Report No. 25019-NEP

Document of
The World Bank

NEPAL

TOWARDS A SUSTAINABLE APPROACH FOR POVERTY REDUCTION AND DECENTRALIZATION

A NOTE ON NEPAL'S PROPOSED POVERTY ALLEVIATION FUND

November 20, 2002

Private Sector Development Department
South Asia Region

CURRENCY EQUIVALENTS

Currency Unit = rupee (NR)
1 rupee = US$0.01308
US$1 = rupee 76.475
(December 2001)

FISCAL YEAR

July 16 – July 15

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
ADB/N	Agricultural Development Bank of Nepal
CBED	Community Based Economic Development
CBO	Community Based Organization
CECI	Canadian Center for International Studies and Cooperation
CSD	Center for Self Development
DDC	District Development Council
ED	Executive Director
ESCAP	UN Economic and Social Commission for Asia and the Pacific
FMIS	Farmer Managed Irrigation System
GBB	Grameen Bikash Banks (Rural Development Bank)
GON	Government of Nepal
GTZ	German Technical Cooperation Agency
HMGN	His Majesty's Government of Nepal
IFAD	International Fund for Agriculture Development
INGO	International Non-Governmental Organization
IS	Institutional Strengthening
LDF	Local Development Fund
LG	Local Government
LIC	Learning and Innovation Credit
MEDEP	Micro Enterprise Development Project
MFI	Micro Finance Intermediary
MIS	Management Information System
MOF	Ministry of Finance
NGO	Non-Governmental Organization
NISP	Nepal Irrigation Sector Project
NPC	National Planning Commission
NRB	Nepali Rashtra Bank (Nepal Central Bank)
NRs	Nepali Rupees
O&M	Operation and Maintenance
PCRW	Production Credit for Rural Women
RMDC	Rural Micro Finance Development Center
ROSCA	Rotating Savings and Cooperative Associations
RUFIN	Rural Finance Nepal
SAPAP	South Asia Poverty Alleviation Program
SAPPROS	Support Activities for Poor Producers of Nepal
SCFL	Small Farmer Cooperative Limited
SCO	Savings and Credit Organization

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A. EXECUTIVE SUMMARY AND RECOMMENDATIONS

- The Government of Nepal would like to use the Poverty Alleviation Fund (PAF) to improve the quality and access to services so that all Nepalese may share the benefits of development. The Government would also like to promote decentralization as the long-term approach to local service improvement. This policy note shows how the two strategies may be combined and how they can reinforce each other. The note also draws on lessons from the experience of different projects and programs in Nepal as well as global experiences to propose effective ways to proceed in the future.

- The large number of donor and NGO-sponsored local development projects implemented throughout the country over the past two decades provide a rich source of data for such institutional comparisons. Fortunately, a number of detailed studies comparing the efficacy and cost effectiveness of projects realized under different institutional models have already been conducted. This note surveys their results for the sectors in which the PAF will operate. Numerous studies financed by the World Bank, (IFAD) and others, and carried out by NGOs and technical consultants in conjunction with His Majesty's Government of Nepal (HMGN), show that the traditional model of public investment and service delivery – in which line ministries and central government agencies plan, finance and execute local public investments – perform less well than participative investment models centered on community organizations and local government institutions, which also involve the private sector. In particular, modalities of investment and service provision which combined explicit social mobilization[1], usually by NGOs, with the inclusion of community organizations, VDCs and DDCs throughout the project cycle resulted in lower unit costs, better quality of infrastructure, greater transparency in the use of funds, and more long-term sustainability. The last point, in the opinion of a number of expert observers, was largely the product of greater local ownership of project outputs, greater transparency, more realistic scope and size of projects so conceived, and the use of more appropriate technologies.

- Studies of the Nepali experience over the past few decades show that product efficiency and quality are closely related to the process by which projects are realized. Where there is strong participation on the part of community and

[1] Social mobilization is a broad term used widely in Nepal which refers to a combination of some or all of the following: organizing community groups, teaching/raising consciousness about the potential benefits of collective action for capturing and maintaining new investments, participative planning of investment projects based on need, organizing community counterparts, and training village/local groups to manage and maintain service provision ex-post.

beneficiary groups throughout the project cycle, quality and efficiency were higher regardless of sector. Adopting the right process leads to better projects, and better levels of service.

- In education there is much unsystematic evidence that community-based approaches work better, and some evidence for health as well. But perhaps the more salient consideration is that in both sectors the government has made the decision to move towards decentralization and a community-based approach. This is consistent with the government's overall decentralization program. The most reasonable conclusion is, therefore, that the PAF should do likewise, and focus on small-scale, local projects with high degrees of participation and community orientation.

- In the case of roads, bridges and trails, water and sanitation, and irrigation, there is abundant evidence that community-based systems for service delivery work better than centralized systems. The infrastructure so produced and the services that result are cheaper, of better quality and more sustainable than those of line ministries. It is not a trivial consideration that users at the grass roots level are more satisfied with them and prefer them to the centralized option. Despite all of this, the bulk of national public investment in these sectors continues to go through the least cost-effective, least sustainable channel. Large gains in efficiency would seem to be there for the taking in Nepal, and the PAF should lead the way in attaining them.

- There does not seem to be any justification for PAF to support micro-finance in Nepal through lending. However, PAF could eventually support micro-finance indirectly through capacity building for micro-finance intermediaries. Even institutional support to micro-finance is difficult and this should not be considered by PAF as an option in its early stages.

- The Nepal experience is similar to experiences from other parts of the world. Social funds (SF) and social fund-type projects have achieved the same results particularly when they have worked closely with local governments. Nepal offers the opportunity to further cement the link between social funds, community driven development and decentralization. Based on the Nepali experience detailed earlier and global experience, some key principles can be developed to guide PAF. These are: (a) limit its scope initially; (b) assure full autonomy and transparency; (c) develop a lean results-oriented organization; (d) avoid identification with current programs (all of which have both supporters and detractors); (e) complement the decentralization process including fiscal decentralization; (f) assure well-designed and sustainable services; (g) avoid micro-finance; and (h) assure ways to reach the poor.

- Linkage to the fiscal decentralization process also provides a way for PAF to develop an exit (or at least a scope reduction) strategy, unlike most social funds. As the process of fiscal decentralization provides more resources to local governments, and as their capacity increases, PAF could diminish its role to focusing on special target groups. There are compelling reasons to believe that social funds can support decentralization by strengthening community groups and the local government system. Nepal's particular characteristics, and the strong political support for decentralization in evidence there, imply that a well-structured PAF could be particularly effective in this role. Pursuing this should have the additional benefit of maximizing PAF effectiveness in a decentralizing environment. But this requires a significantly different design from the majority of SFs currently in existence.

- Theory and empirical evidence strongly suggest that decentralization reduces the tension between social fund efficiency and poverty targeting by helping to redress the institutional and organizational disadvantages of poor communities. The PAF – and Nepal – can best take advantage of this by constructing project identification and design procedures which actively include CBOs and VDCs, and best take advantage of local information and other inputs. Good project identification and design involves combining different sorts of information arising from local government, the community, and the PAF itself into project plans and budgets. The PAF must develop procedures which are able to elicit and combine these different types and sources of information.

- The World Bank should respond positively to HMGN's request for support to the Poverty Alleviation Fund, provided HMGN agrees to the key principles for the following reasons:

(a) Provided the conditions described in the preceding section are meet, PAF has the potential to become an effective program to address risk, vulnerability and poverty in Nepal while encouraging decentralization. Without external support, however, PAF will not materialize due to financing constraints, and even if it does manage to begin functioning, it may not follow "best practice" approaches.

(b) A properly designed PAF can assist the implementation of Nepal's Decentralization program. World Bank involvement at an early stage in PAF will help define the organization and allow it to become more in line with global "best practice".

(c) World Bank involvement will help facilitate linkage to the fiscal decentralization framework and the overall public expenditure program since these are areas in which the donor community has assigned the leadership role to the Bank.

(d) World Bank involvement will encourage more donors to participate and eventually help contribute to HMGN's objective of reducing the number of poverty-targeted projects and eventually help attract in more donor-financed programs into the budget.

B. OBJECTIVES AND OVERVIEW

1. The main objective of this policy note is to provide advice to His Majesty's Government of Nepal (HMGN) on the best approach to adopt for the proposed Poverty Alleviation Fund (PAF). HMGN wants to establish PAF to address the related problems of poverty reduction and service improvement in remote areas. A secondary objective is to guide the World Bank and the donor community on the best way to assist HMGN in its efforts to establish and implement the PAF.

2. The main report starts with an overview of the conceptual framework which is used to analyze the issues. The subsequent section examines the Nepal experience in detail, and is followed by a section which provides recommendations for the successful functioning of PAF given the Nepal experience and global experience. The main report is followed by four complete annexes. The first annex deals with decentralization and the possible linkage to social funds (the Nepal PAF is basically a social fund), the second annex addresses potential operating procedures for the Nepal Poverty Alleviation Fund, the third annex is a review of micro-finance in Nepal and the final annex contains suggestions for the proposed PAF law.

C. CONCEPTUAL FRAMEWORK

3. The 2000 World Development Report focused attention on a particularly important aspect of poverty, i.e., risk and vulnerability. This approach starts with the recognition that the poor are not a static group, and any effort to address the problem of poverty needs to be associated with addressing the risks of people falling into poverty and also providing people with a spring-board to move out of poverty. This concept, which has been developed into the Social Risk Management framework, lies at the heart of the World Bank's and the South Asia Region's social protection strategy. This strategy focuses not only on coping with the consequences of poverty (risk coping), but also on strategies to decrease the impact of future risk (risk mitigation) and reduce the probability of downside risk (risk prevention).

4. The Social Risk Management framework provides useful insights about understanding the nature of poverty in Nepal and how to address it. The proportion of poverty in the Hill and Terai regions are very close, but when examined from the risk management perspective point of view, a much greater proportion of the people in the Hill regions are at risk of falling into poverty than those in the Terai region because the risk factors are greater in the hill and mountain regions. This situation has implications for design and intensity of PAF interventions. Further insights can be developed from the risk management framework regarding how to address poverty in the Terai region where most of the poor are tenant farmers. If tenant farmers are salaried employees, then the risks are borne almost entirely by the landlord; if the tenant farmers pay fixed rent, then they bear almost all the risk. When crop-output is shared, then the risk is shared between the tenant and the landlord. Thus an analysis of the nature of tenancy contracts in the

region can provide insights into the appropriate design of poverty and risk reduction programs.

5. Risk management, if properly carried out, can even induce economic growth - leading to a longer term sustained reduction in poverty. Examples include: (a) micro-irrigation schemes will induce people in rain-fed zones to plant more water intensive high yielding crops; (b) provision of market access roads will encourage diversification of production; (c) education can increase employment options; (d) better health care, sanitation and drinking water will reduce the risk of not being able to work – temporarily or permanently; and (e) erosion control through social forestry not only prevents disastrous landslides but also increase incomes.

6. Decentralization is at the core of HMGN's strategy for empowering local communities and addressing government's failure to deliver services in areas critical to poverty reduction and risk management. But, it will take time and effort to build fully functioning local governments that are capable of being effective instruments for service provision. The establishment of accountable and responsive government will require reform of existing institutions and significant capacity building efforts. However, even a well executed centrally led strategy that combines reform with capacity building will be insufficient - unless complemented by community-led initiatives that build pressure on local governments for improved performance. The challenge of the decentralization process in Nepal is to support a process that avoids elite capture and leads to accountable and transparent local governments that are responsive to the poor. This outcome is far more likely if top down reform is supplemented by mechanisms that allow a wide range of local stakeholders to participate in the on-going task of identifying and implementing priority public actions.

7. Once established, representative and functional local governments can play a critical role in coordination of local development and service provision. However, external incentives may continue to be required - both to ensure that local governments provide adequate poverty targeting and to promote efficiency in service delivery. Local governments may require external incentives to adequately target the poor because the reduction of poverty is a national level public good, and because there may be powerful interests in maintaining the status quo. Thus, rather than allocate sufficient services (and higher investment) to the neediest segments of their population, local governments may be inclined to spread scarce resources evenly, or alternately favor powerful constituents unless there are explicit incentives to do otherwise. There is also a long-term risk that efficiency improvements in service delivery at the local level will not be realized solely through devolution of responsibility and resources to local governments. In this case, external incentives may be necessary to ensure that local governments adopt competitive and efficient outsourcing arrangements involving a variety of local actors for production of those services where government has no comparative advantage.

8. Although strengthening local governments and channeling resources through them is a key priority for achieving pro-poor access to resources and services in Nepal, it alone is not sufficient. Decentralization strategy must include actions to promote greater involvement of potential beneficiaries and civil society, generating pressure from 'below'

for inclusive and accountable local governments; and provide long term incentives for local governments to improve targeting and efficiency of service delivery.

9. HMGN is also aware of that the current insurgency is recruiting from sections of the population which have a sense of being passed over by government and do not see any benefits to them from the system. HMGN would like to increase the services benefiting the sections of the population who feel left out and thus reduce the grievances on which the insurgency recruiters feed.

10. Recognizing the value of complementary instruments that both support decentralization and improve service delivery, HMGN has initiated the formation of a Poverty Alleviation Fund (PAF). Even though there has been no overt linkage made in its papers, HMGN has, in effect, recognized risk management as a key to poverty reduction and designed PAF to help address the sources of risk. Risk management can be done by building sustainable micro-irrigation schemes, erosion control schemes, market access roads, and provision of sustainable services such as education, health and drinking water.

11. In addition to the above-mentioned objectives, HMGN views the PAF as a mechanism for monitoring and evaluating poverty reduction outcomes, for scaling up and replicating successful development programs to achieve 'results on the ground' whilst decentralization reform builds momentum, and for improving coordination and continuity of donor programs by pooling HMGN and donor resources for poverty alleviation. In the FY 2002 Development Budget, there are currently 363 HMGN funded budget lines costing NRs.11.7 billion (US$153.3 million) per year and about 300 donor-funded budget lines costing about NRs.38.8 billion (US$513.5 million) per year. A large portion of the Development Budget seems to be for poverty-targeted interventions. A long-term objective behind PAF is to provide an independent and transparent alternative which would allow the government to eventually shut down many of these existing government programs, while others may be transferred to local governments.. The government would also like to see donor assisted poverty programs also moving under the PAF umbrella by demonstrating an independent and cost effective mechanism.

D. REVIEW OF THE EXPERIENCE OF DEVELOPMENT PROJECTS IN NEPAL

12. The Poverty Alleviation Fund (PAF) has been established to finance social investment and public infrastructure projects at the local level throughout Nepal. Although this mandate is clear, the specific way(s) in which it will be realized is yet to be determined. This note is a summary review of the different approaches to local public investment that have been tried in Nepal, with a focus on the efficacy of competing institutional alternatives. The large number of donor and NGO-sponsored local development projects implemented throughout the country over the past two decades provide a rich source of data for such institutional comparisons. Fortunately, a number of detailed studies comparing the efficacy and cost effectiveness of projects realized under different institutional models has already been done. This note surveys their results for the sectors in which the PAF will operate.

13. Numerous studies financed by the World Bank, IFAD and others, and carried out by NGOs and technical consultants in conjunction with HMGN, show that the traditional model of public investment and service delivery – in which line ministries and central government agencies plan, finance and execute local public investments – perform less well than participative investment models centered on community organizations and local government institutions, which also involve the private sector. In particular, modalities of investment and service provision which combined explicit social mobilization[2], usually by NGOs, with the inclusion of community organizations, VDCs and DDCs throughout the project cycle resulted in lower unit costs, better quality of infrastructure, greater transparency in the use of funds, and longer-term sustainability. The last point, in the opinion of a number of expert observers, was largely the product of greater local ownership of project outputs, greater transparency, more realistic scope and size of projects so conceived, and use of more appropriate technologies.

Local Infrastructure

a) Village Roads, Bridges and Trails

14. Three reports examined competing institutional delivery models in this sector. They were an IFAD-sponsored SAPPROS study of service delivery systems in over 200 case studies in Nepal's hill and mountain regions,[3] a World Bank-sponsored SAPPROS study of service delivery systems in 60 case studies in the Terai region,[4] and a comparative study of road work groups vs. local contractors in eight case studies carried out by the Nepal Rural Infrastructure Project (RIP: World Bank).[5]

15. The first of these found that community-based models of investment and service delivery perform better than central agency models in the hill and mountain regions. Community approaches were marked by high levels of participation and good cost effectiveness, while agency-based models failed to involve users, and suffered from much higher costs, lower community contributions, and lower sustainability. In the Terai region, models that include community-based organizations (CBOs) perform better than agency models across the board. The former are cheaper, more transparent, and more

2 A broad term used widely in Nepal which refers to a combination of some or all of the following: organizing community groups, teaching/raising consciousness about the potential benefits of collective action for capturing and maintaining new investments, participative planning of investment projects based on need, organizing community counterparts, and training village/local groups to manage and maintain service provision ex-post.

3 HMG Nepal/SAPPROS/IFAD, *A Study of Rural Hill Potentials and Service Delivery Systems: A Comparative Assessment of Alternative Institutional Arrangements with a Focus on the Hill and Mountain,* April 2002.

4 HMG Nepal/SAPPROS/World Bank, *Delivery of Rural Development Services: A Comparative Assessment of Alternative Institutional Arrangements with a Focus on the Terai,* October 2000.

5 World Bank, Nepal Rural Infrastructure Project, Review of Overall Project Outcomes and Impact, Part II: Comparative Study of Work Performance Between Road User Groups and Local Contractors, June 2002.

accountable to users. Agency models in Terai were also marked by high costs and, in the authors' opinion, over-designed. Even for the comparatively complex case of suspension bridges, participatory approaches involving users and local bodies resulted in better quality of infrastructure and reduced implementation time, in addition to lower costs and better sustainability.

16. Table 1 compares unit costs for local transport projects under different delivery models. These figures serve for general comparisons only, as the projects on which they are based are very heterogeneous and do not, therefore, compare like with like.

Table 1

Unit Cost of Rural Roads, Bridges and Trails*

	Unit Cost (Rs.'000s/km)		
Institutional Delivery Model	**Rural Roads**	**Bridges**	**Trails**
Central: Agency-Centered	2,670 - 2,870	22.75	----
Intermediate: Donor-Local Body	1000	----	----
Local: Community-Centered	240 - 640	9.3 - 11	150 - 250

* Source: HMG Nepal/SAPPROS/IFAD, *A Study of Rural Hill Potentials and Service Delivery Systems*, April, 2002.

17. Nevertheless, it is clear that community-centered approaches are most cost-effective. Efficiency measures which the authors calculate for roads, bridges and trails likewise show that community-based models of provision score highest for both process and performance.

18. The studies found that VDCs in the hill and mountain regions worked effectively through user groups to mobilize local resources and build cost-effective infrastructure. DDCs, by contrast, were much less effective in this regard, often leading to relatively higher costs and a dependence on outside involvement for sustainability. Very similar results were found in the Terai. Where line agencies were pushed to operate in a more participative manner, the result was "pseudo user groups" with little substance or operational capacity, leading to higher project costs and long-term unsustainability.

19. The RIP study, narrower in scope but deeper and more detailed in its empirical treatment, found little difference in either the quality of works or the standard of maintenance between community-built projects and those built by local contractors. Community projects, however, were more labor intensive, using many more workdays for a given value of contract, and a greater proportion of this labor was local. This was reflected in a lower cost per workday: Rs.225 vs. 487. DDCs, VDCs and road users all reported somewhat greater satisfaction with community-based projects, due mainly to the employment opportunities they generated. The community approach was also useful for solving land acquisition and right-of-way problems quickly. The authors speculate that such projects will ultimately prove more sustainable due to the training that communities receive during implementation, as well as a greater availability of funds.

20. All of the studies underline the importance of social mobilization in achieving these results. Social mobilization was especially important for catalyzing local counterparts and providing technical training in the maintenance of infrastructure.

Because of this, the most effective model of institutional delivery involved NGOs working alongside community organizations, providing advice and technical supervision. Where CBOs worked alone, supervision was often weak and project technicians did not have the time nor the skills to solve social problems arising during implementation. This led to poorer project outcomes. This effect was especially pronounced for bridges.

21. The fact that road work groups are not legal entities in Nepal – not registered with HMGN – lends particular importance to social mobilization and supervision. Work groups can provide no legal guarantee of performance, and there is no legal recourse when their works go awry. Effective mobilization and supervision can solve many of the problems that can arise in community problems *ex ante* at a cost comparable to insurance or a guarantee, thus significantly increasing the probability of project success.

22. The power of a participative approach is evident in the experience of many hill and mountain communities. Despairing of official assistance, they have taken the initiative to build concrete bridges themselves by collecting funds from various sources and mobilizing community laborers. Similarly, in the Terai region CBOs have mobilized themselves to build technically sophisticated large-span bridges. These have been completed successfully at about 1/10 the cost of agency-funded contractors. Such examples point to the often-ignored potential of rural communities to contribute to their own improvement. When the goal is clear, the process transparent and inclusive, and the benefits widespread, local organizations can become protagonists in building roads, trails and bridges that are cheaper, better and more sustainable than the more centralized alternatives which have been tried in Nepal. In this way the developmental impact of relatively small amounts of funds can be multiplied.

b) Water & Sanitation

23. Two reports examined competing institutional delivery models in this sector: the IFAD-sponsored SAPPROS study of service delivery systems in over 200 case studies in Nepal's hill and mountain regions, and a World Bank-sponsored SAPPROS study of service delivery systems in 60 case studies in the Terai region.

24. Both reports found that community-based models of building and maintaining water and sanitation systems performed best overall. This modality resulted in better quality infrastructure and a higher standard of service than central (i.e., agency), private sector or donor-driven modalities. The authors judged these projects far more sustainable than any of the others they studied, with private sector-built systems least sustainable and agency and donor-built projects in-between. Community-driven water systems were also the most cost effective – both capital and O&M – with pure community (i.e., CBO) projects by far the cheapest, followed by private sector and then community-NGO projects. Donor and agency-based projects clearly had the highest unit costs. Table 2 provides more detailed information. Again, these figures serve for general comparisons only as they do not compare like with like.

Table 2

Rural Water & Sanitation Delivery Systems Compared*

Institutional Delivery Model	Per Capita Cost (Rs.)	Sustainability**	Infrastructure & Service Quality**
Central: Agency-Centered	2,863 - 4,961	4	4=
Intermediate: Donor-Community	3,750	3	3
Private Sector	1,064	5	4=
Local: Community-NGO	1,759 - 2,423	1	1
Local: Pure Community	333	2	2

* Source: HMG Nepal/SAPPROS/IFAD, *A Study of Rural Hill Potentials and Service Delivery Systems*, April, 2002.
** Rank based on authors' performance indices; 1 is best

25. The authors also calculated a process efficiency index, which broadly measures the inclusiveness and participatory nature of the different processes examined. Pure community systems did best on this measure, followed by community-NGO systems and donor-driven systems; agency-based systems were fourth best and private sector projects came in last.

26. It is notable that both studies found a strong relationship between the involvement of community and user groups in project planning and implementation, and quality and cost efficiency. The best water systems studied were marked by a total involvement of user groups from the outset. NGOs acted as facilitators only, and systems were designed with the active participation and approval of ultimate users. Users procured materials and handled the construction. Minimum community contributions to investment costs, either cash or in-kind, proved themselves important to project success. Water projects which benefited from comprehensive participation saw sustained improvements in water supply and sanitation, resulting in improved local health. Interestingly, the authors found that the quality of works was higher in these projects where contractors were not used, to which they ascribe causality. Pure CBO models, lacking NGO participation, displayed the most comprehensive community participation, but suffered from inadequate financing mechanisms for ex-post O&M.

27. By contrast, all the agency-based projects studied in the Terai, hills and mountain regions were high cost and mostly non-functional, not least because participation was low across the board. Despite the large investments made in these projects, or perhaps because of the same, they had proven unsustainable and did not work. Many agency schemes had formed user groups only after construction was complete, or formed what the authors term "pseudo user groups" from the start to comply with procedural requirements. Users and communities provided no contributions, and both transparency and accountability were low. No training was provided to designated maintenance workers or caretakers in many agency projects, and women were excluded from participation, except where NGOs were involved. Technical supervision of projects was notably weak, leading subsequently to numerous operational difficulties. Agency projects made more intensive use of contractors, and those contractors with social or political power won a disproportionate share of contracts. Where several sub-contractors were used on a single project, the quality of work was practically guaranteed to be poor.

Not surprisingly, the agency model was least preferred by community groups in these regions.

28. Agency projects were more often large scale despite the fact that many included communities with their own water sources nearby, where much simpler technologies would have been appropriate. This is particularly unfortunate as the evidence in these studies shows clearly that large and complex water schemes did not demonstrate economies of scale, and did not perform satisfactorily in terms of either process or final service production. According to the authors, "in hindsight these systems should not have been built. Rather, alternative low cost and decentralized systems should have been considered as these latter systems have shown far greater potential in terms of efficiency, equity and sustainability."[6]

29. One last, strong recommendation to emerge from the studies is that where possible hybrid projects comprising both drinking water and irrigation should be encouraged. The rigid sectoral division between water and irrigation should be overcome where sources permit, as this can help reduce the unit cost of both water and irrigation, and by giving users a greater stake in a project may well make it more sustainable.

30. The authors conclude that the government of Nepal has already invested some Rs.34 billion (in present value terms) in water and sanitation. "This works out to almost Rs.1700 per citizen. This amount of per capita investment should have been sufficient to provide safe drinking water to all Nepalese.... The status is that only about 60 percent of the Nepalese people have access to drinking water systems. About half of these systems are either fully defunct or are functioning very poorly."[7] If these resources had instead been invested in community-based, participative projects, much better results would almost certainly have been obtained, and perhaps all Nepalese would today have safe water to drink.

c) Irrigation

31. Fully 70 percent of irrigation systems in Nepal are community-managed, usually as Farmer Managed Irrigation Systems (FMISs), while the remaining 30 percent are government managed. Information for this sector is available from the Nepal Irrigation Sector Project (NISP), as well as the aforementioned SAPPROS studies of service delivery systems in the Terai and the hill and mountain regions. The NISP is an on-going World Bank-financed project which works to rehabilitate farmer-owned and managed systems mostly in the hills and mountains, and is thus a particularly appropriate reference point for the PAF.

32. The SAPPROS reports found that community-based investment models were superior for irrigation, with lower capital and maintenance costs and a high quality of construction. As operation and maintenance costs were paid locally by users, such projects were more sustainable than those built under competing modalities. Agency-

6 HMG Nepal/SAPPROS/World Bank (2000), p. 61.
7 HMG Nepal/SAPPROS/IFAD (2002), p.54.

driven projects, meanwhile, were costlier, over-dimensioned as a rule, and often of poorer quality. Of all the projects surveyed, community-based projects were the highest quality and provided the highest standard of service. This is surprising, as table 3 shows that unit costs were lowest for community-based projects, and highest for agency and private sector projects.[8] Pure community projects had by far the lowest costs, but were less well maintained than projects implemented by communities in conjunction with NGOs. NGOs proved valuable for the training and supervision they provided, assuring higher quality of construction than that achieved in CBO-only projects.

Table 3

Irrigation Delivery Systems Compared*

Institutional Delivery Model	Unit Cost (Rs./Ha.)	Sustainability**	Infrastructure & Service Quality**
Central: Agency-Centered	64,748 - 178,953	4	3
Private Sector	140,251	2	4
Local: Community-NGO	40,482 - 74,108	1	1=
Local: Pure Community	16,841	3	1=

* Source: HMG Nepal/SAPPROS/IFAD, *A Study of Rural Hill Potentials and Service Delivery Systems*, April, 2002.
** Rank based on authors' performance indices; 1 is best

33. The NISP experience generally supports these conclusions, but adds crucial subtleties. It is important to note that the quality of construction and maintenance carried out by communities is *not* always better than that of central agencies, and is not always high quality in absolute terms. This is because while some rural communities[9] have the technical capacity to build and operate local irrigation systems, others lack the technical know-how. Communities are especially lacking in the area of financial management and record-keeping. Community systems are often weak where they take water. And some communities (notably the Terai region) suffer from poor traditions of cooperation and self-government, and a low capacity to mobilize members for collective action. For all of these problems, the NISP has found Water User Association Facilitators (WUAFs) particularly useful. WUAFs are recruited from the community, receive technical training from NGOs involved in the project, and are paid modest salaries to help communities manage their projects and facilitate community relationships with higher levels of government. Where such local facilitation exists, and where NGOs are present to provide training and broader technical assistance, the NISP experience with community building and management of irrigation systems has been quite successful. Two important points concerning facilitation should be kept in mind: (i) in order to be able to work successfully in close concert with the community, facilitators should be chosen locally; and (ii) facilitators require technical training, which generally requires outside expertise.

[8] As always, these figures are for general comparisons only.

[9] Village irrigation systems are generally managed through Water User Groups (WUGs – for smaller systems) and Water User Associations (WUAs – for larger systems).

34. Both SAPPROS reports found that the involvement of central agencies tended strongly to increase costs and led to performance below potential. Agency-based projects pay very little attention to the institutional development necessary for sustainable system operation. They also tend to exclude poor and disadvantaged households from participation; when agencies intrude in Farmer Managed Irrigation Systems, they damage trust and community organization. Projects suffer from the ill effects of lack of coordination between organizations under the same ministry. As a result, the need for rehabilitation due to deferred maintenance is widespread amongst agency projects. But rehabilitation budgets are regularly exhausted before the necessary work is done, leading to long-term infrastructure decay.

35. By contrast, private sector and community-based projects feature much greater levels of participation in the planning and execution of investments, and accordingly higher levels of contributions from users during the O&M phase and greater sustainability. When allied to NGOs, private sector projects proved cost-effective and good-quality, especially for groundwater irrigation systems. Community projects benefit from the high level of trust in village societies, which can lead to equitable and efficient operation of the system. And CBOs involved in running local irrigation have proven themselves a rich source of innovation in the sector. Surveying 150 irrigation systems, the authors found that farmer managed projects perform better than agency managed systems. It is important to note that appropriate, empirically proven technologies exist for community irrigation in water-scarce areas (in terms of both irrigation and crops).

36. Lastly, consider the bigger picture. Despite a huge investment of almost Rs.66 billion in irrigation, the impact of centrally-driven projects on agricultural production in Nepal has been minimal because of the poor quality of infrastructure and service. Meanwhile in the hills, gravity schemes built by users with their own resources have been operating efficiently for generations, and provide better service than most centrally-managed projects. The gains to efficiency and production from returning to a locally-based investment regime in irrigation are potentially huge.

d) Education

37. In the education sector, unlike the other sectors reviewed above, no comprehensive studies of service delivery systems have been conducted. Modern Nepali history, nonetheless, affords a great deal of unsystematic evidence on the comparative performance of central vs. local systems for the provision of primary education.

38. Education in Nepal was historically community-based. Until 1972, there were few government/public schools. Communities raised the money and labor to build and maintain new schools themselves. They managed school finances and personnel, including hiring, firing and promoting teachers, receiving only token block grants from the government. Schools were accountable to the community, and functioned reasonably well, with good standards of infrastructure and maintenance in line with private village houses; teachers showed up to teach and pupils to learn, and schools kept regular weekly and term schedules.

39. In 1972, the central government assumed responsibility for primary education. There is little decision-making power at the school level for curriculum, texts, staffing or education finance. Since then, the performance of the sector has fallen dramatically. Classes do not take place with regularity, teachers are regularly absent, and the pass rate for students sitting the school-leaving certificate has fallen in recent years to 17 percent nationally in government schools, half the pass rate for private schools. This effect can even be seen at the micro level as new schools enter the system. New schools in Nepal are built by the community, and only fully qualify to enter the government system a few years later. In the interim they are financed and run locally. Upon qualifying, school performance reliably falls. There are some 3,000 schools in the country in this intermediate state, and the evidence to this effect is abundant. Community-run schools offer a much better service and are cheaper than central government schools.

40. The evidence as described above is so convincing that there is currently a firm national consensus across central and local government, opposition, donors, and community organizations that central delivery has not worked. As a result, Nepal is currently revamping its education system in order to return to the community model. After a large national debate on the issue, the government is returning primary schools to the community. All authority for hiring, firing and promoting school staff, including teachers, responsibility for financial management, and responsibility to build, supply and maintain school infrastructure will revert to school management committees at the community level. Central government will provide block grants to communities for textbooks and teacher salaries. These grants will hopefully be formula-based, and not discretionary. Primary-school students will not be charged fees, while secondary-school students may be.

e) Health

41. In the health sector, there is even less evidence than for education on comparative systems for service delivery. UNICEF is sponsoring one project featuring decentralized service delivery for women and children in 11 districts in the country. But this project only began recently, and it is to soon to judge whether it has been a success or not. As in many countries, the health system in Nepal, such as it is, has always been central. This is not in itself surprising. But it does contain certain local elements which are thought to work well.

42. Most notable amongst these are the Female Community Health Volunteers, present in 42,000 communities across the entire country. These support mothers' groups and provide basic health care to pregnant women, mothers and children. Volunteers are unpaid, receive elemental training, and are given simple health kits and small amounts of money for eventual expenses. As a rule, volunteers are active in the community, and have played an important role both distributing vitamin A capsules and in reaching and treating children with respiratory infections. Respiratory infections have as a result fallen significantly amongst children. Also, some villages have revolving funds for emergency obstetrics care. These are managed by VDC-level health management committees of nine members, and financed from user fees, central government block grants and other sources. These are also thought to work well, providing a needed service at the local

level. Lastly, a study of 15 sub-health posts recorded that moving supervision and monitoring to the community level resulted in facilities opening on time, more regular attendance of staff, better sterilization of equipment, greater cleanliness, and more frequent health education activities.

43. There is thus some evidence in the health sector that community-based approaches work well. In any event, the government has announced a movement towards decentralization in the health sector. In its recent Immediate Action Plan to Expedite Reforms the government has said that it will transfer authority for the management of sub-health posts to health management committees at the VDC level, which will have significant responsibility for these facilities' financial and operational performance. In this light, and given the evidence above, it makes sense for the PAF to adopt a community-based approach for the health sector.

Micro-finance

44. Nepal has a fairly sophisticated group of micro-finance practitioners and donors who are well aware of global best practice that discourages mixing financial service delivery (where loans must be paid back promptly) with the delivery of grant money (which does not need to be paid back). There is a great deal of successful experience in this country of savings-led micro-finance service delivery which has proved to be both operationally and financially self-sustaining after initial investments to build group capacity and social capital.

45. One example is the Small Farmers Development Program (SFDP). After nearly 20 years of the operation the program, run by the government-owned Agricultural Bank of Nepal, was beset by high operating costs and repayment rates that had fallen to unsustainable levels. GTZ's Rural Finance Nepal (RUFIN) project began in the early 90's to convert interested clusters of Small Farmer Groups from their dependence on the ADB/N Group Organizer, the Sup-Project Office and on the availability of below-market, donor funded lending capital, into independent Small Farmers Cooperatives Limited (SFCL). There are now some 107 SCFLs in the country who have attained operational and financial self sufficiency.

46. Another example are the many Savings and Credit Groups, some self-instigated, but many formed by NGOs and International Non-Governmental Organizations (INGOs). One of the leading INGO micro-finance practitioners is Canadian Center for International Studies and Cooperation (CECI) who has supported 106 such groups who have also attained financial self-sufficiency. In addition, other than the five regional government-owned Grameen Banks (all but one of which are insolvent, overstaffed and beset with politics), Nepal has several financially viable registered micro-finance intermediaries. These include the newly established Small Farmers Cooperative Bank which caters to the SCFLs mentioned above, a number of successful micro-finance Banks, as well as a number of NGOs which have registered under the Rastra Bank's legal provisions for Micro-finance NGOs. Many of these institutions operate primarily in the more densely populated and accessible Terai region which has much better market linkages and more commercial opportunities than the hills and mountain regions. But several of these

organizations have also begun delivering services in the hills, mostly based on the cooperative model.

47. Despite Nepal's vibrant micro-finance sector, outreach to poor rural borrowers is still very low with something like 6.5 percent of poor men and women estimated to have access to micro-credit through formal public and private sector institutions. Why has coverage remained so low? There is broad agreement in the micro-finance community that the constraints to scaling up include:

- Weak mainstream formal sector intermediaries – characterized by a cautious and rather bureaucratic banking culture and increasing politicization;
- Shortcomings in the policy and regulatory framework for micro-finance. Despite the fact that Nepal has adopted forward-looking policies which allow development banks with lower levels of capitalization, permit NGOs to register as financial intermediaries and grant limited banking licenses to cooperatives approved by the central bank, many flaws remain in the legislation and the central bank is overstretched in its regulatory role;
- General lack for rural infrastructure and markets which, in turn, limit the potential for high return rural farm and non-farm enterprises and the demand for money to finance these enterprises;
- Inadequate investment in social intermediation, capacity building of Micro-Finance Intermediaries (MFIs) and Business Support Services; and
- The security situation which has increased the general riskiness attached to all economic activities in the rural areas – and has particularly threatened the operation of micro-finance organizations and programs identified with the government.

48. Significantly absent from the list of commonly agreed constraints facing Nepal's micro-finance industry is shortage of lending capital. The remarkable success of Savings and Credit Groups shows that these small groups do not even need outside capital in their early stages because they are functioning in a largely subsistence economy. It is often only when they reach the stage of commercialization after several years of operation – or when a road or some new productive technology comes in – that these groups require capital beyond their own member savings. Indeed, a study done by CECI reports that for many of these groups their usual 97 percent repayment rate actually dropped when they received even small seed capital grants under the PDDP and LDT programs. There is widespread concern among micro-finance specialists that loans or even seed money from PAF could actually damage the discipline and sustainability of the strong Savings and Credit Groups which are emerging all over Nepal.

49. There are several sources of refinance available for the larger MFIs who are performing well and are able to demonstrate good lending and risk management practices. Most prominent is the Rural Micro-finance Development Center (RMDC) which was created several years ago and has a government-secured loan of $20,000,000

from Asian Development Bank available for on-lending to eligible micro-finance intermediaries. In its first three years of operation, RMDC has been able to place only about $2.6 million of its lending capital to some 17 borrowers. As the CEO of RMDC remarked, the problem in Nepal is not a shortage of lending capital. Rather he and many others in the field cite lack of capacity and poor enabling legislation and an inefficient mainstream banking sector as the main constraints on the expansion of micro-finance services in Nepal.

50. But this does not necessarily mean that PAF has no role to play in supporting the expansion of micro-finance in Nepal. There seemed to be broad consensus, that the PAF should provide funds to support NGOs to carry out social intermediation, but it should not provide loans or financial intermediation since ample lending capital is already available in the system as long as the groups are assisted in getting access to it. Since social intermediation and capacity building are public goods, this approach avoids requiring the PAF to involve itself in the allocation of funds that will support private goods (loans to individuals). All PAF funds can be given as grants where the main staff responsibility is to ensure that the grants are used efficiently and for the purposes intended, rather than making sure that the funds are paid back on time. It is very likely that by providing indirect support to build capacity among poor clients (through social intermediation) and among the organizations delivering micro-finance services, PAF will do more to help scale up the sector than itself become another apex intermediary.

Conclusions from the Review of Nepal Experience

51. Studies of the Nepali experience over the past few decades show that product efficiency and quality are closely related to the process by which projects are realized. Where there is strong participation on the part of community and beneficiary groups throughout the project cycle, quality and efficiency were higher regardless of sector. Adopting the right process leads to better projects, and better levels of service.

52. In education there is much unsystematic evidence that community-based approaches work better, and some evidence exists for health. But perhaps the more salient consideration is that in both sectors the government has made the decision to move towards decentralization and community-based approaches. This is consistent with the government's overall decentralization program. The most reasonable conclusion is, therefore, that the PAF should do likewise, and focus on small-scale local projects with high degrees of participation and community orientation.

53. In the case of roads, bridges and trails, water and sanitation, and irrigation, there is abundant evidence that community-based systems for service delivery work better than centralized systems. The infrastructure so produced, and the services that result are cheaper, better quality and more sustainable than those of line ministries. It is not a trivial consideration that users at the grass roots level are more satisfied with them and prefer them to the centralized option. But despite all of this, the bulk of national public investment in these sectors continues to go through the least cost-effective, least sustainable channel. There is great potential for large gains in efficiency in Nepal, and the PAF should lead the way in attaining them.

54. There does not seem to be any justification for PAF to support micro-finance in Nepal through lending. However, eventually PAF could support micro-finance indirectly through capacity building for MFIs. Even institutional support to micro-finance is difficult and this should not be considered by PAF as an option in its early stages.

E. THE WAY FORWARD FOR THE POVERTY ALLEVIATION FUND

55. The Nepali experience, detailed in the preceding section, shows that small community-based investment projects featuring high levels of local participation have had great success. Numerous studies financed by the World Bank, IFAD and others, and carried out by NGOs and technical consultants in conjunction with HMGN, show that the traditional model of public investment and service delivery – in which line ministries and central government agencies plan, finance and execute local public investments – perform significantly worse than participative investment models centered on community organizations and local government institutions. In particular, modalities of investment and service provision which combined explicit social mobilization[10], usually by NGOs, with the inclusion of community organizations, Village Development Committees (VDCs) and District Development Committees (DDCs) throughout the project cycle resulted in lower unit costs, better quality of infrastructure, higher transparency in the use of funds, and greater long-term sustainability. The last point, in the opinion of a number of expert observers, was largely the product of greater local ownership of project outputs, greater transparency, the more realistic scope and size of projects so conceived, and their use of more appropriate technologies – each of these a characteristic of community-based approaches[11].

56. The experience also shows that there is already a large amount of resources available for micro-finance in Nepal and that the results from different micro-finance programs are mixed; some very good, others very poor. Under these circumstances it may be advisable not to include micro-finance under the scope of PAF.

57. The Nepal experience is similar to experience from other parts of the world. Social Funds and social fund-type projects have achieved the same results, particularly when they have worked closely with local Governments[12]. Nepal offers the opportunity

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[10] A broad term used widely in Nepal which refers to a combination of some or all of the following: organizing community groups, teaching/raising consciousness about the potential benefits of collective action for capturing and maintaining new investments, participative planning of investment projects based on need, organizing community counterparts, and training local groups to manage and maintain service provision ex-post.

[11] In its initial phase, PAF staff would analyze the detailed results of such studies, and of the Nepali experience more generally, in order to identify local best practice in each of the sectors in which it will operate. Based on these it will set its own procedures, benchmarks and technical specifications for each of its programs and sub-programs.

[12] The World Bank's *SIF 2000 and Beyond Study* and results from various social funds documented in *SPectrum* special issue entitled *The End of Charity* (2001).

to further cement the link between social funds, community driven development and decentralization.

58. Based on the Nepali experience detailed earlier, and on global experience, certain key principles can be developed to guide PAF. These are: (a) limit its scope initially; (b) assure full autonomy and transparency; (c) develop a small, results-oriented organization; (d) avoid identification with current programs (all of which have both supporters and detractors); (e) complement the decentralization process including fiscal decentralization; (f) assure well-designed and sustainable services; (g) avoid micro-finance; and (h) assure ways to reach the poor.

59. Linkage to the fiscal decentralization process also provides a way for PAF to develop an exit (or at least a scope reduction) strategy unlike most social funds. As the process of fiscal decentralization provides more resources to local governments, and as their capacity increases, PAF could diminish its role to focusing on special target groups.

Limit the Initial Scope of the Poverty Alleviation Fund (PAF)

60. HMGN's long term vision for PAF is to develop an integrated program which can eventually replace most donor and HMGN funded poverty programs. This long-term goal can be supported, but it is strongly recommended that PAF start in a more focused and limited manner to develop an approach which through its efficiency, effectiveness and transparency can attract other programs to work through it. PAF should develop a locally-driven approach based on international Best Practice of Social Funds and also on the Nepali experience which has been documented in various studies. Once PAF has established itself as a credible, transparent, cost-effective organization, it can expand to its broader scope and replace much of the existing HMGN funded programs. The Government would then be in a position to request donors to use PAF as a preferred implementation vehicle for their programs and reduce the overhead costs of running separate programs. But donors are unlikely to agree unless PAF can be shown to be cost-effective, transparent and free from political pressure.

Assure Full Autonomy and Transparency of PAF

61. PAF should be fully autonomous including a Board with limited Government representation, preferably one member. This will not reduce effective Government control because the Ministry of Finance is in a position to control PAF through the flow of funds, including donor funds, if PAF does not perform as expected. The Government would require PAF to meet certain clear-cut objectives and benchmarks and allow PAF the flexibility to do so. These benchmarks and outcome indicators could be codified in a funding convention that the Government establishes with PAF.

62. PAF Board should be seen by all to be independent and above political manipulation. This can be achieved by appointing Board members of high integrity and independence, and giving them full powers, such as the power to formulate and amend rules, bye-laws and set internal conditions such as salary levels. It should have the power to recruit the executive head (Executive Director). Global experience indicates that the

most successful social funds are those that can learn from their experiences and adapt their rules and bye-laws to changing ground conditions, thus the flexibility of the PAF Board to set rules and bye-laws is essential for its success.

63. The Board should be responsible for approving projects but could delegate approval below a certain threshold to the Executive Director. The Board meetings should be held on a regular schedule planned well in advance so that all members can attend. Board members should receive the agenda and supporting documents well in advance of the Board meeting so that they may take decisions in an informed manner.

Develop a Results-Oriented but Lean Organization

64. PAF should be headed by an Executive Director recruited by the Board through open competition. PAF should have a monitoring and evaluation system which would include the following elements: (a) standard MIS; (b) structured field visits by PAF staff or consultants during and after implementation to assure that projects funded by PAF are having the intended impact; (c) a system of benchmarks based on global best practice and Nepali experience to enable PAF management to compare various cost-effectiveness and service delivery measures; (d) beneficiary assessment surveys; and (e) structured impact assessments. The results from this monitoring and evaluation system should be made available to the public in a regular manner to ensure transparency.

65. As noted above, the success of organizations like PAF depends on its ability to learn from field experiences and adapt operational procedures to those findings. While the Board is responsible for formally approving new procedures, it is the Executive Director who would propose the changes based on experience. Thus, a key responsibility of the Executive Director is to continuously examine experience and look at ways to improve effectiveness. The retrospective review may also be useful when the experience is good because of the possibility of improving it.

66. PAF should operate through a very lean structure with limited staff, and use consultants and NGOs to help its operations as needed. Branch offices should only be established if the volume of work in the area requires a presence, but their staffing should be limited. One issue is that Nepal has many districts (75) which are the first layer of local government below the central government level. PAF would be unable to establish offices in each district and still maintain a low overhead[13]. Offices could cover several districts, but the key to assuring synergy with decentralized government would be to give local governments a say in setting priorities. If a decentralized presence is needed at a district level, this can be established by recruiting NGOs or consultants. The advantage of this approach is that less effective personnel can be easily replaced and PAF does not develop too many long-term obligations.

67. This also implies that initially PAF does not work through Local Development Funds (LDFs) because this may increase overhead without bringing benefits, though PAF

[13] A good rule of thumb for overheads of social funds (PAF is essentially like a social fund) is about to 5% to 7% of project disbursements.

could co-finance projects at the district level (see below). In effect, overhead should be kept at a minimum level to ensure efficiency. Another reason not to work through LDFs is to avoid being viewed as a continuation of the old programs which have a mixed record.

68. PAF should finance projects only if they meet clearly established and widely disseminated eligibility criteria. The criteria would differ by type of project, but an essential pre-condition for all projects would be assurance of an effective operations and maintenance approach.

Avoid Identification with Existing Programs

69. If the Government is to succeed in establishing PAF as an attractive organization into which donors and HMGN can divert funding from existing programs, PAF must be given the opportunity to establish itself as a new and credible approach based on global best practices and Nepali experience. While PAF may take up the objectives of many existing programs, it should avoid picking up their approach. Instead, it should apply its own approach to meet the same objectives and in doing so establish a more effective and transparent approach which then may be used to replace that of existing programs.

70. From our discussions, it is clear that existing programs have both supporters and strong detractors. They should not be folded into PAF because of the risk of tainting PAF with the controversial, often poor reputation they have generated. This does not rule out PAF supporting eligible projects with similar objectives or the continuation of these programs outside of PAF but the main issue is to avoid PAF being identified with the negative side of existing programs. It should set a new style and image which will allow it to eventually attract funding from all sources.

71. Once PAF has established itself as a credible organization and developed effective alternatives to existing HMGN programs, then those programs could be eliminated and resources partially or wholly transferred to PAF.

Complement Nepal's Decentralization Process

72. Decentralization is at the core of HMGN's strategy for empowering local communities and addressing government's failure to deliver services in areas critical to poverty reduction and risk management. But Nepal is still far away from achieving such a decentralized institutional framework, and with an alarming situation of extreme poverty, armed conflict, lagging service delivery and a fiscal crisis, short-term emergency interventions for poverty reduction such as PAF are urgently needed. But it is important that in addition to its short term and transitory emergency role in poverty alleviation, PAF does not undermine the emerging decentralization process nor serve as an excuse for the government not to decentralize further and to slow the pace of decentralization. PAF should instead be designed to reinforce the decentralization. Once decentralization has advanced and inter-governmental fiscal transfers can take over for the bulk of the projects to be financed by PAF, the role of PAF would need to be reviewed.

73. There are strong reasons to believe that social funds can support decentralization by strengthening community groups and the local government system. Nepal's particular characteristics, and the strong political support for decentralization in evidence there, imply that a well-structured PAF could be particularly important in this role. Pursuing this should have the additional benefit of maximizing PAF effectiveness in a decentralizing environment. But this requires a significantly different design from the majority of SFs currently in existence.

74. Theory and empirical evidence strongly suggest that decentralization reduces the tension between social fund efficiency and poverty targeting by helping to redress the institutional and organizational disadvantages of poor communities. The PAF – and Nepal – can best take advantage of this by constructing project identification and design procedures which actively include CBOs and VDCs, and best take advantage of local information and other inputs. Good project identification and design involves combining different sorts of information arising from local government, the community, and the PAF itself into project plans and budgets. The PAF must develop procedures which are able to elicit and combine these different types and sources of information.

75. Local commitment to a project is of decisive importance. This should be substantive, and ideally involve concrete expense or the commitment of resources, and not just pro-forma declarations of intent. This must be rigorously confirmed at the project approval stage.

76. Good project identification, design and implementation will contribute strongly to operation and maintenance, helping the flow of benefits that derive from a project to extend well into the future.

77. PAF staff incentives are the key to ensuring that the conditions described above and hence are the key to project success. Staff performance should be measured by ultimate project success and sustainability, and not pass from one stage to the next. This can be reinforced by making project approval completely transparent and publicizing the results so staff and local representatives alike can learn from experience.

78. International as well as Nepali evidence suggests that the PAF should use direct contracting for small, simple projects. It should seek to exploit its supervision of such projects to transfer managerial knowledge on project administration to communities and local governments.

79. For PAF to contribute also to the decentralization agenda in Nepal the following basic rules need to be followed:

- The World Bank and donor financing of PAF should be conditional on clear evidence of advances on the policy framework for decentralization.

- PAF must not become a source of financing for local governments. Instead, PAF should complement a well established system of fiscal transfers channeled through MOF and the budget.

- In its initial phase, PAF should restrict itself to the direct financing of community sub-projects which would be co-financed by local governments to ensure consistency with village priorities.

- PAF must have a clearly spelled out exit strategy to decide from which districts, villages and sectors it withdraws and when.

- PAF should not compete with sources of financing for local governments for example by capturing all ongoing HMGN schemes under its umbrella rather than allowing some of these to be consolidated into a system of inter-governmental transfers.

- To ensure that complementarities between decentralization and PAF are well managed and PAF withdraws as decentralization expands, the PAF secretariat should be linked explicitly to the Fiscal Commission.

Assure Well-Designed, Cost Efficient and Sustained Services

80. A key element in risk management is ensuring that the services designed for risk management are provided regularly. It is important not only to provide the infrastructure for services but also to assure operations and maintenance.

81. A large amount of detailed empirical evidence shows that projects which include community organizations and VDCs throughout the identification, design, implementation and operation phases are not only cheaper to build and operate, but are also better designed, with a more appropriate scope and level of technology given local social and environmental parameters. More surprisingly, the quality of the resulting infrastructure is also superior to centrally-executed projects. And both the community and users are more committed to its continued operation, expressing greater satisfaction with the results than with agency-driven projects. A great deal of evidence shows that community-driven projects are better maintained and simply last longer than those carried out by line ministries and other central agencies. All of the studies consulted underline the importance of social mobilization in achieving these results. Social mobilization was especially important for catalyzing local counterparts and providing technical training in the maintenance of infrastructure. Because of this, the most effective model of institutional delivery involved NGOs working alongside community organizations, providing advice and technical supervision. PAF procedures for project approval should require community involvement and the development of a workable O&M program before funding, paying special attention to technical supervision and social mobilization. Preference should be given to projects that work closely with community based organizations and VDCs.

Avoid Micro-finance

82. The consensus among most donors and the NGO sector is that PAF should not be involved as a financial intermediary giving loans or even making grants of seed money to Savings and Credit Groups. Nepal has a fairly sophisticated group of micro-finance practitioners and donors who are well aware of global best practice which discourages

mixing financial service delivery (where loans must be paid back promptly) with the delivery of grant money (which does not need to be paid back). There is a great deal of successful experience in Nepal of savings-led micro-finance service delivery which has proved to be both operationally and financially self-sustaining after the initial investments to build group capacity and social capital are made. There are also examples of failures which one needs to avoid. The experience of micro-finance in Nepal is described in Annex 3.

83. There is wide-spread concern among micro-finance specialists that loans or even seed money from PAF could actually damage the discipline and sustainability of the strong Savings and Credit Groups which are emerging all over Nepal. PAF should avoid getting involved in micro-finance lending under any circumstances. Eventually, when PAF is well established, it could consider capacity building for micro-finance intermediaries but not lending (or even providing seed money to intermediaries for on-lending). Even micro-finance capacity building should be avoided until PAF is fully operational as this activity can be very management intensive and can distract PAF management from other activities with quicker benefits in terms of poverty and risk reduction.

Reaching the Poor

84. Poverty targeting takes two forms, explicit and implicit. Explicit targeting comprises overt attempt to match PAF resources to poor areas, through such devices as poverty maps and the use of poverty indices and human development type data at the project approval stage. Implicit targeting refers to the self-targeting of communities as a result of the PAF offering to finance projects that are naturally aimed at poor populations and not rich ones, such as primary medical care and latrines. It also operates via the explicit articulation of the PAF's poverty bias, which attaches a social stigma (or disseminates a general message that these investments are meant for poor communities) to PAF projects such that wealthy communities do not request them. In practice, these efforts are complementary and the PAF will employ both.

85. In general, social funds face a constant tension between reaching the poorest of the poor and financing projects in communities where the best conditions for project success exist. But decentralization and the spread of the institutions of local governance throughout a country will tend to reduce the tension between efficiency and poverty-targeting by redressing the organizational disadvantage of poorer communities and giving them voice and political power. Decentralization thus marks a two-fold stimulus to pro-poor institutions: the first directly through local government which is responsive to its constituency, the majority of which in developing countries will likely be poor; and the second indirectly by providing an incentive for the poor to organize themselves to take better advantage of local government's resources (demand effect).

ANNEX –1: ROLE OF PAF IN DECENTRALIZATION

The long-term outcome of Bank support should lead to functional, effective and accountable local governments delivering services to empowered rural and poor constituencies. The outcome would include:

- local governments financed through a combination of untied, matching, and tied transfers from central government, channeled through Ministry of Finance and internalized in the budgeting process. Transfers would guarantee vertical and horizontal equalization and be performance based and provide incentives for local governments to generate local revenues and to deliver on the regional and national public goods for which they may have a delivery advantage, including poverty reduction. Local governments will be generating local revenues based on their taxable and cost-recovery capacity;
- local governments with the basic financial and administrative capacity in place, and able to procure capacity support for more complex activities;
- accountability downwards not only through the electoral process but also through participatory budgeting, transparency and full disclosure and dissemination of information;
- empowered communities able to force responses from local governments; and
- a functional system at the central level to monitor the performance of local governments.

However, Nepal is still far from achieving such a decentralized institutional framework. Local governments in Nepal are new-born, and there is still a long way to go on administrative and fiscal decentralization, on capacity building and on empowering constituents.

Nepal is in a crisis situation with extreme poverty, armed conflict, lagging service delivery and a fiscal crisis. While effective decentralization is the long-term solution, short-term emergency interventions for poverty reduction are urgently needed. An instrument such as PAF has an important role to play as a transient mechanism to improve service delivery for the poor.

But it is equally important that in addition to its short term and transitory emergency role in poverty alleviation, PAF does not undermine the emerging decentralization process nor serve as an excuse for the government not to decentralize further and to slow the pace of decentralization. On the contrary, PAF should be designed also to create incentives for a more thorough and rapid decentralization process.

For PAF to contribute also to the decentralization agenda in Nepal the following basic rules need to be followed:

- PAF should be used to sharpen the demand for local governments;
- PAF must not become a source of financing for local governments, instead, PAF should complement a well established system of fiscal transfers channeled through MOF and the budget. The Bank and donor financing of PAF should be conditional on clear evidence of advances on the policy framework for decentralization. Support to PAF should be tied to the development and implementation of the fiscal framework for local governments. In its initial phase, PAF should restrict itself to the direct financing of community sub-projects which would be co-financed by local governments to ensure consistency with village priorities;
- PAF must have a clearly spelled out exit strategy to decide from which districts, villages and sectors it should withdraw and when. One criteria would be for PAF to withdraw from the financing of local public goods once transfers with incentives for poverty reduction are in place, transparency and participation in budgeting are practiced at the local level, and basic local public administrative capacity is in place;
- PAF should not compete with sources of financing for local governments, for example, by capturing all ongoing HMGN schemes under its umbrella rather than allowing some of these to be consolidated into a system of inter-governmental transfers; and
- To ensure that complementarities between decentralization and PAF are well managed and PAF withdraws as decentralization expands, the PAF secretariat should be linked explicitly to the Fiscal Commission.

The scenario one would like to see evolve would move from an initial period in which poverty funds are channeled mostly through PAF but where local governments have a say in how these funds are used to one where government puts in place the basic framework for decentralization and as local governments access more resources and capacity, PAF gradually reduces its presence and withdraws.

ANNEX 2: DETAILED NOTES ON POSSIBLE OPERATIONAL CRITERIA FOR PAF

General: The Nepal Poverty Alleviation Fund (PAF) should be a flexible and dynamic organization with a small, professional staff which works alongside decentralized governments to co-finance local investment in local infrastructure, social services and social mobilization. In accordance with the government's decentralization program, the PAF will be demand-driven, working directly with Village Development Councils (VDCs) and community-based organizations (CBOs) to identify local needs, design specific interventions in response to those needs, implement the resulting projects[14] (*i.e.*, infrastructure, training programs) and transfer project outputs to local governments.

The PAF will have the following characteristics:

Demand-driven: Proposals for PAF projects will come from CBOs in partnership with their VDCs or municipalities, or in some cases DDCs. They will preferably arise out of participative planning exercises that the PAF will be willing to finance (see *Social Mobilization* below). Such exercises, especially at the outset, will be mediated by facilitators skilled in participative methodologies, including NGOs and private consultants. They will aim to articulate comprehensive local development plans, different subsets of which will be executable by the PAF, line ministries and central government agencies, international donors and NGOs.

Co-financing: The PAF will finance a large share of total project costs. But in order to be eligible, projects must include significant contributions toward investment costs by communities, VDCs and/or DDCs. Limits for what constitutes "significant" will vary by poverty level, and the poorest villages may contribute only labor and materials. But a letter of intent or similar communication will not be enough for project approval – a significant local contribution is essential. In terms of the income distribution, suggested minima are:

Poorest Decile:	15% of investment costs
Next Quintile:	30% of investment costs
Third Quintile:	50% of investment costs
Upper Half:	Ineligible

Simple declaratory evidence of local support, such as community resolutions, letters from mayors or other local leaders, or verbal expressions of enthusiasm, will not be sufficient. Such evidence is close to costless, and will often be proffered on behalf of projects that are valued marginally by a community with few outside options. By contrast, municipal and community contributions in cash and kind, especially when made up-front in the project identification and design phases, represent a much higher hurdle. They require communities in particular to raise funds and solve the collective action problem, and thus constitute an acid test of their commitment.

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14 "Project" is used throughout to refer to PAF-funded sub-projects.

Consistent with the HMGN's decentralization program and the local focus of the PAF, project owners shall be VDCs or municipalities, or on occasion DDCs, and not central government or NGOs. Community groups and VDCs/Municipalities (and where appropriate DDCs) will co-sign all relevant contracts, and receive funds from the PAF. Once the investment phase is completed, the local government body (VDC, municipality or DDC) will own all assets created by the project. This is because a key purpose of the PAF is to strengthen local government, and not central government or NGOs.

What can be financed? Full investment costs, including materials, labor and equipment, as well as operation and maintenance during a project's critical start-up phase, are all eligible for inclusion in PAF project budgets. These will be co-financed as detailed above.

Eligible sectors will include:

Social Investment	Primary Health Primary Education Youth Training Programs[15]
Local Infrastructure	Water Supply & Sanitation Small-Scale Irrigation Village Roads Small Bridges
Social Mobilization	To include facilitation of community awareness, capacity building in local self-government organizations, fostering communities' ability to identify and prioritize their own needs through participative approaches, and building skills for project operation and maintenance. The PAF will finance such activities in order to help the poorest of the poor gain access to PAF projects, and thus as an input towards projects in the previous two categories.

Project Selection: Local needs, and corresponding (project) interventions, will be identified through participative planning exercises, per above. To be eligible for PAF funding, the resulting projects must fall under one of the eligible sectors above, and must benefit the Nepali poor. "Poor" is defined as the lower 50 percent of the income distribution. This focus on the poor will be operationalized through poverty targeting.

Poverty Targeting: Poverty targeting takes two forms, explicit and implicit. *Explicit targeting* comprises overt attempt to match PAF resources to poor areas, through such

[15] Providing formal training to poor youth who have abandoned formal studies for their incorporation into the labor market. These also help the young to develop their own recreational and cultural programs, and to become more involved in the activities of their communities. Such projects have proven successful at building human and social capital in Latin America, Africa and Eastern Europe.

devices as poverty maps and the use of poverty indices and human development type data at the project approval stage. *Implicit targeting* refers to the self-targeting of communities as a result of the PAF offering to finance projects that are attractive to poor populations only, such as primary medical care and latrines. It also operates via the explicit articulation of the PAF's poverty bias, which attaches a social stigma (or disseminates a general message that these investments are meant for poor communities) to PAF projects such that wealthy communities do not request them. In practice these efforts are complementary and the PAF will employ both.

In general, social funds face a constant tension between reaching the poorest of the poor and financing projects in communities where the best conditions for project success exist. But decentralization and the spread of the institutions of local governance throughout a country will tend to reduce the tension between efficiency and poverty-targeting by redressing the organizational disadvantage of poorer communities and giving them voice and political power. Decentralization thus marks a two-fold stimulus to pro-poor institutions: the first directly through local government which is responsive to its constituency, the majority of which in developing countries will likely be poor; and the second indirectly by providing an incentive for the poor to organize themselves to take better advantage of local government's resources (demand effect).

Social Fund Administration: In order to accomplish all of this efficiently, and ensure an agile, flexible, responsive and rapid PAF, its administration will have the following characteristics:

- Small;
- Professional;
- Highly transparent, with full public disclosure of all activities and results/outputs;
- Operationally independent of politics and day-to-day government and external pressures;
- Well-paid on a private-sector scale commensurate with acquiring and keeping the highest level of professional employees;
- Flexible, so as to allow goals to change and unexpected opportunities to be seized – an important characteristic of good social funds internationally;
- Good MIS system that makes all fund and project-related data available to all SF offices and personnel;
- A monitoring and evaluation system which includes benchmarking, beneficiary assessments, structured site visits and impact assessment;
- Extensive contracting-out of non-mission-critical activities, such as:
    - project identification (participative planning facilitation)
    - project design
    - project implementation/execution
    - operation & maintenance
    - institutional strengthening

Such contracting-out can reduce PAF overheads and increase institutional agility by allowing for rapid scaling up and less painful scaling down of activities, as conditions and demand dictate. Properly structured, it can combine with operational deconcentration to spur the formation of a skilled coterie of professionals in towns and villages throughout the countryside who are accustomed to the rigorous technical and administrative standards of the PAF, thus helping to spread human capital throughout a country rather than concentrating it in the capital.

ANNEX –3: POTENTIAL FOR PAF IN MICRO-FINANCE IN NEPAL

I. Introduction

There is substantial global evidence that the sustainable provision of financial services (including savings and a range of credit and even insurance products) to the working poor can help them manage risk and move out of poverty. Nepal has developed a large and vibrant micro-finance sector containing several examples of high outreach and financially sustainable institutions on the cutting edge of the industry. The country also has many more promising but as yet relatively small-scale programs – and some that have not followed industry best practice and are unlikely to survive donor withdrawal. From the mid 1950's, the Government of Nepal (GON) has in various ways tried to promote increased financial services for the generally underserved rural, and micro-finance sectors. Some government initiatives, such as the Small Farmer Development Program (SFDP)[16], have with donor assistance, transformed themselves from loss-making public sector programs into financially viable member-owned Small Farmer Cooperative Ltds. (SFCLs). Other government efforts, such as the Production Credit for Rural Women, and the five regional Grameen Bikas Banks, have made considerable outreach to rural poor and disadvantaged groups, but continue to be dependent on high levels of government subsidy and have often not been able to respond flexibly to client needs.

In the last 10 to 15 years, however, several private sector micro-finance institutions (MFIs) have emerged, along with numerous NGO-sponsored micro-finance programs that organize and support Self Help Groups (SHGs) or Savings and Credit Organizations (SCOs). In addition, there are many small self-organized informal SCOs that have sprung up to meet the need for financial services that are not being supplied to low-end rural customers by the formal banking sector. GON wishes to continue its tradition of support to micro-finance through the PAF. This note is an attempt to assess whether or not PAF can add value to Nepal's micro-finance industry – and if so, how.

The World Bank has recently completed a review of the Financial Sector in Nepal[17] which contains a chapter on micro-finance that gives an overview of the sector, describing the regulatory environment and key actors and also identifying some of the important issues and challenges presently before the micro-finance industry in Nepal. This note will draw from that review as well as other more recent data and reports as it seeks to assess the potential role of PAF *vis a vis* micro-finance; the reader is referred to the review for a more exhaustive picture of the sector.

This note is organized into four sections. After this brief introduction, section II will present a sketch of the micro-finance industry in Nepal including both public and private providers in the formal sector as well as an indication of the size and variety of informal sector

[16] Initiated in 1975 by the Agricultural Development Bank of Nepal (ADB/N).
[17] Nepal: Financial Sector Study, Chapter 7, pages 71- 85 and Annex 5 and 6, February 28, 2002.

providers. The main approaches or "models" which are being used in the Hills and Terai will be outlined and some of the most successful examples will be highlighted. The next section lays out the main constraints to sustainability and scaling up and finally, the note concludes by suggesting the potential role of PAF in easing these constraints.

II. What is going on in the Nepal's micro-finance sector?

(a) Informal Sector

By far, the largest source of finance for the rural poor of Nepal is through the informal sector which includes interest-free loans from family and friends (*sapat*), interest-bearing loans from money-lenders, landlords, traders, etc. (*rin*) and a variety of traditional rotating savings and credit associations (ROSCAs) where a group of generally homogenous people join to pool their capital through monthly savings which rotate to the group members by turn[18].

The Nepal Rastra Bank Rural Credit Survey of 1994 estimates that on average, nearly 80 percent of rural borrowing is from the informal sector. Dependence on informal sources is higher in the hills than in the Terai and increases as household income/land holding declines. Based on the available data for cumulative credit flows to micro-finance in the public and private sectors in Nepal over the last 20 years or so as presented in Table 1 and applying the Rastra Bank's estimate of the proportion of formal and informal sources of lending in the rural economy, the estimated magnitude of informal sector lending in rural Nepal would be somewhere around NRs. 14 billion ($940 million) over the last two decades, or NRs. 754 million (approximately $10 million) annually. Added to this are the previously underestimated annual undocumented inflows from Nepali migrants abroad which Seddon estimated to be between NRs. 35 and 70 billion in 1997.[19] What portion of these remittances find their way into the informal rural financial markets? From a series of in-depth case studies contained in the study, Seddon observes that "receivers of remittances and pensions are often involved in local money lending," but "the first use of remittances is to improve the standards of living (current consumption and house construction) and then to invest in non-agricultural sectors" and also in education and in marriage into wealthier, more influential families[20]. Based on this, it is estimated that somewhere around 10 percent of the remittances enter the informal credit markets. If we take Seddon's lower figure for annual remittances (Rs. 35 billion) and assume that only half of that goes to the rural areas[21], this would be an

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[18] These ROSCAs are called variously *dhikur, dhikuti, thakur,* in the local language. For more detailed description of the forms – both cooperative and exploitative – of informal finance see *Rural Indebtedness in Nepal,* Lynn Bennett, World Bank, 1990.

[19] Seddon and Acharya, "Foreign Labor Migration and the Remittance Economy in Nepal", ODA/University of East Anglia, 2000.

[20] Ibid, page 73.

[21] This is based on the fact that even though 70% of Nepal's population live in the rural areas (and hence could be expected to send their remittances to their families there), their remittances would be relatively *smaller per person* than those from urban migrants. As Seddon documents, urban migrants are more likely to have both the human capital and the social networks needed to get more highly paid jobs in developed

additional NRs 1.75 billion ($298 million) a year flowing into informal rural financial markets.

countries. Until recently, when the Middle East opened up as a source of more lucrative jobs for those with lower educational qualifications, the traditional employment destinations in India which were the only ones available for those with little education, paid relatively poorly.

Table 1: Estimated Savings Levels and Credit Availability in Nepal's Micro-Finance Sector

Program/Institution/ Source	Repayment Rate[1]	Number of Borrowing Members (% Female)	Number of Groups	Cumulative Savings (NRs millions)	Total Capital Available/ Loan Outstanding (NRs Millions)	Date and Data Source
1. Informal Sector[2]						
□Undeclared remittances from workers abroad		NA	NA	NA	750.	1997[3]
□Traditional ROSCAs[4]		NA	NA	NA		
□Unregistered SCOs[5]		500-700,000	20-30,000	NA		2002[6]
□Money lenders, friends, relatives		NA	NA	NA		
2. Public Sector						
□Deprived Sector Policy					3,000.	2000[7]
>IBP[8]	46%	256,439	NA	NA	1,730.8	1996[9]
>PCRW[10]	82%	73,700 (100%)	14,658	25.2	230.	1998[11]
>MCPW[12]	83%	20,855 (100%)	1,885	3.6	69.	1997
>BWP	92%	8,720 (82%)	1,664	8.7	81.	1998[13]
□Small Farmer Development Project	58%	189,061 (21%)	26,743	69.9	3,681.5	1999[14]
□Rural Self Reliance Fund	92%	3,323	84[15]	NA	16.6	1999[16]
□Grameen Bikas Banks (GBBs)	98%	148,247 (100%)	32,357	344.	5,728.	1998[17]
□Rural Micro-finance Development Center	NA	NA	NA	NA	1,336.	2002[18]
3. Private Sector						
□Registered Credit Cooperatives	NA	90,000	1,300	NA	243.	
□Small Farmer Cooperative Ltd (SCFL)		64,000 (37%)	107	5.8	10.7	2002[19]
□Small Farmer Development Bank (Sana Kisan Bikas Bank)[20]					105.	2002[21]
□NirdhanUttam Bank	(100%)	31,399		2.6	120.3	1997/2002[22]
□Center for Self Development (CSD)	(100%)	36,493		45.	153.7	2000/2002[23]
□SAPPROS		17,752 (63%)	1,167	9.	5.6	2001[24]
□CSD/Swabalamban Bank		10,340	402	2.	NA	
□SBP[25]		2,629	542	2.	7.4	1995
□WEP[26]		35,000 (100%)	7,000	NA	NA	
□CBED[27]	(97.8%)	15,600 (50%)	106	16.	70.1	2002[28]
□SAPAP[29]	(94%)	5,783 (54%)	213	9.[30]	11.7	Dec 1999[31]
□UNDP/LPG[32]		150,000 (45%)	6,091	4.	6.7	2002[33]
□PDDP[34]		76,858 (50%)	2,823	31.	NA	

[1]Estimated repayment rates may not be strictly comparable due to data and definitional problems.
[2]According to the Nepal Rastra Bank Rural Credit Survey (1994), the informal sector accounts for 80% of rural lending.
[3]Sedden and Acharya, "Foreign Labor Migration and the Remittance Economy in Nepal", OD/ University of East Anglia, 2000.
[4]Rotating Savings and Credit Associations
[5]Savings and Credit Organizations
[6]World Bank, "Nepal Financial Sector Study", Feb, 2002, p.
[7]Nepal Rastra Bank, "Banking and Financial Statistics", April, 2001.
[8]Intensive Banking with the Poor Program
[9]Shalik Ram Sharma and Vishnu Nepal, "Programs for Rural Poverty Alleviation in Nepal", ESCAP, April 1997, p.39.
[10]Production Credit for Rural Women Program
[11]Women's Development Division, Ministry of Local Development, HMGN, 1998; Sharma and Nepal, op.cip. p.43.
[12]Micro Credit Project for Women
[13]Rastriya Banijya Bank, "A Review of the Banking with the Poor Program of Rastriya Banijya Bank", Sept. 1999, Kathmandu
[14]Sharma and Nepal, op.cit.
[15]The Rural Self Reliance Fund lends to NGOs and CBOs.
[16]Sanjay Sinha, 2000
[17]Ibid (cross check with Shankar Man)
[18]RMDC Half Yearly Report, June 2002
[19]GTZ Powerpoint Presentation at World Bank, June 12, 2002
[20]Newly registered; will begin operations in mid 2002.
[21]Ulrich Werner, GTZ, personal communication
[22]Sharma and Nepal, 1997 op.cit. p.51; World Bank, 2002 op. cit.
[23]CSD Annual Reprot, July 2000; World Bank, op.cit.
[24]SAPPROS, "Profile of Support Activities for Poor Producers of Nepal", 2001
[25]Self Help Banking Program
[26]The Women's Empowerment Program (WEP) works with pre-existing groups rather than forming its own.
[27]Community Based Economic Development
[28]CECI, Community Based Economic Development (CBED) Progress Report, April 2002
[29]South Asia Poverty Alleviation Project
[30]May include NRs. 6.28 million of seed capital provided through the Local Trust Fund.
[31]SAPAP Report, UNDP, Dec. 1999
[32]UNDP Local Governance Program
[33]Center for Micro-finance (CMF), "Desk top research done to relevant work done to develop appropriate micro-finance models that can be offered to poor people in the hills of Nepal", May 24, 2002
[34]UNDP Participatory Development Program

Much of this credit, of course, would not go to the poor who cannot offer collateral. And the portion that would go to poor borrowers would probably bear a high interest rate and might also entail other onerous obligations (such as providing labor to the lender at below market rates or at the time of peak demand). However, many recent studies have found that the continuing "evil money-lender" stereotype is not always justified. The higher interest rates charged by the informal sector often reflect a very real risk of non-repayment as well as the much lower transactions costs for the borrower compared to formal sector sources. In its 2001 *Overview of the Micro-finance Sector in Nepal*, CECI reports :

> *Although informal sector interest rates are higher, the actual cost of borrowing is competitive. The average interest rate of formal sources is approximately 18 percent and informal sources are at least 36 percent, and often much higher. Borrowers interviewed in the Western hills indicated that the actual cost (including administration fees, transport, opportunity costs of time required for procedures, etc) is actually higher in banks even though interest rates are commonly 8-20 percent higher at cooperatives or informal sources."* [22]

Nevertheless, the historical records show that in the past informal finance has indeed often been highly exploitative in Nepal. While enslavement for debt (*misipe*) was forbidden in 1893, bondage (*badha/badhetyani*) was not outlawed until 1951[23]. And the practice has persisted despite its formal abolition[24]. Only in 2001, did the government pass a law freeing the *Kamaiya,* or bonded laborers, who are mostly concentrated in the far western region of the country.

Over the last 50 years or so, a new and much more encouraging kind of institution has emerged in the informal sector – one that is not based on asymmetrical relations between lender and borrower, but rather on mutual trust and collective risk sharing among people of roughly the same economic and social level. In 1988 the Nepal Rastra Bank carried out a study which uncovered a large number of permanent savings and credit organizations operating in the rural areas[25]. Unlike the traditional ROSCAs, these organizations did not disband after the savings had revolved, but instead remained together to lend pooled savings in a more flexible way as investment opportunities or consumption needs arose amongst their members. The anglicized name used for these organizations, *sosaitee,* suggests that the idea may have been imported with

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[22] CECI, Overview of the Microfinance Sector in Nepal, March 2001, p. 13. Similar findings are presented for India in Vijay Mahjan and Bharti Gupa Ramola, "Financial Services for the Rural Poor in India", page 215, *Journal of International Development,* Vol 8, no 2, Special Issue on Sustainable Banking with the Poor, edited by Lynn Bennett and Carlos Cuevas, John Wiley and sons, March-April, 1996.

[23] One of the key distinctions here is that bondage extended only until the debtor died (or was able to pay off the principal and interest of his debt) while enslavement extended beyond his own life and affected the status of his offspring as well.

[24] In 1984 a government study of 29 VDCs uncovered 89 bonded laborers (32 in the hills and 57 in the Terai). The average amount of debt which they were working without wages to pay off was Rs. 3,165. (HMG, 1984:31)

[25] Nepal Rastra Bank, 1988, "Promotion of Linkages between Banks and Self-Help Groups in Nepal", Agricultural Credit Division, Development Finance Dept, Kathmandu, Nepal.

migrant laborers returning from India or Burma who may have participated in informal savings and credit "societies" among workers or company-sponsored employee credit cooperatives. In any case, by 1996 there were an estimated 12,000[26] such SCOs or SHGs operating in Nepal and current estimates are between 20,000 and 30,000.[27] Most of them are unregistered and generally they have around 25 members, though this varies[28]. Some – especially those established more recently - have been mobilized by NGOs, but many are self-instigated. Some begin with a focus on savings and lending; others begin as user groups of some kind, organized around forest protection, drinking water systems, irrigation, health care, etc., that subsequently decide to add savings and credit to their activities. While this is an encouraging development, a recent report from the Rural Micro-finance Development Center (RMDC) cautions that not only is the scale of operations of these SCOs very small, but that most of the shareholders and beneficiaries, at least of the self-instigated SCOs, are from better-off members of the community and do not necessarily provide services to the poor and women.[29]

(b) Public Sector

The government's involvement in rural and micro-finance began in the mid '50s with its promotion of cooperatives in Chitwan. Some of the early **government-sponsored cooperatives** connected with the settlement of the Terai or plains area of Nepal that borders India, were initially successful. However, during the 1960's a system of compulsory savings was initiated which, over time, became highly politicized. The funds were controlled by ward or village chairmen who were often the biggest defaulters. For many years the world *sajha,* or cooperative, has had a negative connotation in Nepal which is only now beginning to be dispelled as genuinely member-owned institutions are beginning to re-emerge.

The government-owned Cooperative Bank established in 1963 was converted into the **Agriculture Development Bank of Nepal** (ADB/N) in 1968, lending not only to cooperatives, but to individual farmers and agricultural enterprises. At that time, ADB/N supplied 80 percent of the formal institutional credit to Nepal's rural sector.[30] In 1975, ADB/N initiated its well-known **Small Farmers Development Program (SFDP)** which organized small and landless farmers into groups and provided credit and technology training. These groups also became a vehicle used by UNICEF and other agencies to deliver social services to poor rural SFDP households. It is difficult to obtain consistent, up-to-date data on SFDP, but from the most

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[26]CECI, Community Based Savings and Credit Organizations in Nepal: Current Status and Future Prospects, 1996

[27] Nepal Financial Sector Study, 2002, op cit, p. 73.

[28] CECI, GTZ and other experts working in this field have pointed out that this is too small a membership base to permit the SCO to reach long-term financial sustainability. Both encourage the groups they work with to increase membership size of the primary groups (the average size of CECI-supported groups has grown to 147 members) and to federate with other groups.

[29] Half-Yearly Progress Report, July 2001-Jan 2002, Rural Microfinance Development Centre, Ltd, Kathmandu.

[30] Vijaya Ram Mathema, Microfinance and its Regulatory Framework in Nepal, paper presented at National Seminar on Micro Insurance Services, Kathmandu June 20-22 2000, p4.

reliable data available (for 1996)[31], there were some 189,000 farmer members organized into 26,743 groups served by 322 Sub Project Offices (SPOs) spread through all 75 districts of Nepal. The program had disbursed some NRs 3.6 billion in loans, but with this massive scaling up, the repayment rate had fallen to around 58 percent[32]. A World Bank study conducted in 1993[33] showed that high overhead costs of the program (37 percent of every rupee lent) would require it to charge an interest rate of 42.5 percent *per anim* if it were to become financially viable. Since this is considerably higher than the 24-36 percent generally charged in the informal sector, it became clear that the SFDP in its current form was unsustainable.

By the early 1990's GTZ had diagnosed the weakness of the SFDP model and in 1993 began to assist ADB/N to transform Sub Project Offices, which are run and managed by ADB/N, into member-owned and managed **Small Farmer Cooperatives Limited (SFCLs).** The conversion of this loss-making public sector program into profitable member-owned institutions is one of the success stories of Nepal's micro-finance sector. As of June 2002, the GTZ program has helped transform 107 SPOs into autonomous SFCLs and assisted them in registering and moving towards operational and financial self sufficiency[34]. Their membership and deposits are growing, and an unpublished GTZ study of a sample of 87 SFCLs showed that the financial self-sufficiency ratio had increased from a poor 39 percent in mid 1997 to 108 percent in mid-2000.[35] Membership and deposits have grown steadily and mature SFCLs have begun helping to replicate other SFCLs from existing SFDP groups, thus substantially reducing the costs of institution building that has been borne by the GTZ project and creating a larger membership base. The SFCLs have had the advantage of being able to augment their own savings with loans from ADB/N to expand their lending, but they have now established their own independent Apex institution. In July 2001, the Small Farmer Development Bank (*Sana Kisan Bikas Bank)* was registered; it received its operating license from Nepal Rastra Bank in March 2002 and expects begin lending from three area offices in mid 2002.

GTZ experience has been that it takes about three years and around $10,000 (excluding GTZ's own overhead costs) to transform an ADB/N Sub Project Office into an autonomous SFCL; but as noted above, these costs can be reduced by contracting with existing SCFLs to do the work . GTZ is targeting roughly 25 conversions per year for the next three years. However, over the last two years as the security situation has worsened, many of the SFCLs have been targeted by Maoist insurgents who have burned down offices, destroyed records and demanded

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[31] Shalik Ram Sharma and Vishnu Nepal, "Strengthening of Credit Institutions/Programmes for Rural Poverty Alleviation in Nepal", United Nations Economic and Social Commission for Asia and the Pacific (ESCAP), Bangkok, April 1997.

[32] It had fallen to a low of 39% repayment in 1990/91 immediately following the fall of Panchayat system and the institution of multi-party democracy in Nepal.

[33] J.D. von Pischke and Lynn Bennett, "Sustainable Financial Services for the Poor: Building on Local Capacity", World Bank, 1993, p.14-15.

[34] Broadly, operational sustainability means that the intermediary is earning enough from its lending and other services to cover the cost of operation (staff, offices, provisions and write-offs etc.) while financial sustainability means that these operational costs are covered as well as the true market costs of capital which the intermediary lends.

[35] These findings confirm an earlier published study of a smaller sample of 33 SFCLs by Ulrich Wehnert and Roshan Shakya entitled *Are Small Farmer Co-operatives Ltd. (SFCLs) Viable Microfinance Organisations?,* GTZ, Kathmandu, 2001.

that the SFCLs reduce their interest rates. Although most of the SFCLs have resumed business after the attacks, the security situation has affected them and reduced the pace of progress towards financial sustainability for some.

Another major government effort to direct credit to the rural areas and to the poor is its **Priority Sector Credit** policy which mandates commercial banks to allocate 12 percent of their loanable funds to rural, small scale industry and service sector lending at subsidized rates. Of the priority sector allocation, one-fourth, or a total of 3 percent of loanable funds, must go to the **Deprived Sector** – defined as those below the poverty line and various vulnerable groups, including women. This policy has lead to a number of government and donor-sponsored programs which since the early 1980's have tried to develop the institutional channels to deliver subsidized lending to poor and disadvantaged groups. The earliest of these was the **Intensive Banking Program (IBP)** which began in 1982 and worked through the rural branches[36] of commercial banks with special staff deputed to reach poor borrowers.

At around the same time, the UNICEF-supported **Production Credit for Rural Women (PCRW) program** began which used the newly formed Women's Development Department of the Ministry of Local Development to organize women into groups and assist them to gain access to a share of the Deprived Sector credit through linkages with the rural commercial bank branches. Most analysts have judged PCRW as successful in its *social intermediation* work because it was the first effort to organize poor rural women into groups and because it developed a strong cadre of Women Development Officers who lived in the villages where they worked and were highly committed to empowering poor women through group solidarity and access to economic resources to improve their livelihoods.[37] Like the SFDP groups, the PCRW groups became the focal point for a whole range of community development efforts sponsored by UNCEF and other donors during the 1980's and 1990's. Many of the groups developed into strong and sustainable local organizations and, although it was not part of the original project design, many groups decided to begin group savings. Some essentially transformed themselves into Savings and Credit Organizations that were still operating 10 years after the project had begun[38] and this has now become part of the PCRW program strategy .

However, in terms of the project's *financial intermediation* goals and its effort to link rural women into the formal banking system, the results were mixed at best. Despite the government "deprived sector" lending mandate, branch bank managers had little incentive to lend to the women's groups; loans were delayed and often came after the productive opportunity or the planting season had passed; repayment rates declined and overhead costs of the program were high and unsustainable. A follow-on program, the **Micro-credit Project for Women (MCPW)** funded by ADB/M in 1994, brought in NGOs to work with the Women's Development Department on social mobilization and to act as credit agents for the Banks in an effort to cut costs and improve women's access to

[36] Part of the government's policy was to require the two publicly owned commercial banks to open (usually loss-making) branches in the rural areas to increase access to formal sector finance for the rural majority of Nepal's population.

[37] Bina Pradhan, FASID, 1998; Mimi Church, (get rest of references)

[38] Von Pischke and Bennett, op.cit. p 40.

credit. It also introduced the idea of helping at least some of the NGOs that qualified to themselves become Micro-finance Intermediaries (MFIs). These specialized MFIs would then "compete" with the commercial banks to offer services to rural women, a clearly underserved market niche.

The most recent government effort in the micro-finance sector has been the establishment of five **Grameen Bikas Banks (GBBs)** in each of the five development regions between 1992 and 1996. These banks are replicating the well-known model of Grameen Bank in Bangladesh. They target only poor women and operate only in the more densely settled and accessible terai region where they have together reached a total of 148,247 borrowing clients[39]. The problem with the GBBs is that, despite high reported repayment rates (between 86 and100 percent), all but one of them (Western Grameen) are insolvent because they are overstaffed and beset with politics. By April 2002, they had accumulated losses of NRs. 177 million[40]. They are being recaptialized by the government now and steps are being taken to recruit professional management from the market (rather than retired central bank staff as at present), to downsize the staff and improve their accounting and bad debt provisioning practices.

In general, the performance of public sector micro-finance institutions and programs in Nepal has not been encouraging[41]. With high costs, little emphasis on savings mobilization and generally poor repayment, the programs threaten to be a continuing drain on the already strained government budget because most of them are far from even *operational* sustainability, let alone *financial* sustainability. In addition, they are increasingly vulnerable to political influence and many, because of their identification with government, have become a target for attacks by Maoist insurgents.

One exception in the generally bleak picture of government-sponsored micro-finance efforts is the recently established **Rural Micro-finance Development Center (RMDC).** In terms of its governance structure, RMDC is on the borderline between the public and private sector. Although GON is only permitted to own 49 percent of the institution, and 5 of its 7 board members are from private sector banks operating in Nepal, nevertheless RMDC has close links with Nepal Rastra Bank (NRB, Nepal's central bank) and has been permitted by GON to receive a government-secured loan of $20 million from the Asian Development Bank to on-lend to eligible micro-finance intermediaries. However, in terms of its "corporate culture," RMDC is decidedly private sector. It is managed in a highly professional manner and follows international best practice standards including requirements that the institutions it lends to meet rigorous criteria for financial soundness and good management. It is telling that as of June 2002,

[39] Nepal Rastra Bank, Development Finance Department, "Comparative Progress Report of five Grameen Banks", April, 2002
[40] Ibid.
[41] See Joanna Ledgerwood and DEPROS-NEPAL, *Critical Issues in Nepal's Microfinance Circumstances,* Institute for Reform and the Informal Sector (IRIS) University of Maryland, Collage Park, 1997, pp and Sanjay Sinha, chapter on Nepal in *The Role of Central Banks in Microfinance in Asia and the Pacific,* 1999, p161.

in its first three years of operation, RMDC has been able to make only 17 loans, placing about $2.6 million, or little over 10 percent of its available lending capital[42]
Some micro-finance practitioners complain that RMDC is "too strict" in its requirements. And it has had a difficult time in its first years of operation. Its initial on-lending rates (10 percent) were also not competitive with the subsidized lending available (at 6 percent) from commercial banks that are required to meet their "deprived sector" lending quota[43]. And, ironically, although RMDC was established to provide refinancing to the government-owned GBBs, it has refused to lend to all but one because, as noted above, these institutions have been so poorly managed that they are now technically insolvent.

However, RMDC has been instrumental in developing the conditions that must be met before GBBs are recapitalized by government and in getting NRB to agree and enforce the recommended changes in governance and management of the GBBs. RMDC has also provided training to a wide range of MFIs in Nepal to upgrade their accounting skills and knowledge of global micro-finance best practice. It has also been instrumental in building a consensus (through 3 major workshops it has organized on the subject over 2 years) to redraft of the flawed Financial Intermediary Act. The new law, which was recently passed by both houses of parliament, permits NGO-sponsored Savings and Credit Organizations to take deposits from their members and will make it much easier for NGOs to register as MFIs and thus be eligible for refinance from RMDC. Therefore, despite its slow start-up, RMDC is playing an important role in leading Nepal's transition from the previous era of unsustainable, highly-subsidized government micro-finance "programs," to a viable micro-finance industry with a range of private sector, public sector and NGO institutions that serve different parts of the market, but do so with the goal of long-term sustainability as well as outreach to the poor. The indirect "arm's length" support which HMGN provides to RMDC, reflects the global best practice trend in finance and many other sectors for government to increase its effectiveness by withdrawing from direct implementation to an enabling and regulatory role.

(c) Private Sector

Since the advent of democracy in 1990, the space for private sector participation in the formal micro-finance sector has grown. A substantial number of the many development NGOs formed after 1990 have pursued micro-finance, either as a main focus for their work – or, more often, as one of the many community development interventions they support. Nineteen NGOs have been able to register as MFIs, even under the difficult conditions of the old Financial Intermediary Act discussed earlier. Thirty-six more have submitted their requests and are awaiting NRB approval which should come more quickly now that the new law has been passed[44]. Nepal now has a

[42] "Progress and New Developments in Microfinance Sector (Feb-June 2002)", RMDC, Kathmandu.
[43] Over the last 10 years, commercial banks have increasingly chosen to discharge their priority/deprived sector lending obligations by wholesale lending to NGO or specialized institutions like the Grameen Bikas Banks who undertake the retail lending .
[44] RMDC, "Progress and New Developments in the Microfinance Sector : Feb-June 2002"

number of financially viable registered private sector micro-finance intermediaries. The NGO Nirdhan has established the Nirdhan Utthan Bank; the Center for Self Development (CSD) has established Swabalamban Bikas Bank; Deprosc Bank, and Chimek Bikas Bank have also been established by NGOs. There are also two cooperative banks which offer micro-finance services (Bindhabasini and Sahara Nepal). All of these institutions have received refinance from RMDC. In addition, there is the new Small Farmers Development Bank (*Sana Kisan Bikas Bank* or SKBB) noted earlier, which should begin providing services soon. With the exception of SKBB, most of these institutions operate primarily in the more densely populated and accessible Terai region which has much better market linkages and more commercial opportunities that the hills and mountain regions. Most of the micro-finance Banks have used the Grameen model (with modifications). But several of these organizations have also begun delivering services in the hills, mostly based on the cooperative model. Table 1 gives a rough sense of the outreach of these institutions and the magnitude of their savings and lending services.

There are also a number of INGOs, bilateral and multilateral agencies that are active in the micro-finance field including UNDP, ADB, IFAD, Action Aid, and PACT. GTZ's Rural Finance Nepal (RUFIN) program has already been cited in the discussion of the SFDP/SFCL transformation and it is certainly one of the best practice leaders in Nepal. Another best practice leader is the Canadian INGO, CECI that has supported the development of more than 106 SCOs in the remote western hills through its **Community-Based Economic Development (CBED)** program . This savings-led program teaches SCOs to use rigorous accounting methods (including ageing of arrears and bad debt provisioning). Clear benchmarks are set out including: (i) steady membership growth -- with a target for female and occupational caste membership; (ii) increased capital from retained earnings and savings; (iii) formal registration under the cooperative act; (iv) the hiring of professional bookkeepers; (v) higher capital use rates; and (vi) an emphasis on maintaining high on-time repayment performance. With initial help from CBED staff, each SCO carefully monitors its progresses towards the common goal of financial sustainability with wide social access.

Clearly CBED's business-like approach and its attention to performance tracking have paid off. As of April 2002, the aggregate repayment rate was 97.87 percent and arrears due more than a year were down to 0.85 percent of outstanding loans. The average SCO profit was NRs. 6,602 -- even after 75 of the SCOs have increased their expenses by hiring professional bookkeepers. Women represent half of the general members and 46 percent of the Board members of the SCOs, while people from occupational castes, represent 16 percent of the general members and 13 percent of the Board members. Seventy four of the SCOs have now formally registered as cooperatives.

The UNDP sponsored **South Asia Poverty Alleviation Program (SAPAP)** was the pilot for two much larger scale follow-ons, the **Participatory District Development Program (PDDP)** and the **Local Governance Program (LGP),** both of which worked closely with the newly established decentralized local government bodies. All three programs illustrate the difficulty of (i) combining micro-finance with a range of other interventions; and (ii) focusing primarily on outreach rather than on building sustainable micro-finance institutions that can continue to offer services long after the donor has withdrawn.

All three of these programs place great emphasis on social mobilization and the development of Village Organizations (VOs) in the case of SAPAP and Community Organizations (COs) for PDDP and LGP. The main difference between the VOs and COs on the one hand, and the SCOs and SCFLs on the other, is that the former are charged with a whole array of poverty alleviation/community development objectives, while the SCOs and SFCLs concentrate on micro-finance service delivery and the building of their own institutions – and they have a very clear set of financial management and accounting practices they are trained to follow to achieve the commonly understood goal of financial and institutional self-sufficiency. A comparison of SAPAP, SFCLs and CBED-sponsored SCOs carried out by CECI[45], concluded that the performance of SAPAP in the area of micro-finance was limited by the program's broad range of objectives, by the relatively lower level of emphasis placed on institution-building and by its lack of a business-like (rather than a welfare) approach to micro-finance. As the CECI report notes:

> *SAPAP is a poverty alleviation program in which savings and credit are a complement to activities that build community awareness, confidence and links with (local) government. The activities and program are designed around this central goal. SCFL and CBED, on the other hand, follow Best Practice of the micro-finance industry and aim to promote sustainable permanentinstitutions. While this could be one aim of SAPAP and PDDP within a 10-15 year framework, savings and credit remain a "program activity" at the present stage. Groups have not reached the scale to cover operating costs of a professional operation, and services remain at the most basic level. SAPAP is not an institutionalized finance program and does not have protective mechanisms such as reserves and supervision committees*[46].

It is important to note that this is not a judgment on the value or even the performance of the SAPAP and PDDP/LGP projects, but rather a reflection of the fact that these projects had different – and much broader – outcome objectives than the CBED or SFCL projects which were narrowly focused on developing sustainable micro-finance institutions[47]. While the SAPAP-promoted VOs have a high aggregate repayment rate of 94 percent, the 1999 SAPAP Progress Report mentions that VOs sometimes allow renewal of loans from VO capital – meaning that repayment figures may be misleading. In terms of broad objectives, the COs formed under the PDDP program have the same

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[45] An Overview of the Microfinance Sector in Nepal,. CECI, March 2001
[46] Ibid, p. 100
[47] It should also be pointed out that comparative analysis was conducted by CECI which sponsors the CBED project and generally supports the cooperative approach to micro-finance, there may have been some tendency to interpret CBED and SFCLs in a more favorable light.

weakness. Neither the capital base mobilized through savings, nor the average number of current members (26) is sufficient to enable a CO to become an autonomous, economically viable institution. The CECI study concluded that there is a high level of government involvement in the COs which function primarily as units promoted to deliver project services rather than viable institutions. The small scale of (micro-finance) activities, the provision of seed funds and the combination of financial and non-financial services within the same organization may be considered weaknesses from the point of view of Best Practice."[48]

The passage above alludes to one of the important findings from all three programs, CBED, SFCLs and SAPAP, and indeed from programs across Nepal and from global micro-finance experience: group members are always more careful to repay loans which they have taken from their own pooled savings than they are when loans come from money they perceive as coming from an external source. GTZ reports that the repayment rates of SFCLs are much lower on the loans they "inherited" from the subsidized government SFDP program, than on their own internally generated capital. CBED reports that where SCOs in their program have obtained access to "seed money" through the PDDP or LGP programs or other sources, repayment rates have declined. Even SAPAP found that group members' repayment of the seed money grants from the project and the Local Development Fund (LDF) was lower than repayment for loans from members own pooled savings[49]. UNDP's review of the program concluded that "ownership of funds greatly influences the interest rates set on loans and the repayment of loans". Five in-depth case studies of rural group-based micro-finance initiatives carried out in India, Sri Lanka, Pakistan and Nepal, found that "the central concept of client ownership" was the main factor behind the success of some programs and the failure:

"Internally generated funds (known in financial circles as "hot money") tend to instill a sense of ownership and respect for loan contract enforcement by all group members. External funds from government for donors channeled through the NGO ("cold money") may be called loans, but they are often perceived as grants by borrowers – especially if they are given by the same NGO that gives other services and inputs for free." [50]

This issue of mixing the delivery of "business and charity" or loans and grants in a single institution is a central one for the PAF and its involvement in micro-finance, and one to which we will need to return.

(d) Fitting the Institution to the Geographic and Economic Setting.

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[48] Ibid, p. 71
[49] Ibid, p. 100
[50] Bennett, Goldberg and Hunte, "Ownership and Sustainability: Lessons on Group-based Financial Services from South Asia" in *Journal of International Development*, Vol. 8, no. 2, March April, 1996, pp 271-288.

It is notable that both of the most successful micro-finance initiatives discussed so far (the CECI supported SCOs and GTZ-supported SCFLs) which have worked in the hills of Nepal, as well as many other smaller programs, are based on the cooperative model. But there is another model based on the Grameen Bank in Bangladesh that has also had considerable success in the Terai (plains) region of Nepal. Although the government-sponsored GBBs have not proven to be sustainable, there are two private sector Grameen replicators, the Swabalamban Bank and the Uttam Bank implemented by two NGOs (CSD and Nirdhan, respectively) which have both achieved financial sustainability and considerable outreach among poor rural women.

There is some rivalry between the Grameen replicator and the cooperative models -- though it is increasingly acknowledged among micro-finance practitioners in Nepal, that no single model will fit the great variety of geographic and market conditions that characterize the country[51]. It is generally recognized that the hill and mountain areas of Nepal require a different kind of delivery model, one that has much lower overheads and can thrive in a landscape of scattered settlements and in a less dynamic, still largely subsistence economy where there are fewer obviously "bankable" quick turn around activities for borrowers to invest in. However, developments in Bangladesh, where the Grameen model originated, show that the cooperative model can operate with overheads of between 2-3 percent, while the highly centralized Grameen model requires overheads of around 30 percent[52]. This suggests that even those working in the Terai in conditions roughly similar to those in Bangladesh, may need to rethink their assumptions about the best business model for sustainable micro-finance delivery.

III. Constraints to Scaling Up

The preceding section documents the fact that Nepal has been able to develop a number of promising approaches to sustainable financial service delivery to poor rural women and men. However, coverage is still very low. The World Bank review estimates that only 6.5 percent of Nepal's poor has access to micro-credit through the formal public and private sector institutions described in the preceding section[53]. And if we were to raise the bar and estimate access to *sustainable* micro-finance services, the proportion would be even smaller.

What are the constraints to scaling up the successful models which have emerged? There is a high degree of consensus in the micro-finance community in Nepal about the ills that beset it and keep it from reaching its potential. The main issues are described in the following sections.

(e) Quality of the Overall Financial Sector and Mainstream Formal Sector Intermediaries.

[51] This observation was endorsed by the participants in the June 14, 2002, conference on "Models for Microfinance delivery to the poor in the Hills of Nepal" sponsored by the Center for Microfinance (CMF).
[52] Shri Krishna Uprety, personal communication.
[53] Nepal Financial Sector Study, p.79, op. cit.

It is difficult to build a financially sound, well-managed micro-finance sector when the overall financial sector is performing as poorly as Nepal's. The weaknesses of the financial sector are well known and have been reviewed in several publications including the recent World Bank Financial Sector Study[54]. Lax accounting standards and provisioning practices, a plethora of institution specific regulations, an over stretched central bank, heavy government intervention, over staffing, politicization and corruption: all of these issues inevitably influence the practice of micro-finance in Nepal even though most micro-finance practitioners are themselves struggling to create alternative systems. We will mention only a few issues where the direct negative effects of overall ills of the financial sector on micro-finance operations in Nepal can be most clearly seen.

Even though it is difficult to document, there is little doubt that the **cautious and rather bureaucratic "banking culture"** that prevails in much of the sector has meant that few commercial or even development banks have been willing to do the extra work and take the risks involved in developing a profitable rural finance business – let alone seeking out the micro-finance niche. This is true despite the fact that Nepal's commercial banking sector currently has some NRs 50 billion[55] in liquidity – considerably more than it is able to profitably lend to its existing client base.

Where government-owned financial intermediaries such as the ADB/N or the Grameen Bikas Banks have been active in the rural and micro-finance sectors they have been beset by **increasing politicization**. As noted in the preceding section this has meant: (i) low performance expectations of unionized and highly politicized staff; (ii) interference from political parties in staff hiring and firing with little reference to merit or performance; and (iii) lax enforcement of repayment from politically influential borrowers with the resulting overall erosion of repayment performance and consequent lack of financial sustainability of public sector banking institutions.

(f) Policies and regulatory framework.

As noted above, during the 1990's GON had begun to move from an implementing to a facilitating role in its support to micro-finance. Although progress has come in fits and starts, there has been a definite shift away from direct intervention and government involvement in retail micro-finance lending to greater reliance on indirect influence through legislation and policy reform and through wholesale lending to NGOs, Co-operatives and the growing number of MFIs. Allowing commercial banks to meet their deprived sector quota through wholesale lending to the Grameen Banks and other specialized micro-finance lenders, support for the transformation of the government-sponsored SFDP program to autonomous SCFLs with their own Apex bank; on-lending

[54] See also Shalik Ram Sharma and Vishu Nepal,"Strengthening of Credit Institutions/Programmes for Rural Poverty Alleviation in Nepal", ESCAP, 1997; Vijay Ram Mathema, "Micro Finance and its Regulatory Framework in Nepal", paper prepared for National Seminar on Micro-Insurance Services, June 20-22,2000, Kathmandu; CECI-Nepal, "Overview of Microfinance Sector, op.cit.

[55] Shakti Prasad Shrestha, personal communication.

to well-run MFIs through institutions like the Rural Self Reliance Fund and RMDC are all moves in the right direction.

On the legislative front, the **Cooperative Act** of 1992 was a welcome change. It replaced the previous system of government-controlled cooperatives with provisions for member-owned cooperative organizations. However, a number of shortcomings in the Act remain which have been discussed in detail by others[56]. One of the most obvious constraints to the development of a healthy cooperative sector is the provision for only one single-purpose cooperative federation per district and one at the national level. This provision effectively grants monopoly status to the first savings and credit cooperative to register in a given district (or at the national level) and prevents the organic growth of federations in different (often geographically unconnected) regions of the same district. The Act also provides no specific guidance for savings and credit coops – which have different needs from sector-oriented, production cooperatives (such as milk producers) or cooperatives organized to provide agricultural inputs and processing services to members.

Another shortcoming of the Act is the recent amendment that imposes taxes on cooperatives. This amendment was a legitimate response to the fact that many urban "cooperatives" have sprung up that are not true member-owned organizations, but really profit-oriented entities interested in raising deposits. While it makes sense to try to bring this category of financial intermediary into the tax net, the amendment has had the unintended consequence of increasing the operating costs of legitimate member-owned cooperatives that are serving remote rural areas.

One area where Nepal has been a regional leader in South Asia has been the willingness of the NRB to grant limited Banking licenses to NGOs engaged in micro-finance. However, there continues to be some ambiguity about precisely what is permitted under this act since NRB retains the right to impose additional restrictions on deposit mobilization, interest rate spread, area expansion and capital adequacy requirements, etc.[57] on a case by case basis -- and has done so on numerous occasions. Another significant advance has been the passage of the Development Banking Act in 1996 which encourages the establishment of development banks in underserved regions by offering lower capitalization requirements depending on the remoteness of the bank's headquarters. It is this Act which has allowed a number of prominent micro-finance NGOs (such as Nirdhan, CSD and others) to transform themselves into banking institutions.

Another piece of legislation, which was greeted with considerable enthusiasm at first until its flaws became apparent, is the Financial Intermediaries Society Act of 1998. Intended to permit registered NGOs to offer limited financial service to their beneficiaries, the Act had a number of provisions which made NGOs reluctant to register under it. For one thing, it made NGO Board members and management personally

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[56] CECI, 2001, op. cit., pp.47-48; Sharma and Nepal, 1997, op.cit. pp.13-14;

[57] Sharma and Nepal, op.cit. p14

responsible for liabilities assumed by the NGO; it also required that NGOs travel to the Head Office of NRB each year for renewal, which is a logistical and financial burden for small rural-based NGOs working far from the capital. But the most paradoxical provision was the restriction on NGO mobilization savings when this is the very basis of their route to sustainability[58]. The way the Act was interpreted by the Legal Department of the NRB resulted in the prohibition of exactly what it was intended to permit. Fortunately, major amendments to the Act have recently been passed by both houses of parliament, so it should now serve to support rather than constrain the institutionalization of MFIs in Nepal.

Micro-finance practitioners in Nepal correctly point out that many drawbacks and inconsistencies remain in the policy and regulatory framework for micro-finance. It is also true that some of the "old-style" government-implemented programs like SFDP and PCRW remain in operation. Even worse, many politicians are still keen to see government support certain populist poverty lending programs like Mahila Jagriti and Biseswor with the Poor. But overall, GON is moving in the right direction in its efforts to support micro-finance as an important element of its poverty reduction strategy.

(g) General lack of Rural Infrastructure and Markets

Micro-finance practitioners have long known that perhaps the greatest constraint on the growth of a vibrant micro-finance industry in Nepal is the lack of opportunity for productive micro-finance investment in vast areas of the country where lack of motor access cuts communities off from commercial markets. The remoteness of many of Nepal's poorest communities means that getting access to productive inputs is expensive – and that all too often what is produced finds no local market and is prohibitively expensive when it must be transported for sale by animal or human labor. The example is often cited of the delicious apples of Jumla in western Nepal. All too often these apples serve only as expensive animal fodder because they are produced in a location where there is insufficient local demand and too far (a threeweek walk) to the nearest road head. To compare this with the success of apple production in the adjoining Indian Himal where there is motor access is to understand that part of the success of micro-finance in Nepal lies outside the micro-finance sector itself.

(h) Inadequate Investment in Social Intermediation, Capacity Building and Micro-enterprise Support Services

This review has focused mainly on estimating the financial flows to micro-finance, assessing the various informal sector, public sector and private sector institutions available to intermediate these financial flows and the overall legal and regulatory structure in which these institutions operate. However, it is widely recognized in Nepal and in the global micro-finance community that sustainable financial intermediation with the poor depends critically on investment in social intermediation. Especially in countries like Nepal where literacy levels are low, infrastructure poor, and where many of

[58] RMDC Half-yearly Report, June 2002

the poorest live in scattered remote settlements, women and men whose social identity, economic status or geographic location have excluded them from access to mainstream financial services must be mobilized and assisted to organize themselves. Their capacity for collective action and their organizational and financial management skills must be developed to prepare them to interact with mainstream financial institutions, not as beneficiaries or recipients of perpetual welfare subsidies, but as good customers. The CBED and SFCL examples cited earlier, the work of SAPPROS and many others – show that underserved groups in Nepal can learn how to take on the high cost task of retail financial intermediation thus enabling formal financial institutions to serve them much more efficiently as wholesalers.

Social intermediation is not, however, costless. Based on the earlier noted GTZ costs per rural community and estimating around 40,000 rural communities in Nepal, it would take an investment of around $400 million to build sufficient capacity in these communities to enable them to handle basic retail savings and lending services themselves and to develop their local organizations to the point where they can either federate and have their own Apex wholesale institution on the cooperative model, or they become attractive customers for development banks such as RMDC or private sector MFIs such as Nirdhan Uttam Bank [59]. This is only a very tentative estimate since GTZ itself notes that the per community cost does not include the costs of GTZ's expert staff, while on the other hand, they have found that these costs can be cut in half when the local organizations themselves begin to take on the social intermediation work of organizing and building the capacity of new groups. Of course, there are many other donors (many of them mentioned in the preceding sections) who have already made substantial investments in social intermediation through projects like SAPAP, PDDP, LDP and many NGOs and INGOs who are active in this area and have developed effective approaches. Nonetheless, it appears that a financing gap remains in this area and support for social intermediation could be an important long-term investment in poverty reduction.

In addition to the critical local self-organizing dimension of social intermediation, there are two other dimensions that are important to the creation of a vibrant micro-finance sector in Nepal. One is the need to **build the organizational capacity and the global best practice knowledge of the MFIs** who seek to offer social intermediation and sustainable financial intermediation services directly to the poor or to their Savings and Credit Organizations. Most of the recent reviews of Nepal's micro-finance sector have concluded that in addition to the poor enabling legislation and inefficient mainstream banking sector already discussed, the central problem for the micro-finance sector in Nepal is <u>not</u> shortage of lending capital, but rather a <u>lack of professional capacity</u> [60].

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[59] As noted in the text, GTZ's estimate is that it takes $10,000 over three years to convert one SPO into a sustainable SFCL. The estimate of 40,000 rural communities was given a in presentation made to the World Bank by Ulrich Wehnert who is Principal Adviser to GTZ's Rural Finance Nepal (RUFIN) program in Nepal.

[60] RMDC, CECI, World Bank, Sharma and Nepal, Joanne Legerwood, Sanjay Sinha. (get full references and page numbers.

Fortunately, Nepal has a number of organizations which are seeking to advocate for a better enabling framework and to improve the overall awareness of best practice in the sector. In addition to RMDC, which carries out advocacy and training in addition to its refinancing role, these support organizations include:

- the Micro Finance Association of Nepal (MIFAN)
- the National Federation of Savings and Credit Co-operative Unions Ltd. (NEFCUN)
- the National Co-operative Federation (NCF)
- the Center for Micro Finance (CMF)

Several of these organizations also offer technical and managerial training to the staff of MFIs – and NGOs involved in micro-finance but not yet registered as MFIs. In addition, there are projects such as the ADB-funded Micro Credit Project for Women (MCPW) and the recently completed USAID supported Women's Empowerment Project (WEP) which have focused on preparing NGOs undertaking micro-finance to bring their accounting standards and staff skills to the level where they could qualify to be registered under the Micro Finance Intermediary Act.

The other important non-financial dimension of successful micro-finance is **business development support (BDS)** for borrowers who graduate beyond small subsistence enterprises and seek to expand into higher return, more commercially-oriented small businesses. Many of the barriers they face have to do with the lack of infrastructure and market access mentioned above. But in addition, there are many basic business skills that borrowers need to acquire and services that can help them when they seek to grow their small businesses or enter new markets. These include linkages with business networks, advisory services, entrepreneur training, provision of market information and the development of lower-cost or higher value-added technologies.

Many donors, including the Swiss Development Cooperation (SDC) and GTZ, have supported the provision of business development services in rural areas. INGOs, such as CECI, and NGOs such as SAPPROS and DEPROS, have also been active in this area. In addition, UNDP is supporting the Micro Enterprise Development Project (MEDEP) which has reached some 4,977 low income entrepreneurs (58 percent female) in 10 districts since it began in July 1998. The project works closely with the DDCs and has been able to offer entrepreneurship training to 2,940 clients and make small loans available (from a NRs 15,300,000 fund available to the project from ADB/N). According to MEDEP progress reports, its below poverty line clients have been able to build small, but profitable businesses with MEDEP assistance. On average, participants have been able to increase their incomes by some 264 percent and most have emerged from poverty[61].

[61] MEDEP Annual Report 2000, p.10.

In considering the provision of these three inter-related services (social intermediation, NGO/MFI capacity building and business development services), it is important to note that while the first and to some extent the second service are often provided as "public goods", business development services are increasingly expected over time to become commercial operations that can pay for themselves[62]. Figure 1, modified from a recent CGAP Focus Note [63], presents a "suggested continuum from social intermediation to BDS, based on the attainable level of cost recovery. The gray area represents the blurred distinction between those non-financial services requiring at least a degree of subsidization and those that can be provided on a commercial basis."[64] We have also placed NGO and MFI capacity-building in that gray area in this version of the CGAP figure.

Figure 1. The Non-Financial Services Continuum

Social Intermediation..> BDS

Subsidized *Fully Commercial*

Health education Literacy Training Group capacity-building	NGO/MFI Capacity-building	Business networks Provision of market info Entrepreneur training Advisory services Technology development

IV. The Security Situation

A final and extremely serious constraint to up-scaling micro-finance service coverage in Nepal is the Maoist Insurgency. The ideological foundations of the Maoists makes them suspicious of financial intermediation to begin with and their lack of technical knowledge about the real costs involved has led them in some instances to accuse even member-owned cooperative organizations of charging interest rates that are too high. Their reaction is not uniform, however, and in general, NGO-led organizations and especially those which are seen as more indigenous and locally controlled, are reported to be able to operate without too much interference. The most vulnerable to disruption are programs that are strongly identified with central government, such as the PCRW, MCPRW and the SFDP. Ironically, some of the SFCLs have also been targeted by the Maoists, despite the fact that they are actually moving quite effectively away from their earlier dependence on the government-owned ADB/N. GTZ reports that although a

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[62] See "The Blue Book", a publication of the Committee of Donor Agencies for Small Enterprise Development, for an introduction to the revised thinking and approach for BDS that is now increasingly accepted by donors and practitioners: "Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention", (February 2001).

1. [63] Joan Parker and Doug Pearce, "Microfinance, Grants and Non-Financial Responses to Poverty Reduction: Where does Microcredit fit?", 2001.

[64] Op.cit. p 11.

number of the SFCL offices have been attacked and had their records destroyed, almost all of them have rebuilt and continued their operations – though not without some slowing of their previously rapid pace of expansion and growing financial and institutional sustainability.

The degree and nature of the impact of the insurgency on various types of micro-finance activities needs to be better understood. But it is clear that the conflict has increased the risks and costs attached to all economic transactions in the affected areas, damped the overall climate for productive rural investments and certainly constrained the growth of micro-finance services.

V. Potential Role of PAF in Scaling-up Micro-finance.

As it is currently envisioned, the Poverty Alleviation Fund in the PAF Act approved by Cabinet and placed before Parliament during the winter session of 2002, the PAF would provide funding to support micro-finance. However, there is still considerable lack of clarity on exactly what form such support would take. In stakeholder consultations held in March of 2002 a number of government stakeholders spoke of using PAF funds to increase the availability of lending capital available for micro-finance. Several members of the NPC spoke of "seed money" grants to expand the loanable funds of community-based Savings and Credit Groups. One official from MLD ,however, saw PAF engaged in wholesale lending to NGOs and other MFIs with the profits from this line of business as a route to eventual financial self-sustainability for the PAF.

Most stakeholders from among the donors and the NGO[65] sector felt strongly that ***the PAF should <u>not</u> be involved as a financial intermediary giving loans or even making grants of seed money to Savings and Credit Groups.*** These views are reflective of global best practice that discourages mixing financial service delivery (where loans must be paid back promptly) with the delivery of grant money (which does not need to be paid back). The World Bank's review of micro-finance components in its own social fund operations[66] found that the specialized skills and mindset required for successful and sustainable micro-finance operations was difficult to incorporate successfully into the institutional culture of a social fund which are "created primarily as income-transfer safety net programs to support small-scale public infrastructure projects and social service programs."

Although the review did encounter some examples of success, they occurred where (i) either an existing implementing agency was used to administer the micro-

[65] Those who shared this view include Dr. Shankar Man Shrestha, CEO of RMDC, Ms. Namrata Sharma, Managing Director of CMS, Prahlad Mali, Kabita Bhattarai and Michael Casey from CECI, Hans van Rijn of SNV, Kathie Julian, ADB, Ulirich Wehnert, Team Leader for the GTZ-sponsored Rural Finance Nepal program and Shree Krishna Upadhyay of SAPPROS.

[66] Khalid Siraj and Bikki Randhawa,"Portfolio Improvement Program – A Review of Social Fund Microfinance Components, FSD, 1996.

finance component to avoid start up delays, or a realistic time frame was allowed for the newly formed agency to become operational before the first funds for micro-finance were disbursed; (ii) the micro-finance component was designed by a micro-finance expert ; (iii) it was kept institutionally separate from the other "social service functions to avoid overlap of loan and grant-based operations;" and (iv) the micro-finance component has a high degree of "management autonomy to lessen the likelihood of (its) becoming a political tool of the government." [67]

This general guidance is underlined by in the CGAP Focus Note cited earlier: "Where institutions are providing a mix of non-financial and financial services, these need to be clearly separated at every operational level (client, systems, accounting and management)." The Note cautions that "for every 20 non-financial service organizations that consider micro-credit as a new service, only one may actually be able or willing to pay the high price of implementing the operating principles required for sustainability."

As evident in the forgoing sections, there is a great deal of successful experience in Nepal savings-led micro finance service delivery which has proved to be both operationally and financially self-sustaining after initial investments to build group capacity and social capital. There is wide-spread concern among micro-finance specialists that loans or even seed money from PAF could actually damage the discipline and sustainability of the strong Savings and Credit Groups which are emerging all over Nepal.

The point came up repeatedly during the stakeholder consultations that for well performing MFIs, NGOs and CBOs there are ample sources of capital for on-lending. Table 1 provides a rough idea the funds that have flowed to the sector over the past two decades of development and a sense of the funds currently available. Especially noteworthy is the more that $18 million dollars remaining from the ADB loan of $20 million for RMDC on leading. Added to that is the mandatory Deprived Sector quota from the commercial banks which is now generally flowing through the GBBs, the NRB's Rural Self Reliance Fund, the funds that ADB/N is making available to the SFCLs and MEDEP and the funds available with some of the new private sector intermediaries. such as the Small Farmer's Development Bank and the various NGOs, such as Nirdhan and CSD, which are running micro-finance banks. At the present time, it would seem to make the most sense to focus on what needs to be done to remove the remaining blockages that have slowed the flow of these existing funds through intermediaries which are already operational rather than create yet another.

But this does not mean that PAF has no role to play in supporting the expansion of micro-finance in Nepal. There seemed to be broad consensus, [68] that ***the PAF should provide funds to support NGOs to carry out <u>social intermediation</u>, but it should not***

[67] Op Cit. pp. 22-23.

[68] There were three exceptions: Rita Thapa and Jaysingh Saha, who had both worked with SAPAP where seed money is given to groups; and Ganesh Awasthi from MLD, who felt that the PAF should offer micro-credit.

provide loans or financial intermediation since ample lending capital is already available in the system as long as the groups are assisted in getting access to it. Since social intermediation and capacity building are public goods, this approach avoids requiring the PAF to involve itself in the allocation of funds that will support private goods (loans to individuals). All PAF funds can be given as grants where the main staff responsibility is to ensure that the grants are used efficiently and for the purposes intended, rather than making sure that the funds are paid back on time. It is very likely that by providing indirect support to build capacity among poor clients (through social intermediation) and among the organizations delivering micro-finance services, PAF will do more to help scale up the sector than by itself becoming another apex intermediary.

ANNEX –4 : SOCIAL FUNDS AND DECENTRALIZATION: CONCEPTUAL ISSUES[69]

The large majority of the 60+ social funds operating throughout the world do so as central government agencies, in a highly vertical manner. The Bank has only recently turned its attention to the question of how to design SFs for a decentralized context. There are strong reasons to believe that SFs can support decentralization by strengthening community groups and the local government system. Nepal's particular characteristics, and the strong political support for decentralization in evidence, imply that the PAF could be particularly important in this role there. Pursuing this should have the additional benefit of maximizing PAF effectiveness in a decentralizing environment. But this requires a significantly different design from the majority of SFs currently in existence.

From the point of view of public service delivery, the key differences between centralized and decentralized government can be distilled into two issues: information and accountability. **Information** is important for the prioritization of projects amongst competing uses of public funds, and the design of interventions best suited to meet a specific need. These informational requirements can be broken down into three types:

Local needs and real demand – including demographic data (e.g., illiteracy and infant mortality rates), the extent and quality of existing services, and the degree of community support for a particular project;

Local geographic, economic and social characteristics – important to project siting, timing and design (e.g., where to place a clinic, when to build it and of which materials); and

Best practice – technical or organizational knowledge specific to the project chosen, which permits efficiency and effectiveness in service provision (e.g., the proper dimensions of a classroom, medical equipment required in a primary health clinic).

Local government (VDCs and CBOs) will tend to have an advantage in both the quantity and quality of the first two, locally-specific types of information. But central government, with its superior resources and the ability to attract highly-trained staff, will tend to have a superior command of the third – sectoral best practice.

Figure 1
Key Differences Between Centralized and Decentralized Government

1 Information
→ Local Demand
→ Local Characteristics
→ Best Practice
2 Accountability

Accountability can be defined as the process by which the public officials serving a particular community are given clear

[69] This section and the following are based on Faguet, JP. 2002. "Designing Effective Social Funds for a Decentralized Context," World Bank Social Protection Discussion Paper (forthcoming).

incentives to provide projects that concretely address local needs. Local government accomplishes this by placing politicians' fates in the hands of local voters, in the presence of a transparent electoral mechanism. Central government could, in theory, accomplish the same through the design of appropriate salary and bonus incentives for its officials, but this, in turn, requires higher-level officials to be interested in and informed of the state of affairs in that community. This is a logical circularity, as there is no ultimate incentive for any central official to focus on conditions in any particular community. With their broad mandates, central government officials will be less accountable to the voters in a given district than that district's own local government.

These differences are not just conceptual, but strongly affect the way in which a SF is designed and operates. In a centralized state, central government agencies will tend to carry out all aspects of social investment themselves, from promotion and needs assessment to project design, financing, supervision of execution, and often initial operation and maintenance of the services in question. Where line ministries are weak, even in the regulatory and normative aspects of their sectors, funds can find themselves essentially setting policy via innovation in their projects and the collective weight of the portfolios they finance.

The process of decentralization changes a social fund's role fundamentally. No longer can it approach rural communities as an administrative *terra nullis*, abandoned by other arms of the state, as has been standard practice amongst donors, NGOs and central agencies in Nepal. A community must instead be approached as a social unit where civic organizations and political institutions exist to express the popular will and respond to local needs. The fund is not a catalyst for local preference revelation and consensus-building. When it enters a new region, local priorities should already have been determined. Multiple and complementary procedures will exist for ascertaining local opinion and planning future priorities, including elections, lobbying by civic and business groups, and others. A long tradition of grass-roots civic organization and village self-government makes this especially true of Nepal. Equally importantly, the fund will no longer be the prime source of local funds. Local government will have its own budget, and the administrative ability to finance projects independently. The PAF's primary role will then be to ask what priorities have been identified and offer to co-finance those which fall under its mandate, in the process injecting a measure of technical expertise in the design and planning of local services.

Figure 2
Important SF Qualities in an Environment Which Is:

Centralized	**Decentralized**
1 Process efficiency	1 Manage complexity
2 Competence throughout the project cycle	2 Negotiation
	3 Listening/Openness
3 Command and control	4 Coordination and delegation

The greater number of independent actors intervening in the project process will inevitably increase the complexity of the PAF's task. Whereas SFs operating in a centralized environment may well find a top-down command structure efficient; one facing government decentralization must learn different abilities – negotiation, consensus-building, and the ability to engender trust amongst a wide variety of external actors.

If decentralization presents the PAF with significant challenges, the PAF offers the Bank a significant advantage when dealing with a decentralized framework. SFs are flexible, demand-driven institutions, and hence must be counted amongst the most appropriate ways in which donors can support social investment and combat poverty in a decentralized country. They are designed to respond to demand, and can fairly easily be adapted to work with decentralized government. When the two work together to reach the fund's goals they are also advancing toward local government's goals, in the process strengthening effectiveness and legitimacy in the eyes of the voters. And when a fund works effectively with a given local government, it establishes relationships of trust which facilitate institutional strengthening and the transfer of organizational abilities from fund to district. The challenge is to see that this is true of the PAF.

Social Funds and Decentralization:

(i) Lessons in Design from the Field

This section first considers the implications of decentralization for three general issues that will affect all aspects of PAF performance: project menu, poverty targeting and internal administration. It then focuses on the stages of the project cycle to examine how decentralization affects the fundamental tasks implicit in each, and provides suggestions for design of the PAF.

What kinds of projects should the PAF finance? The menu of projects that a fund presents to local communities is a crucial form of outreach, announcing what sort of fund it is. This topic is important, as certain project types will tend to attract and involve local governments more than others. The evidence suggests a good general rule: the simpler and smaller-scale a fund's projects are, the more success the fund is likely to have with communities and municipalities. There exists good evidence, both from a cross-country impact evaluation undertaken by the Bank and from independent research, that investments in primary health and education, water and sewerage, local roads, and small-scale agriculture are high local priorities, and hence, tend to attract and involve local governments deeply in the gestation thereof. These projects are likely to be successful in a decentralized framework.[70] Abundant evidence from Nepal reviewed elsewhere in this paper additionally suggests that small, community-driven projects in these sectors have

[70] Research in Faguet (2001) and Faguet (2002) shows that such projects are local communities' top priorities in Bolivia, and hence more likely to result in significant participation by local government *and* community groups.

been not only more cost-effective and better quality, but also have produced more sustainable benefits. Bank research also indicates that social funds are good at such projects, increasing both the quality of services and access to them in these sectors.[71] But ultimately, task managers must be creative with the menu of projects a fund will finance, and allow the fund itself to be creative by building into it a facility for generating new programs as the fund learns over time and new opportunities are identified.

Poverty Targeting. Poverty targeting in social funds takes two forms: explicit and implicit. Explicit targeting comprises overt attempt to match SF resources to poorer areas, through such devices as poverty maps and the use of poverty indices and human development type data at the project approval stage. Implicit targeting refers to the self-targeting of communities as a result of the fund offering to finance projects that are natural to poor populations and not rich ones, such as primary medical care and latrines. It also operates via the explicit articulation of the fund's poverty bias, which attaches a social stigma to SF projects such that wealthy communities do not request them. In practice these efforts are complementary and social funds employ both.

The PAF will face a constant tension between reaching the poorest of the poor and financing projects in communities where the best conditions for project success exist. Strong local organizations, the resources to identify and plan projects, and the time and energy to supervise them during execution and maintain them afterwards are more likely to exist in better off communities than in poorer ones. **Decentralization and the spread of the institutions of local governance throughout Nepal will tend to reduce the tension between efficiency and poverty-targeting by redressing the organizational disadvantage of poorer communities.** Decentralization marks a two-fold stimulus to pro-poor institutions: the first directly through local government which is responsive to its constituency, the majority of which in developing countries will likely be poor; and the second indirectly by providing an incentive for the poor to organize themselves to take better advantage of local government's resources.

PAF Administration. International experience has shown that there are three important principles of good SF design in a decentralized environment: administrative deconcentration, good MIS, and contracting out. In order to work effectively with local government, social fund functionaries must be well informed of local needs and local conditions, and it is preferable that they have relationships of trust with local leaders. Hence, in a decentralized context it may well be advantageous for the PAF to deconcentrate its own internal operation in order to interact better with local government authorities and communities. But this raises questions of the tradeoffs between reaping economies of scale by centralizing fund operations in one office, versus gathering local knowledge through a more dispersed organization. The experience of social funds in Zambia, Argentina and Bolivia, as well as a recent World Bank study[72], suggest that the

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[71] Chapter 3 in *Proceedings of the Second International Conference on Social Funds: Evolving in the New Millennium,* 5-8 June, 2000, manuscript, pp.23-38.

[72] Alton, G, *Social Funds Performance: A Review,* World Bank Social Protection Department, Human Development Network, 1999.

information and trust gained from a deconcentrating internal SF organization more than compensate for the reduction in scale efficiencies, leading to an improvement in both SF operations and project quality across many countries.

Secondly, the experience of a number of funds shows that an effective management information system (MIS), which makes all fund and project-related data available to all SF offices and personnel, can help to lessen the efficiency vs. information tradeoff, and is thus an important tool for SF deconcentration. Thirdly, contracting out large portions of what have traditionally been considered mission-critical activities, such as project evaluation and implementation, can reduce SF overheads and increase institutional agility by allowing for rapid scaling up and less painful scaling down of activities, as conditions and demand dictate. Properly structured, this can combine with operational deconcentration to spur the formation of a skilled coterie of professionals in towns and villages throughout the countryside, thus helping to spread human capital throughout a country. A final lesson from the field which should be kept in mind is that the trade-offs between speed of operation/disbursement and other outcomes (e.g., poverty-targeting, participation) are heavily biased in favor of speed.

The Project Cycle

(j) Demand Revelation and Project Identification

This first stage of the project cycle consists of two distinct components: (i) determining communities' needs and preferences for public investment, and (ii) identifying a project the PAF can finance which responds to these needs. This is the first exposure that rural communities have to PAF staff and procedures, and can often set the tone for the interactions – cooperative or conflictive – that follow. Under decentralization, CBOs and VDCs (and DDCs) are the arbiters of local priorities and agents of local development. As such, they should have already carried out a broad form of demand revelation natural to their role as the agents of the will of the people. Communities should have identified projects which are included in the fund's menu, and ideally also others that go beyond them. PAF staff should approach local government officials seeking to help them, within the context of the preferences they have articulated, and not try to change these. Where local government has not identified local needs or is too weak to do so, the PAF should be prepared to assist by offering both financial and technical support.

In designing the PAF, HMGN should bear in mind that poor project identification is operationally more efficient (*i.e.,* less expensive) than good identification, and also that the costs of getting it wrong are high: poor communities with limited resources to dedicate to collective action may never achieve their highest priority project if they expend their efforts securing a social fund project which is lower down their priority list. The best way to promote good project identification is via the incentives PAF staff face. Staff managing a super-abundance of projects at the earliest stage of the project cycle, where few resources have been invested in any given project, will be more likely to abandon an unpromising project than staff seeking to nurse a few projects to approval.

Likewise, the performance of staff involved in identification should be based, in part, on the ultimate success of projects in the medium term, and not entirely on project approvals or – worse – on the proportion of projects approved. This is part of a general recommendation which applies throughout the project cycle. The performance of staff at each stage should be judged by long-term project success, and not solely on the successful passing-on of projects to the next stage of the cycle.

Figure 3
Elements of Effective Project Identification

1 Work through local government to support community to identify its own needs.
2 Ascertain and accept local needs that are identified.
3 Do not "bulldoze" local leaders - Be prepared to walk away from communities whose needs do not match SF priorities.
4 Ensure specific projects are supported by beneficiary communities via cash, labor & in-kind contributions.
5 Tie SF staff incentives to long-term project success, and not project pass-through or approval rate.

Measures to ensure that both the local government and the relevant community actively support a project should be built into the PAF's project identification system. This is especially important in a country with extremely poor rural areas, like Nepal, where many communities may be willing to sign onto *any* project so long as at least some fresh resources enter the area. Acceptable evidence of commitment are municipal and community contributions in cash and kind, especially when made up-front in the project identification and design phases. This requires communities to pool resources and solve the collective action problem, and thus constitutes an acid test of their commitment. Experience from a number of countries shows that the attainment of such strong community and local government support contributes powerfully to projects' ex-post sustainability.

A last lesson from the field is that a competitive mechanism for project selection can generate important benefits. Chief amongst these is the introduction of an element of contestability into the PAF's project-identification-as-resource-allocation mechanism, which, according to the public management literature, is an essential component of any well-functioning budget process. Good local decisions depend on having tradeoffs between alternative investments in order to arrive at the option with the highest benefits – to identify the highest-value project.

Project Design

Project design refers specifically to the process by which a project idea is turned into specific technical plans, with a budget and timetable. This implies resolving important questions such as size/scale, technology and location. Local governments and communities must be included in project design and thereafter if the project is to become a success. The project design process must, again, strike a careful balance between the comparative advantage of the social fund, technical expertise and efficiency in project design, and that of the community, the specific knowledge locals have about their needs and surroundings. Both types of knowledge are important to the design process, which must be capable of melding diverse information into a single set of technical and budgetary plans. Hence, in order to succeed, a design process must contain incentives for each side to contribute its share of the necessary information. Such incentives occur naturally in local government, and are generated through the electoral process. Where local communities are institutionalized in self-governing and accountable structures, as in Nepal, they are also likely to occur.

Obtaining substantive PAF commitment to participative project design is not necessarily straightforward or easy. Remember that the process of consultation by which local inputs are obtained is costly. And unlike local authorities, PAF staff will be central government employees, and ultimately accountable to their superiors within the fund, not to citizens of the districts in which their projects are located. Hence, HMGN must ensure that the PAF's internal incentives lead its staff to include the inputs of local community and government representatives in the design process. This can be achieved by structuring the process to actively seek out local consensus and approval of both the relevant community and district government during project design. If project design is a coordinated exercise between PAF staff and local representatives, and the approval of local government and community authorities is required at crucial junctures throughout, the resulting project is much more likely to address real needs and maximize local benefits than if the project has an in-house PAF design.

Figure 4
Elements of Good Project Design

1 Ability to integrate technical information on project design with locally-specific information on needs and the environment
2 Incentives for SF staff to include community and local government inputs into the design process
→ Require local approval at crucial junctures
→ Judge staff performance according to long-term project success

Project Approval

Project approval refers to the substantive acceptance that a project meets PAF technical, social and financial standards, and the fund agrees to finance it. Regardless of its degree of administrative deconcentration, this should be an internal PAF process that serves to rigorously confirm that the standards of project design and approval have been met, and the guidelines outlined above for social and governmental consensus have been followed. Approval criteria can be separated into six general categories:

i. Real local **need;**
ii. Community and local government **commitment** to the project;
iii. **Technical design standards** particular to each sector or sub-sector (e.g., schools, roads, micro-credit loans);
iv. **Cost;**
v. **Sustainability** – technical, financial and social; and
vi. **Environmental impact**

The PAF should establish clear criteria for each category, including explicit trade-offs between criteria, and should conduct project review with a high degree of transparency so that the approval process itself serves to reinforce performance incentives within the fund and project standards beyond it.

Project Implementation/Execution

Project implementation refers to the execution of programs (e.g., literacy campaigns, vaccinations), or the construction and initial operation (i.e., during a handover phase) of project infrastructure. The first SFs relied mainly on contractors and NGOs – external to beneficiary community – for implementation. But more recently, direct contracting and community-driven development have become important. Although community implementation can take longer, the evidence shows that it can result in overall efficiency gains through lowered costs. A cross-country study found that closer community involvement and increased community responsibility generally reduced project costs and improved project quality. This is fully consistent with the Nepali experience, as reviewed earlier. A number of multi-country and Nepali sectoral studies agree that communities should be allowed to manage money directly, and use community contracting where possible.[73] The benefits include:

- Better supervision;
- Accountability;
- Local capacity building;
- Greater mobilization of local resources; and
- Productive efficiency.

Social fund supervision of direct contracting can and should become a process of technology transfer by the PAF to the community (or local government) in which the former – which knows how – teaches the latter – which is interested, present on the ground and able to operate much more cheaply – how to build or implement a project, manage skilled labor, organize group work, and check the quality of technical inputs. In community-driven projects, local mechanisms of accountability will take care of basic issues of compliance (e.g., amounts of raw materials used, number of days worked)

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[73] See especially *Social Fund Performance: A Review (2000), CAP Sourcebook* (2000), and Parker and Serrano (2001).

allowing fund supervision to become less intensive, and more focused on technical or managerial issues in which it has a particular comparative advantage.

Operation and Maintenance (O&M)

The PAF's primary concern regarding O&M should be to implement good-quality projects with firm social and technical foundations, which can then be transferred to ultimate owners that are committed to their maintenance. In a decentralizing Nepal, communities and VDCs will tend to be the ultimate owners of projects. The best the PAF can do for O&M in such an environment is to carry out careful project identification, design, approval and implementation, and follow the guidelines set out above before handing a project on. Hence we see why involving local government at each stage of the project cycle and obtaining its approval *ex ante* is of such great importance. **If project identification and design have been done competently, then the chances are that a given project at the O&M stage commands the enthusiasm and commitment of the local people and the local government.** This does not guarantee successful operation and maintenance, but it does make success considerably more likely.

Monitoring and disseminating long-term project results nationwide can enhance electoral accountability by making voters aware of the performance of their local governments. The PAF could create a rough-and-ready sustainability index, for example, by which CBOs, VDCs and DDCs are ranked in terms of the long-term project results they achieve. The dissemination of such an indicator nationwide would allow communities to compare their performance on fairly transparent, standardized terms. In the best case this could create a competitive dynamic conducive to the improvement of maintenance and the long-term sustainability of projects.

Institutional Strengthening (IS)

Institutional strengthening arises as the final topic not because it is an afterthought, but rather because – not unlike O&M – it is more a cumulative product of the entire project cycle than a specific stage within it. Institutional strengthening happens throughout project identification, design, approval, implementation and O&M, and in a well-designed PAF it should be impossible to separate it from any of these "other" stages. Given this, the main thrust of a good institutional strengthening program resides in social funds undertaking well-thought-out and coherent project identification, design, etc procedures. Beyond that, and to the extent that IS depends on the transfer of institutional learning from fund to external institutions, strengthening can be improved through the explicit incorporation of technology transfer mechanisms throughout the project cycle. These can include everything from asking PAF staff and contractors to be alert to local officials' needs, to training sessions conducted by visiting PAF staff, to including explicit IS components in PAF projects. VDCs and CBOs where IS has occurred can be "twinned" with those untrained so that they teach each other; and support can be sought from associations of VDCs, NGOs, or professional organizations of public-sector officials for specific training activities.

ANNEX –5: COMMENTS ON PAF LAW VERSION SUBMITTED TO PARLIAMENT FOR APPROVAL

The following are some comments on the Bill. The World Bank had forwarded comments on an earlier version of the Bill on December 21, 2001. Some of those comments have been addressed (some partially). These comments (in italics) are presented following the serial sequence in the Bill.

Chapter II, Section 6(a): Micro-credit is a component of the PAF. *It is recommended that micro-credit should not be done under the PAF.*

Chapter II Section 7(2): To carry out its activities the Fund is required to consult and coordinate with NPC. *This is not necessary as NPC is represented on the Board and PAF will work according to the terms of financing agreement.*

Chapter III, Section 8(2): All financial resources received by the Fund need to be reflected in the HMGN budget. *This is useful and will help in future transition from PAF finance to the use of intergovernmental fiscal transfers.*

Chapter IV, Section 10(2): Including the Deputy Governor of Rastra Bank, the Executive Committee (Board) now has three (reduced from an earlier proposal of 6) HMGN members. *This is an improvement. However, it is recommended that this be further reduced to one. It is preferable that there be a provision in the Bill to elect the chairperson of the Committee from among the members.*

Chapter IV, Section 10(3): The term of office of individual members are increased from 2 to 3 years. *Consider five years as the start up process will be slow.*

Chapter IV, Section 10(4): Only one requirement for nominated individuals is specified under this section, i.e., the individuals should not be a member of any political party. *The minimum qualifications for the individual Board members, the chairperson and the Executive Director should be specified in the Bill. Also, the process of nomination of the non-government members should be specified.*

Chapter IV, Section 11(1): Requires the Board to meet at least six times a year (not less than once in two months). *This is very important.*

Chapter IV, Section 11(2): Requires the Executive Director to notify the members about Committee meetings and provide the agenda. *It does not say anything about how the decision to call a meeting is made; who makes the decision and also does not specify how many days of advance notice need to be given in calling a meeting. The details could be specified in the Rules.*

Chapter IV, Section 11(4, 5): The quorum for a meeting is more than 50 percent of all the members and decision is by majority vote where the chairperson casts the deciding vote in the case of a tie. *However, for major decisions, like approving annual* *plans and programs, the quorum should be 75 percent of the members. This comment was made on an earlier version too.*

Chapter IV, Section 13: Activities shall not be reversed. *It should be deleted as it allows cover up for mistakes.*

Chapter IV , Section 14: The functions of the chairperson is not mentioned here but shall be as specified in the rules. *Since the recommendation is for the Board is to frame its own rules, the key functions of the chairperson should be specified in the Bill.*

Chapter V, Section 16(1): Specifies that the ED would be selected through a process of open competition. *It is recommended that a provision be included in the Bill to establish an independent committee for the selection of the ED and the Board members to be nominated under Section 10(1(g)).*

Chapter V, Section 16(2): A maximum period of one year is allowed for a gazetted officer of HMGN to act as the Executive Director, until the ED is recruited. *The duration should be reduced – it should be just adequate to process the recruitment of an ED, 3 months may suffice.*

Chapter V, Section 16(v): Regarding dismissal of the ED, reference to corruption which was in an earlier version has been removed. *It should be put back in.*

Chapter VI, Section 19(4): It is suggested that an endowment fund be established to make the activities of the Fund sustainable. *This is not necessary. The Fund is a mechanism designed to assure services before government's decentralization framework can take over the bulk of the services.*

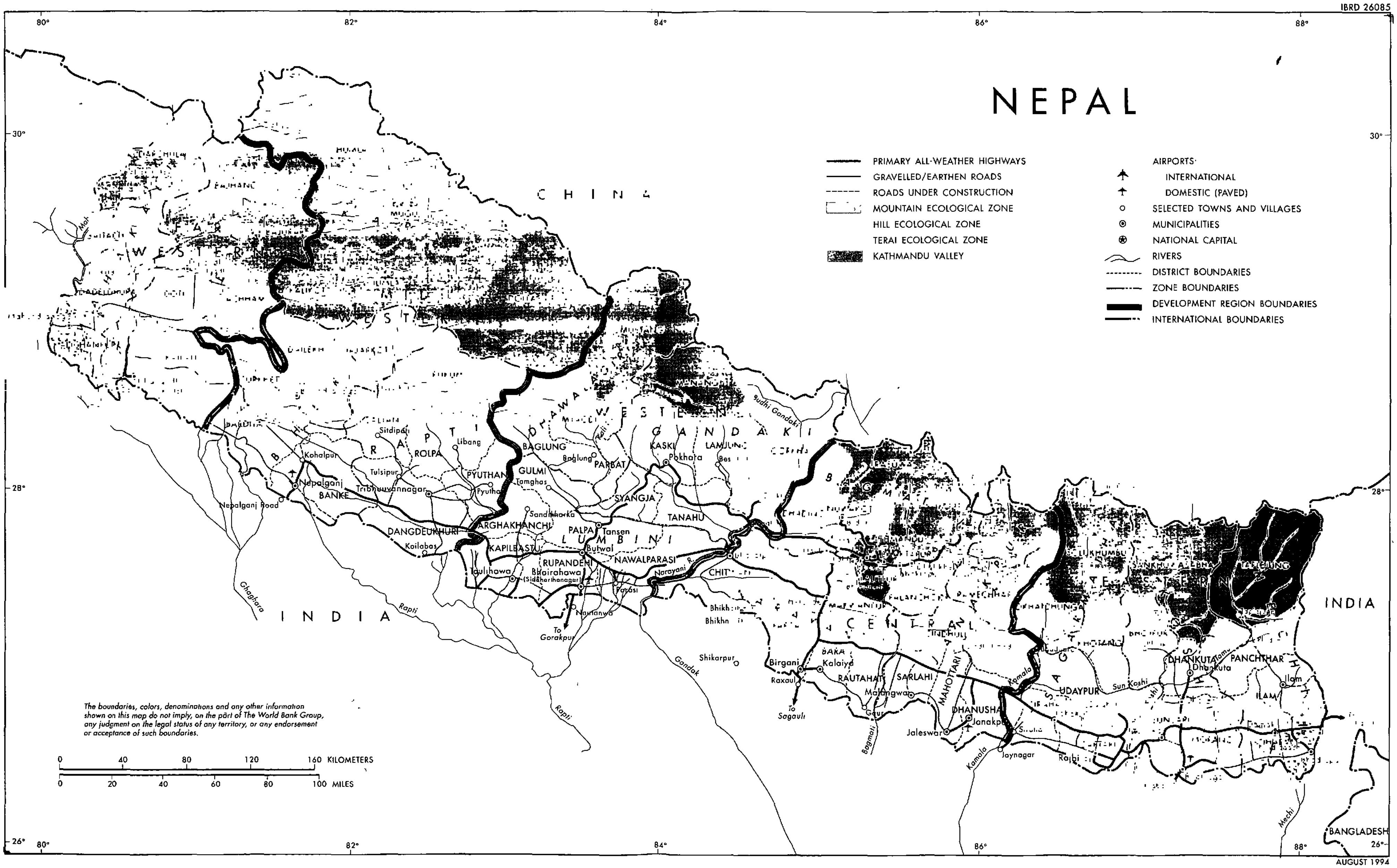
Chapter VI, Section 20(2): Makes a provision to have a chartered accountant registered with the Nepal Chartered Accountant Act, 1996, to do internal audit of the Fund. *This is extremely important.*

Chapter VII, Section 28: For official contact with HMGN, the Fund is required to do so through the Cabinet Secretariat and on daily administrative matters it could contact the concerned agency. *In view of the Government's decentralization policy, reference should also be made to local governments.*

Chapter VII, Section 29 (1, 2): The Act requires HMGN to frame rules and allows the Fund to frame sub-rules which become effective only after approval by HMGN. *These provisions will affect the autonomy of the Fund. The Fund should be allowed to frame its rules and sub-rules which will be within the provisions in the Act. Unless this is changed to allow PAF Board to formulate and approve rules and bye-laws, the Fund will not have fully autonomy.*

Further, the linkage of the Fund with the Local Government Act is unclear. The linkage with, and the role sought for, the local governments, particularly in view of the

Local Self Governance Act (1998) which also aims at enabling the grass root VDCs and the DDCs to prepare and implement work for their development locally, are not clearly articulated. *This aspect needs to be carefully studied and addressed so that there will be no conflict in the future on powers and responsibilities, leading to impossibility in implementing the Act and making of it one of the many "promulgated but never implemented documents".*



IBRD 26085
NEPAL
PRIMARY ALL-WEATHER HIGHWAYS
GRAVELLED/EARTHEN ROADS
ROADS UNDER CONSTRUCTION
MOUNTAIN ECOLOGICAL ZONE
HILL ECOLOGICAL ZONE
TERAI ECOLOGICAL ZONE
KATHMANDU VALLEY
AIRPORTS:
INTERNATIONAL
DOMESTIC (PAVED)
SELECTED TOWNS AND VILLAGES
MUNICIPALITIES
NATIONAL CAPITAL
RIVERS
DISTRICT BOUNDARIES
ZONE BOUNDARIES
DEVELOPMENT REGION BOUNDARIES
INTERNATIONAL BOUNDARIES
CHINA
INDIA
BANGLADESH
80°
82°
84°
86°
88°
30°
28°
26°
BAGLUNG
GULMI
PYUTHAN
ROLPA
PARBAT
KASKI
LAMJUNG
SYANGJA
TANAHU
PALPA
ARGHAKHANCHI
KAPILBASTU
RUPANDEHI
NAWALPARASI
DANGDEUKHURI
BANKE
LUMBINI
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BARA
RAUTAHAT
SARLAHI
MAHOTTARI
DHANUSHA
UDAYPUR
DHANKUTA
PANCHTHAR
ILAM
TAPLEJUNG
Nepalganj
Nepalganj Road
Kohalpur
Tulsipur
Tribhuvannagar
Sitdipur
Libang
Pyuthan
Tamghas
Baglung
Pokhara
Sandhikharka
Tansen
Butwal
Bhairahawa
Taulihawa
Koilabas
Parasi
Nautanwa
To Gorakhpur
Shikarpur
Birganj
Raxaul
To Sagauli
Kalaiya
Malangwa
Gaur
Jaleswar
Janakpur
Jaynagar
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AUGUST 1994

IMAGING

Report No.: 25019 NEP
Type: SR