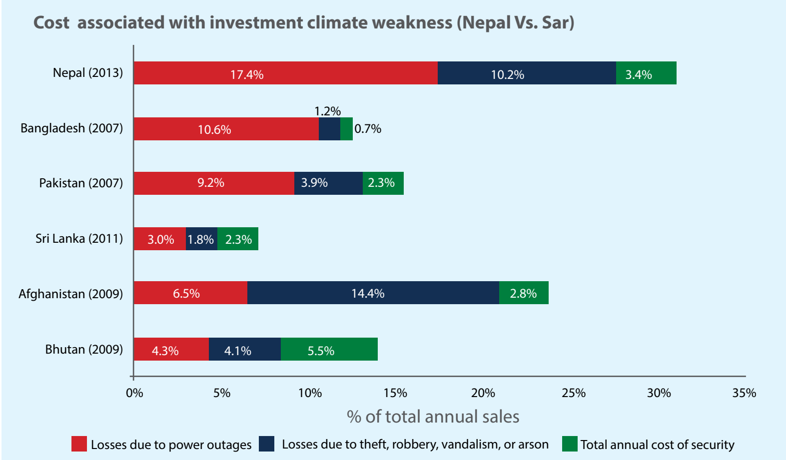
[1] NEA Annual Report, 2013
[2] Note of the Independent Power Producers' Association of Nepal (IPPAN), August 2010

generate the financing for needed investment in critical power generation, transmission and distribution infrastructures nor be a creditworthy off-taker to secure expected private investments in hydropower development. The situation is the result of NEA's tariff, which is about 25% lower than the cost of service. Cost of service is high in part because of high system losses (over 25%). The poor quality of services explains strong public resistance to tariff increases.

6. Chronic under investment in the power sector is partially attributable to the poor financial performance of NEA. Since 2002, almost no transmission line has been built and only 92 MW of power generation capacity have been added to the system. Successive governments have expressed a commitment to attract private investments in hydropower development, and ninety percent of the survey licenses for new hydropower projects have been issued to IPPs. However, lack of transmission capacity and risks on NEA payment default, in addition to other country risks such as political force majeure, currency conversion and exchange, limited domestic market size and lack of firm commitment of neighboring countries to purchase hydropower from Nepal are major bottlenecks for sizable private investment in large hydropower generation.

7. On-going transmission line projects have suffered prolonged delays due to disputes on compensation for the ROW. Dispute with affected communities on compensation of the ROW have resulted in unprecedented delays in project implementation. One of the World Bank-funded transmission line projects has been under implementation for 11 years but still could not be completed due to the dispute for a 3.85 km ROW stretch. Another transmission line project funded by Asian Development Bank could not be completed due to the ROW compensation issue and has become a stranded asset. While government laws and regulations allow proper compensation for land acquisition, there is no clear policy on ROW compensation for transmission line where land is not acquired. NEA has neither a clear corporate policy for determining necessary compensation, nor a corporate social responsibility (CSR) policy for additional social benefits to the affected communities.

FIGURE 2: Losses due to power outages constitute a significant impediment to private sector activity



Source: Enterprise Surveys, World Bank

Key Challenges and Recommendations

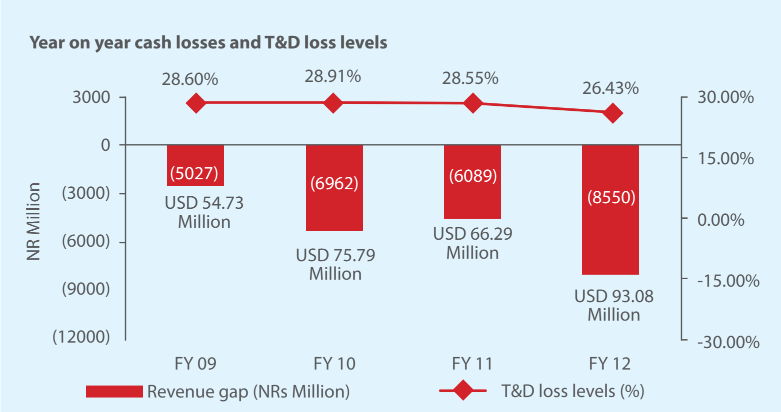
KEY CHALLENGE 1: POOR FINANCIAL PERFORMANCE OF THE POWER UTILITY

8. The power utility, NEA is structurally accumulating losses. The current average tariff charged to consumers is about 25% below the cost of supply by NEA, while the cost is 'inflated' by high transmission and distribution (T&D) losses. Operating costs are increasing every year due to (i) overall inflation, (ii) the depreciation of the Nepalese currency vis-à-vis the dollar[3] and (iii) increases in interest costs on long term borrowings. NEA had a net loss of over NRs. 8.55 billion in FY12, representing an increase by 27.42 % from FY09. Figure 3 shows T&D losses and the revenue gap of NEA from 2009 to 2012.

9. Tariffs charged are too low for NEA to breakeven, let alone be able to make capital investment. The power sector is caught in a vicious circle: the low quality of services provided by the NEA makes it difficult to increase consumer tariff, which depresses

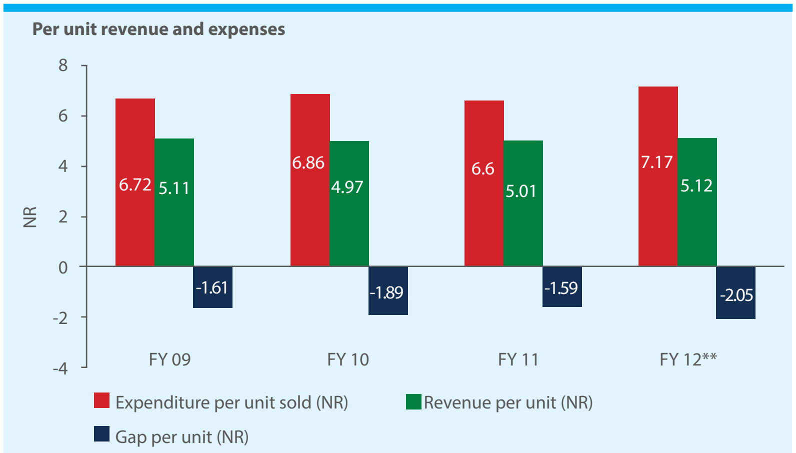
[3] The NEA has revenues in NRs, but USD payment obligation under some of its take-or-pay PPAs with IPPS

FIGURE 3: Cash and T&D losses



Source: NEA Distribution and consumer service business overview, PWC 2013

FIGURE 4: Per Unit Revenue and Expenses



Source: NEA Distribution and consumer service business overview, PWC 2013

investment and ultimately service delivery. The tariff was not revised for over a decade until 2012 when the tariff was increased by 20% on average for all customers. The tariff structure varies according to uses as follows: (i) commercial sales at NRs. 9.75/kWh; (ii) domestic sales at NRs. 6.38-6.53/kWh, and (iii) community sales at NRs. 3.48/kWh. Figure 4 illustrates the cost and revenue gap per unit.

10. Reducing cost of services and achieving cost recovery tariff are the first step needed to achieve financial sustainability of NEA and the power sector. The tariff reform would need to consider a stepped approach to address social impacts and allow tariff adjustment with, for example, indexation to inflation and foreign exchange rates, and tariff category restructuring that allows cross-subsidies among consumer categories to address impacts on the poor.

Recommendation:* *Carry out tariff reform with the objective of cost recovery first and a positive return on revalued fixed assets of NEA

11. NEA's liquidity position is precarious and its debt service coverage ratios have sunk below 1.0 over the past five years. Without significant support from external sources, NEA can neither service its existing debts nor fund any critical generation and transmission capacity expansion. Without rapid implementation of reforms to improve operational efficiency and tariff adjustment to recover costs of service, NEA will continue the downward spiral of increasing costs, decreasing revenues, dependence on external sources for debt service and chronic underinvestment.

12. A financial restructuring plan (FRP) was prepared by a task force set up by the Cabinet but it must be embedded in a forward looking corporate development plan. Key reforms proposed include: writing-off accumulated losses and debts for foreign technical assistance, reducing the on lending interest rate of GoN loans, capitalizing projects constructed with foreign grants, settling outstanding dues between GoN and NEA, and adjusting tariffs to reflect cost. Analysis of the reform proposals indicates that NEA would indeed be able to become viable and remain so, assuming periodic adjustment of tariffs and continued enhancements of revenue collections. Some of the proposed actions in the FRP were approved by the GoN in January 2012.

Recommendation:* *Prepare a corporate development plan that details the technical and financial performance improvements and a loss reduction master plan that outlines the targets and actions for T&D loss reduction.

KEY CHALLENGE 2: LACK OF POLICY TO GUARANTEE PRIVATE INVESTMENT IN HYDROPOWER

13. While the NEA cannot provide the financing needed for investments in generation, transmission and distribution, there are major impediments to private investment in

hydropower generation. Table 1 shows that the share of private sector entities in hydropower remains modest (at 34%) even though the hydropower sector has opened to private investment since 1992. Private investors and commercial lenders are facing many challenges including lack of transmission facilities, as well as a variety of risks including: market, NEA power purchase payment default, termination of contractual obligation, political force majeure, confiscation, expropriation and nationalization (CEN Risk), and foreign exchange. In addition, there are risks during construction and operation as well. Cost and time overrun risks are very high due to weak geological conditions, limited infrastructure facilities and regular nation-wide strikes. During operation, hydrological risk (variation in river-inflow) is the major problem, which impacts generation. Unless these risks are addressed properly, private sector participation in hydropower is unlikely to reach desired levels. Therefore, it is essential to develop risk sharing mechanisms and to reflect them in transaction agreements that provide private investors with sufficient guarantees.

TABLE 1: Share of NEA and IPPs in Total Installed Capacity, MW

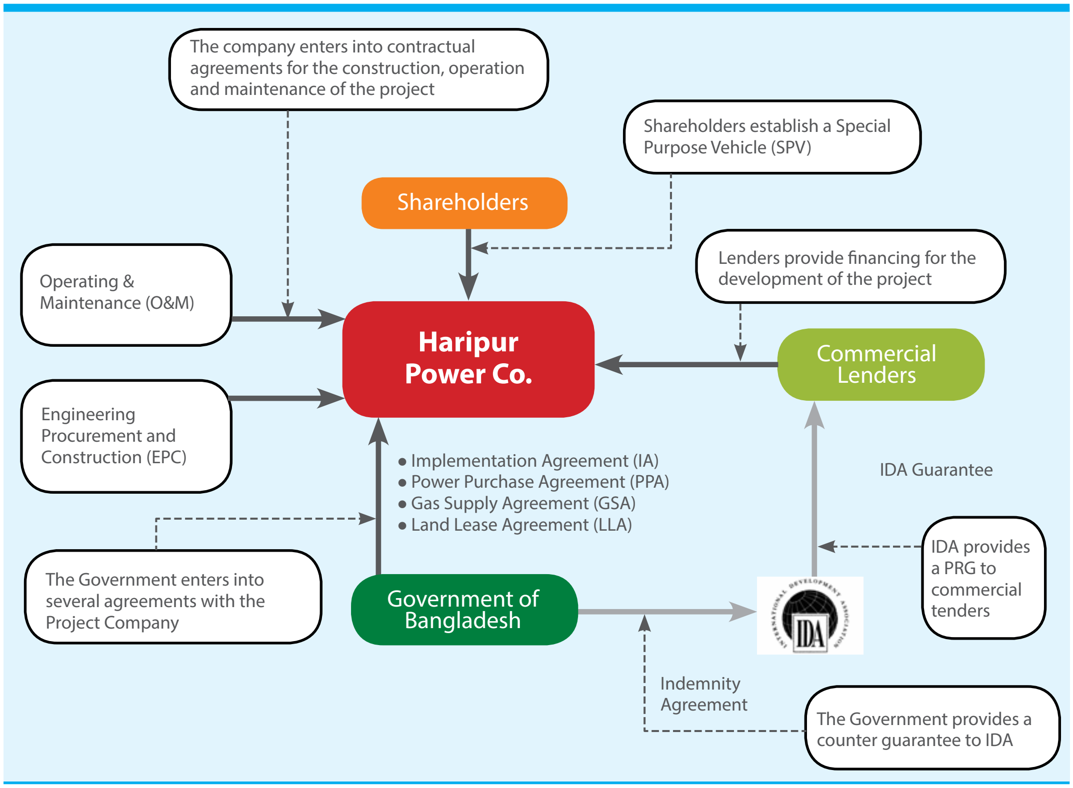
	NEA	IPP	Total
Hydro	478.32	267.37	745.69
Solar	0.10	7.45	7.55
Thermal	53.41	NA	53.41
Total	531.83	274.82	806.65
Percentage	66%	34%	100%

Source: NEA Annual Report 2013, AEPC 2012

14. The lack of proper policies for government guarantee to mitigate these risks is the main hurdle for private investment. International agencies such as the Multilateral Investment Guarantee Association (MIGA) provide guarantees against some of the risks for a fee. However, the availability of such insurance is limited to foreign investors and some of the key risks, such as NEA payment default, have to be covered by the government since Nepal still does not have a financially and technically robust off-taker to take these risks without government backstops.

15. Partial risk guarantees (PRG) have been used instrumentally to unlock key power investments, including in South Asia. A regional example of an international agency providing a partial risk guarantee is the

FIGURE 5: Partial Risk Guarantee structure for Haripur power co.



Haripur project in Bangladesh (Figure 4) - an independent power producer (IPP) of a 360 MW gas-fired combined cycle power plant. The PRG (provided by IDA) covers commercial lenders for loan repayment default by the Project Company such as would result from the Government's failure to meet its payment obligations under the Indemnity Agreement (IA) and the Government Guarantee (GA) in support of the Power Purchase Agreement (PPA), Gas Supply Agreement (GSA), and the Land Lease Agreement (LLA). The total project cost is USD 181 million and the guarantee amount is USD 60.9 million and with maturity of 15 years.

16. So far the GoN has no clear policy to provide any guarantee to private investors, but without such government support attracting private investment for large hydropower projects will be difficult. The government, at minimum should (i) backstop NEA contracted Power Purchase Agreements to mitigate the risk of power purchase payment default, and (ii) allow further credit enhancement such as through Partial Risk Guarantee Mechanisms available with multi-lateral development bank

Recommendation:* *Update the Project Development Agreement (PDA) template to provide a reasonable coverage of country risks through guarantees for obligations of government entities and allow PRG from multilateral development banks.

BOX 1: Khimti-Dhalkebar transmission line project

Compensation for a 3.85 km ROW stretch for the Khimti-Dhalkebar 220 kV Transmission Line funded by the Bank has been a major issue since 2009. Local community in the disputed stretch obstructed the construction of the transmission line even with the offer of 100 percent compensation to acquire the affected land as per Land Acquisition Act. Asian Development Bank (ADB) funded transmission line project in Kathmandu had to be abandoned due to affected people not providing the ROW for stringing even with 25 percent compensation offered. Similarly second circuit stringing of the exiting transmission line with double circuit tower were obstructed in a project funded by ADB.

KEY CHALLENGE 3: LACK OF POLICIES FOR COMPENSATION FOR TRANSMISSION LINE RIGHT OF WAY (ROW)

17. Transmission lines require land to be acquired for the construction of towers[4] and a ROW to be cleared for the overhead conductor lines strung between the towers, but the process has become increasingly difficult in Nepal. The width of the ROW is determined by the voltage level (e.g. 30 meter wide for a 220 kV line as per regulation), to keep a safety clearance from the live wires. ROW land owners can maintain their ownership and continue farming under the overhead conductors if needed, but cannot build any structures or grow trees to a certain height in the ROW. As is common practice in many countries, NEA provides full compensation for losses of properties, trees and crops for ROW clearance. In addition, NEA also provides a compensation for the restricted use of the ROW equivalent to 10 percent of the land value. This practice has worked well in remote rural areas where the land is used predominantly for cultivation.

18. However, ROW compensation has become a serious issue in urban and peri-urban areas. This is because land value has appreciated significantly in these areas (along with the growing real-estate market in Nepal), and because NEA does not have a clear corporate policy for compensations. As a result, it often takes prolonged time for NEA to make a decision in cases where compensation of more than 10 percent is needed, such as in urban and per-urban areas.

Recommendation:* *Formulate a transmission line ROW compensation policy that provides site specific justifiable compensation for restricted land use within the legal framework of Nepal

19. Additional benefits may be provided above and beyond ROW compensation, to gain support of local communities for transmission ROWs. The Power Grid of India developed an effective Coporate Social Responsibility (CSR) policy, which helped in getting necessary ROW for transmission corridor. NEA should also prepare and adopt similar CSR policy for benefit enhancement programs.

Recommendation:* *Prepare and adopt a Corporate Social Responsibility policy to address social impacts, livelihood restoration needs and enhance benefits for the local community affected by the transmission line ROW.

[4] Up to 20 x 20 meters per tower pad for 220 kV line

Connecting Nepal

Executive Summary

Inaccessibility has been a defining feature in Nepal's history and remains a significant challenge owing both to Nepal's specific topography and population distribution but also inefficient allocation of scarce resources across competing uses and poor implementation of projects.

Building Nepal's transport infrastructure is key for both economic growth and inclusion. There are proven links between greater connectivity and economic activity and enterprise surveys consistently identify transport bottlenecks as a major impediment to private sector operation and expansion. At the same time, greater connectivity allows the benefits of growth to be shared more evenly across geographic and socio-economic boundaries thus acting as a powerful integrating force.

The recommendations below aim to help the GoN to make better use of the resources it allocates to critical transportation infrastructure as well as, looking forward, to focus selectively on transformative interventions:

- **Improve transport connectivity**
  - Accelerate implementation of the Road Safety Action Plan
  - Manage Tribhuvan Int. Airport's role as a financial lynchpin in the aviation sector
- **Improve the efficiency of spending on transport infrastructure**
  - Prioritize maintenance of assets over new constructions
  - Strengthen the capacity of implementing agencies and eliminate 'mandate overlaps'
  - Establish a pinnacle institution to manage urban transport in the Kathmandu valley
  - Codify criteria for investment selection to help mitigate the high cost of playing politics with critical transport infrastructure
  - Approach PPPs as a vehicle for enhancing efficiency and sharing risks rather than a funding mechanism
- **Target transformative interventions**
  - Get the "fast track" project back on track
  - Develop pedestrian infrastructure and improve bus services in the Kathmandu valley

Context

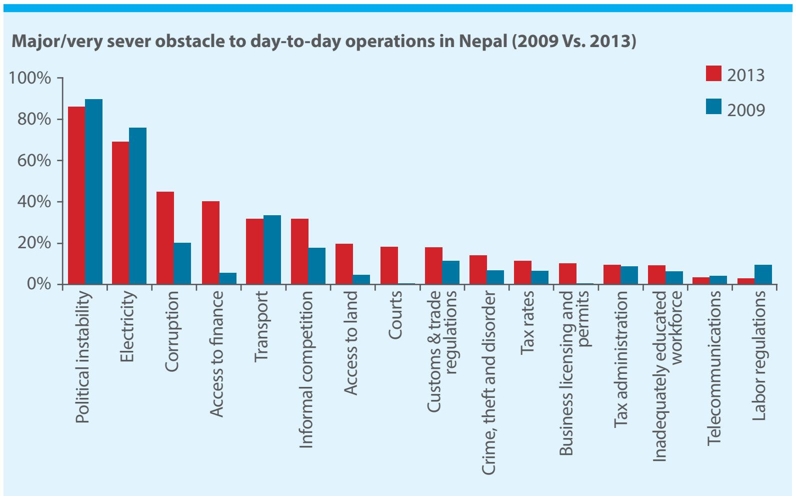
1. Inaccessibility has been a defining characteristic in Nepal's history. Geographic isolation, including within the country, accounts for its cultural diversity: there are 125 distinct caste/ethnic groups and 123 spoken languages according to the 2011 National Population and Housing Census, with less than half of households reporting Nepali as their mother tongue.[1] The notion of Nepal as an integrated nation is relatively recent and remains somewhat elusive as evidenced by the recent rise in 'identity politics.' In part, this reflects challenges relating to physical connectivity.

2. Nepal's topography and geology, combined with a predominantly rural and scattered population distribution, make transport connectivity inherently challenging. Respondents to the World Bank's 2010 Logistic Performance Index (LPI) found the quality of Nepal's road infrastructure particularly poor; some 80% ranked Nepal's roads as low or very low quality and 100% ranked the cost of road transport as high or very high.[2]

3. Improving connectivity throughout Nepal is a key consideration for both economic growth and inclusion. Transport connectivity is consistently identified by Nepalese firms as a key bottleneck to their activities (Figure 1). Moreover access to markets, social services, and assistance during emergency events directly depends on the quality of transport services and connectivity is therefore at the center of any inclusive growth strategy.

4. Many of the transport challenges facing Nepal - notably those related to urbanization - are new and unprecedented. Nepal is urbanizing at the fastest pace of any South Asian nation. Urban populations have grown at an average rate of 5% per annum against national population growth of only 2% per annum. Paralleling this increase has been an expansion of consumer finance that has facilitated access to private vehicles. Between 2001 and 2010 the annual number of new motorcycle registrations in the Kathmandu Valley increased by 2.3 times. Kathmandu's air quality has become particularly poor due to emissions from the transport sector.[3] This has increased disease burdens – especially in the city's more densely populated areas. As evidence of this impact, acute respiratory infection is now one of the top five diseases reported in Nepal.

FIGURE 1: Transport bottlenecks hinder private sector development



Source: Enterprise Survey for Nepal 2009 and 2013, World Bank

Key Challenges and Recommendations

5. The transport sector is of vital importance for Nepal, much beyond its impact on economic growth. Indeed, greater and better connectivity can accelerate the process of nation building, allow public services to be delivered more quickly and efficiently and avoid unnecessary loss of life to accidents and pollution-related diseases.

6. While closing the infrastructure gap would require a vast expansion of resources, much can be done to better leverage these resources. This would require (i) renewed attention to the quality and efficiency with

[1] Central Bureau of Statistics National Population and Housing Census. Available at: http://cbs.gov.np/wp-content/uploads/2012/11/National%20Report.pdf

[2] http://info.worldbank.org/etools/tradesurvey/mode2a.asp?countryID=85

[3] ICIMOD (2012) Rapid Urban Assessment of Air Quality for Kathmandu

BOX 1: The cost of transport in Nepal's energy sector[7]

All petroleum products in Nepal arrive via truck along the Strategic Road Network. The Nepal Oil Corporation (NOC) is the sole entity responsible for the import and distribution of petroleum products that consumers subsequently purchase from retail vendors at regulated (in some cases subsidized) prices. NOC purchases petroleum products from 6 refineries / depots across the border with India. In September of 2013 alone NOC distributed roughly 99 million liters of liquid fuels (about 3,000 tanker trucks worth) and 1.4 million cylinders of gas. Total direct transport and insurance costs that Nepal Oil Corporation incurred during this single month were approximately NPR 384 million (US$ 3.9 million). This was equivalent to approximately 37% of the overall selling losses of 1.04 billion (US$ 10.5 million) that NOC incurred on petroleum product sales during the month of September 2013. Nepal's Central Development Region consumes roughly 70% of NOC's petroleum imports and is the location for the proposed 'fast track' road linkage. NOC's largest fuel storage facilities (one at Kathmandu and the other at Amlekhgunj) are roughly at opposite ends of the proposed alignment for the 'Fast Track' project.

which resources are used in the sector and (ii) enhanced focus on critical interventions.

KEY CHALLENGE 1: IMPROVE TRANSPORT CONNECTIVITY TO BUILD AN INTEGRATED AND ECONOMICALLY PROSPEROUS NEPAL.

7. Transport connectivity is essential to nation and state building. A 2009 study on poverty and conflict in Nepal[4] noted that the intensity of conflict between 1996 and 2006 was less in districts with higher road densities. This observation may result from the role that physical connectivity plays in: (i) providing access to economic opportunity which reduces many of the underlying causes for conflict; and/or (ii) facilitating the government's efforts to provide security. The history of IDA's partnership with Nepal provides evidence for how improved transport connectivity can help to integrate Nepal as a nation. Perhaps the best example of this is the Third Highway Project (begun in the mid-1980s) that developed the Karnali bridge and effectively connected the Far Western region's economy to the rest of Nepal.

8. Transport access can increase agricultural incomes by linking producers to markets. A 2012 research paper illustrated how farms in hill districts that have closer proximity to Nepal's major North-South road linkages are more profitable.[5] A similar study observed that, between 1997 and 2002, the likelihood of escaping poverty for households in rural communities was 0.51% higher for every 10% reduction in their travel time to access public services.[6]

9. Improved transportation would lower costs for businesses and enable better delivery of public services. Improving Nepal's competitiveness depends on improving transportation services. The World Bank / International Finance Corporation 2014 Doing Business survey observes that the average cost of importing or exporting a 20ft shipping container from Kathmandu is about US$ 2,295. This is 28% higher than the average for all countries in South Asia. Roughly 61% of estimated export costs relate to inland transportation and handling which hints at the impact that transportation has on the cost structures of Nepal's private

4 Do, Quy-Toan (World Bank DECPI); Iyer, Lakshmi; "Geography, Poverty and Conflict in Nepal" Harvard Business School, 2009
5 Shrestha, Slesh A. "Access to the North-South Roads and Farm Profits in Rural Nepal" University of Michigan, 2012.
6 Dillon, Andrew; Sharma, Manohar; Zhang, Xiaobo; "Estimating the Impact of Access to Infrastructure and Extension Services in Rural Nepal," International Feed Policy Research Institute, 2011.
7 Nepal Oil Corporation monthly profit and loss details as of November 1, 2013 available at: http://www.nepaloil.com.np/main/?opt1=sellingprice&opt2=profitloss

BOX 2: Tansen Municipality and transport bottlenecks to effective solid waste management

Tansen municipality (Palpa District) constructed a new sanitary landfill to manage municipal solid waste. After construction completed, the landfill remained unused until very recently as the access road to the landfill site was in such poor condition that rubbish collection vehicles could not reach the landfill to offload. During this time the municipality deposited waste in an unprepared dumpsite in a nearby forest resulting in considerable environmental damage and potential risks to public health.

enterprises.[8] Similarly, transportation affects other critical basic services such as solid waste management (Box 2).

10. Poor road safety policies result in excessively high rates of accidents with large human and economic costs. Statistics from the Nepal Police Traffic Directorate estimate that there were approximately 13,582 road traffic accidents in Nepal during FY12/13 (Figure 2). These accidents resulted in 1,816 fatalities, 3.986 major injuries, and approximately 8,000 minor injuries. A 2007 estimate suggested that road traffic accidents cost Nepal between 0.4% and 0.8% of GDP annually.[9] The challenges posed by road safety are different for different regions of Nepal. While roughly half of all accidents occur in the Kathmandu Valley, these tend to be less severe than accidents in regions outside of Kathmandu. For example, in FY09/10 the rate of fatalities per 10,000 registered vehicles in regions outside Kathmandu ranged from 7 to 33 times higher than the rate of fatalities observed in the valley. One explanation for this disparity is mass-casualty events that arise from single bus accidents, where vehicles lose control and plummet from steep hill or mountain roads. Bus accidents along long-distance routes account for roughly 13% of all fatalities and 31% of serious injuries suffered as a result of road traffic accidents in Nepal. The UK's Department for International Development (DfID) and the World Bank are partnering to mitigate this risk by installing crash attenuation barriers at hazardous points along roads developed via the Road Sector Development Project. To make further headway the GoN should accelerate implementation of the Road Safety Action Plan (2013-2020). Within urban areas, two key interventions that could save many lives include: (i) requiring helmets for all motorcycle passengers; and (ii) improvements in pedestrian facilities and associated safety measures.

11. The aviation sector is central to the challenge of integrating Nepal, with TIA a strategic asset. A common misconception is that the primary market for aviation in Nepal is tourism. Actually, Nepal's air transport industry primarily serves domestic air travel, a large market for migrant labor, and a much smaller low-end tourist market. These markets are important for national integration and providing access to economic opportunity. The Nepal Trade and Logistics Facilitation Study estimates that about 60% of international passengers traveling through Tribhuvan International Airport (TIA) are migrant workers whereas only 2-3% of passengers are tourists. TIA provides a financial lynchpin for Nepal's overall aviation sector and represents a critical asset for the Government of Nepal (GoN). The 2011 / 12 civil aviation report suggests that TIA accounts for roughly 91% of the Civil Aviation Authority of Nepal's (CAAN) revenues while only accounting for about 42% of CAAN's operating and other costs. TIA looks to be generating something on the order of US$ 20 million / year in operating surplus that helps keep other airports in Nepal functioning.[10] Even with the operating surplus that TIA supplies, there is still a need for additional funding to support airport investment in Nepal. The Red Book for FY14 includes capital subsidies to CAAN to help in meeting this need. It is critically important for the GoN to manage TIA's role in the aviation sector carefully as forgoing the operating surplus it provides will require greater subsidies to keep other vital air linkages between Kathmandu and regional airports functioning.

8 2014 IFC doing business survey data for Nepal

9 "Cost of Road Traffic Accidents in Nepal"; GoN DoR Road Connectivity Sector I Project (ADB Grant 0051-NEP); N.D. Lea (Canada) - CEMAT- Soil Test- TMS JV: 2008.

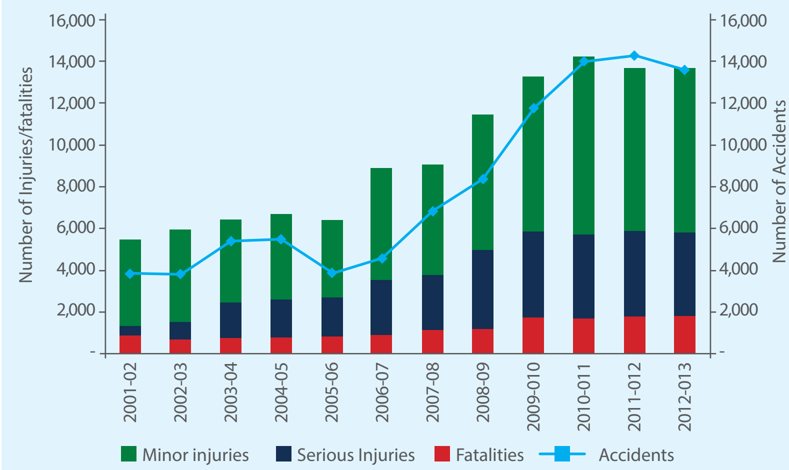
10 The CAAN Act (1996) allows this surplus to cross subsidize the operations, capex, and maintenance of other airports that CAAN manages throughout Nepal

KEY CHALLENGE 2: GETTING MORE MILEAGE OUT OF EACH RUPEE SPENT IN THE SECTOR

12. Because Nepal's needs are so big relative to available resources, the opportunity cost of inefficient or low priority interventions is enormous. Neither the GoN nor the development partners can fund the entirety of transport investments that Nepal will need to drive development. For example, the estimated cost of backlog maintenance and new bridge construction on the strategic roads network is roughly NPR 26.5 billion (US$ 275 million) against a FY 13/14 budget of NPR 3 billion (US$ 31.2 million) which includes funding from an IDA loan. Bridges represent a small subset of Nepal's transport sector and the overall gross investment needs for Nepal's entire transport sector are obviously much greater. World Bank analysis[11] suggests that Nepal would need to devote 2.3-3.5% of GDP per year (or 3.7-5.5 USD billion -2010) between 2011 and 2020 on transport alone to bridge the gap. In other words, investment needs are likely to outstrip available resources well into Nepal's future, which means that expenditures on lower impact projects carry a high cost to the overall transport sector's performance.

13. Systematic maintenance of transport assets is the single most important way to leverage scarce capital funding, but it is under-prioritized. The recent Nepal Road Sector Assessment Study has identified that maintenance continues to receive less priority throughout both government and donor supported transport programs. The importance of maintenance is clear from analysis that UK's Department for International Development (DfID) undertook to cost the impact of relative under-spending on road maintenance relative to new road development. The result suggests that, for an equal amount of expenditure, Nepal can develop more new roads by funding the entirety of maintenance needs before upgrading existing roads or

FIGURE 2: Road Traffic Accidents in Nepal



Source: Department of Transport Management, MoPIT

building new roads than it can by prioritizing new road construction alone. Maintenance is a relatively low cost way of prolonging asset lives and sustaining more road kilometers per rupee spent. In contrast, rebuilding roads more frequently due to neglected maintenance carries comparatively higher costs.[12] The GoN's most important challenge, therefore, is ensuring that maintenance work is actually implemented. Current monitoring mechanisms for maintenance grants stop at the level of expenditures, which is insufficient to ensure that maintenance funding actually achieves its intended purpose.

Recommendation:* *Prioritize maintenance of assets over new constructions and enhance monitoring mechanisms for maintenance grants.

14. The soundness of existing transport sector investments is undermined by weaknesses in implementing institutions, with significant waste linked to mismanagement and unclear and overlapping mandates. According to the World Bank's 2011 Roads Sector Public Expenditure Review, roughly 70% of spending in the transport sector occurs in the last trimester of each fiscal year. This fact evidences that the

[11] Infrastructure Gaps in South Asia, World Bank, June 2013
[12] DfID "Briefing Note: RTI-Maintenance Pilots" 2013

budgeting, planning, procurement, and contract management processes applied throughout the transport sector need to work more smoothly. The capacity of local government entities and the accountability framework that applies to their transport sector investment activities also require significant improvement. Roughly 30 paisa of every rupee that the GoN transferred to support local government-led transport sector investment triggered some form of audit observation from the Office of Auditor General. Throughout the transport sector, there are instances of overlapping institutional roles and mandates. Different implementing departments often encroach into each other's areas. For instance, the department responsible for strategic road network bridges (i.e. DOR) commonly takes up local road network bridges that fall under another department's mandate (i.e. DoLIDAR). Such overlaps weaken all institutions involved and diminish their accountability.

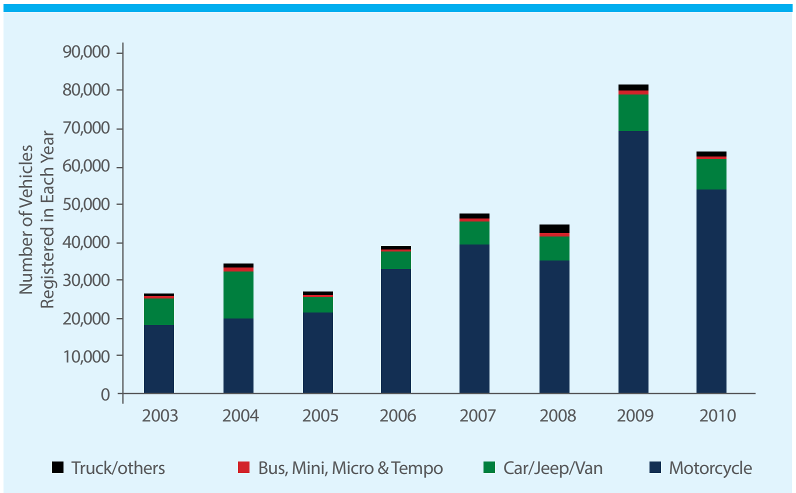
***Recommendation:* Strengthen the capacity of implementing agencies and eliminate mandate overlaps**

15. Better coordination is needed particularly to manage urban transport in the Kathmandu valley. Improving urban transport in Kathmandu is especially challenging as potential interventions must aim at complementary improvements in physical infrastructure, traffic management, regulations, and policies that fall under different ministries or departments. At present, four different line ministries and roughly 23 different departments, divisions, or local government bodies have jurisdiction over issues relating to urban transportation in the Kathmandu valley. Reducing this complexity will help make meaningful urban transport interventions less unwieldy. There is an acute need to improve urban transport in Kathmandu in response to rapidly increasing private vehicle ownership and use. The number of vehicles registered annually in the Kathmandu valley grew by an average rate of 14% each year between 2001 and 2010 (Figure 3). Improving the quality of public transport services in Kathmandu should be a priority in order to provide a viable alternative to growing private vehicle ownership and use.

***Recommendation:* Establishing a pinnacle institution with overall responsibility for managing urban transport in the Kathmandu valley.**

16. Currently, the impact of resources spent in the sector is undermined because funds are not allocated strategically. To get more from what Nepal spends on transport, greater prioritization is needed in project selection and focus in implementation. Focusing investment and –limited- institutional bandwidth on Nepal's highest priority transport investments is essential as there is no short term solution to satisfying the level of investment needed. Achieving greater prioritization and policy focus requires building systems to insulate decision making from political interference. Politics play heavily in Nepal's transport sector, especially with respect to new construction projects. This is particularly detrimental given Nepal's resource constraints and the severity of need for improved transport connectivity. Codifying the technical systems pertaining to investment selection is one method for channeling the influence that political actors may otherwise

FIGURE 3: Annual vehicle registrations in the Kathmandu Valley (2003-2010)



Source: Department of Transport Management data

[13] The World Bank "Nepal Public Expenditure Review – Roads," 2011.

have on the transport sector. The IDA-supported Bridges Improvement and Maintenance Program within DOR seeks to do this by introducing transparent technical criteria as the basis for selecting bridge investments. Box 3 below provides one example from the bridges sub-sector that illustrates why such measures are necessary. Pursuing similar technical measures for other transport sector programs should be a key priority for the GoN.

***Recommendation:* Codify criteria for investment selection to insulate the process from political interference**

17. PPP will not create new money for transport investment and, therefore, should be pursued selectively. While the GoN may wish to consider PPP as an implementation modality for achieving greater efficiencies, it is important to note that PPP will not create new money to fill funding gaps. Private developers may finance infrastructure investment in exchange for financial returns. However, the debt and equity instruments they use to do this will require repayment (with interest and returns on equity). The underlying cash flows that ultimately support private financing will need to come from one of three sources: (i) user charging such as tolls, fares, vehicle taxes, etc.; (ii) transfers from general tax revenues; or (iii) bilateral or multilateral grants from foreign institutions. In other words approaching PPP purely as a funding mechanism is unlikely to yield good results but rather it should be seen as an alternative approach to realizing efficiency gains.

***Recommendation:* Approach PPPs selectively as a way to realize efficiency gains not as a funding mechanism**

KEY CHALLENGE 3: THINK STRATEGICALLY AND TACKLE BIG ISSUES RATHER THAN DOING 'BUSINESS AS USUAL' TINKERING AT THE MARGINS

18. Get the "Fast Track" project on track, fast. There have been approximately four different feasibility studies for the Fast Track project (1974, 1993, 2003, and 2008). The most recent attempt at delivering the Fast Track project via a PPP modality has reached an impasse and pursuing an alternative approach is advisable. It is critically important to approach Fast Track with an appreciation for the scale and scope of this project. Estimated costs for Fast Track amount to roughly: (i) 7-8% of Nepal's 2012/13 GDP; (ii) 25% of the GoN's entire FY13/14 expenditure budget; (iii) 152% of the GoN's FY13/14 capital expenditure budget. Many of the engineering works required to build Fast Track are unprecedented for Nepal (e.g. complex tunneling). After construction, Fast Track will become a strategically important national infrastructure lifeline and will warrant a rigorous approach to asset management that is to date unprecedented in Nepal's roads sub-sector. It is unlikely that Nepal can achieve success on Fast Track via business as usual within the public sector or a simplistic approach that assumes a private developer can deliver the project without significant support from the public sector. Regardless of how the GoN elects to implement Fast Track, the three critical actions listed below are necessary.

BOX 3: The cost of political influence on critical transport infrastructure

> "[In the district of Lamjung the conflict between the three major political parties regarding the site of a new bridge over the Marsyangdi River] . . .became so intense that it reached the central level and, because of political pressure, the government was compelled to allocate resources for three bridges (one bridge for each party) within a distance of 4 km over the last two years. No bridge has been completed; nor is one expected to be completed for years as the government will not be able to allocate required resources to all three bridges... Had the political parties arrived at consensus, one bridge would have been completed by now, VDCs from the said constituency would have been directly linked with the district headquarters and the people from across the river would have benefited."

Source: Dwarika Nath Dhungel, Mahendra Raj Sapkota and Marit Haug with Pradyuman Prasad Regmi "Decentralization in Nepal: Laws and Practices" Norwegian Institute for Urban and Regional Research, 2011.– *Decentralization in Nepal: Laws and Practices (2011)*

BOX 4: Nepal's "Fast Track" - A transformative project

At present many cargo and large passenger transport vehicles make a 250 km detour to avoid the Tribhuvan Highway between Hetuada and Kathmandu which has steep gradients and unfavorable alignment for larger vehicles. The 2008 feasibility study for a 'fast track' alternative alignment estimated potential time savings of 4-5 hours and potential fuel savings on the order of NPR 3,000 (US$ 30) per one-way trip for a heavy truck. Preliminary economic analysis conducted in 2008 forecasted Economic Rates of Return in excess of 30% and a fuel savings of approximately 32 million liters of fuel during the first year of operations. Rough cost estimates suggest that building the fast track will require approximately US$ 1 billion. However, the benefits of Fast Track are potentially transformational for the Kathmandu Valley. The IDA-supported Third Highway Project in Nepal (Credit 1515-NEP, approved in FY85) that improved connectivity between Birgunj and Kathmandu provides evidence for the transformational impacts that Fast Track can provide. The economic rates of return observed for the Birgunj-Kathmandu road which was upgraded under this project were assessed at 30% against an original estimate of 18% due to greater than envisaged demand for connectivity with India.

Recommendation: To get the Fast Track project back on track, Nepal must do the following (i) stabilize the project environment to allow a steady focus on implementation; (ii) get the technical fundamentals of the project "right" to avoid further delays or increased costs; and (iii) get an updated and accurate view on cost and traffic to devise a strategy for funding the project.

19. Private vehicle use has expanded dramatically in Nepal's cities and needs to be effectively managed. There has been an extraordinary increase in the ownership and use of personal motorcycles. As of 2012 roughly 7 out of 10 households in the Kathmandu valley own at least one motorcycle. Between 1991 and 2012 the number of trips made by motorcycle increased by 5.8 times.[14] Increased motorization has dramatically affected the urban environment in the Kathmandu valley. The average concentration of course particulates (PM10)[15] in the Kathmandu valley's air between 2003 and 2006 was more than six times the World Health Organization's standard. Analysis from 2005 suggested that motorized vehicles were responsible for 62% of the course particulates in the valley's air. In 2007, the World Bank estimated that the annual economic cost of poor urban air quality was about US$21 million or 0.29% of Nepal's GDP at the time.[16] International examples show that Nepal can adopt a variety of measures to offset these impacts.

Recommendation: improve the quality of public transport services so that commuters have a viable option to private vehicle use.

20. Improve the Kathmandu valley's bus services to make large impacts on nearly 1 million trips per day. An estimated 28% of trips in the Kathmandu valley involve busses, tempos, or minibuses. Bus services are second only to walking as the most common mode of transport. Every day passengers make an estimated 985,000 trips via bus services in the Kathmandu Valley. Approximately 68,000 people pass through Ratnapark[17] bus station alone each day. The quality, safety, and level of service offered by bus transport in Kathmandu are typically poor.[18] As one example, Lonely Planet (a popular publisher of travel guides) calls Ranta Park bus station "a bit of a horror."[19] Investments to improve public transport facilities and bus services would have a far reaching impact for the Kathmandu valley's residents. Similarly, there are likely large improvements possible through less costly measures to improve regulation of quality, safety, and service level considerations.

21. Prioritize pedestrians over vehicles. Increased motorization and reliance on motorcycles is particularly relevant to pedestrian transport as these modes often compete for sidewalk space. Providing attractive

14 Japan International Cooperation Agency (JICA) "Data Collection on Improving Traffic Management in Kathmandu Valley" Final Report. October 2012

15 PM10 is particulate matter of measuring less than 10 microns (.01 millimeters) in diameter.

16 The World Bank "Strengthening Institutions and Management Systems for Improved Environmental Governance" Report No: 38984 – NP, 2008

17 also called "old bus park"

18 JICA 2012 op. cit.

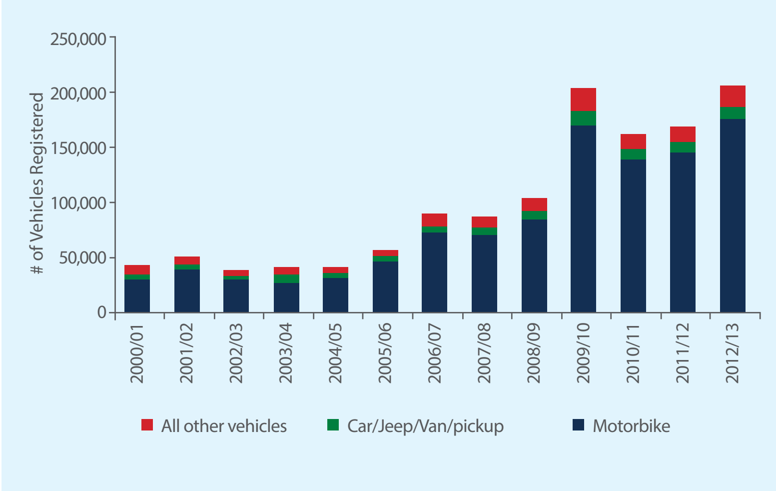
19 http://www.lonelyplanet.com/nepal/kathmandu/transport/getting-there-away

pedestrian infrastructure should be a policy priority as walking accounted for nearly 40% of all trips the Kathmandu valley in 2012 – more than any other mode. This is despite the fact that a 2011 survey by ADB identified Kathmandu as one of the least 'walkable' cities in Asia. Pedestrian safety is also an issue that requires urgent attention as pedestrians are among the most vulnerable to road traffic accidents in built up urban areas.

***Recommendation:* Improve bus services and pedestrian infrastructure in the Kathmandu valley.**

22. Systematically channel all development partner support to transport via Government systems to increase the value Nepal derives from development assistance. Many development partners have engaged in Nepal's transport but are circumventing Government systems that relate to technical implementation and fiduciary management. This leads to questions regarding the sustainability of any impacts achieved. In contrast, using and strengthening government systems is a key area of focus for IDA's transport sector operations in Nepal. Using Government systems is especially important for addressing institutional constraints within the Ministry of Physical Infrastructure and Transport (MoPIT) and the Ministry of Federal Affairs and Local Development (MoFALD). These line ministries manage the Strategic Roads Network and Local Roads Network respectively. Their combined budgets for FY13-14 contain planned expenditures of roughly NPR 27.3 billion (roughly US$ 207 million) sourced from development partners. This is roughly 24% of all funds from foreign development partners that the GoN has budgeted for FY13-14.[20] Efforts to build capacity within MoFALD and MoPIT will benefit from channeling greater portions of development partner support through their fiduciary, and technical systems. These systems remain imperfect. However, circumventing them will not add the strength that Nepal needs to achieve sustainable results.

FIGURE 4: Annual vehicle registrations in Nepal (FY00/01 to FY12/13)



Source: Department of Transport Management, MoPIT

[20] Ministry of Finance budget source book for FY13-14 (i.e. "white book")

Increasing the Sustainability, Coverage and Quality of Water and Sanitation Services

Executive Summary

Indicators of access to water and sanitation services are in line with regional averages but there are major issues with quality and sustainability. The quality of services is variable and, overall, tends to be deteriorating, especially in the Kathmandu Valley. In rural areas, where schemes are relatively simple, many schemes are not fully functional. In both urban and rural areas investment is needed but public policy has tended to overemphasize asset creation rather than long term asset management and service delivery. Private sector provision is anemic.

Sub-sector development planning could be improved. Whilst the Government can be congratulated in its planning and execution of a program to reduce open defecation across the country, its forward looking plans for the other subsectors remain to be improved.

This note flags the following issues that need particular attention:

- Uncertain sustainability of rural water supply schemes
- Missing emphasis on improving service delivery in urban areas
- Poor financial performance of service providers
- Poor governance/accountability of service providers
- Low environmental sustainability of schemes, primarily in urban areas
- Poor sector planning and implementation of existing strategies

Proposed reforms and actions include:

- Improve sector governance, particularly by improving the capture and reporting of sector performance, introducing greater accountability of service providers, and providing more incentives to deliver sustainable, efficient and quality services.
- Introduce greater competition into the sector – through partnering with the private sector and, in Kathmandu, considering the disaggregation of KUKL into smaller units which are more locally accountable and where different management teams can showcase different results.
- Develop more results-based financing instruments that would be open to any service provider or local government that met the eligibility criteria and delivered the expected results
- Pilot different, and sustainable, service delivery arrangements in all sub- sectors, whether rural, small town, large towns or Kathmandu.
- Create realistic sector plans for the next 10 years, which are supported by key stakeholders and provide the basis for on-going monitoring and project priorities.

Context

Access to water and sanitation services

1. On most dimensions of water and sanitation coverage, Nepal's performance is in line with South Asia. Compared to other countries in the region the figures show the following: (i) the country is the most rural in the region[1], (ii) Nepal ranks fourth in most aspects of water supply coverage, but variation between countries is modest, (iii) Nepal ranks fourth in most aspects of sanitation coverage, but there are significant variations between countries, and (iv) Nepal has high levels of open defecation (43.5%) and unimproved facilities (64.6%) compared to Sri Lanka and Bangladesh which both have <5% open defecation.

2. Like most countries in the region, Nepal has met the MDG target for water supply but remains off track for sanitation, nonetheless significant progress has been achieved. The JMP figures for urban water supply are somewhat contradictory showing both a decline in access to improved services whilst at the same time seeing an increase in access to piped services. The sanitation figures are encouraging with all statistics moving in the right direction. Access to improved sanitation is up, access to unimproved sanitation is down, and substantial reductions in open defecation have been achieved.

TABLE 1: Water Coverage – A Country Comparison in South Asia, 2011

Country	Population					Access to Water as % of Total Population					
	Urban		Rural		National	URBAN		RURAL		NATIONAL	
	x1000	%	x1000	%	x1000	Total Improved (%)	Piped on Premises (%)	Total Improved (%)	Piped on Premises (%)	Total Improved (%)	Piped on Premises (%)
Bangladesh	42,698	28	107,795	72	150,494	85.3	31.5	82.4	1.0	83.2	9.6
India	388,286	31	853,206	69	1,241,492	96.3	51.0	89.5	13.5	91.6	25.2
Nepal	5,176	17	25,309	83	30,486	91.2	48.6	86.8	13.5	87.6	19.5
Pakistan	63,967	36	112,778	64	176,745	95.7	57.7	89.0	23.5	91.4	35.9
Sri Lanka	3,175	15	17,871	85	21,045	98.8	66.7	91.5	22.9	92.6	29.5
Total	**503,302**	**31**	**1,116,960**	**69**	**1,620,262**	**95.0**	**50.0**	**89.0**	**13.0**	**91.0**	**25.0**

Source: Joint Monitoring Program (JMP) 2011

TABLE 2: Sanitation Coverage – A Country Comparison in South Asia, 2011

COUNTRY	URBAN			RURAL			NATIONAL		
	Total Improved (%)	Total Unimproved (%)	Open Defecation (%)	Total Improved (%)	Total Unimproved (%)	Open Defecation (%)	Total Improved (%)	Total Unimproved (%)	Open Defecation (%)
Bangladesh	55.3	44.7	1.5	54.5	45.5	4.8	54.7	45.3	3.9
India	59.7	40.3	13.1	23.9	76.1	66.2	35.1	64.9	49.6
Nepal	50.1	49.9	11.1	32.4	67.6	50.1	35.4	64.6	43.5
Pakistan	71.8	28.2	3.5	33.6	66.4	34.3	47.4	52.6	23.2
Sri Lanka	82.7	17.3	1.1	92.6	7.4	0.5	91.1	8.9	0.6
Total	**61.0**	**39.0**	**11.0**	**29.0**	**71.0**	**56.0**	**39.0**	**61.0**	**42.0**

Source: Joint Monitoring Program (JMP) 2011

[1] Although Sri Lanka shows slightly higher level the categorization of urban/rural varies and, on average, Nepal is likely to be more rural

TABLE 3: Nepal – Progress on Access To Water Services between 1990 to 2011

Year	Population					Access To Water as % of Total Population					
	Urban		Rural		National	URBAN		RURAL		NATIONAL	
	x1000	%	x1000	%	x1000	Total Improved (%)	Piped on Premises (%)	Total Improved (%)	Piped on Premises (%)	Total Improved (%)	Piped on Premises (%)
1990	1689	8.9	17391	91.1	19081	96.2	44.4	64.1	2.1	66.9	5.8
2011	5176	17.0	25309	83.0	30485	91.0	49.0	87.0	14.0	88.0	19.0

TABLE 4: Nepal – Progress on Access To Sanitation Services between 1990 to 2011

Year	URBAN			RURAL			NATIONAL		
	Total Improved (%)	Total Unimproved (%)	Open Defecation (%)	Total Improved (%)	Total Unimproved (%)	Open Defecation (%)	Total Improved (%)	Total Unimproved (%)	Open Defecation (%)
1990	36.3	63.7	30.7	3.8	96.2	88.9	6.7	93.3	83.7
2011	50.0	50.0	11.0	32.0	68.0	50.0	35.0	65.0	43.0

Service performance:

3. While Nepal performs reasonably well in terms of access, quality of service –while hard to gauge precisely- is low. Quality of service is not captured by the JMP figures and there are no publicly available data on service performance. With regards to water supply, any resident in the Kathmandu valley knows the quality of water service has deteriorated significantly over the last decade. More and more people rely on tanker supplies and other coping strategies, and water provided through the public service provider (KUKL) has become less frequent. This has happened in spite of the establishment KUKL as a corporate entity which was expected to perform in a more business like way.

4. Fast urban growth is putting a strain on sanitation services leading to unsightly, unhealthy and environmentally threatening pollution. This, coupled with the high levels of open defecation across the country, has prompted the government to set ambitious targets to achieve national ODF status by 2017.

5. In the rural areas existing water schemes are often not functional. The data available from the government monitoring systems (NMIP) for functionality of the 38,000 rural water schemes in the country shows that a high proportion are not fully functional. This was confirmed by a recent study that highlighted the lack of attention to post construction support to the communities which was further compounded by the existence of numerous actors in the sector with overlapping roles and responsibilities.

Financial performance:

6. Water User Committees have not managed to maintain local assets. The rural water supply policy (2004) requires communities to cover the cost of operations and maintenance of the schemes. These are typically very simple, gravity fed, schemes and the policy should be achievable. In practice the implementation of the policy requires active Water User Committees (WUC) that collect user fees and hold them in a bank account. The evidence indicates that practice is variable, and when funds are not collected, then breakdowns are not repaired and systems become non-functional. Therefore WUCs should be supported post construction so that they remain functional and, as a result, are likely to keep the schemes functional.

7. In urban settings the water utility operates below cost recovery and is poorly managed. In urban water supply tariffs are held low by political pressure. Weak commercial practices and lack of hard budget constraints mean that billing is inadequate, and even when bills are issued, the poor service results in low levels of payment. Although no statistics on levels of cost recovery are available it is unlikely that Nepal will be much different from the rest of the region where recovery of O&M cost from user fees is typically 50% or less. Well run service providers should collect 100% of O&M costs from user fees.

Institutional Arrangements:

8. In the rural sector the existence of many actors, both government and non-government, has led to overlapping and often conflicting roles and responsibilities. This is widely recognized but to date no action has been taken to simplify and streamline the sector. The lack of strong political leadership and the future uncertainties on centre/local power sharing has meant that to date there has been little appetite to address this issue.

9. In the urban sector there is a mix of institutional arrangements but none have demonstrated the ability to deliver good quality services. These institutional arrangements reflect different market segments which can be summarized broadly as a) small towns b) large towns and c) metropolitan.

Planning:

10. All sub sectors, perhaps with the exception of rural sanitation, suffer from weak planning. There appears to be a lack of a long term vision, consensus on how to achieve that vision in a methodical way, and even when there is a coherent approach, it can be sidelined by short term/reactive responses to an ever changing dynamic driven by poor service delivery.

11. The above issues all adversely impact Nepali citizens through a declining quality of service. This leads to high coping costs driven by time spent in collecting water, investment and operation of storage/treatment facilities, and costs associated with adverse health impacts from an intermittent water supply and/or poor sanitation. To give some insights into these costs the results from recent studies in India are summarized below.

Key Challenges and Recommendations

KEY CHALLENGE 1: BUILDING THE LONG TERM SUSTAINABILITY OF RURAL WATER SUPPLY SCHEMES

12. Improving the sustainability of existing assets is a priority. Investment needs in rural water supply schemes may sky-rocket in the near future**.** With some 38,000 community managed schemes, many more than 10 years old, there is the potential for a tidal wave of rebuilding as old schemes fail; likewise poor management / maintenance of newer schemes could create a second tidal wave. Whilst all schemes will need replacement in time, the critical issue is to maximize the effective life of these assets so that the full value of the investments made by government, communities and donors can be realized. Rebuilding schemes before the end of their life diverts scarce resources from other sectors. However, initiatives to improve the sustainability of schemes are few and un-coordinated.

Recommendation:

- ***Clarify the roles and responsibilities of the various actors in the sector to remove or minimize overlaps and put DDCs in the driving seat.*** This should put the DDC in the driving seat in terms of responsibility for ensuring the sustainable provision of rural water services in line with the Local Self Governance Act. There are many agencies/ actors that can help the DDC meets its responsibilities (DWSS, Dolidar, donors, NGOs) but these should support a plan driven by the DDC. Currently finances flow through the different actors. In the long term these should be consolidated and flow through the DDC.
- ***Support the DDCs to discharge their responsibilities***: through strengthening the functions at the District level and in particular by the creation of a DWASH unit within the DDC which will coordinate with other actors through the DWASH-CC.

- ***Improve M&E systems so that the DWASH units can monitor performance of the schemes, and the actors that develop those schemes, allowing them to plan better for the future.***
- ***Create an incentive financing framework that will encourage user committees to properly maintain the functionality of their schemes, and encourage development agencies to build schemes/establish user committees that are functional and sustainable.***
- ***Create networks across the user committees and providers of services at the District level so that user committees can help each other and access services when they need them, without having to work through local government agencies.***
- ***Create networks at the national level to help develop a way to build capacity, to capture and share good practices, and to create a community or federation of user committees who can meet and learn from each other.***

13. The starting point would be to identify a small number of Districts where this approach can be tested, and allow subsequent roll out to reflect capacities.

KEY CHALLENGE 2: ENCOURAGING A GREATER EMPHASIS ON SERVICE DELIVERY IN URBAN AREAS BY LINKING INVESTMENT TO SERVICE IMPROVEMENTS:

14. Water service providers remain insufficiently accountable for service delivery. One of the challenges in the water and sanitation sectors internationally is to use investment funds wisely given lack of accountability for, and incentives to, deliver good quality sustainable services. Within Nepal -and in Kathmandu in particular- the creation of more autonomous and more accountable ring fenced water service providers has been seen as a possible solution to this challenge. However, the lack of genuine autonomy and accountability has left this institutional model needing further enhancement to deliver on its promise. In particular the service providers have remained publicly managed, with limited external oversight, and few incentives to perform.

15. Three models have been seen as ways to address this challenge: (i) results based financing and/or output based financing (ii) introducing more players into the sector to spur competition, and (iii) using the private sector to leverage public sector capacity through contracts that provide strong performance incentives, create the autonomy and accountability required, and allow for innovation and creativity often stifled in the public sector. Some steps have been taken to test out improved institutional models in Nepal, particularly in the creation of ring fenced, and sometimes corporatized, entities to deliver water services. On their own, however, these reforms have been insufficient – primarily because they have not managed to introduce a changed dynamic into the sector.

Recommendation: **Establish approaches that encourage a greater emphasis on service delivery in urban areas by linking investment to service improvements**

- ***Develop an investment screening process that links proposed investments to specific deliverables in service improvement.*** This is a critical step in changing the mindset away from projects and asset creation, towards asset management and service delivery.
- ***Pilot the use of results based financing (through a national vertical program) for some elements of sector investments.*** Examples might include financing for energy efficiency, for NRW reduction, for connections to low income households, for wastewater treatment.
- ***Develop a simple, but robust, system to measure the quality of urban service delivery and to make the results available to the public in a timely manner.***

KEY CHALLENGE 3: IMPROVING FINANCIAL PERFORMANCE OF SERVICE PROVIDERS THROUGH BETTER COST RECOVERY FROM USER FEES.

16. World-wide, well-run water service providers are those able/allowed to recover at least their O&M costs from user fees. This is important as it allows the service provider sufficient funds to deliver reasonable services, maintains management discipline (services need to be such that customers are willing to pay for them) and avoids the otherwise inevitable downward spiral that results from inadequate funds - poor operations and maintenance, poorer service, poorer payment by customers, etc. When revenues are not directly tied to management and service quality, such as when public subsidies are sought, managers divert their attention to securing funds from above (government), rather than ensuring good service to their customers. Globally it is very rare that an "O&M cost recovering tariff" is unaffordable, even to the poor.

17. While raising tariffs may be difficult, there are other avenues for cost recovery. Whilst tariff levels may need to be adjusted there is also scope to (i) optimize costs - particularly leakage and energy efficiency, and (ii) improve commercial practices – better collection. This however would require making managers accountable for cost recovery performance.

Recommendation:* *Take steps to improve financial performance of service providers by recovering at least O&M costs from user fees.

- ***Ring fence the finances of the service provision arrangements at the municipal level (i.e. the larger towns only) and prepare financial statements and projections for the ring fenced entity.***
- ***Make government investment support conditional on moving towards O&M cost recovery over an agreed timeframe, with incentives for faster improvements and over achievements.***

KEY CHALLENGE 4: IMPROVING GOVERNANCE THROUGH BETTER ACCOUNTABILITY AND INCENTIVES FOR SERVICE PROVIDERS, PRIMARILY IN URBAN AREAS

18. Enhanced monitoring and reporting of service performance can improve sector governance. Sector governance is characterized by limited accountability to the public and few incentives to do better. Turning this situation around –absent a full-fledged crisis- is not easy. In many instances it is only a crisis that forces through the changes needed. Where there has been success in improving governance it has come from better monitoring and reporting of performance, creating a more "contractual" relationship between the service provider and the local governments, introducing competition, and leveraging the public sector through partnerships with the private sector. None of these have been tested yet in Nepal.

Recommendation:* *Take steps to improve urban water sector governance through better accountability and incentives for service providers which reflect the different urban characteristics

- **Institutional arrangements in small towns.** Different models for service deliver in small towns need to be tested. These towns present particular challenges in water service delivery. They are generally considered too large to follow the rural water supply model (with community participation in all stages of design/construction and O&M management responsibility thereafter) and too small for a "utility" model used in larger urban areas (they lack economies of scale and can't attract good staff). As a result there are a number of models that have developed internationally to service this segment. These comprise:
    - "Atomistic" – where each urban center is responsible for service delivery. To address lack of capacity these atomistic service providers receive technical and administrative back stopping from another entity and/or they contract out to the private sector or both.
    - "Aggregated" – where groups of urban centers join together to form a single entity for operational management purposes, even though they may not be physically connected. The resulting regional entity is overseen by the participating urban bodies and can provide service itself and/or by contracting with the private sector. Importantly the entity can capture the benefits from economies of scale and be attractive for better qualified staff. Such aggregation is facilitated under the Water Supply Management Board Act 2006 (2063).
    - "Scale through the market" – where large service providers contract with small municipalities to deliver service. These large providers achieve economy of scale, and attractiveness

to qualified staff, by servicing many tens or hundreds of small towns. This market derived model results from decades of mergers of small service providers and, as such, is not a model that can be simply created, for example as part of sector reforms.

- **Institutional arrangements in large towns.** These towns are already effectively serviced by the "scale through the market" model. In this case the National Water Supply Company (NWSC) is mandated to provide service in these towns. The proposed actions here would be threefold:
  - Develop a more transparent contract or MoU between the NWSC and the Municipal Councils. These would lay out the roles, responsibilities, payment and monitoring arrangements.
  - Support the NWSC to take on this role by building its operational capacity so that it can compete for service contracts in other segments such as the small towns
  - Facilitate the entry of the local private sector to deliver water services to the Municipal Councils, thus introducing an element of competition into the market.

- **Institutional arrangements in Kathmandu.** There is a need to further develop the KUKL model and introduce some new dynamics to create genuine pressures to improve performance. The proposed actions would be three fold:
  - To disaggregate KUKL into a number (2-3) of distribution companies (child KUKL) and a bulk supply company. This would break its monopoly position, create greater local accountability, and encourage competition (especially when complemented by a performance monitoring and reporting system).
  - To encourage the introduction of national or international private providers into the market. This could be for operation of one of the "child KUKL" companies noted above, or for some specific activities where the private partners bring specific technical knowhow – such as leakage management. The PPP contracting arrangement, by itself, brings in improved accountability, autonomy, and incentives, which are all key ingredients to good performance.
  - To introduce a ward by ward performance monitoring and public reporting system so as to highlight in a transparent manner the variability of service delivery across the city.
  - To have the KUKL enter into a formal contract with the KMC which clarifies the roles and responsibilities of each party, the expected service delivery improvements, the methods of financing KUKL (mix of user fees and grants from government), and the monitoring system.

KEY CHALLENGE 5: IMPROVING THE ENVIRONMENTAL SUSTAINABILITY OF SCHEMES, PRIMARILY IN URBAN AREAS, THROUGH REDUCING POLLUTION AND IMPROVING WATER USE EFFICIENCY

19. Achieving better environmental performance is largely a technical and financial issue. Financially, more investment is needed to capture and treat urban liquid wastes, which lead to visible pollution in the rivers in the Katmandu valley and elsewhere. Technically, the key issue relates to the use of on-site versus off-site systems although the increasing density of urban development points to the use of off-site systems, particularly in Kathmandu.

20. In relation to water efficiency, much of this is driven by the ability of service providers to address leakage management and demand management. In both cases the ability to do this is influenced by a) tariff policy and b) performance incentives.

Recommendation: Take steps to improve the environmental sustainability of schemes, primarily in urban areas, through reducing pollution and improving water use efficiency

- **Implement the main recommendations of the ADB masterplan.**
- **Encourage the use of the private sector to leverage the public sector in delivery of the Master Plan, for example through use of DBO or BOT approaches to wastewater treatment plan.** This approach brings opportunities to include all the recommendations given above in terms of output/performance based financing, incentives to perform, autonomy and accountability of the service provider (the PPP operator).

KEY CHALLENGE 6: IMPROVED SECTOR PLANNING AND EXECUTION:

21. With inadequate sector planning interventions tend to be piecemeal, and driven by donors or political influence, rather than an objective assessment of priorities and "road maps". The exception may be the issue of sanitation where there has been a concerted effort to move the country towards ODF status, driven by the country's poor performance revealed through the JMP reporting process. Sector fragmentation between different government agencies (DWSS, DOLIDAR, LGD), and the reliance on external funding, means that it has been difficult to create a vision and road map. There have been good initiatives that have brought stakeholders together but these have tended to be retrospective and disbursement focused rather than prospective.

Recommendation:

- ***Prepare national plans for each sub sector for the next 10 years.*** *The plans should be based on objective targets, realistic financing plans, and confirmed after extensive consultation with key stakeholders.*

- ***Establish a national monitoring and reporting procedure so that progress against the plan can be monitored on an annual basis.*** *Mid course corrections can be made in response to the results on the ground and the forward looking program adjusted accordingly.*

Towards a more Productive Commercialized and Diversified Agriculture

Executive Summary

Agriculture is the mainstay of the rural economy and a source of income for a majority of Nepali. It makes up over one-third of GDP while employing over two-thirds of the population. About 92 percent of the poverty reduction achieved over the last seven years took place in rural areas, and incomes in the rural areas are expected to continue to drive poverty reduction over the medium term due to the concentration of the poor in the countryside. Yet the sector remains characterized by low productivity, the use of traditional crops and methods and overly dependent on weather outcomes. Food insecurity remains prevalent.

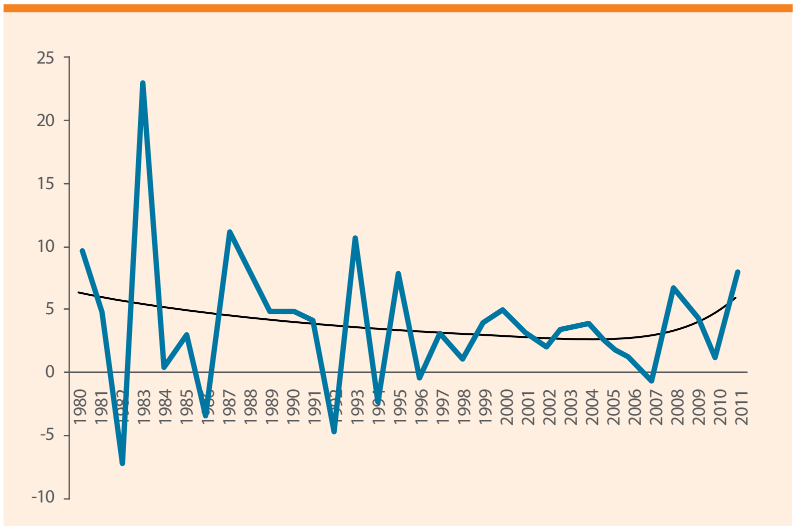
There is therefore a strong need to modernize agriculture through increased productivity, commercialization and diversification. To move towards a more productive, commercialized and diversified agriculture, Nepal should:

- **Boost agricultural productivity by:**
  - Focusing on irrigation infrastructure development and management improvements by WUAs
  - Levering technology spill-ins from India;
  - Rationalizing and streamlining input subsidies.
- **Promote agribusiness development by:**
  - Enhancing the role of the private/cooperative sector in input supply
  - Developing agricultural value chains and strengthening the Agribusiness Promotion Unit in MOAD.
- **Support crop diversification in remote areas by:**
  - Developing area-specific plans for technological upgrading in remote regions;
  - Identifying and supporting production of non-traditional crops for the Indian market.
- **Modernize land policy and administration by:**
  - Reviewing existing land laws and regulations and working-out a strategy for implementation / enforcement.
- **Enhance the government's strategic policy framework by:**
  - Developing a prioritized and budgeted Implementation Plan for the Agriculture Development Strategy (ADS).

Context

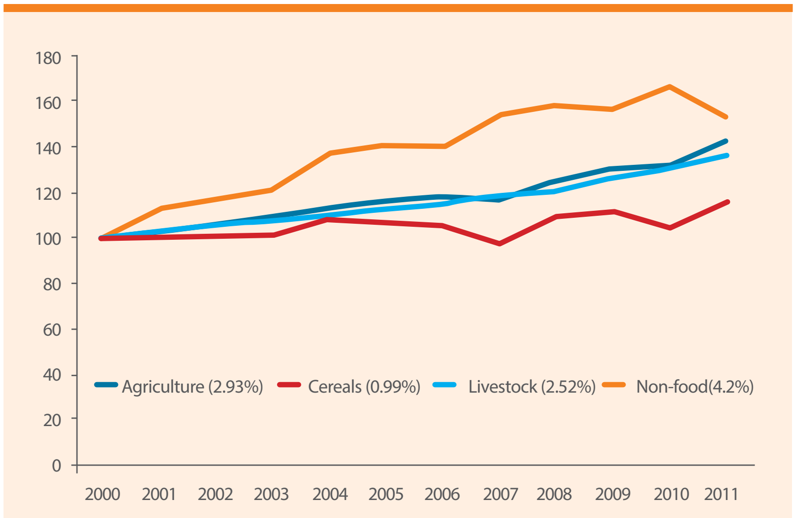
1. No significant additional reduction in poverty will happen in Nepal without improved agricultural productivity. This simple fact reflects the extent to which the livelihoods of a majority of Nepali still depend on agriculture. Between FY04 and FY11 some 92% of the spectacular decrease in poverty prevalence in Nepal occurred in rural areas. In turn much of this was attributable to rising farm incomes, which accounted for 34% of the income gains registered by the poorest 40% of Nepali. These gains, however, were reflective less of productivity gains than of the fact that agricultural income growth, of around 3 percent on average, registered fully as per-capita income growth given that the population dependent on agriculture remained constant, at 15 million, over the period.

FIGURE 1: **Annual agricultural production growth (1980-2011)**



Source: FAO

FIGURE 2: **Sub-sector production indices (2000=100, average growth rate in parentheses)**



Source: FAO data in Fuglie, Wang and Ball (2012).

2. Agricultural growth has been modest in recent history and Nepal has not experienced the type of productive boost that other South Asian countries managed to engineer. Agricultural growth averaged around 3 percent per year since the 1970s. It declined slightly in the early to mid-2000s but accelerated again after 2006 (Figure 1). While the post-2006 performance improvement is partly due to growth in total factor productivity, fluctuations in agricultural performance continue to be driven mostly by weather variations and flooding.

3. Under the surface of slow overall growth, the picture is markedly mixed: some agricultural subsectors have stagnated, but others have done well, especially non-traditional crops. Most of the output growth has been driven by non-food crops (Figure 2), with dairy processing, poultry, tea, vegetable seed and fisheries are among the best performers. By contrast cereals production and livestock have performed poorly. Growth in non-cereals production has been largely based on high-value products (horticulture, fruits, nuts, spices, etc.) in response to growing domestic demand (partly reflecting the impact of remittances) and rising exports to a booming market in India. The large size of the Indian market, together with Nepal's diverse agro-ecological endowments, reveals potential comparative advantages, which could be exploited further and more strategically.

4. Going forward, the low productivity of Nepal's agriculture could reflect a silver lining, pointing to significant potential gains. Nepal has the lowest agriculture productivity levels among all of its neighbors, for example with respect to cereal yields (Table 1). The low performance in cereals productivity reflects

TABLE 1: Performance Indicators of Nepal and neighboring countries

Country	Average GDP% over 1995-2010	Average Agricultural GDP% over 1995-2010	GDP/cap ($) in 2010	Arable Land/ capita (ha) in 2008	Cereal yield (kg per ha) in 2010	Ag GDP/arable land($/ ha)in 2008
Bangladesh	5.6	3.6	673	0.054	3890	1845
China	9.9	4.1	4393	0.082	5460	4467
India	7.2	2.8	1477	0.139	2471	1277
Pakistan	4.2	3.7	1007	0.122	2083	1586
Nepal	4.1	3.0	524	0.082	2374	1165

Source: Draft ADS, May 2013

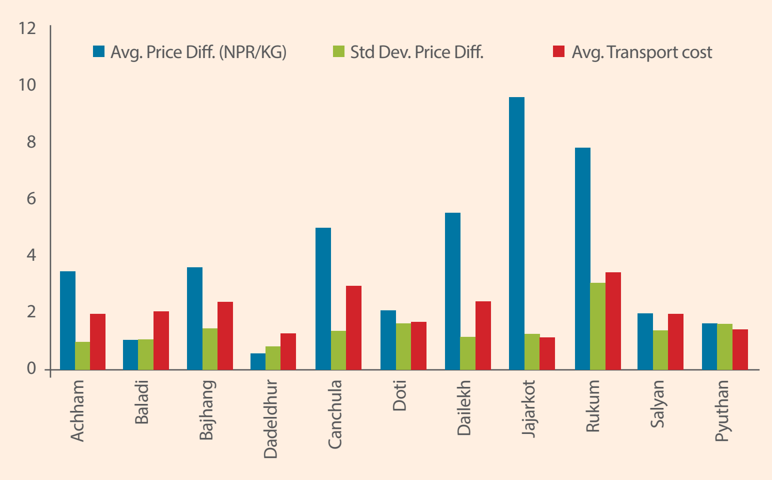
constraints relating to some basic services like technology, irrigation and extension, with consequent implications for sustaining poverty reduction and improving food security and nutrition.

5. Agricultural markets do not work as well as they could. Given Nepal's challenging terrain, poor access to markets provides significant challenge for farmers. However, in addition to transport costs, other market inefficiencies related to the functioning of markets, such as telecommunications and physical market infrastructure such as cold storage, play a key role as reflected in the high price differentials in rural markets vis-à-vis transport costs (Figure 3). Improving competitiveness thus requires both infrastructure investment and addressing the underlying causes of market inefficiency.

6. Agricultural production in Nepal remains characterized by smallholder and subsistence farming, and weak support services. The sector is characterized by limited use of improved livestock breeds, crop varieties or modern inputs and management practices, and production is often susceptible to pests and diseases. Shortcomings include: (i) lack of good quality seed and improved breeds of livestock; (ii) lack of cultivars better suited to the local situation; (iii) weak research-extension-farmer linkages; (iv) thin and inadequate extension support (with each support center covering approximately 9000 holdings, dispersed over difficult terrains); (v) low investment in productive assets, including supplementary irrigation infrastructure, to reduce rain-dependence; (vi) poorly developed market linkages; and (vii) lack of institutions and instruments for agricultural risk-bearing and risk-sharing. Budgetary and staff resources for public research and extension agencies are stretched and the gap in agricultural support services is filled only partially by non-governmental entities and community-based organizations.

7. Food insecurity remains a major challenge in Nepal's remote regions. According to the 2012 *Agriculture Atlas of Nepal*, food production in the Mid West and Far West regions barely meets more than six months' demand. Chronic energy

FIGURE 3: Price differentials and transport costs in Mid-West and Far West Nepal

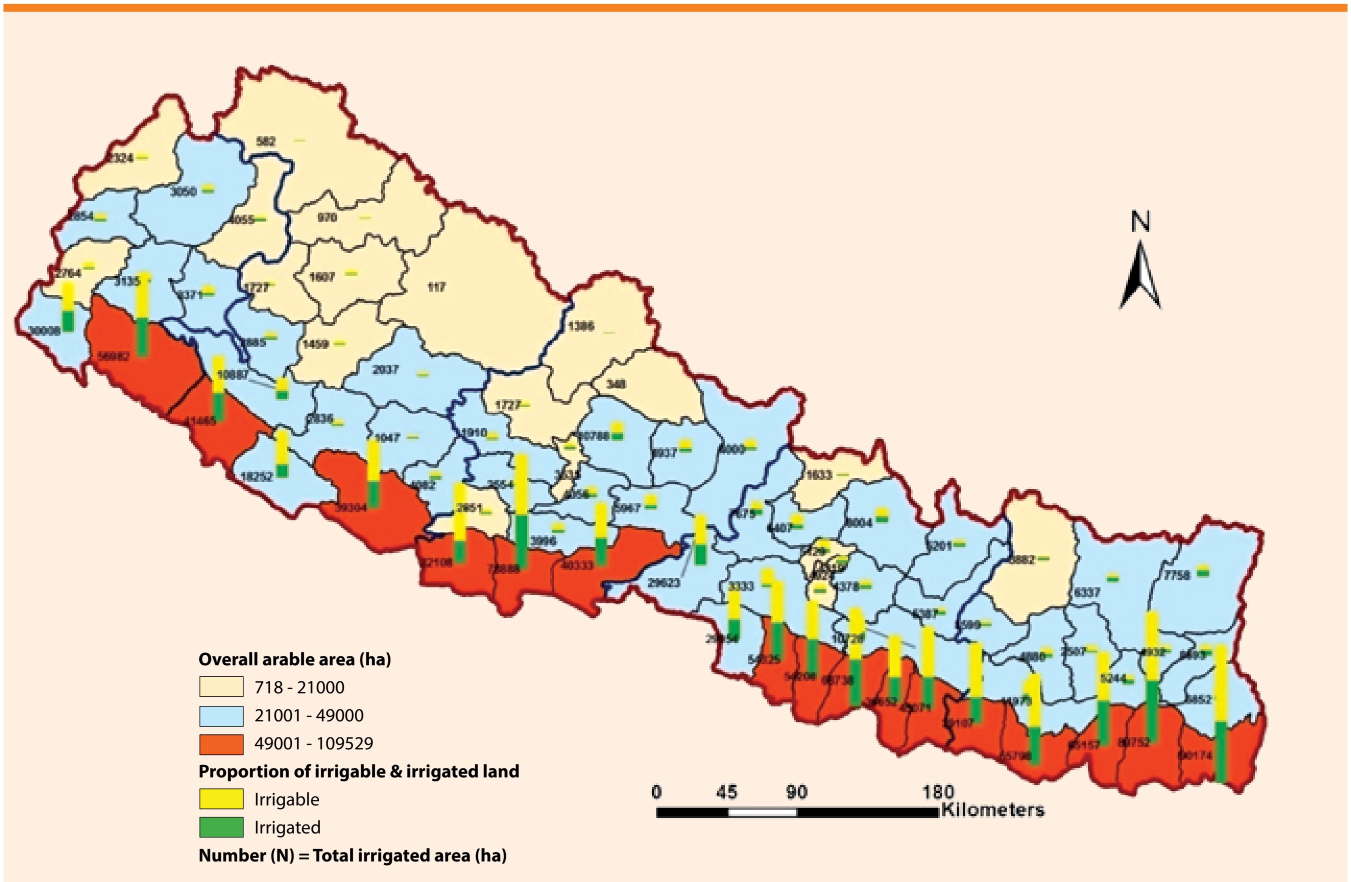


Source: Sanogo, 2008

deficiency in women (as measured in body mass index – BMI) remains high at 23.9 percent in the Far West and 19.3 percent in the Mid West. The prevalence of low-birth-weight babies is 14.1 percent in the Mid West and 14.9 percent in the Far West. In the Far West, nearly half the children under five (46.4 percent) are stunted and one-third (32.6 percent) are underweight. Similarly, in the Mid West, over half the children under five (50.3 percent) are stunted and over one-third (36.9 percent) are underweight. Wasting, which reflects more short-term under-nutrition, currently stands at 11.3 percent in the Mid West and 10.9 percent in the Far West. The consequences from wasting are significant and long-term, ranging from increased neonatal mortality and morbidity to irreversible adverse physical and cognitive outcomes that lead to unfavorable lifelong consequences for health, productivity and economic growth.

8. Paradoxically, Nepal's more remote regions –because of their unique topography- also offer great potential. Infrastructure gaps and challenges in the accessibility to Nepal's remote regions have prevented significant agricultural development in those parts of the country – where farming has remained primarily driven by subsistence. Continued food insecurity and lack of economic opportunities in Nepal's remote regions have triggered out-migration of youth in search of employment opportunities. In this context, the nascent growth in non-cereal exports is important as the poverty ridden districts of the Mid West and West are also the districts with significant potential for non-traditional and high-value crops, as are the mountain and higher elevation hilly areas of Nepal. Strategic investments in infrastructure, coupled with agricultural research and extension programs tailored to exploiting the agro-ecological potential of those regions and focused on commodities with higher value per unit of weight, could help overcome the geographical and transport disadvantages and trigger a transformation from subsistence farming to high-value, income generating, market oriented agriculture.

FIGURE 4: **Irrigation Development in Nepal, 2010-11**



Source: Agriculture Atlas of Nepal, 2012

9. The GoN has developed a comprehensive policy framework for agriculture development and food security. The Interim Constitution of Nepal 2007 recognizes food sovereignty as a fundamental right of each citizen. The importance of agricultural growth and food security has been underscored in a sequence of GoN documents and plans, including: the second Three Year Plan (2010/11-12/13), the National Agriculture Sector Development Priority plan (NASDP 2011-2015), and the associated Country Investment Plan (CIP). A Multi-Sectoral Nutrition Plan, led by the National Planning Commission, also aims to integrate contributions from the agriculture sector. With the support of various development partners, a number of projects aim to address many of the challenges listed above – albeit often at a limited scale. These project experiences have generated useful lessons about the viability of these interventions as well as the importance of involving beneficiaries groups to overcome challenges of capacity and outreach in the formal extension or technical support systems. A Draft Agricultural Development Strategy has been formulated to build on the lessons learned.

Key Challenges and Recommendations

KEY CHALLENGE 1: LOW AGRICULTURAL PRODUCTIVITY

10. Boosting total factor productivity in agriculture could make a significant contribution to overall GDP growth and poverty reduction. While boosting labor and land productivity has remained rather elusive in the past, much can be achieved by focusing on input improvements.

11. Water remains a key input and irrigation continues to be a major driver for Nepal's agricultural growth (Figure 4). Therefore, enhancing the irrigation infrastructure as well as pursuing more efficient irrigation management through better governance mechanisms in the sector, particularly through promotion and support of Water Users Associations, should be priorities in the government's agenda for agriculture.

Recommendation:* *Focus on irrigation infrastructure development through better analysis of investment alternatives to identify the most cost-effective infrastructure enhancements and pursue management improvements, especially via WUAs

12. Nepal needs to prioritize agricultural technology (R&D) in its public expenditure and capitalize on advances made in other countries in agricultural technologies. While boosting productivity is a huge agenda with multiple options, a good place to start would be to pursue "spill-ins" of improved agricultural technologies, especially for food grains. Specifically, Nepal could take advantage of the knowledge accumulated in India, where the national agricultural research system is now highly productive. This can be done quickly by building on existing cooperation agreements. For example, two-year work-plans currently facilitate active cooperation between the national agricultural research councils in India and Nepal. Wider agreements are also in place, such as the 2009 treaty of trade between both countries and the 2012 discussion on cooperation on safety and quality of import/export food products. These arrangements should be renegotiated and aggressively activated. In the short-term, the GoN should support identifying and accessing improved cultivars of crops and livestock and improved agricultural chemicals, especially from India but or from global agriculture research. MOAD should set up a taskforce, possibly led by NARC, to define the objectives and launch the process. At the same time, the necessary precautions with regard to biosafety and quarantine standards would need to be put in place to avoid bringing new pests and diseases. Getting the materials into the fields and stalls of farmers will require strengthened and more integrated linkages between research and extension (including through NGO services), and greater attention to more effective delivery of public extension services, as well as more active effort by private agribusiness operators.

Recommendation:* *Activate a taskforce to identify and acquire improved agricultural technologies from relevant sources such as a re-energized interaction with the CGIAR system and other national agricultural research systems, with strong attention to strengthening the research-extension linkages, and gaining useful "spill-ins" from India.

13. Additional gains could be reaped from revamping and refocusing agricultural subsidies. Current subsidies do not sufficiently address several key aspects, as outlined in the Draft ADS, including agricultural inputs (e.g., fertilizer). The key challenge is to (i) review the efficiency and limited success of the recent fertilizer subsidies program; and (ii) streamline the subsidy program and reallocate resources to research and extension. The 2011 fertilizer subsidy program was budgeted at only NPR 3.0 billion ($42 million) and is ineffective in providing materials of the appropriate type and volume. Meanwhile, research and extension services struggle to function on insufficient budget allocations. Additional resources will be required to permit Nepal's research and extension staff to travel to and engage with the Indian agricultural research systems, public and private.

Recommendation:* *Carry out a thorough review of the fertilizer subsidy program (including effectiveness) and redirect some of these resources to research and extension (including levering partnerships with India).

KEY CHALLENGE 2: INADEQUATE ACCESS TO MARKETS HAMPERING AGRIBUSINESS DEVELOPMENT

14. The private sector needs to play a more active role in agriculture but this requires coordinated public action to create a favorable environment. Accelerating private sector-led agricultural growth will require a package of targeted measures, and corresponding budgetary allocations. Key measures include: (i) bridging the infrastructure gaps (rural roads and electrification), (ii) providing farmers and processors better access to financial products and services, (iii) helping to establish a critical mass of (job-creating) agro entrepreneurs in rural areas and building their capacity to plan and conduct business, and (iv) supporting select commodity value-chain developments (including livestock and other high-value products). Several of these themes are being addressed in on-going GoN programs and others are canvassed in the Draft ADS, which need to be highlighted as priority.

15. In the short-term a key bottleneck is inadequate access to markets, both for inputs and outputs. On the input side, the private and cooperative sector must be encouraged to take over the commercial production of seeds and saplings. The government's role should focus on being a facilitator by providing quality control, policy and regulations, information, and monitoring and evaluation. Relevant experience in Nepal comes from the Seed Sector Support Project, funded by the UK Department for International Development (DfID), which helped organize and train Nepalese farmers in vegetable seed production. Such efforts have expanded the amount of vegetable seed for sale in Nepal and in several cases established Nepal as a seed exporter to neighboring countries. However, the model so far has had little success in establishing commercially viable small-scale seed production for crops such as rice, wheat, or maize. Nevertheless, efforts in this direction should be revitalized, especially through the strengthened agribusiness group in MOAD, which can focus on lessons from past endeavor to ensure that future interventions do not fall victim to the problems met in the past.

16. On the output side, much can and should be done to support the development of competitive agricultural value chains that increase value added and benefits to smallholder farmers and agro-enterprises. Many of the elements of potential interventions are listed in chapter 5 of the ADS, including strengthened associations of producers and processors, and prioritized value chains for dairy, lentil, tea and horticulture, but other crops should also be considered. In the short run, the Agribusiness Promotion unit of MOAD warrants further strengthening to take forward those innovative efforts.

Recommendation: ***Encourage private sector participation in seed production (and refocus the role of government on regulation and facilitation); adopt policies to develop competitive agricultural value chains (with strengthening of the agribusiness promotion unit at MOAD).***

KEY CHALLENGE 3: LOW CROP DIVERSITY AND VALUE

17. Nepal's challenging terrain is both a handicap and a potential source of comparative advantage. While hills are not well suited to large-scale cultivation of traditional crops they are favorable to non-traditional crops production. Infrastructure and connectivity requirements in these areas are formidable, which means that the economic viability of traditional high-volume and low-value crops will remain low. The key challenge is therefore to move toward lower-volume but higher-value crops. While households will understandably continue to address their own food security through local subsistence outputs, for income growth their focus needs to shift more to higher-value products including fruits, nuts, spices and herbs, as well as certain vegetables and livestock products (Figure 5).

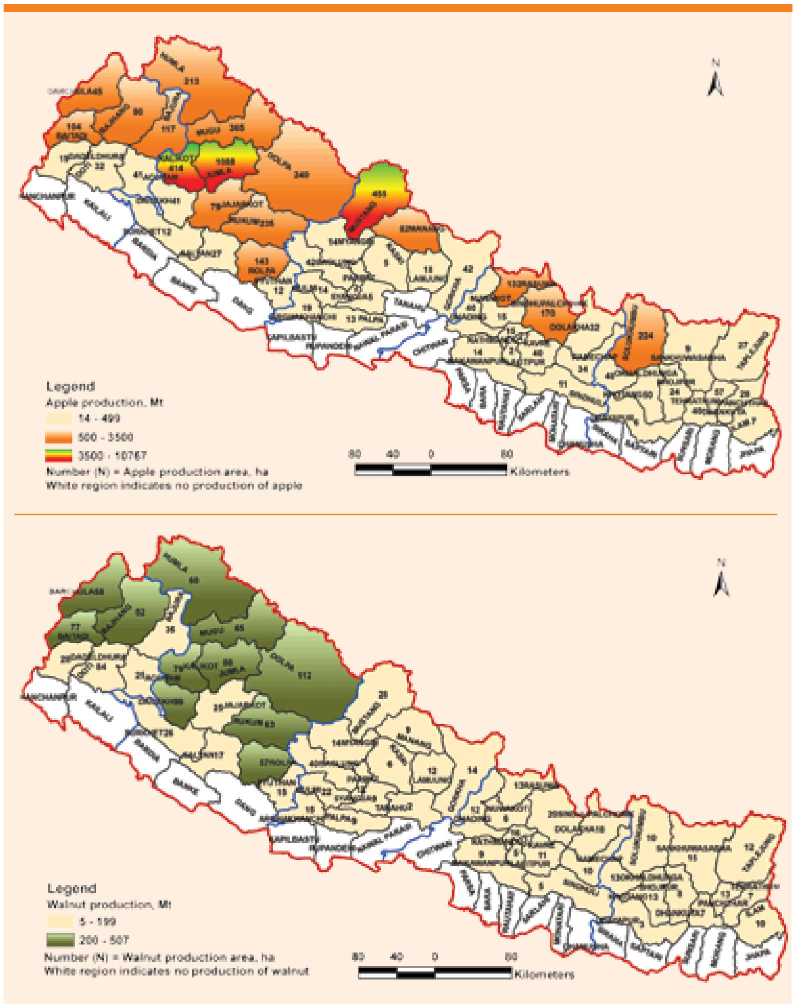
18. There is significant potential to gain from exporting to large and booming international markets where import demand for higher-value commodities for which Nepal can develop a comparative advantage is unmet. The Indian market provides a formidable and as yet largely untapped source of demand for high-value products. Nepal has comparative advantage for high-value commodities, including cardamom, ginger and turmeric, some of which will likely emerge as priorities under the value-chain development initiatives described above. The increase in total factor productivity for non-food agricultural production as shown above suggests that a strong focus on these commodities would have a strong positive effect on agriculture growth.

Recommendation: ***Focus on producing high-value agricultural products that meet the quality standards set by international demand, and which can be exported to external markets, especially the Indian.***

KEY CHALLENGE 4: LACK OF ENFORCEMENT OF LAND MANAGEMENT POLICY AND ADMINISTRATION

19. Poor and controversial land management has held back Nepal's agricultural development. Strengthening land policy analysis, land administration, land management and land-use planning are therefore critical. Other land issues such as tenancy, fragmentation, degradation, and sustainable land use need to be resolved as well. While progress in this area has been slow, a number of

FIGURE 5: Production area of Apple (top) and Walnut (bottom), 2010/11



Source: Agriculture Atlas of Nepal, 2012

TABLE 2: Targets for the strategic components of the ADS

Component	Indicator	Current Situation	Target
Governance	Agricultural Growth	3 % average annual growth	5% average annual growth
Productivity	land productivity	$ 1,804/ha	$ 4,787/ha
	Labour productivity	$794/agricultural labor	$ 1,833 /agricultural labor
Commercialization	Marketed surplus	Less than 50% of agricultural production	More than 80% of agricultural production
	Agribusiness GDP	10% of GDP	20% of GDP
Competitiveness	Agifood exports	$ 248 million	$ 2,000 million

positive regulations and laws (such as ceilings on individual land holding areas, which are of great significance in addressing the issues of fragmentation of farms into unviable areas) have been developed, passed and approved. However, enforcement of these regulations has been lacking, due largely it seems to lack of political will. Moreover, the rapid pace at which some of the most fertile land is converted to urban development is problematic, exacerbating as it does land access and tenure insecurity issues, so a coherent policy would be helpful. These prevalent shortcomings often have a detrimental effect on the most disadvantaged groups (women farmers, ethnic groups, landless etc.) and therefore on the inclusiveness of rural growth.

***Recommendation:* Effectively enforce the land reforms that have already been passed and implement regulations to manage in a considered economically rational manner the rapid conversion of the most fertile lands to urban space.**

KEY CHALLENGE 5: SHARPENING AND OPERATIONALIZING THE STRATEGIC FRAMEWORK

20. The development of a new Agricultural Development Strategy is a welcome first step. The Draft ADS, issued in June 2013, is comprehensive and ambitious (Table 2). The Ministry of Agriculture Development (MOAD) has launched a series of broad-based consultations with diverse stakeholders to determine the extent of which the draft ADS should be adopted and implemented.

21. Broad ownership of the ADS by different parts of government and agreement on a concrete implementation plan will be critical. The ADS will set the stage for agriculture and rural development for the next 5-10 years. However, the intended consultations with government and stakeholders in Nepal have not advanced to a satisfactory degree. These deliberations must be accelerated so that the authorities can come up with a GoN Plan of Action for the implementation of the agreed ADS.

***Recommendation:* Develop a realistic and budgeted implementation plan for the ADS.**

Improving Opportunities for All to Escape from Poverty

Executive Summary

Recent gains in extending access to key social services need to be consolidated and leveraged to ensure that they translate effectively into expanded opportunities for all. This will require additional focus on (i) bridging remaining supply gaps, (ii) targeting inequities in effective access to and uptake of services, and (iii) improving the overall quality of services delivered; especially education and health services that are the foundations of future 'opportunities' for children and youth. Today, several groups of individuals are systematically less able to access opportunities due to circumstances, including parental income, location of residence, education level of household head, gender, social/ethnic identity (such as caste and ethnic groups), religious identity and linguistic background. Moreover, even when they are provided and received, services are often of low quality such that the benefits of extending access are not fully leveraged.

For Nepal to successfully make poverty history, children and the youth need to be able to access the same set of opportunities regardless certain inherited starting points. The recommendations below aim to assist Nepal in improving the quality and equity of access to services:

- **Equity: Adopt explicit policies and programs to reach those groups structurally less able to access services:**
  - Continue planning and budgeting for the implementation of the Gender and Social Inclusion (GESI) Strategy in the health sector
  - Expand the coverage of poverty-targeted education scholarships, especially at the secondary and tertiary levels, while phasing out some of the categorically targeted scholarship programs

- **Quality: Focus on the quality of services provided, especially at the local level**
  - Adopt a strategy for regularly and systematically monitoring learning outcomes
  - Develop and implement a national early grade reading program
  - Improve incentives for accountable delivery of services at the local level

- **Financing: use available resources strategically**
  - Consolidate existing programs to subsidize access to basic health services and make them poverty targeted
  - Pilot the planned health financing scheme with space for learning and adjusting the design and limit the benefits initially

- **Management: emphasize hitherto neglected stewardship functions of MoH and develop PPP models for service delivery**
  - Establish a contracting/purchasing capacity at the MOPH.
  - Pilot performance-based contracting out of the management of remote health facilities, results-based financing of health facilities and continue and expand the pilot for contracting with public hospitals.

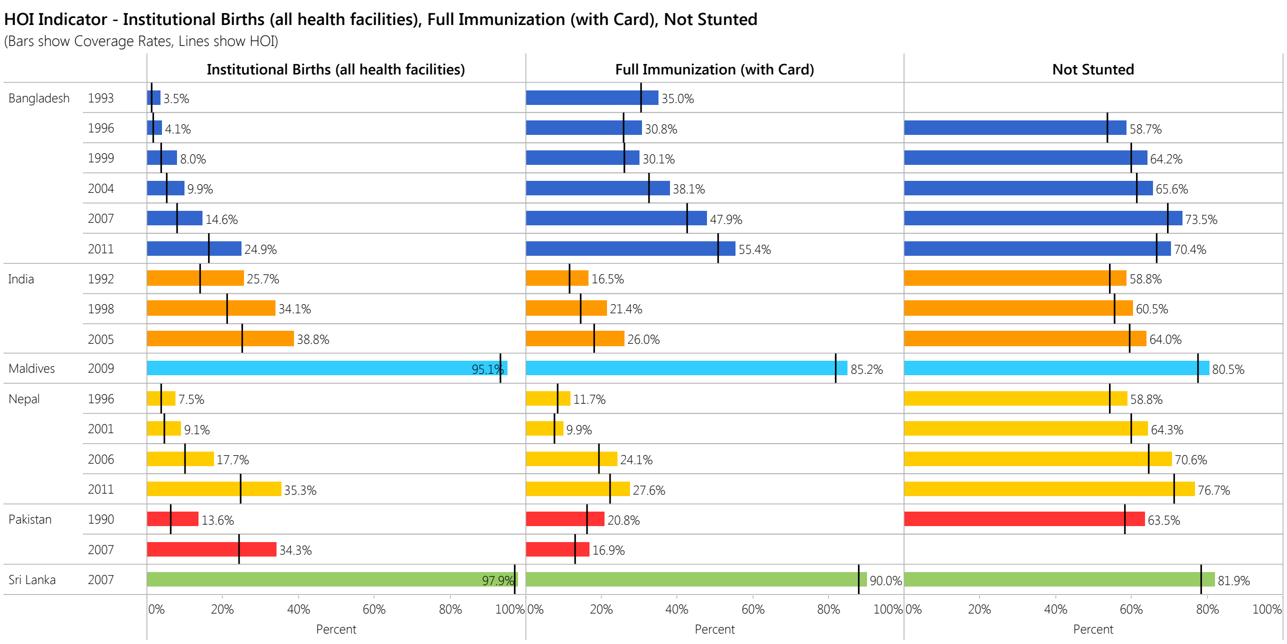
Context

1. Access to core human development opportunities is fundamental to (i) help children and youth to eventually move out of poverty, and (ii) strengthen the 'social contract' that is a foundation of any state building effort. It helps new entrants into the labor market to better manage and cope with shocks, build the ability to adapt to technological changes, create new ideas and secure meaningful employment. It provides young adults the ability to build healthy and educated families and to effectively engage in civic life. A key set of goods and services every individual under the age of 16 years should have access to include nutrition, health care, education, social support services and skills programs for employment opportunities. Access to these services, provided that they are effectively and equitably used and of improved quality, can result in improved labor outcomes and prosperity as well as lower overall inequality. The Government of Nepal has made great strides in expanding the supply of basic services. A second generation challenge is to ensure that uptake is effective and equitable and that the quality of services is such that initial investments are fully leveraged into outcomes and opportunities.

2. Opportunities matter for equality and social mobility. Equalizing opportunities is different from equalizing income: it involves "leveling the playing field" to make sure that all individuals are able to compete equally in the job market and have the same basic 'toolkit' to lead productive and healthy lives. It implies that one receives the same package of services (in equal access and quality) irrespective of circumstances. In turn, societies with greater equality of opportunity also tend to be less income-unequal and more socially mobile (i.e. a lower probability to see the children of the poor grow up as poor and remain so).

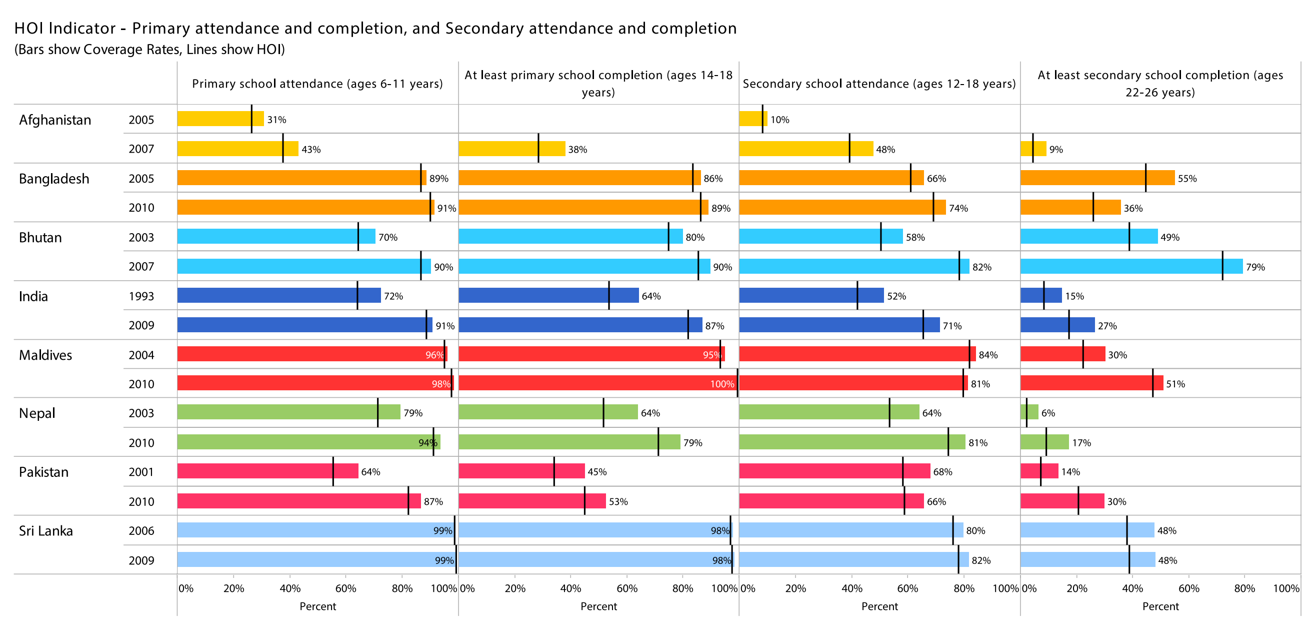
3. Basic opportunities in health and education remain unequally distributed in Nepal and significantly correlated with income, location and ethnicity. Several groups of individuals are systematically less able to access opportunities due to circumstances,

FIGURE 1: Nepal in international perspective: health and nutrition



Source: Household survey

FIGURE 2: Nepal in international perspective: education



Source: Household survey

including parental income, location of residence, education level of household head, gender, ethnicity, social/ethnic identity (such as caste and ethnic group), religious identity and linguistic background. In the case of the core opportunities in health and nutrition, children belonging to the poorest quintile are less likely to have experienced an institutional birth or to be fully immunized, and are more likely to be stunted. For instance, in Nepal, in 2011 approximately 11 percent of births in the poorest quintile were institutional births, while the corresponding number for the richest quintile was 78 percent. Similarly, there are stark differences in net attendance rates and educational outcomes across income quintiles, ethnic groups and geographical areas. In particular, the poorest quintiles have the lowest attendance rates, are located furthest away from schools, and have the largest percentage of out-of-school children. Furthermore, the disparity in access across income quintiles increases progressively at higher levels of education.

4. The ability to translate access to education into access to good jobs will be key to sustain poverty reduction in the future, especially given Nepal's demographic profile. But good jobs require quality education and skills, and Nepal has not been very successful to date in improving the quality and relevance of higher education and vocational training. Over 300,000 workers migrate abroad each year for employment purposes. But most Nepali workers, including those migrating abroad, are unskilled and more than 75 percent of the workers migrating abroad are engaged in low-skilled jobs. Therefore, to make future Nepali workers more competitive, internally and externally, additional focus needs to be put on cognitive and non-cognitive development and skills.

TABLE 1: Average annual real wage by education level for all employed workers (in 2003 Rupees)

Education completed	Wage in 2010 (NRs)	Wage in 2003 (NRs)
No education	12,839	8,520
Primary Level completed	24,528	17,651
Lower secondary completed	44,220	33,681
Secondary completed	67,841	58,981
Tertiary (bachelors and higher) completed	99,695	172, 436
Average for Nepal	29,282	24,776

Source: WB estimates using NLSS II and NLSS III data

Key Challenges and Recommendations

KEY CHALLENGE 1: INEQUALITY IN ACCESS TO HEALTH SERVICES AND POST-PRIMARY EDUCATION

5. Nepal needs to tackle the "second generation challenge" of leveraging improved coverage through equity and quality enhancing interventions. The main driver of change for opportunities to access health and education services and good nutrition in Nepal has been increased coverage rather than equity-enhancing programs. While this was important as a first step, Nepal now faces the next generation of challenge – to ensure that all sections of the population residing in all locations have not only access, but are able to fully utilize the services made available. Improving coverage also does not adequately discriminate between those that are relatively more or less likely to take up services offered. As a result, major inequities remain in health outcomes and service utilization across locations, income and ethnic groups. The rate of child malnutrition increases rapidly from richer to poorer income quintiles and from urban to rural areas. Disparities also persist along other geographic lines – for example, ethnic groups based in the Hills are less likely to be malnourished in comparision to the ethnic groups in the Terai. Utilization of pre-natal care is lower in rural areas (75.5%) compared to urban areas (93.2%).

TABLE 2: Skilled birth assistance across group characteristics

Characteristics	N (%) 5,391 (100%)	SBA use Multivariate model Odds ratio (95% confidence interval)
Place of residence		
Rural VDCs	4,771 (88.5)	1
Rural district HQ	117 (2.2)	5.56 (2.08-14.82)*
Urban	503 (9.3)	4.55 (1.84-11.26)*
Ecological zone		
Mountain	428 (7.9)	1
Hill	2,130 (39.5)	1.81 (1.09-3.02)*
Terai	2,833 (52.6)	2.27 (1.49-3.45)*
Age group (years)		
<20	381 (7.1)	1
20-34	4,383 (81.3)	0.45 (0.19-1.01)
≥35	628 (11.6)	0.27 (0.10-0.72)*
Education level		
No education	2,550 (47.3)	1
Primary	1,079 (20.0)	1.51 (0.19-1.01)
Secondary	1,468 (27.2)	2.25 (1.17-4.34)*
Higher	294 (5.5)	16.33 (1.30-204.66)*
Wealth quintile		
Lowest	1,390 (25.8)	1
Second	1,182 (21.9)	2.12 (1.44-3.11)*
Middle	1,133 (21.0)	1.88 (1.25-2.84)*
Fourth	938 (17.4)	2.80 (1.92-4.09)*
Highest	748 (13.9)	6.02 (1.39-26.04)*

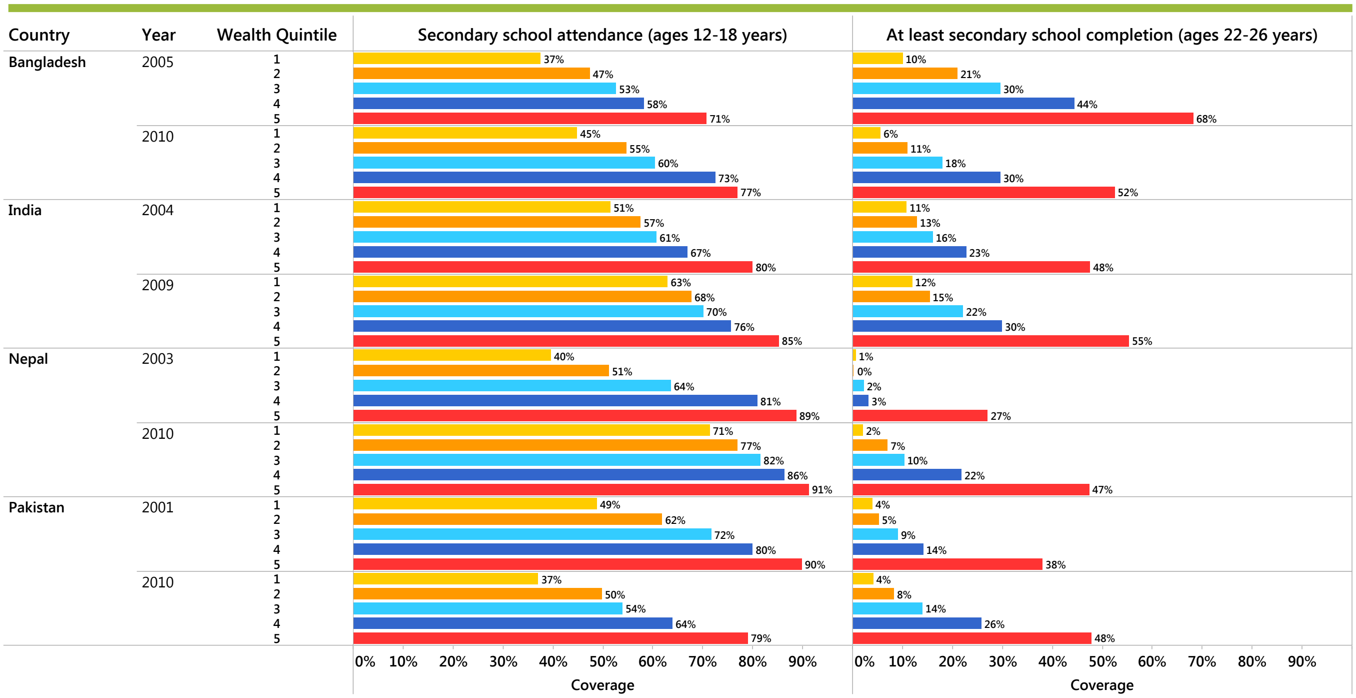
Source: WB estimates using NLSS II and NLSS III data

6. Going forward greater emphasis must be placed on targeting subsidies to the poor so that they can better utilize essential health services. For instance, the opportunity to access skilled birth assistance (SBA) is significantly influenced by circumstances that are beyond the control of pregnant women or their households (Table 2). Women in living rural headquarters are five times more likely to get skilled birth attendance as compared to women living in a rural village; women with secondary education are two times more likely to access that opportunity as compared to women with no education, and women in the Terai are two times more likely to benefit from such service than women in the mountain regions.

Recommendation: Continue planning and budgeting for the implementation for the Gender and Social Inclusion (GESI) Strategy in the health sector.

7. While Nepal has made substantial progress in enhancing access to primary schooling, it stills faces the challenge of improving access to education at the post-primary levels. The net enrollment rates (NERs) and net attendance rates (NARs) decrease progressively at higher levels of education: starting at 78% for primary schooling, the NAR drops to 42% for lower secondary education and continues falling steeply at the secondary, higher secondary and tertiary levels. Given other demands

FIGURE 3: Secondary school attendance and completion by wealth quintile



Source: World Bank (2013) from national surveys

on children's time and the relatively long commutes for rural students attending higher level education facilities, many poor families are unable to support their children' schooling beyond the lower secondary level (Figure 3).

8. Nepal has done well in increasing both the supply of and demand for basic education. The government's ongoing School Sector Reform Program (SSRP) as well as the preceding Education for All (EFA) Program have given high priority to enhancing access to primary and basic education (grades 1-8) through both supply side and demand side measures. For example, between 2004 and 2011, the total number of schools and teachers increased by 30% and 75%, respectively; most of the increase took place at the primary level. Demand side interventions have included annual enrollment campaigns at the beginning of each school year, the provision of free textbooks, formal abolition of school fees, and the provision of categorically targeted scholarships (for specific population groups including girls) at the basic level. Partly as a result of these interventions, the "bulge" of children entering secondary education has increased substantially.

9. However, the cost of education is substantially greater at higher levels, posing challenges to economically disadvantaged students. Recognizing the need to focus more on the poor, the government has recently started providing some poverty targeted scholarships at the secondary and tertiary levels using the proxy means testing (PMT) approach to select scholarship candidates. Nevertheless, most of the scholarship programs in Nepal continue to use a categorical targeting approach to select candidates, which results in funds being distributed to many households that are not in need of financial assistance. Hence there is a need to develop a strategy for expanding the coverage of poverty-targeted scholarships, especially at the secondary and tertiary levels, while phasing out some of the categorically targeted scholarship programs. In order to increase the effectiveness and accountability of such programs, it would also be relevant to make scholarship payments conditional on regular school attendance.

Recommendation: Develop a strategy for expanding the coverage of poverty-targeted scholarships, especially at the secondary and tertiary levels, while phasing out some of the categorically targeted scholarship programs.

KEY CHALLENGE 2: THE QUALITY OF EDUCATION AND HEALTH SERVICES IS LOW AND UNEQUALLY DISTRIBUTED

10. Nepal has done well in providing services that respond to the needs and expectations of the population but more can be done. In particular, because human development (HD) services are labor intensive, last mile service providers (primary school teachers, local public health workers) play an important role in determining the quality of HD services. Health, education and social protection services are often the first point of contact of the citizens with the government and its programs.

11. The poor quality of Nepal's public education is a key concern requiring a shift in policy focus toward better and more regular monitoring and evaluation. As a crucial prerequisite for improving education quality, Nepal needs to commit to improved measurement of learning outcomes. In general, education systems give priority to high-stakes school exit examinations instead of classroom and system-level assessment. Nepal has recently started conducting periodic national assessments of student achievements (NASA) for basic education (grades 1-8). It is now important to ensure that these assessments are conducted regularly and that their findings are utilized to improve quality. In the future, a policy priority should be to participate in international learning assessments (e.g. PISA, TIMSS).

Recommendation:* *Ensure that NASA is properly institutionalized and learning outcomes are monitored regularly and systematically, ideally using international quality assessment tools.

12. As reading is a foundational skill, that is a prerequisite for ensuring and enhancing the quality of student learning in all areas, the acquisition of independent reading skills and the development of reading habits by students must be placed at the center of education programs. While rigorous national level assessments of reading skills have yet to be performed, evidence from a number of small scale studies suggest that Nepali students at the primary level have unacceptably weak reading skills. Considering that "investing early is investing smartly", policy priority should be given to implementing a national program for early grade (grades 1-5) reading that also includes periodic national assessments of reading skills whose findings would be systematically used to revise and enhance the program over time.

13. The Ministry of Education (MoE) has recognized that early grade reading programs will need to be at the center of the education quality improvement agenda. The MoE has recently prepared a preliminary program document for a national early grade reading program (NEGRP) that is expected to be launched next fiscal year. As part of the preparatory activities for this program, a national early grade reading assessment (EGRA) is being conducted in collaboration with USAID. Similarly some baseline information on reading readiness will come from the NASA for grades 3 and 5, which includes some questions related to reading skills in Nepali and English. It will be important to feed the findings from EGRA and NASA into the early grade reading program strategy.

Recommendation:* *Feed the findings from EGRA and NASA for grades 3 and 5 into the early grade reading program under development.

14. Another major constraint to improved learning outcomes is loose teacher accountability reflecting weak systems. While accountability has many facets (e.g. empowering communities to play an enhanced role in school management, linking financing to performance measures), much also depends on the incentives teachers face in providing the best possible service. Patronage-based recruitments and deployment systems, the low quality of pre-service and in-service training, and weak career progression/path structures often lead to high rates of teacher absenteeism (15-20%) and poor quality instruction. Strong vested interests and political economy concerns make policy reforms challenging, but addressing these – e.g. through measures like recruitment based on qualifications and standardized testing, deployment based on clearly identified local needs, and clear policies on career development linked to measures of teacher performance, will be crucial if Nepal wants to move towards improving learning outcomes.

15. As far as health services are concerned, the quality of delivery is compromised, in the more remote areas, by shortages of qualified workers, the frequent absence of female health workers, language barriers, stock-outs of even essential drugs and a shortage of adequate and appropriate physical infrastructure (health facility buildings with water and electricity, equipment, etc.). Although the situation of VDCs closer to district headquarters has improved over the last few years, the more remote VDCs are still facing major challenges with regards to the quality of health services. In addition, there are also bottlenecks for the urban poor to receive quality health services. With very few public health facilities in Kathmandu, the urban poor only have a choice between expensive private health care provision and the use of unqualified providers, like pharmacies. Systematic monitoring of the quality of health service delivery, performance-based contracting out of the management of remote health facilities, results-based financing of health facilities and health programs are some of the initiatives that Nepal may want to consider in order to improve the management of its health services.

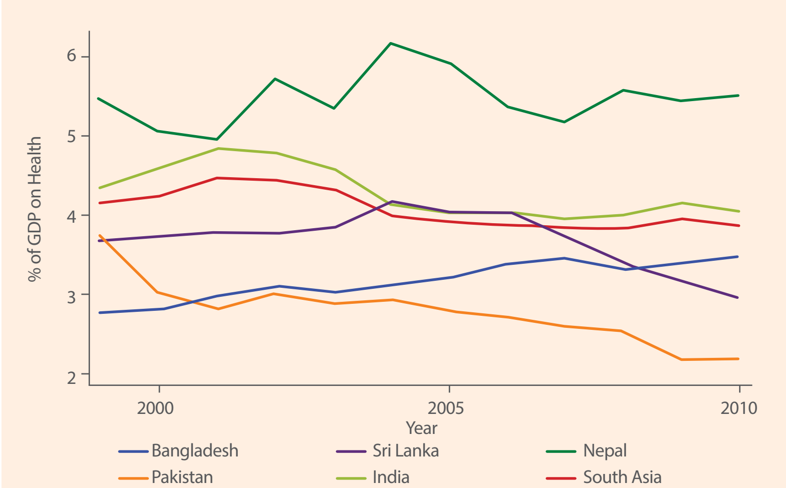
Recommendation:* *Improve and institutionalize the decentralized accountability of health and education delivery systems, including teacher attendance, availability of qualified health workers, and essential medical consumables.

KEY CHALLENGE 3: HIGH OUT-OF-POCKET EXPENDITURES ON HEALTH CARE COMPROMISE MOBILITY OUT OF POVERTY

16. Some programs exist to promote access to services for the poor but they are not targeted and their coverage is unknown. The most significant financial protection measure in the country is the free delivery of basic health services for all. However, the actual availability of this service, particularly to the poor, is far from perfect due to inadequate planning, management and implementation of the program. There are significant shortfalls in the procurement and supply chain management of pharmaceuticals and medical consumables by the central Ministry of Health and Population, resulting in the failure of timely availability of these free services to the population. There are also some programs focused especially on addressing financial and transportation barriers in accessing certain services like institutional deliveries, treatment of TB, HIV/AIDS, Kala Azar, cancer, uterine prolapse and heart diseases. However well-intentioned, these programs are fragmented and therefore administratively costly and –because they target broad categories of beneficiaries- relatively inefficient at helping the poor, who need greater support.

17. Moreover, in spite of these measures, households still pay high out-of-pocket (OOP) expenditures for health (Figure 4). Based on 2003 data, it was estimated that 6.7 per cent of Nepali households fell below the poverty line in a given year as a consequence of out-of-pocket expenditures on health. Data from the Nepal Living Standard Survey III show that the bulk of expenditures are incurred while being treated at either a public or a private facility and that most expenditure is incurred

FIGURE 4: Percentage budget allocation in health, 1999 to 2010



Source: World Bank (2013b)

on medicine (more than 60%), including in public facilities because of stock-outs. The burden of the out of pocket expenditures, as a percentage of total household consumption, falls disproportionally on the poorest, rural and hardest to reach households.

***Recommendation:* Consolidate existing programs to subsidize access to basic health services and make them poverty targeted.**

18. Currently there is limited scope to increase fiscal resources allocated to health. External assistance to Nepal is already one of the highest in the region and it is unlikely to increase significantly. The share of health in government spending is also relatively high as compared to other countries in the region – 7 -10%. Given this, negotiating a higher allocation for health would be difficult. An alternative option would be to earmark specific taxes (or a portion) where associated activities impact health directly (such as tobacco taxation) but these usually raise only a small proportion of the health budget. Likewise earmarking a fraction of payroll taxes as mandatory contributions to a social insurance scheme could be problematic given the limited size of the formal sector in Nepal and the risk of creating a two tier system that would marginalize the large section of the population that is engaged in the informal sector.

19. Instead the GoN should consider ways to use existing resources more efficiently. The Government should consider integrating the scattered demand side financing schemes under a single program and making that program poverty targeted to achieve efficiency gains and introduce a prepayment mechanism to help reduce OOP expenditures at the point of use of services. Different health programs (basic health care, institutional deliveries, TB treatment, HIV/AIDS management) would all be included under a health insurance program which targets to subsidize the poor, thereby reducing inefficiencies in the system and reducing OPP expenditures. The government has already planned the introduction of a national health insurance scheme and additional resources are required to finance the planned scheme but the resources are limited, as mentioned above.

20. The planned insurance pilot is a critical intervention from which lessons should be drawn before it is brought to scale. It is critical to learn from implementation and provide space to adjust the design of the insurance pilot under consideration. From fiscal perspective, it is advisable to put a cap on the benefits that households can claim per given year under the insurance scheme and to expand the benefits gradually, over time, in proportion to available resources. Indeed it is also much easier politically to expand a program gradually from a small benefit base then to cutting down the benefit package because of resource constraints. In order to move ahead quickly and cautiously, it is suggested that the benefit package, for the moment, should only be defined in monetary terms and with reference to broad areas of service (e.g. in-patient, drugs) as opposed to specific eligible services. Such an approach would allow households to choose which expenses they wish to get reimbursed while at the same time realizing that there is a limit to the total amount that can be claimed.

***Recommendation:* Use existing resources to promote uptake of health services more strategically by**

- ***Consolidating existing demand side financing schemes under a single poverty targeted program***
- ***Piloting the planned health financing scheme with space for learning and adjusting the design.***

KEY CHALLENGE 4: THE ROLE OF THE PUBLIC SECTOR HAS FOCUSED ON SERVICE DELIVERY AT THE EXPENSE OF THE STEWARDSHIP FUNCTIONS.

21. Stewardship functions have been neglected and need to be strengthened. In Nepal the prevailing view, which is a reflection of its history, is that the state should finance and deliver health for all. Reflecting this mandate the government has been designed to own, operate and manage health services. This is a departure from what is now being recommended globally and implemented in countries which have more efficient systems. As a result the Ministry of Health and Population views its role as primarily to deliver services with comparatively much weaker emphasis on stewardship functions in the health sector. Accordingly these functions –policy formulation, quality assurance, standard setting, accreditation, regulatory frameworks and systems, M&E, surveillance, research, economic analyses, information sharing, and financing mechanisms -- are weak if not absent altogether. By contrast the Ministry should focus on stewardship role (including making policy) and develop mechanisms to "purchase" services from providers, both public and private sector.

***Recommendation:* Establish a contracting/ purchasing capacity at the MOHP**

22. Purchasing will improve the level of accountability of service providers. By separating the financing and provision of health services, strategic purchasing has shown to improve accountability of service providers. Moreover, purchasing can channel the innovation, drive and energy of the private sector for the attainment of national objectives. The private sector could play a much greater role in service delivery. Given the limited availability of quality public services, non-state actors have taken on increasingly large roles to provide these services, though the regulatory and financing systems for these public-private partnerships need to be augmented. More importantly, because of the pre-occupation with service delivery by the public sector, the potential of non-state actors to increase access to critical opportunities and services has not been sufficiently explored and taken advantage of.

***Recommendation:* Pilot performance-based contracting out of the management of remote health facilities, results-based financing of health facilities and continue and expand the pilot for contracting with public hospitals**

KEY CHALLENGE 5: ACCESS TO MORE AND BETTER JOBS IS CRITICAL FOR NEPAL TO TAKE ADVANTAGE OF THE DEMOGRAPHIC TRANSITION AND ASSIST HOUSEHOLDS MOVE OUT OF POVERTY

23. Skills are key to employability but the GoN has not focused enough on this important agenda. With a young population, every year large numbers of young people are now finishing school and looking for jobs in addition to those who have not had the opportunity to complete schooling. If these large numbers of young labor market entrants do not have the human capital and employment opportunities to find productive and fulfilling livelihoods, the demographic dividend will instead generate political and social pressures. The youth bulge and low generic as well as limited advanced skills levels (including the underlying persistent challenge of malnutrition) contribute to people unable to transition into the type of jobs which could lift them out of poverty. Building on the strong results in health and education, especially on female education, improving the delivery and reach of social services will require much sharper and focused attention on the vulnerable populations, especially Dalits, Janjatis and women. A healthy and skilled labor force will enhance Nepal's efforts to develop industry, promote local and foreign investments and compete for more skilled jobs in the regional and international markets.

24. Currently, a significant portion of the Nepali workforce can be characterized as migrants—either internal or international. There are nearly 2 million Nepalis working in India, the Middle East, East Asia and other destination countries. In 2011, remittances were to the tune of $4.2 billion and contributed 22% to the country's GDP. Yet, nearly two-thirds of out-migrants are semi-skilled or low-skilled workers. The share of professional and technical workers among migrants is low and has grown slowly. Hence, the earning levels of migrant workers are severely constrained by their skill sets. At the same time, household members of migrant workers and migrant returnees often do not have the capacity and financial management skills to productively invest the earnings sent home by migrants, thereby limiting the positive impacts of remittance incomes.

Recommendations: Develop a program for skills development with employment focus and fostering partnership between the public and private sector, while giving special attention to skill demand in the informal sector and among migrants and their households.

25. Programs targeted at promoting employability ought to be developed and piloted. The Enhanced Vocational Education and Training Project (EVENT) aims at expanding the supply of skilled and employable labor by increasing access to quality training programs (both short-term and medium-term), providing opportunities to informally trained workers for the recognition of prior learning, and strengthening the TEVT system in Nepal. However, given the importance of the skills development agenda for Nepal's economy and the fact that the bulk of the poor and migrant workers are more likely to be able to access informal and short-term skills training, the GoN should leverage external support and expertise to develop a program for skills development with employment focus and fostering partnership between the public and private sector, while giving special attention to skill demand in the informal and migration sectors. As workers in the informal economy are largely self-employed, the program should put special emphasis on linking trained workers to finance and helping them to start their own businesses. It should also support the development of soft skills, basic literacy and numeracy, and financial literacy among both workers and their families. The program would benefit from the lessons and findings from several planned and ongoing evaluations and analytical work in the area of skills and employability.

Recommendation: Explore the feasibility of skills development initiative focusing on entrepreneurship.

Toward a Streamlined, Efficient and Poverty-Focused Social Protection System

Executive Summary

A more efficient and poverty-focused Social Protection (SP) program can help Nepal to make extreme poverty history and prevent people from falling back into poverty. SP spending in Nepal has substantially increased in recent years from around one percent of GDP in 2004/05 to over three percent today in 2013/14. A number of new schemes across various ministries have been launched during this period, although the bulk of the increased spending has been driven by the expansion of the largest existing programs such as the civil service pensions and cash allowances for various categories of the population. Despite this increase, SP programs have only a limited impact on reducing poverty and inequality.

Nepal's SP system is fragmented and poorly coordinated—delivered by a range of line ministries and agencies. Targeting is generally by category (age, ethnicity, etc.) of recipients and the system lacks the necessary administrative setup to support proactive monitoring and informed policy-making. As a consequence its effect in reducing poverty and protecting the vulnerable is quite limited.

The recommendations below aim to assist Nepal to develop a more effective SP system that can better leverage resources to help the poorest without jeopardizing fiscal sustainability:

■ **Enhance poverty impact of SP programs while maintaining fiscal sustainability**

- Limit further proliferation of SP programs to avoid increasing the overall fiscal cost and prevent worsening of the coordination problems;
- Invest in systematic empirical diagnostic to identify gaps in coverage in the current SP program mix and draw on relevant international and domestic experiences so that the poverty impact of the SP program(s) could be enhanced.

■ **Strengthen SP delivery systems**

- Continue refining the MIS developed by the Ministry of Federal Affairs and Local Development (MOFALD) with a view to extending its application to other MOFALD programs and as a basis for an eventual unified beneficiary data management system across ministries;
- Accelerate the development of the national ID system;
- Complete the ongoing branchless banking payment pilots, draw lessons from the process evaluation and other inputs, and roll it out to other programs and eventually to other ministries and strengthen the grievance redress system;
- Craft and implement a medium-term MOFALD institutional strengthening plan based on thorough organizational diagnostic and internal consultations

Context

1. SP programs are important in reducing deep deprivations for the extreme poor and in mitigating risks for vulnerable parts of the population to fall into poverty. Evidence from the World Bank's Atlas of Social Protection Indicators of Resilience and Equity (ASPIRE) shows that each year safety nets in developing countries help maintain 50.3 million people above the international line for extreme poverty of US$1.25/day. Safety nets have also helped lower inequality by providing income security to the poorest. Effective social protection also allows the poor to prepare for the future, either by investing in human capital development of their own or of their children or by supporting them in upgrading their skills and accessing available jobs. In short, a good SP policy is both a poverty-reduction policy and a pro-growth policy.

2. Nepal has made dramatic progress in reducing poverty. It attained the first Millennium Development Goal (MDG) to halve extreme poverty ahead of time. The percentage of people living on less than US$1.25 per day fell from 53.1% to 24.8% of the population in just seven years from 2003/2004 to 2010/2011.[1] The decline in poverty was accompanied by a decline in inequality; the Gini coefficient dropped from 0.41 to 0.35 over the same period. With the right policy choices—including the ones outlined in this note— Nepal could make extreme poverty history and prevent people from falling back into poverty.

3. Poverty varies widely across geographic location, ethnicity, caste and gender. It is more severe in rural areas (27%) than urban areas (16%) and particularly severe in mountainous areas (42%). The Far-Western and Mid-Western regions have much higher poverty rates (32% and 46%, respectively) than the Eastern, Central, and Western regions (at less than 23%). In addition, many Nepali households are vulnerable to natural and economic shocks. According to the Nepal Safety Net Survey (NSNS) in 2008 more than 57% of rural households experienced shocks that had a negative effect on household welfare. Poorer households were more vulnerable than richer households: For example, 61% of households in the poorest quintile of wealth distribution faced one or more shocks compared to 45% of households in the richest quintile. Furthermore, many Nepali households remain food insecure.

4. Nepal's operates a diverse portfolio of SP programs.[2] The programs include contributory pensions and unemployment insurance schemes, non-contributory cash and in-kind transfers, and workfare programs. In addition the government provides subsidies on goods and services like agricultural inputs, energy, food, housing, health, education, utilities and transport, whose intents and effects are often similar to those of SP programs.

5. The Government of Nepal's commitment to SP programs has steadily increased in recent years as demonstrated by a large increase in social protection spending. Nepal's total SP expenditure was only around one percent of GDP until 2005/06. By 2011/12 SP expenditure reached nearly three percent of GDP. The increase was driven by the introduction of new programs, increases in benefit amounts and the relaxation of eligibility criteria.

6. Despite the increase in SP spending, its impact on poverty reduction has remained negligible. According to the Third Nepal Living Standard Survey (NLSS3), social insurance only covers 2% of the poorest 40% of the population.[3] While social assistance schemes cover over 41.5% of the poorest 40%, these programs have a significant level of leakage to the non-poor due to the reliance on categorical targeting which makes benefits available to particular segments of the population (e.g., elderly) irrespective of their income level.[4] More

[1] The percentage of people living on less than US$2.00 per day was 57.3% in 2010/11.

[2] SP programs include: (i) social assistance programs (e.g. cash and in-kind transfers); (ii) social insurance programs (e.g. contributory old age pensions or unemployment insurance); and (iii) labor market programs (e.g. skills-building programs).

[3] Social insurance in NLSS3 covers internal and external pensions and benefits from Employees Provident Fund.

[4] Social assistance in NLSS3 includes cash transfers (old age, widow, endangered ethnicity and disability allowance, maternity incentive scheme, martyr's family and peoples' movement victims) and scholarships.

than half (53.4%) of the beneficiaries of these programs belong to the top three quintiles including 25% of the richest quintile. Low coverage, small size of benefits and substantial leakages result in a low impact of SP programs on poverty and inequality. Evidence from NLSS3 shows the SP system's insignificant impact on poverty reduction and inequality. In the absence of cash transfers and scholarship schemes, the poverty headcount would increase only by 0.5 percentage points without any impact on the Gini index.

7. Moreover, no overarching framework has been in place to guide the recent expansion in SP spending. Categorical targeting (e.g. reaching participants based on certain demographic criteria such as age, ethnicity/caste, disability, etc. regardless of income and welfare status) of SP programs is a pragmatic choice when the government's capacity is limited to deploy a more sophisticated targeting strategy. But categorical targeting tends to be inefficient as a particular categorical identity and socioeconomic status are usually not perfectly correlated with each other. The SP programs' fragmentation across multiple schemes and multiple line ministries tends to worsen this inefficiency.

8. Fiscal sustainability is another important consideration in designing an SP policy framework. The recent surge in SP spending raises a concern about the current policy's fiscal sustainability. The recent rise in the spending level resulted from the government's one-off decisions to increase benefit levels and/or relax eligibility criteria of some of the existing programs while at the same time launching a number of new initiatives, apparently without coordination. If similar decisions were repeated in the future, the fiscal burden of the SP portfolio would begin to threaten the overall health of Nepal's public finances. On the other hand, Nepal's demographic dynamic means that so long as the government refrains from repeating such decisions in the future (i.e., the key parameters of the existing programs such as the eligibility criteria and the benefit level was kept unchanged), the fiscal weight (as a share of GDP) of the current mix of SP spending is projected to shrink, thus creating additional fiscal space for better-designed poverty reduction programs.[5]

BOX 1: Nepal's Social Protection System in international perspective

Social protection spending in Nepal reached 2.5% of GDP in 2011/12, including 0.92% of GDP on safety nets or social assistance. This compares to an average 2% in South Asia, 1-2% in developing countries and 3% in OECD countries and places Nepal as one of the highest SP spender in South Asia, behind only Sri Lanka and Maldives. Worldwide there is a paradigm shift prompting governments to build social protection programs on a national scale and as a means to support the extreme poor, decrease inequality, promote human development and improve resilience to crisis. Several South Asian countries are embarking on significant reforms of their social protection systems. For example, Pakistan has shifted from categorical targeting to poverty-based targeting while Bangladesh and some Indian states are embarking on reforms to consolidate their SP programs and build up coherent systems. As a first step, they are establishing national databases of the poor.

Well-designed safety net programs minimize the leakage to the non-poor. For example in Pakistan's Banazir Income Support Program 70% of the benefits go to the poorest 40% of the population. In addition, social assistance programs normally contribute to 15-20% of household per capita consumption. In contrast, Nepal's cash transfers and scholarships programs reach only 41.5% of the poorest 40% of the population and social assistance programs contribute only around 1.2% to household per capita consumption of the poor. Countries with a reformed SP system, such as Mongolia, Thailand, Romania, Latvia and Chile, reach well over 90% of the poorest 20% of the population.

Source: World Bank Social Protection Strategy, WB – April 2012;

9. In sum, Nepal faces several policy, design and implementation issues that need to be addressed to improve the SP system's impact on poverty reduction and inequality. Nepal can benefit from a wealth of international experience to build an effective and sustainable social protection system by (i) enhancing SP's

5 The projection is for a subset of the SP programs including the old-age cash allowance, single-women's cash allowance, endangered ethnicities allowance, disability allowance, child grant, scholarships and public works programs. Altogether these programs' budget amounted to around 0.7% of GDP in 2014. The fiscal simulation shows that this amount will shrink to 0.3%-0.5% of GDP depending on different assumptions used (including the scenario of indexing the benefit amount to inflation to preserve the purchasing power). See World Bank (2014) for details.

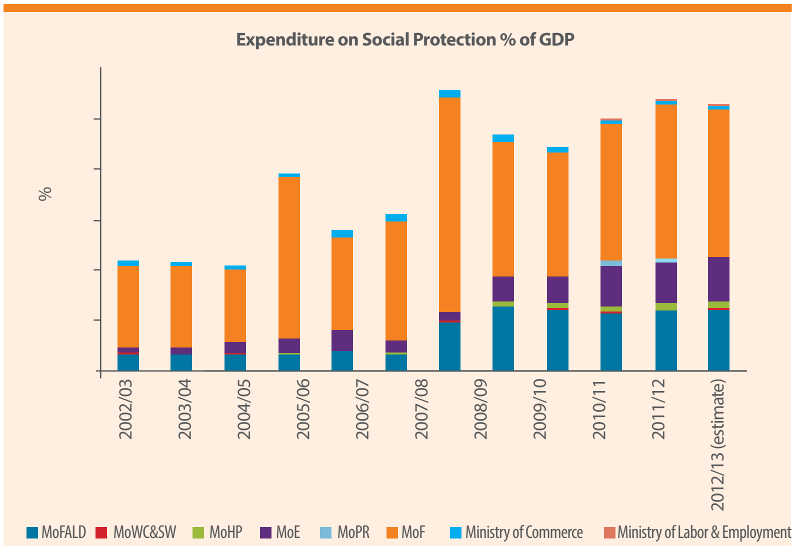
poverty impact, possibly by introducing a new, explicitly poverty-focused program over the medium term; and (ii) investing in strengthening the SP delivery systems.

Key Challenges and Recommendations

KEY CHALLENGE 1: NEPAL'S SOCIAL PROTECTION PROGRAMS ARE RELATIVELY COSTLY AS A WHOLE BUT THEIR POVERTY IMPACT IS NEGLIGIBLE

10. Social protection expenditure in Nepal, at 2.63% of GDP, is high by comparison to neighboring countries. On top of the natural growth due to demographic changes and gradual expansion in program coverage, the relatively high expenditure level has been driven by recent surges in both social insurance and social assistance spending. These surges followed the government's major policy decisions to relax eligibility criteria for key cash transfer programs (e.g., lowering the age of eligibility from 75 to 70 for all and 60 for dalits and those in Karnali, and removal of the age criterion for the single women allowance in 2009), increase the benefit amount (e.g., from Rs. 200 to Rs. 500 for both old-age and single women allowances) and introduce a large number of new schemes across multiple ministries. At least 20 new schemes were introduced since 2000 including food for education, maternity incentive scheme, child grant, youth self-employment fund, schemes for the conflict-affected, and various scholarship schemes.

FIGURE 1: Evolution of Social Protection Expenditure by Ministry, FY2002/03-FY2013/14 (% of GDP)



Source: Ministry of Finance.

11. Current social protection programs are spread across several ministries with weak links among them as they have grown organically over time without an overarching policy framework to guide and coordinate their creation. The largest cash transfer programs are administered by the Ministry of Federal Affairs and Local Development (MOFALD). SP programs are also carried out by other ministries including the Ministry of Education, the Ministry of Labor and Transport Management, the Ministry of Health and Population, and others. The available resources are spread thinly across these programs, which dilutes their potential impact.

12. It is imperative that this proliferation be brought under control over time. This, however, will require both a solid evidentiary base to determine relative effectiveness of the programs and ascertain the extent of overlaps among them as well as coverage gaps left in-between. The national SP policy framework under development by the National Planning Commission (NPC) presumably fills this information gap. Until the framework is finalized to guide future policy decisions, a prudent immediate priority is to limit uncontrolled introduction of new schemes.

Recommendation:* *Limit further proliferation of SP programs to avoid increasing the overall fiscal cost and prevent worsening of the coordination problems

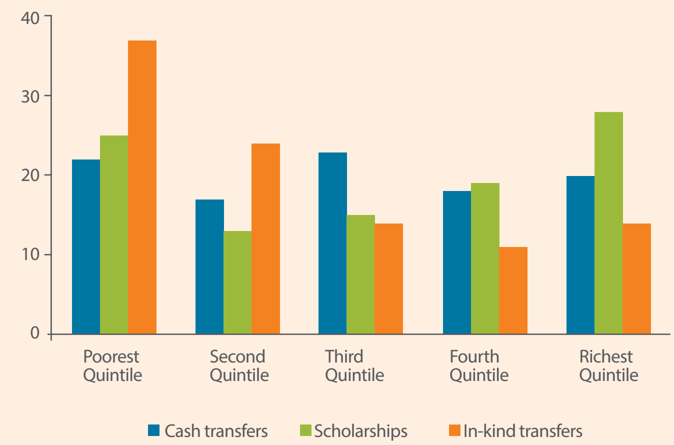
13. The dearth of explicit poverty focus further erodes the programs' poverty impact. Most of the existing programs are not explicitly targeted to the poor but instead are made available to certain categories of the population such as the elderly or endangered ethnic groups irrespective of their socioeconomic status and relative needs. As a result, the benefits accrue more or less evenly across income quintiles (i.e., they do not favor the poor) except the in-kind transfers, which are only available in certain districts known for poverty and high levels of food insecurity and because the participation in these programs is voluntary (i.e., the poor self-select themselves as beneficiaries).[6]

14. A combined effect of the program proliferation and the absence of explicit poverty targeting is the minimum impact on reducing poverty. Table 1 below shows how little impact SP programs have on the poverty headcount (percentage of the households below the poverty line) and the Gini coefficient (a measure of income inequality). For example, if Nepal did not have the MOFALD cash transfer programs, the percentage of the households below the poverty line would have been 25.6% as opposed to the actual rate of 25.2% (i.e., the cash transfers reduce the poverty rate only by 0.4 percentage points). Similarly, the differences in the Gini coefficients with and without SP programs are negligible.

15. Fiscal sustainability is less likely to be a major constraint over the medium term. The fiscal simulation recently conducted by the Bank shows that barring any significant change in the benefit level and the eligibility criteria or introduction of large, new schemes, the fiscal cost of the current mix of SP programs is projected to decline over the next decade thanks to Nepal's demographic dynamics. The projection reveals that the main cash transfer and scholarship programs which amounted to just below 0.7% of GDP in 2014 would cost between 0.3% and 0.5% by 2024. This means that over time Nepal will find additional fiscal space while maintaining today's program mix.

16. Over the medium term, enhancing the poverty impact of the SP programs may require introduction of a new, more explicitly poverty-focused program. This could be achieved by either consolidating some of the existing programs into fewer and larger

FIGURE 2: Benefits Incidence of Key Social Assistance Programs



Source: Ministry of Finance.

programs (e.g., similar to what Brazil did when it created its flagship conditional cash transfer program, Bolsa Familia by merging several existing programs) or by creating an entirely new program (e.g., similar to what Pakistan did with the creation of the Benazir Income Support Programme).

17. Given the lack of explicit poverty focus of most existing programs, mere expansion of these is unlikely to achieve the objective. For example, the largest cash transfers in Nepal tend to benefit the elderly more whereas the poverty level is higher among children (i.e., young families). Yet, after taking into account the effect of the available cash transfers, the poverty incidence among the younger age groups in the

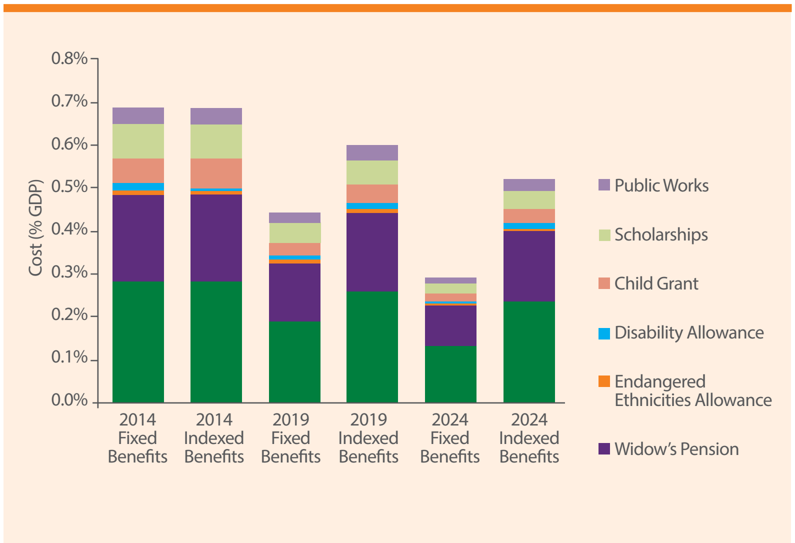
TABLE 1: Nepal Social Protection System impact on poverty and inequality

	Poverty Rate	Gini Coefficient
Current	25.2%	0.328
In absence of social insurance programs	26.6%	0.329
In absence of social assistance (cash transfer + scholarships) programs	25.7%	0.330
In absence of cash transfer programs	25.6%	0.330
In absence of scholarship programs	25.3%	0.329

Source: World Bank team estimates from NLSS 3 analysis

[6] These in-kind transfers in the Figure 2 below refer to the two public works programs managed by MOFALD.

FIGURE 3: Projected Total Cost of SP Programs over 2014-2024 (Nominally fixed benefits)



Source: Bank staff calculations using NLSS III.
Notes: Widow's pension includes single women's benefit. Public works includes Rural Community Infrastructure Works and Karnali Employment Program.

population barely changes (Figure 4). Simply increasing allocations to the current mix of programs would not address this imbalance.

18. Whichever strategy is chosen, it is essential that the decision to create a new program be based on solid empirical analysis of the priority needs in terms of poverty, vulnerability and risks that the population faces. Nepal currently lacks sufficient data and analysis to have a comprehensive perspective on the types of vulnerabilities and risks the population is exposed to. Available qualitative information strongly indicates the current mix of SP programs leaves certain segments of the population unattended or under-covered (e.g., families with young children, working-age adults in precarious employment). But more robust evidence is necessary for determining what kind of program best meets these unmet needs. Information based on such an analysis would also help the government refine the National SP Framework.

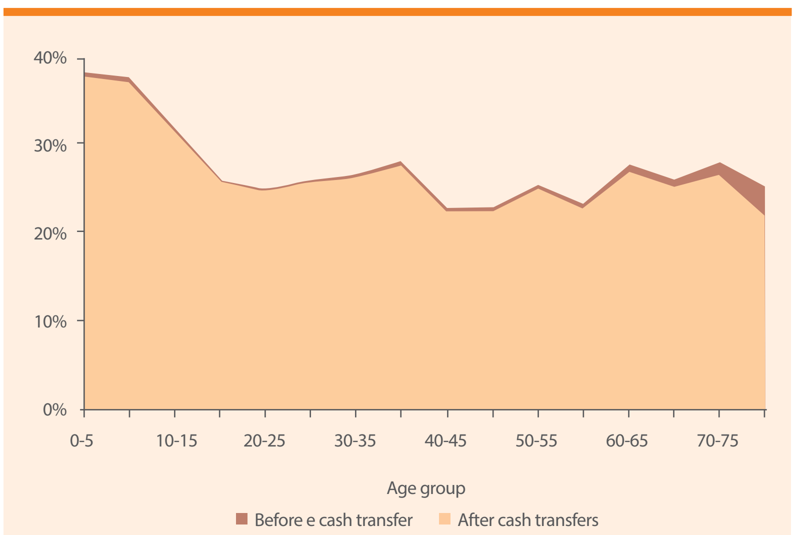
Recommendation:* *Invest in systematic empirical diagnostic to identify gaps in coverage in the current SP program mix and draw on relevant international and domestic experiences so that the poverty impact of the SP program(s) could be enhanced, either by consolidating existing programs or by creating an entirely new one.

KEY CHALLENGE 2: ADMINISTRATIVE SYSTEMS FOR SP SERVICE DELIVERY ARE UNDERDEVELOPED

19. Effective social protection programs rely heavily on a range of modern administrative systems. Yet Nepal has been implementing its SP programs without such a system. The government has invested little on administration in allocating funding for social protection. In each of FY2011-14, MOFALD has allocated less than one percent of its cash transfer budget on administration. While it is understandable that the government wishes to prioritize budget allocation for direct benefits, the state of the SP administration systems in Nepal calls for a significant investment for their modernization and upgrading to realize medium-term gains in efficiency, effectiveness and transparency.

20. The backbone of a modern SP delivery system is a comprehensive beneficiary database and a management information system (MIS). Lack of an effective MIS invites human errors, as well as fraud and political manipulation (e.g., the creation of ghost beneficiaries or inclusion of ineligible beneficiaries). For example, the weaknesses in the beneficiary identification system and

FIGURE 4: Impact of Cash Transfers on Headcount Poverty Rate by Age group



Source: Bank staff calculations from NLSS III data.

database management result in significant levels of exclusion errors (or under-coverage) in MOFALD's cash transfer programs (Table 2). A beneficiary registry which is unified across districts and online could ensure timely updating of critical information such as registration of new beneficiaries, updating of vital event data, and verification of payments to individual beneficiaries.

21. The MIS for cash transfers under MOFALD has already been established, and is being rolled out across 14 districts. In the three districts where the data entry was completed first, over 5% of beneficiary data was found to be incomplete on manual records existing in the District Development Committees (DDCs). The roll-out of this MIS across the rest of the country, and its possible integration with the beneficiary databases of other MOFALD programs such as the two public works programs could ensure better record keeping as well as improved transparency and accountability across the country.

Recommendation:* *Continue refining the MOFALD MIS with a view to extending its application to other MOFALD programs and as a basis for an eventual unified beneficiary data management system across ministries.

22. A key area of investment to strengthen the integrity and administrative efficiency of any social protection scheme over the medium term will be creation of a system for unique individual and family identification and proper registration of vital events. These will establish the building blocks for beneficiary database integration across the country, which in turn would allow cross program de-duplication of beneficiaries and both individual and family benefits monitoring.

23. An effective interim solution would be to develop unique identification numbers common across the SP programs. These could be linked to the vital registration system of the country and captured in the national SP MIS. For example, the MIS currently being rolled out

TABLE 2 : Under-coverage and Inclusion Errors

	Old-age pension	Widow's pension	Endangered ethnicities
Number eligible ('000)	1,135.0	372.5	21.1
Of which receiving	705.2	201.1	9.1
Of which not receiving	429.8	171.4	12.0
Under-coverage rate c (%)	37.9%	46.0%	56.7%
Ineligible receiving benefit ('000)	12.2	6.6	5.0
Inclusion error rate (%)	1.7	3.2	35.5

Source: Bank staff calculations from NLSS III, official budget statistics and program administrative data.
Notes: (a) Disability benefit is excluded here because it was not possible to determine eligibility from household survey data. (b) Under-coverage rate is proportion of eligible individuals not receiving the benefit.

to 14 districts by MOFALD has the capability to assign a unique identification number to each beneficiary. If the same MIS is rolled out to the rest of MOFALD programs and eventually to other social protection or similar programs managed by other ministries, the government could effectively have a unique ID system for its social protection beneficiaries. Once a national unique ID system is operational, it can support the eventual adoption of poverty targeting (whatever the specific method of choice may be)[7] and an integrated SP beneficiary database across ministries and programs. Combined with other sub-systems such as the payment system (as discussed below), the unique ID system would considerably strengthen the government's ability to respond rapidly to crisis and shocks (e.g., natural disaster, unexpected economic crisis) with financial protection and compensation.

Recommendation:* *Accelerate the development of the national ID system

24. Other priorities in the SP systems strengthening agenda include an efficient and transparent payment system, a credible grievance redress system and internal control, and an effective monitoring and evaluation (M&E) system with a proper feedback loop to inform decision-making. MOFALD has already started to pilot payments through branchless banking methods in five districts in FY2013-14. The use of biometrics by the banks to verify the identity of the individual

[7] The social protection beneficiary ID system would not have this capability.

beneficiaries helps ensure only the correct beneficiaries can receive the cash allowance. While the pilots have not advanced far enough to produce sufficient data to demonstrate efficiency gain (e.g., the number of ghost beneficiaries eliminated from the beneficiary list), systematic use of modern technology such as biometric verification of beneficiary identify is expected to enhance the efficiency of SP service delivery considerably. Scale-up of this process across the programs and the country, based on a proper review and adjustments, if and as needed, would signify an important advance in Nepal's SP systems strengthening agenda.[8]

25. The reforms are less advanced with respect to other priorities. Although the various ministries have their own grievance redress systems, their functioning appears rudimentary. The absence of a functioning MIS hampers efforts to monitor and evaluate program performance and exercise adequate control to minimize errors, fraud and possible corruption. As the MIS gets rolled out across MOFALD and subsequently to other ministries, the government will be able to invest in an M&E system. In the meantime, the priority would be to strengthen the grievance redress system, combined with certain ad hoc tools such as spot check surveys, as a primary means for collecting beneficiary feedback.

Recommendation: Complete the ongoing branchless banking payment pilots, draw lessons from the process evaluation and other inputs, and roll it out to other programs and eventually to other ministries and strengthen the grievance redress system

26. A proper alignment of institutional roles, responsibilities, capacities and incentives is the indispensable foundation of the systems strengthening agenda. Currently SP services are delivered through the existing hierarchy that connects MOFALD to the Village Development Committees (VDCs) through the DDCs. VDCs, as the front line of government service delivery, are responsible for a broad range of public services besides delivery of SP services. Their capacities are limited both in terms of physical infrastructure and human resources and in some locations the secretaries heading them are absent. DDCs institutional capacity for managing modern SP service delivery is similarly limited. They typical lack specialist personnel and SP-related functions are often handled by low-rank clerical staff.

27. MOFALD intends to review its internal organizational set-up for SP service delivery and management of vital event registration. The availability of modern SP deliver systems such as the MIS and cashless payments would lead to possible changes in internal business processes and skill requirements. It is important that MOFALD review its organizational set-up with these new realities in mind and conduct broad consultations to manage what is likely to be an extensive change management process. Organizational strengthening will be a long, "never-ending" process of continuous adjustments and improvements. But if done right, it should bear fruit over a medium to long run in the form of enhanced MOFALD capability to manage complex SP programs efficiently and transparently.

Recommendation: Craft and implement a medium-term MOFALD institutional strengthening plan based on thorough organizational diagnostic and broad internal consultations

8 The World Bank is conducting a process evaluation of the initial phase of this branchless banking payment pilot, in partnership with MOFALD and the United Nations Capital Development Fund.

Preparing for Decentralization

Executive Summary

There is political consensus to create a federal system of government in Nepal, but implementation of reforms to establish such a system is complex. Decentralization can empower local communities, improve service delivery and ensure greater equity across regions if the design is right and, in equal measure if the process is well managed.

While the design of the federal state will reflect a political settlement to be reached by Nepal's decision-makers, key steps can be taken now to prepare for the transition. The following recommendations focus on four crucial dimensions of implementation that will be required irrespective of the ultimate shape that a federal state ultimately takes:

- **Form dedicated institutions directly accountable to top political leadership to oversee the decentralization process, including a coordinating council, a finance commission to balance national and local interests in designing the intergovernmental finance framework, and a demarcation commission to address boundary issues among new subnational units;**
- **Compile detailed data on the immediate financing costs, deployment of personnel, physical infrastructure, soft assets broken down by functions and their constituent features of regulation; ongoing implementation; and financing of capital costs;**
- **Prepare a plan and benchmarks for sequencing the transfer of functions and management of associated assets over the course of up to two years as the capacity of new subnational governments develops, particularly in the areas of personnel management, tax administration and PFM;**
- **Develop a new framework to adapt the civil service to a federal structure with common standards, provisions allowing for mobility among levels of government, and mechanisms to deploy personnel to remote areas.**

Context

1. Decentralization involves both issues of designing a new structure for the functioning of the state and preparing and managing a substantial transition to the new structure. The fundamental choice of moving to a federal state, as well as its basic features, including tiers of government, powers and attributions and their relations with one another, are to be decided by the Constituent Assembly. At the same time, working out the implementation arrangements for a new federal system will itself be an enormous task. The timing and substance of administrative reorganization, fiscal restructuring, human resources deployment, public financial management, and accountability mechanisms will be complex. The difficulty of carrying out decentralization is heightened by the inevitable need to make numerous trade-offs among the interests of a large number of stakeholders.

2. Some key elements of design of a federal state have already been agreed upon. The 2010 Report of the Restructuring of the State and Distribution of State Power Committee of the former Constituent Assembly ("Restructuring Report") covers the 'building blocks' of an effective decentralized system:

- Identification of sub-national units and the principles and process for their establishment;
- Assignment of functional responsibilities for public services;
- Establishment of a system of financing the operations of all levels of government through own source revenues and inter-governmental transfers; and
- Provision of administrative authority to levels of government to ensure that public service functions are carried out, including control over relevant staff and intangible and physical assets associated with the service.

3. The new Constituent Assembly has affirmed that it will build on the prior work, including on the federal framework. While the specific arrangements (e.g. on functional or revenue assignments) called for in the report may not be followed, the framing of the issues is a good basis for policy-makers to decide on what Nepal's federal system should look like.

4. Translating this new template into workable institutional and financial arrangements will be a tall order and critical to obtaining the desired benefits of a federal system. The transition to a federal system with empowered, capable subnational units requires careful management to minimize disruption to the functioning of the state, particularly in the provision of public services. Once a political settlement can be reached on the basic design of the federal system, the changes to implement that design will involve a fundamental reworking of how the public sector is organized. Policy-makers need to be clear about what happens on "Day One" of a move to a federal system. There needs to be clarity about when and how various elements of the transition are to be carried out over time.

5. The transition from the current to the new system should not be extended indefinitely. Once a new architecture is agreed upon and signed into law, expectations will be high from local politicians and the public alike, that responsibilities and resources will be transferred rapidly. At the same time, hasty transfers of power could result in waste and disruption of services. To manage these tradeoffs as best as possible key building blocks –institutional and analytical- need to be put in place to guide the transition from the start.

Key Challenges and Recommendations

KEY CHALLENGE 1: STEERING THE PROCESS AND BALANCING COMPETING INSTITUTIONAL INTERESTS

6. Decentralization is both complex and highly political since it involves the transfer of power. The process of decentralization needs to be managed. While the design for a federal structure will anticipate matching functions with financing and administrative authority, it is unlikely that there will be easy agreement on a technical "right answer" to the division of responsibilities or resources. Governments at all levels are certain to argue that resource allocations are inadequate. There will also be tension and perhaps resistance within central ministries over the transfer of powers to lower levels of government. An institutional set-up is needed that can handle these challenges.

7. In finalizing the design of the new federal structure it will be important to balance the need for clear safeguards of local government autonomy with flexibility to adjust over time. Nepal has positive experience in the work of the multi-stakeholder Restructuring Committee of the former Constituent Assembly. Further review of the federal design that emerged from this Committee should be conducted by a similarly broad-based committee. Confirmation of the design, as well as inclusion of basic principles of the design into the Constitution, of course will be made by the new Constituent Assembly. A balance will need to be struck between sufficiently high level Constitutional safeguards for the autonomy and effective functioning of sub-national governments and flexibility in order to make adjustments as are needed to respond to circumstances. The Constitution should outline a basic framework concerning the roles of sub-national governments (including, crucially, whether provinces are empowered to define the framework for local governments within their borders), guarantees of sources of revenue to fulfill those roles, the relationship between provinces and local governments, and ownership of natural resources. More easily adjusted laws and administrative orders should be used to determine specific issues of implementation.

8. The Government might consider establishing a high level entity to oversee decentralization reforms. The entity will need to enjoy substantial power within Government in order to carry through with changes. The structure may be a Ministry such as the present Ministry of Federal Affairs and Local Development or a specially designated ministry and/or office in the Prime Minister's Office for carrying out decentralization work within the new Cabinet. What was critical in other countries' experience was that the institutional set-up for carrying out the reforms received prominent support from political leadership to coordinate among ministries and, where necessary, overcome bureaucratic resistance. Thus, while a Ministry may play a key role in the ongoing implementation of reforms, it needs to have prominent linkage to the Prime Minister.

9. The entity responsible for reforms will need to have an effective capacity for communicating with, and receiving and acting on feedback from, the breadth of stakeholders. This will include stakeholders across the political spectrum at the central level as well as the subnational governments themselves. Although there will doubtless be contentiousness as the reforms are carried out,

BOX 1: International experience of managing decentralization

International Experience with Managing Decentralization Reforms

Many countries have carried out decentralization reforms, but management of this change is rarely smooth. This is because countries tend to decentralize in response to a political imperative to redistribute power rather than a technocratic imperative to organize services to be more responsive. There is often a relatively short window of opportunity within which a new system is designed; implementation of changes to have the public sector operate under a more decentralized political system has to catch up and many ad hoc arrangements emerge. However, a few features appear to have helped facilitate the carrying out of such reforms in other countries.

Empower a prominent entity to lead the decentralization process. For instance, Indonesia had a dedicated ministry carrying out decentralization reforms in the period 1998-2002. India's reforms to strengthen local government have been prepared and led by specially formed commissions. Russia's local government reforms in the early 2000s similarly were led by a specially appointed commission that was close to the President.

Identify the present deployment of resources which are to be reassigned. As part of its 'Big Bang' reforms, Indonesia identified financial and human resources used in the delivery of services. This information in turn served as the basis for their reallocation. Although changes were carried through quickly, some preparation of staff for the changes was thus made possible.

a proactive, open agency will both facilitate implementation and draw on information to make adjustments as reforms proceed.

***Recommendation:* Create a high level entity with substantial power and political support to facilitate the decentralization reforms that will also have the flexibility to draw on information to make adjustments during the reform process.**

10. Intergovernmental finance arrangements would benefit from a special commission capable of mediating among national and local interests. In addition to overall coordination of the reform process, a strong finance commission will need to be maintained to devise and manage intergovernmental transfers. Countries are often tweaking their transfer systems from year to year; one can expect substantial adjustments to the intergovernmental transfer systems for several years as decentralization unfolds in Nepal. Such a commission should build on the experience and capacity of Nepal's Local Bodies Fiscal Commission, but with a broader composition and stronger independent mandate. The membership of the commission should be such that it can credibly balance between the federal center, provinces, and likely local government interests. For instance, South Africa's Finance Commission includes civil society representation for the purposes of achieving such balance. The Commission would further need to have its own technical secretariat capable of conducting financial analysis rather than being beholden to either the Ministry of Finance or to the ministry responsible for local affairs.

***Recommendation:* Create a strong finance commission with its own technical secretariat capable of conducting financial analysis to devise and manage intergovernmental transfers.**

11. A special commission to address demarcation among subnational units will need to be established. Both provinces and local government units can be expected to consist of groupings of the present territorial units (districts, municipalities, and VDC territories). However, to the extent that significant powers are vested at the provincial and/or local government level, there may emerge potential conflict over boundaries which previously were less important. An independent commission with geodesic expertise and powers to draw on Government agencies involved with land management and surveying should be in place to quickly address and resolve these issues.

***Recommendation:* Establish a special commission with geodesic expertise to address demarcation among subnational units.**

KEY CHALLENGE 2: PREPARING FOR THE TRANSFER OF FUNCTIONS, REVENUE ASSIGNMENTS, AND ADMINISTRATIVE CONTROL

12. The establishment of provinces and local governments represents a major change from the current system, where local bodies de facto have limited service delivery responsibilities and provinces are absent. There is substantial preparatory work that must be undertaken, even prior to finalization of the boundaries of provinces and local government units, to determine what actually is to be transferred to provincial and local governments to underpin functional assignments. Such assignments involve the designation of responsibility for a service that the public sector undertakes, such as primary education, ensuring provision of potable water, roads, and other public goods that governments usually ensure are in place. Consideration should be given to a (i) a functional mapping – unbundling into subcomponents each main function (many of which are typically concurrent across levels of government) and (ii) a calculation for the costs associated with carrying out functions in order to design properly an intergovernmental finance system. For instance, assigning 'primary healthcare' as a local government function or 'university education' as a provincial function may be appropriate in theory but the current actual delivery of these functions involves human, financial, and other resources at a variety of levels which in turn will need to be reassigned.

Recommendations: Carryout detailed functional unbundling and mapping across levels of government and perform cost calculations of carrying out functions prior to actual transfer of function and finance.

13. Assigning costs to functions is complex, especially if disaggregated geographically. There are three main methods to determining the cost of delivering services. One method is to determine a level of service quality as per policy, identify necessary inputs, and cost these inputs. This is laborious and subject to lack of precision, due to great variety in assigning standards and defining what inputs are necessary and their costs; moreover this tends to result in unrealistic budgeting (as needs –to meet standards- tend to exceed available resources). The second and more straightforward method is to identify historically observed actual costs for delivery of a service. This approach is still quite difficult in Nepal as the current budget classification does not follow such functional classifications neatly, especially for the present local bodies, and hence expenses need to be 'reconstructed'. The drawback is that such 'costing' tends to perpetuate suboptimal patterns of spending. The third method involves mixing the two: using historical spending patterns, but adjusting for needs of localities. While costing functional assignment in the aggregate (vertically across levels of government) is complex enough, it is even trickier do disaggregate such costs/needs geographically (horizontally). In the present context, the most straightforward approach may consist in identifying historical spending patterns broken down for each function by different aspects of public service delivery (regulation/standard setting & enforcement; day-to-day implementation; and capital investment) to determine both the appropriate vertical split of resources between central, provincial and local levels as well as horizontal allocation between provincial governments and local governments within them.

14. Even the most straightforward approach to costing will face challenges. Human and other resources are rarely dedicated fully to a particular service area and hence it is difficult to simply identify them as associated with one given function, even when subdivided by aspect. Second, determining actual levels of financing for delivery of services may be complicated insofar as not all expenditures for, say, primary education, are presently captured in line budgets. There are ad hoc contributions from local governments as well as parents' payments that may be important at the local level. Third, data is often missing to make the calculations.

Recommendation:* *Compile as much data as is possible on the immediate financing costs, deployment of personnel, physical infrastructure, soft assets broken down by functions and their constituent features of regulation; ongoing implementation; and financing of capital costs.

KEY CHALLENGE 3: SEQUENCING OF REFORMS

15. Given the challenge of setting up new levels of government, sequencing of reforms will be critical to avoid disruption of service. While decentralization may be expected to bring medium and long term benefits, the complexity of creating two new types of subnational governments carries the potential for disruption of service. Even though most civil servants would be expected to continue playing similar roles, there will be a new institutional framework and new lines of accountability to subnational political leaders, some of whom may lack experience with public administration as well as potentially vastly increased responsibilities at the local level. Furthermore, new subnational governments endowed with genuine decision-making authority may make sudden far-reaching decisions that would affect the overall health of public finances and management of the public service. A sequencing of reforms can minimize these risks while still obtaining the goal of establishing a federal system.

16. Some preparatory and initial steps can be taken prior to the transfer of actual power. As noted above, preparatory work regarding costing and deployment of human and other resources for delivery of public services should be carried out in advance. While this is ongoing the first major steps can be taken: establishing the provincial and local units within which governments will be formed and, after sufficient time for organizing an election campaign, forming new subnational governments. The formation of local governments would depend on whether the design of the federal system empowers provinces to decide functions and guarantee financing arrangements for their local governments (in which case local elections would be subsequent to provincial ones) or if the central government makes these arrangements. Based on the Restructuring Report, this note assumes that the central government would set out local government functions, financing, and administrative powers.

***Recommendation:* Establish the provincial and local units within which the governments will be formed and allow adequate time for organizing elections campaigns before forming new subnational governments.**

17. The new subnational governments will need staff, equipment, systems and resources to function, as well as empowering legislation and institutions. There will need to be a tight timeline for the implementation of changes in the organization of the public sector that will empower the newly formed provincial and local governments to perform. Support for reform will sour if newly elected officials don't have functional responsibilities and resources to carry out these responsibilities. This entails changes in the legal responsibility for a set of functions (public services); revenues (both own source and transfers); the transfer of staff as is needed to carry out those functions which are legally assigned; and the transfer of control over the physical assets as well as soft assets, such as databases. These changes should be synchronized to the extent possible to avoid imbalances that would impair service delivery.

18. It is best to define as fully as possible the expected functional responsibilities and associated administrative control to be transferred, but the actual transfer should be sequenced in order to ensure continuity of service. Interim arrangements for line agencies currently carrying out aspects of service delivery should be put in place. In order to avoid entrenchment of interim arrangements where subnational governments do not assume full powers, a clear and relatively short time frame of not more than a few years should be allowed. The nature of what powers would be held back should be driven both by the expertise required to maintain services, economies of scale, and recognition of the need for subnational governments to build their own institutional capacity. One particular example of an area that may not be transferred right away are databases regarding employees, provision of benefits, or service arrangements are typically hard to subdivide and there is considerable risk that capacity at subnational levels may be lacking to maintain these soft assets. Another example is maintaining the public service system while subnational governments develop their own personnel policies.

19. Each function (service area) should have a timeline for what responsibilities and powers get transferred and when. The national level decentralization coordination entity, together with the respective line agency which will necessarily be tasked with defining what is transferred to local governments. There should be a clear understanding of how the service will continue to be delivered on day one after some powers and/or responsibilities are transferred and by what time all responsibilities and powers are too transferred. To the extent possible, the national level decentralization coordination entity should ensure that the timing to transfer powers and responsibility and powers coincides for a number of services. One hypothetical example would be as follows: if rural transportation networks, primary education, and primary healthcare are to be full responsibilities of local governments, then presumably operations and maintenance responsibility for all buildings might be transferred immediately, oversight over staff at a later time, and responsibility for capital investment at a much later date.

***Recommendation:* Develop a timeline and criteria for the transfer of responsibilities and powers.**

20. Perhaps the most important area for a phased transfer of powers is in the area of tax administration. It is critical that provincial and local governments rely on some own taxes, because having citizens thus 'pay' for services through taxes builds accountability and greater responsiveness. But all aspects of administration of provincial or local taxes need and should not be transferred all together. What is most important is that local governments have substantial discretion to determine tax rates and tax bases. Responsibility for collection, appeals, maintenance of rolls does not need to be transferred immediately. Much consideration is needed before any transfer is made in order to avoid disruption.

***Recommendation:* Provide local governments with substantial discretion to determine tax rates and tax bases while still sequencing the transfer of other aspects of administration of provincial and local taxes.**

21. Guidelines on the spending powers of the new subnational governments are desirable, especially in the short term, to forestall abuse. Decentralization is expected to improve the public sector's performance when subnational governments have discretion to determine their expenditures according to local needs. For instance, one provincial government may decide to spend proportionately more on major roads than another in response to its population's preferences. On the other hand, political pressure and other motivations may prompt subnational governments to undertake fiscally irrational decisions such as excessive hiring or diverting funds to capital projects at the cost of service delivery. There is also ambiguous evidence that corruption risk would be any less at subnational levels as well. Of course, central government is also prone to the same problems, but there are more subnational governments and there is likely to be less experience with administration and an increased probability that some governments may behave irresponsibly. Therefore, for an interim period of at least a few years while subnational governments come to terms with managing their functional responsibilities some constraints likely should be put in place, namely:

- Limitations on the number of staff that can be on provincial/local roles (with progressively greater variation allowed for over time);
- Limitations on salaries following nationally set wage scales;
- Conditions on transfers tied to maintaining a limited level of operations for functional responsibilities.

***Recommendation:* Enforce limitations on subnational governments for an interim timeframe to allow them to gain experience and improve their capacity to manage their responsibilities.**

KEY CHALLENGE 4: FEDERALIZING THE PUBLIC SERVICE

22. Decentralization will require a significant reengineering of public human resources. The public service will need to be restructured to allow for personnel to be reallocated to different levels of government according to functional assignments. Control over personnel is integral to subnational governments' ability to carry out their functions. But creating provincial (and perhaps local) public service cadres will pose problems. It may cause stress among many existing civil servants who may expect or want to remain part of a national service with corresponding career opportunities and personal circumstances. There is certain to be uneven availability of personnel with expertise for more remote areas. Furthermore, provinces will likely have specific linguistic and other characteristics that would affect overall mobility for civil servants around the country. There is no 'best practice' in balancing the interests of empowering subnational government, flexibility in deployment, and keeping up motivation of civil servants. Nonetheless, at least for the short and medium term it may make sense that management of human resources be seen as a shared, corporate responsibility of all levels of Government.

***Recommendation:* Manage human resources as a shared corporate responsibility of all levels of government for the short and medium term.**

23. A 'Public Service Management Board' may be established to provide for the uniform application of rules governing the civil service. Such a Board would have membership from every Province and the central Ministries and would be underpinned by a secretariat. It would then be charged with development and enforcement of common standards and norms for recruitment, promotion, and remuneration of public servants. There will also need to be mechanisms to allow for transferability of civil servants between levels of Government, whereby benefits and years of experience are recognized. At the same time, decisions on hiring would ultimately be the prerogative of the respective level of government. Some jobs, particularly in more senior management would also be open to lateral entry, both to provide for fresh talent and to encourage applications from previously excluded or marginalized members of society.

24. The system would need to provide for a means of deploying personnel to remote locations, particularly in management positions. A national 'senior executive service' would be developed to allow for deployment anywhere in the country based on need, with an incentive structure to encourage movement. Ultimately, if management positions are not filled through a competitive process, this cadre would be called upon to fill positions through compulsory deployment.

Recommendation:* *Establish a 'Public Service Management Board' to develop common standards for civil service management and management track with incentives for service in remote locations.

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