Report No. 20229 NEP

# Nepal
# 2000 Economic Update

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Poverty Reduction and Economic Management Unit
South Asia Region



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# CURRENCY

| Currency | NRs/US$ |
|---|---|
| 1980 | 12.00 |
| 1981 | 12.34 |
| 1982 | 13.24 |
| 1983 | 14.55 |
| 1984 | 16.46 |
| 1985 | 18.25 |
| 1986 | 21.23 |
| 1987 | 21.82 |
| 1988 | 23.29 |
| 1989 | 27.19 |
| 1990 | 29.37 |
| 1991 | 37.26 |
| 1992 | 42.72 |
| 1993 | 48.61 |
| 1994 | 49.40 |
| 1995 | 51.89 |
| 1996 | 56.69 |
| 1997 | 58.01 |
| 1998 | 65.97 |
| 1999 | 68.25 |

*Note:* **The Nepali fiscal year runs from July 16 through July 15.**
*Source:* **IMF, International Finance Statistics (IFS), line "rf" (period average).**

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[a] **Starting November 30, 1985, the Nepali Rupee was linked to a basket of currencies. Subsequently in early 1992, a two-tier exchange rate system with partial convertibility was introduced. In February 1993, the dual exchange rate system was replaced by a unified market-determined exchange rate system providing de facto convertibility for all current account transactions.**

| | | |
|---|---|---|
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# Abbreviations And Acronyms

| | |
|---|---|
| AIC | Agricultural Inputs Corporation |
| DDC | District Development Committee |
| DFID | Department for International Development |
| ESAF | Enhanced Structural Adjustment Facility |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| IDA | International Development Association |
| IMF | International Monetary Fund |
| MOF | Ministry of Finance |
| NBL | Nepal Bank Limited |
| NDF | Nepal Development Forum |
| NGO | Non Governmental Organization |
| NLSS | Nepal Living Standards Survey |
| NPC | National Planning Commission |
| PER | Public Expenditure Review |
| RBB | Rastriya Banijya Bank |
| RNAC | Royal Nepal Airlines Corporation |
| SAF | South Asian Federation |
| UNDP | United Nations Development Program |
| VAT | Value Added Tax |
| VDC | Village District Committee |

# ACKNOWLEDGEMENTS

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# Economic Development Data

GNP Per Capita (US$, 1998): 210 a/

**Gross Domestic Product (FY99) b/**

| | FY99 | | Annual Growth Rate (% p. a., constant prices) | | |
|---|---|---|---|---|---|
| | US$ Million | % of GDP | FY86-90 | FY91-94 | FY95-99 |
| GDP at Factor Cost | 4754 | 96.5 | 4.8 | 5.6 | 3.9 |
| GDP at Producers' Prices | 4926 | 100.0 | 4.6 | 5.6 | 3.9 |
| Gross Domestic Investment | 956 | 19.4 | 19.8/c | 21.9/c | 22.8/c |
| Gross National Saving | 700 | 14.2 | 12.2/c | 14.2/c | 14.2/c |
| Current Account Balance | -256 | -5.2 | -7.6/c | -7.6/c | -8.6/c |

**Output, Employment and Productivity**

| | Value Added, FY 99b/ | | Labor Force d/ | | V.A. per Worker | |
|---|---|---|---|---|---|---|
| | US$ Million | % of Total | Million | % of Total | US$ | % of Average |
| Agriculture | 1906 | 40.1 | 7.2 | 76.1 | 265 | 52.7 |
| Industry | 998 | 21.0 | 0.9 | 9.8 | 1072 | 213.5 |
| Services | 1849 | 38.9 | 1.3 | 14.0 | 1391 | 277.0 |
| Total | 4754 | 100.0 | 9.5 | 100.0 | 502 | 100.0 |

**Government Finance e/**

| | NRs. billion | % of GDP | As % of GDP | | |
|---|---|---|---|---|---|
| | FY99 | | FY86-90 | FY91-94 | FY95-99 |
| Revenue Receipts | 37.2 | 11.1 | 9.0 | 9.2 | 11.1 |
| Total Expenditures | 63.2 | 18.9 | 18.8 | 17.4 | 18.4 |
| Regular Expenditures | 31.8 | 9.5 | 6.4 | 6.5 | 9.0 |
| Development Expenditures | 31.4 | 9.4 | 12.4 | 10.9 | 9.5 |
| Overall Deficit | -24.7/f | -7.4/f | -9.8 | -8.2 | -7.4 |
| External Assistance | 18.7 | 5.6 | 7.4 | 6.2 | 5.5 |
| Domestic Borrowings | 6.0 | 1.8 | 2.4 | 2.0 | 1.9 |

**Money, Credit , and Prices g/**

| | FY94 | FY95 | FY96 | FY97 | FY98 | FY99 |
|---|---|---|---|---|---|---|
| | NRs. Billion outstanding, end of period | | | | | |
| Broad Money (M2) h/ | 69.8 | 81.0 | 92.7 | 103.7 | 126.5 | 152.9 |
| Bank Credit to Government (net) | 23.5 | 25.2 | 27.5 | 29.2 | 31.8 | 35.5 |
| Bank Credit to Private Sector | 32.3 | 44.9 | 57.7 | 64.7 | 76.8 | 90.8 |
| | Percentage or index number | | | | | |
| Broad Money as % of GDP | 35.0 | 36.9 | 37.2 | 37.0 | 42.6 | 45.7 |
| Consumer Price Index (1983/84=100) | 284 | 305 | 330 | 356 | 370 | 417 |
| Annual Percentage Changes in: | | | | | | |
| Consumer Price Index | 9.0 | 7.6 | 8.1 | 7.8 | 4.0 | 12.7 |
| Broad Money (M2) | 19.6 | 16.1 | 14.4 | 11.9 | 21.9 | 20.9 |
| Bank Credit to Government (net) | 0.2 | 7.3 | 9.3 | 6.2 | 8.6 | 11.7 |
| Bank Credit to Private Sector | 35.1 | 38.8 | 28.7 | 12.0 | 18.8 | 18.2 |

a/ World Development Report 2000, The World Bank.

b/ National Accounts of Nepal 1999, Central Bureau of Statistics.

c/ Data for Gross Domestic Investment, Gross Domestic Savings and Current Account Balance are as percentage of GDP.

d/ Nepal Labor Force Survey 1998/99, Central Bureau of Statistics.

e/ Economic Survey FY99, Ministry of Finance.

f/ After "non-budgetary receipts" of Rs. 1.3 billion.

g/ Nepal Rastra Bank.

h/ Includes money supply (M1) and time deposits.

**Balance of Payments (US$ Million)**

| | FY97 | FY98 | FY99 |
|---|---|---|---|
| Exports of Goods & NFS | 1295.0 | 1108.3 | 1061.9 |
| Merchandise, fob | 397.4 | 444.6 | 525.3 |
| Imports of Goods & NFS | 1854.7 | 1645.7 | 1495.9 |
| Merchandise, cif | 1642.3 | 1439.1 | 1290.6 |
| of which POL products | 126.5 | 154.0 | 128.6 |
| Trade Balance | -1244.9 | -994.6 | -765.3 |
| Non Factor Services (net) | 685.2 | 457.2 | 331.3 |
| Resource Balance | -559.7 | -537.4 | -434.0 |
| Net Factor Income | 5.0 | 13.0 | 25.0 |
| Net Transfers | 94.5 | 103.0 | 152.9 |
| Current Account Balance | -460.3 | -421.4 | -256.1 |
| Official Grants | 170.8 | 176.3 | 171.4 |
| Medium & Long Term Capital | | | |
| Gross Inflows | 197.0 | 229.8 | 195.2 |
| Principal Repayments | 49.8 | 62.4 | 61.3 |
| Miscellaneous Capital Flows | 198.5 | 254.8 | 95.5 |
| Overall Balance (-Increase) | -56.1 | -177.0 | -144.8 |
| Gross Reserves (end year) | 865 | 969 | 1128 |
| **Rate of Exchange** | | | |
| Period Average Rate (US$/NRs.) | 57.03 | 61.95 | 67.95 |

**Merchandise Exports (Average FY95 - FY99)**

| | US$ Million | % of Total |
|---|---|---|
| Woolen Carpets | 147.9 | 35.5 |
| Readymade Garments | 112.1 | 26.9 |
| Others | 156.5 | 37.6 |
| Total | 416.4 | 100.0 |

**Total External Debt,1998 a/**

| | US$ Million |
|---|---|
| External Debt | 2646.0 |

**Debt Service Ratio for 1998 a/**

| | % of current Receipts |
|---|---|
| Debt Service | 7.1 |

**IDA Lending, January 2000 i/**

| | US$ Million |
|---|---|
| Outstanding & Disbursed | 1211.1 |
| Undisbursed | 253.6 |

i/ The World Bank.

# Nepal Social Indicators

| | Latest single year | | | Same region/income group | |
|---|---|---|---|---|---|
| | 1970-75 | 1980-85 | 1992-97 | South Asia | Low-income |
| **POPULATION** | | | | | |
| Total population, mid-year (millions) | 12.8 | 16.5 | 22.3 | 1,281.3 | 2,035.6 |
| Growth rate (% annual average) | 2.4 | 2.6 | 2.5 | 1.5 | 1.7 |
| Urban population (% of population) | 5.0 | 7.8 | 10.9 | 27.0 | 28.4 |
| Total fertility rate (births per woman) | 6.3 | 6.1 | 4.4 | 3.5 | 4.0 |
| **POVERTY** | | | | | |
| *(% of population)* | | | | | |
| National headcount index | .. | .. | 42.0 | .. | .. |
| Urban headcount index | .. | .. | 23.0 | .. | .. |
| Rural headcount index | .. | .. | 44.0 | .. | .. |
| **INCOME** | | | | | |
| GNP per capita (US$) | 120 | 170 | 220 | 380 | 350 |
| Consumer price index (1995=100) | 17 | 35 | 114 | 117 | 122 |
| Food price index (1995=100) | .. | 33 | 111 | .. | .. |
| **INCOME/CONSUMPTION DISTRIBUTION** | | | | | |
| Share of income or consumption | | | | | |
| Gini index | .. | .. | 36.7 | .. | .. |
| Lowest quintile (% of income or consum | .. | .. | 7.6 | .. | .. |
| Highest quintile (% of income or consun | .. | .. | 44.8 | .. | .. |
| **SOCIAL INDICATORS** | | | | | |
| **Public expenditure** | | | | | |
| Health (% of GDP) | .. | .. | 1.2 | 0.8 | 1.0 |
| Education (% of GNP) | 1.5 | 2.6 | 2.8 | 3.0 | .. |
| Social security and welfare (% of GDI | 0.1 | 0.1 | .. | .. | .. |
| **Net primary school enrollment rate** | | | | | |
| *(% of age group)* | | | | | |
| Total | .. | 58 | .. | .. | .. |
| Male | .. | 79 | .. | .. | .. |
| Female | .. | 36 | .. | .. | .. |
| **Access to safe water** | | | | | |
| *(% of population)* | | | | | |
| Total | 8 | 24 | 59 | 81 | 69 |
| Urban | 85 | 78 | 61 | 84 | 80 |
| Rural | 5 | 20 | 59 | 80 | 66 |
| **Immunization rate** | | | | | |
| *(% under 12 months)* | | | | | |
| Measles | .. | 34 | 85 | 81 | 74 |
| DPT | .. | 32 | 78 | 87 | 76 |
| Child malnutrition (% under 5 years) | 69 | .. | 47 | 53 | .. |
| **Life expectancy at birth** | | | | | |
| *(years)* | | | | | |
| Total | 43 | 49 | 57 | 62 | 59 |
| Male | 44 | 50 | 58 | 62 | 58 |
| Female | 43 | 48 | 57 | 63 | 60 |
| **Mortality** | | | | | |
| Infant (per thousand live births) | 160 | 125 | 83 | 77 | 82 |
| Under 5 (per thousand live births) | 234 | 180 | 117 | 100 | 118 |
| **Adult (15-59)** | | | | | |
| Male (per 1,000 population) | 482 | 376 | 274 | 219 | 274 |
| Female (per 1,000 population) | 476 | 395 | 314 | 212 | 255 |
| Maternal (per 100,000 live births) | .. | .. | .. | .. | .. |

1999 World Development Indicators CD-ROM, World Bank.

# EXECUTIVE SUMMARY

1. With a per-capita income of only $210 p.a., Nepal is one of the poorest countries in the world. Nearly half of its population is living below the poverty line; and its social indicators are unsatisfactory. A series of economic reforms in the late eighties and early nineties enabled Nepal to make good progress in accelerating economic growth and modestly improving its social and economic indicators; and on the political front, Nepal also made a major transition from an absolute monarchy to a democratic government in 1991. However, *this momentum slowed down markedly in the last five to six years, largely due to political instability.* Between 1994 and early 2000, there have been nine different governments (including six coalitions), and notwithstanding strong declarations of intent, there has been no coherent overall drive to promote economic development. Moreover, this period has witnessed increasing politicization; weakening of administrative and institutional capacity; increasing corruption and governance problems; and poor economic policies including, among others, ineffective public expenditure management, weak pricing policies, inefficient public enterprises, a dysfunctional financial system and a weak tax administration/low tax compliance. Consequently, *economic performance has been in many respects less than satisfactory.* On the positive side, macroeconomic stability has been maintained, the balance of payments position has strengthened, and domestic inflationary pressures remain moderate. But, *from a development perspective, there is little doubt that the aforementioned policy and implementation shortcomings have put the Nepalese economy on a low growth path.* Over the last few years economic growth has decelerated; overall investment and savings levels in the economy have declined; and although exports have recently again increased strongly, private sector economic activities geared to the domestic market remain sluggish. Fiscal management has been poor; and the budget has been balanced largely at the expense of development activities. And, there has been *little tangible progress in reducing widespread poverty*—Nepal's principal development challenge—*as well as in addressing structural problems which are hampering Nepal's longer term development.* At best, Nepal appears to have stood still, while most of her South Asian neighbors have been making strides in reducing poverty.

2. Given its acute poverty situation; *Nepal needs to take forceful action to accelerate economic development.* The development strategy which is needed for this purpose is well known. Its key elements include: (i) Accelerating economic growth, together with a more equitable pattern of growth so as to improve incomes and living standards in rural areas where the bulk of Nepal's population and its poor live, while reducing its high population growth rate of 2.5% p.a., (ii) provision of rural infrastructure and social services (such as basic education and health care); and (iii) limited and well-targeted interventions for reducing poverty among the most vulnerable groups. It is also recognized that, in order to accelerate economic growth on a sustainable basis, in the short to medium term Nepal needs to adopt a balanced development strategy aimed at exploiting its potential for growth particularly in agriculture and rural development, tourism, the service sectors, and developing manufacturing activities for export to niche markets in India as well as third countries. And, given its long gestation periods, human resource development (including the provision of basic social infrastructure) also needs to be given high immediate priority. Over the longer term, Nepal will need to develop its two major potential sources of economic growth—its water resources and its as yet largely uneducated and unskilled human resources—both of which will take considerable time and effort as well as huge investments.

3. To accelerate economic growth and bring about the changes that are needed in the economy's structure and performance, *Nepal needs to significantly improve its economic policies and their implementation*. These can be grouped into three broad and closely interrelated areas: (i) *Improving public resource management* through a re-definition of the role of the state and reforms to strengthen expenditure management and enhance revenue mobilization; (ii) *Promoting private sector development*, particularly by improving the enabling environment for both domestic and foreign investment, undertaking much-needed reforms in the financial sector, and further improving trade policies; and (iii) *Addressing a range of over-arching systemic issues which affect the performance of the economy at virtually every level*, including both the public and private sectors—such as governance, institutional capacity, ownership and participation, and devolution/decentralization.

4. Efforts to improve public resource management in Nepal must begin with a *re-examination of the role of the public sector in the economy*. The government's resource position is expected to improve only modestly over the next few years. Accordingly, *limited public resources will need to be used efficiently and wisely. For this purpose, the Government needs to decide where to put its limited resources in terms of key priority areas*: (i) Wherever the private sector can undertake economic activities and/or deliver goods and services competitively, there is little justification for public involvement; (ii) *Public involvement should be limited to those areas and activities which the private sector will not find attractive*, i.e., where social benefits exceed private costs, but are not adequately factored in by private providers; (iii) In terms of resource allocation, on a broad sectoral basis, public resources should be channeled to such areas as agriculture and irrigation, human resource development (education, health, drinking water), rural infrastructure, poverty alleviation programs, and backward area development, among others, as well as for O & M activities. But *areas such telecommunications, power generation and tourism should be left to the private sector;* (iv) Even within the priority areas identified above, there is considerable scope for private involvement within specific sub-sectors—such as fertilizer and seed supply and distribution, higher education, urban hospitals and air transport; and (v) *There is also little justification for continued government involvement in many public enterprises*, particularly where these involve commercial activities. Thus, the protection currently afforded to public enterprises in several areas (for example, in power generation, telecommunications, the government-owned airline, etc.) will need to be eliminated.

5. To improve the efficiency of public spending, *the government will need to formulate a manageable and prioritized development program and implement it effectively to produce measurable results*. As a part of such reform, a number of actions are needed: (i) To improve budget allocations, it is necessary to *integrate the regular and development budgets*. This would help to assess resource needs for O & M, other recurrent activities and for development projects/programs in an integrated manner, and to provide the necessary resources for them in terms of priorities for growth, poverty reduction and service delivery objectives; (ii) To avoid over-programming of the development budget, it is essential to ensure *greater realism in forecasting revenue and aid inflows*, i.e. in line with recent performance and reasonable expectations; (iii) Such estimates, prepared for three years at a time, should provide a *medium term framework for the development budget*. This would help to bring out the key trade offs that would have to be made, including the need for prioritization, limiting new project starts, downsizing projects/programs which are not working well etc. in order to bring the development program to a manageable level; (iv) *Strengthening project screening and appraisal capacity* in the National Planning Commission and the line ministries so that there is greater discipline initiating new projects; (v) Once formulated, the expenditure program would need to be better managed, without resorting to ad-hoc expenditure cuts which disrupt project implementation. To this end, the *mid year budget review* could be used to reassess resource outlook and to make expenditure adjustments in a more systematic manner; (vi) To protect priority projects

from any resource shortfalls, *a core program of priority projects* could be formulated and fund releases to projects/programs based on the core program; (vii) *Expenditure reporting by spending units needs to be improved*, both in terms of timeliness and quality of reporting; while the capacity for *monitoring expenditures as well as physical progress of projects/programs should also be strengthened* at various levels of the government; and (viii) To expedite project implementation, *political interference needs to be eliminated.* Clearly defining the approval limits for procurement decisions that can be taken at various administrative levels, together with clarification of procedures to be followed and sanctions for transgressions (through an anti-corruption program); and strict implementation of the recently amended civil service rules regarding staff transfers would help in this regard.

6. *If such actions are taken to improve the effectiveness of public spending, then additional revenue mobilization by the government would be warranted.* The agenda for revenue enhancement is well known, since considerable analytical work has been done already, with technical assistance from donors. Possible measures include, among others: (i) the *effective implementation of the VAT;* (ii) *Improving customs valuation procedures and reducing the scope for administrative discretion;* (iii) *Simplifying income tax legislation* in order to make tax assessment more transparent and predictable; (iv) *Reducing pervasive leakages and improving supervision*; and (v) *Strengthening tax administration.*

7. Improved public resource management could help to get relatively quick results and to build development momentum in the short term. But over the medium term, *the private sector will need to play a greater role* in undertaking necessary investments and the provision of goods and services. To nurture and encourage Nepal's small but growing private sector, a number of actions can be taken: (i) It is important to send *clear signals to the private sector and the public at large* about the private sector's role in the economy. For this to happen, a clearer redefinition of the role of the state as a facilitator and regulator is needed; (ii) It is also necessary to *provide a level playing field for the private sector vis-à-vis public enterprises,* for example by further opening up virtual public monopolies to private competition, in such areas as power generation, telecommunications and RNAC's international routes; (iii) The *provision of a clear and transparent legal and institutional framework for supporting private sector activities - "the rule of law"* - is of paramount importance; and (iv) *Strengthening of governance aspects affecting the private sector* by *reducing the discretionary powers of officials, and* developing *appropriate accounting, auditing and disclosure standards which are effectively applied* is also important. These improvements should also help attract *foreign investors.* For this purpose, *ensuring an attractive enabling environment* where the costs of doing business are transparent and predictable, and where business-related decisions can be transacted with efficiency and speed, is paramount. To be successful, as one of the late entrants into the competition, *Nepal needs to demonstrate that it can compete with, or even do better than, other countries in this regard.*

8. *Financial sector reform* is a critical issue which needs to be addressed, not only for private sector development, but also for ensuring macro-economic stability. It is generally agreed that the strengthening of the financial system should be anchored on three broad themes: (i) *Making the system stable and resilient to crises by effectively regulating and supervising banks, improving management and encouraging good corporate governance;*(ii) *Improving efficiency and cost-effectiveness* by supporting improvements in the legal framework for financial markets, increasing competition and the promotion of institutional investors; and (iii) *facilitating broad access to key financial services* by creating diverse market instruments and developing domestic debt markets. The priorities for the short term, given the current state of preparations, include the following: (iv)

*Restructuring of Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL),* with improved management, branch rationalization, and improved control mechanisms; (v) *Improved prudential regulation, accounting, and auditing practices;*(vi) *Strengthened regulatory and oversight functions of the central bank;* and (vii) *Strengthened legislative and institutional framework for loan recovery.*

9. Nepal's trade and foreign exchange regime is already quite liberal. Nevertheless *further improvements in trade and investment policies can help stimulate exports, private sector activity and economic growth*: (i) To take advantage of emerging opportunities through membership in World Trade Organization (WTO) and SAPTA and economic liberalization in India, Nepal will need to improve its competitiveness through technological upgrading, skill development, export and tourism promotion, as well as investments aimed at supplying the neighboring Indian market; and (ii) Nepal also needs to work out appropriate administrative arrangements with India and undertake the necessary investments in transport improvements, in order to take advantage of bilateral trade and transit agreements.

10. Technical improvements such as those outlined above would help to improve the effectiveness of resource use and send strong signals to the private sector. However, they alone are unlikely to be sufficient to pull the Nepalese economy out of its present predicament without addressing the key over-arching problems afflicting the economy. Indeed, the central constraint on Nepal's development over the last few decades has not been the paucity of financial resources, but the *lack of effective governance* and well functioning institutions which can adequately perform the vital state functions which are essential for a coherent economic and social development process. As outlined in a recent working paper on Governance, there are many manifestations of this problem, including weak institutions and procedures, lack of ownership of development projects and programs, lack of accountability and mismanagement of resources, failure to provide effective delivery of public services, including law and order, and the absence of a well-functioning judicial system, all of which are reflected in increased corruption. While progress in all these areas is important, concerted action in two particular areas can help achieve better development results quickly: (i) *Building a consensus within the Nepalese society and among major political parties and leaders on an economic development agenda* which is suited to Nepal's current needs, together *with strong actions to implement such an agenda*; and (ii) *Implementing an effective anti-corruption agenda.* In addressing these issues, the government undoubtedly needs to take the lead; but it is ultimately the responsibility of Nepalese civil society, including major political parties, authorities at different levels, the private sector and NGOs. It is also important to recognize that whether the governance situation in Nepal is better or worse than in other developing countries is a moot point. As one of the poorest countries in the world, Nepal can least afford the misuse and waste of its limited development resources through continued governance problems; and it needs to address these issues quickly without further semantic debate.

11. *Persistent institutional weaknesses at virtually all levels* are a major impediment to development effectiveness in Nepal. At the heart of the problem is a weak, underpaid and unmotivated civil service. Increased political interference at key points in the project cycle, particularly in procurement matters and in appointments and transfers of key staff, has further undermined the efficiency and effectiveness of the civil service. Against this background, recent efforts to transfer more resources and responsibility for local level programs to district and village committees have met with limited success, both because of the pervasive weaknesses cited above, and because technical and institutional capacity is even more limited at local levels. *To enhance development effectiveness, improvements in two areas are critical (i) Civil service reform; and (ii) Strengthening the decentralization process.*

12. Civil service reform *needs to be geared to the type of development administration that is needed to deliver public services more effectively in the future and to the severe local resource limitations* hampering Nepal. First, with increased emphasis on decentralization, the role of the center, line ministries and supervisory agencies will need to change over time. This will have important *implications for skill needs, staffing levels and personnel management. Second, to provide adequate incentives*, the overall compensation levels may need to increase significantly, together with a widening of salary differentials between lower and higher grades (i.e. decompressing the salary structure) and the introduction of a merit- based, performance-oriented reward/promotion system. *How to pay for civil service reforms thus will be a major issue*. Third, different alternatives therefore will have to be considered. Enhancing government revenue through tax reforms is one such option. This will however present its own challenges. Moreover, additional revenues are also needed for increased O & M and other development activities. *Other alternatives therefore will also have to be looked at, including downsizing, as well as donor funding for civil service reforms on a relatively short term basis*. External assistance however is likely to be forthcoming *only if a credible reform program is developed and initiated.*

13. *Decentralization* is an important means for delivering the benefits of development to rural communities; but it has its own pitfalls. To make the decentralization process work better, a number of actions are needed: (i) First, it is necessary to remove the political and bureaucratic impediments which currently hamper the decentralization initiative; (ii) Second, it is *necessary to improve the technical capacity of local bodies* (DDCs and VDCs) both for managing their expenditure programs efficiently and for mobilizing resources at the local level; (iii) Third, to promote better management and accountability, the *participation of beneficiary groups in the decision-making and implementation process needs to be increased*; together with *greater transparency* (for example, through an "open-book system") in regard to the availability of budget funds, the nature of projects being financed and public access to financial records; (iv) This would call for *greater efforts to promote community mobilization and empowerment*, particularly of the poorer and under-privileged groups; and (v) Finally, the role of line ministries and departments may need to change from implementers to facilitators, providing essential technical support for and monitoring and supervising the activities of local bodies.

14. *To foster greater ownership, the government will need to take the lead in designing, financing, and implementing the development program and, even more importantly, in aid coordination itself.* It will need to decide what its own development priorities and programs are, and ask the donors to support such programs. And external donors should support this process. Similar efforts are required in the case of fully government-financed programs, for example through: greater devolution of responsibilities by NPC to line ministries for program formulation, monitoring and supervision; (ii) increased involvement of local bodies and beneficiary groups in determining priorities and designing projects to better reflect local needs and implementing such projects; and (iii) developing alternative approaches for project implementation and service delivery, for example, involving the private sector in implementation, contracting out to NGOs specific tasks such as supervision, technical services or program implementation on behalf of community groups etc.

15. Finally, the growing *law and order problem is an important issue which needs to be addressed as a high priority*. This has important political and economic implications. While the reasons and motivations for the current unrest are indeed complex, there is little doubt that widespread poverty; significant disparities in incomes, employment opportunities, and access to resources and basic social and economic services and infrastructure between urban and rural areas and between regions; frustrated public expectations from successive governments for better

development results; and perceptions of increasing corruption/weak governance have contributed to these developments. And *solutions to the problem cannot focus only on security measures but will need to address the acute development needs of affected areas.* This will require substantial additional fiscal resources, which should provide a compelling argument for the government (and the donor community) to take stock of the fiscal position and prioritize the expenditure program.

16. *The agenda outlined above is long, and would be a major undertaking for any government. Given the capacity and other constraints discussed above, it will not be possible to implement all of it in the short term, and indeed it may not be useful to initiate all of it at once; but given the pervasive poverty and lack of progress in addressing the issue in recent years, a major effort is needed now. The immediate challenge facing the government is two-fold: (i) In the coming months, develop an implementable, prioritized action program consistent with institutional capacity and resource constraints; and (ii) Build up support among the key stakeholders including major political parties, Nepali public and external donors for implementing such an agenda.*

17. In parallel, *important changes will also be required from external donors.* While the government takes the lead in introducing critical reforms, the *donors need to actively support this process.* Towards this end: (i) *Donors will need to help the government to prepare the reform program in the short term, as well as help strengthen institutional capacity at various levels over the longer term;* (ii) *Donors will need to accept the consequences of reform programs* (for example, downsizing/canceling poor projects, limiting new project starts for some time etc.); *and adjust their own aid programs to support only those projects and activities which fit the country's needs;* (iii) It will require *stronger efforts among the donors themselves to coordinate their support without competing with each other;* (iv) It may call for *changes in the way donors prepare and manage projects and technical assistance programs in order to promote greater local ownership.* For example, instead of extensive reliance on external consultants, they need to look at alternative, more cost-effective ways of providing technical support; and (v) Similarly, *donors need to provide the kind of support that is warranted under present circumstances.* For example, *when the government is ready to move forward with a well-defined reform agenda, donors should be prepared to support such a process with increased assistance, including program aid. But if such a reform effort is not forthcoming, providing more assistance, particularly program aid, is likely to be counter-productive.*

# 1 RECENT ECONOMIC PERFORMANCE

## *A. INTRODUCTION*

1.1 With a per capita income of $210, Nepal is one of the poorest countries in the world; and nearly half of its population is estimated to be living below the poverty line. Given its limited resource endowments, a land-locked location and rugged terrain, and centuries of political and economic isolation which in turn contributed to underdeveloped economic and social infrastructure, economic development is a challenging task in Nepal. Following the transition to a democratic government in 1991, Nepal initiated wide-ranging economic reforms in the early nineties, which initially helped to accelerate economic growth and bring about improvements in some key areas of the economy, such as the trade, investment and foreign exchange regimes. Since then, Nepal has gone through an extended period of political instability. Between 1994 and early 2000, there have been nine different governments (including six coalitions), and notwithstanding strong declarations of intent, there has been no coherent overall drive to promote economic development. Moreover, this period has witnessed increasing politicization; weakening of administrative and institutional capacity; increasing corruption and governance problems; poor economic policies including, among others, ineffective public expenditure management, weak pricing policies, inefficient public enterprises, a dysfunctional financial system and a weak tax administration/low tax compliance; and more recently a deterioration in the law and order situation. Although successive governments were able to maintain macroeconomic stability during this period, economic performance in many respects has been less than satisfactory. The new government which took office in March 2000 will now need to provide the leadership and direction that is required for Nepal to address its formidable development challenges.

## *B. SCOPE OF THE REPORT*

1.2 This report is one of the documents which are being prepared for supporting the discussions at an upcoming Nepal Development Forum (NDF) meeting. Other documents for this purpose include: papers on Financial Sector Reform, Progress on Privatization and an Improved Framework for Private Sector Development. In addition, several other reports/working papers would also be available as background papers for the NDF: (i) An IMF Staff Report for the 1999 Article IV Consultations; (ii) A Public Expenditure Review; and (iii) Working papers on Measuring Development Effectiveness and Performance: Social Sectors and Social Indicators as an Example, Governance, Decentralization/Local Empowerment, and the Role of Civil Society. Accordingly, in order to avoid duplication, this report focuses first on areas/issues not covered in these other reports, viz. updating *macroeconomic developments and the performance of related key areas of the economy* in recent years, particularly since the last Economic Update was published in November 1997 (**Chapter 1**). Given the broad range of issues discussed in the various papers under preparation, **Chapter 2** of this Update *also seeks to provide an overall framework for the reform agenda*, pulling together the key reform issues reviewed in those papers.

1.3 **Overview.** Nepal's overall demand management has been quite good in the last two to three years. The balance of payments position has strengthened and domestic inflationary pressures remain moderate. However, from a development perspective, performance has been less than satisfactory. Economic growth decelerated; overall investment has declined; private sector economic activities geared to the domestic market, as well as development activities in the public sector remained sluggish; and there has been little tangible progress in reducing widespread poverty—Nepal's principal development challenge—as well as in addressing structural problems which are hampering Nepal's longer term development.

## *C. RECENT ECONOMIC PERFORMANCE*

1.4 **Macroeconomic Performance.** Key macroeconomic indicators, summarized in Table 1.1 below, provide both a longer term and a shorter-term perspective on recent economic performance. (i) From a longer term perspective, the period averages in Table 1.1 show that over the past five years (FY95-99), the *economy has slowed down compared to the early nineties in many respects*—GDP growth, per capita incomes, government revenues and expenditures, investment and savings, and imports, among others. This is not surprising since the last five years has been characterized by political instability, frequent government changes and little action in terms of development

**Table 1.1: Indicators of Macroeconomic Performance, FY86 - 99**

| | Annual Data | | | | | Period Average | | |
|---|---|---|---|---|---|---|---|---|
| | FY94 | FY96 | FY97 | FY98 | FY99 | FY86-90 | FY91-94 | FY95-99 |
| ***Economic Growth:*** | | | | | | | | |
| GDP Growth (Real) a/ | 8.2 | 5.3 | 5.0 | 2.3 | 3.4 | 4.6 | 5.6 | 3.9 |
| Per Capita GDP Growth (Real) | 5.7 | 2.8 | 2.5 | -0.2 | 0.9 | 2.0 | 3.1 | 1.4 |
| ***Investment/Savings*** | | | | | | | | |
| Total Investment / GDP | 22.4 | 25.3 | 23.3 | 21.7 | 19.4 | 19.8 | 21.9 | 22.8 |
| Public Investment / GDP | 6.7 | 7.1 | 6.9 | 6.7 | 6.0 | 7.6 | 6.9 | 6.7 |
| National Savings / GDP | 16.8 | 13.6 | 13.9 | 12.9 | 14.2 | 12.2 | 14.2 | 14.2 |
| Public Savings / GDP/b | -0.6 | -0.7 | -0.8 | -1.0 | -1.1 | -2.1 | -1.7 | -0.9 |
| ***Government Finances:*** | | | | | | | | |
| Government Revenue Growth | 29.3 | 13.5 | 8.9 | 8.4 | 13.1 | 19.1 | 20.7 | 13.9 |
| Government Expenditure Growth | 8.7 | 19.2 | 9.0 | 10.6 | 10.7 | 18.7 | 14.8 | 13.1 |
| Government Budget Balance / GDP | -7.0 | -7.5 | -7.3 | -7.8 | -7.4 | -9.6 | -8.2 | -7.3 |
| ***Balance of Payments:*** | | | | | | | | |
| Export Value Growth /c (in US$) | 3.1 | 1.9 | 10.2 | 11.9 | 18.2 | 4.5 | 22.2 | 6.5 |
| Import Value Growth /cd (in US$) | 21.4 | 5.8 | 21.6 | -12.4 | -10.3 | 8.4 | 13.2 | 5.3 |
| Current Account Balance / GDP | -5.6 | -11.7 | -9.4 | -8.8 | -5.2 | -7.6 | -7.6 | -8.6 |
| Aid Disbursement(gross) / GDP | 8.0 | 7.2 | 7.5 | 8.5 | 7.4 | 7.0 | 7.1 | 7.6 |
| Gross Foreign Exchange Reserves (in months of imports of goods and services) | 8.1 | 6.6 | 5.5 | 7.7 | 8.9 | 4.7 | 8.2 | 7.3 |
| ***Monetary Data:*** | | | | | | | | |
| Broad Money Growth | 19.6 | 14.4 | 11.9 | 21.9 | 20.9 | 20.8 | 22.0 | 17.0 |
| Domestic Credit Growth | 17.0 | 22.7 | 13.9 | 14.8 | 16.5 | 18.9 | 18.2 | 18.5 |
| ***Inflation:*** | | | | | | | | |
| Consumer Prices | 9.0 | 8.1 | 7.8 | 4.0 | 12.7/e | 11.6 | 12.2 | 8.0 |

a/ At producers' prices.
b/ Difference between government revenues and recurrent expenditures (i.e. government consumption as estimated in national accounts data) and debt service payments.
c/ Exports of goods and imports of goods only.
d/ Includes imports of gold & silver – US $191 million in FY94, US $250 million in FY96, US $551 million in FY97, US $259 million in FY98 and US $ 130 million in FY99.
e/ The urban consumer price index, on a twelve month point-to-point basis, has come down to an annual rate of 2% in December, 1999.

management, as compared to the early nineties when political stability enabled vigorous development efforts by the government; and (ii) More detailed annual data in Table 1.1 for recent years confirm this finding—*while macroeconomic stability has been maintained, and even improvements have been made in some areas, economic performance has weakened over the past 2-3 years.*

1.5 In regard to *short term improvements in the economy,* (i) the most noteworthy has been the *strengthening of the external payments position* in the last two-to-three years, due both to a *strong recovery of exports* and to a *slowdown in non-gold imports,* the latter in turn reflecting lower investment/development activity and tight fiscal policies. The current account deficit has narrowed steadily from nearly 12% of GDP in FY96 to around 5.0% of GDP in FY99, with a significant strengthening of gross foreign exchange reserves (para 1.15); (ii) *Macroeconomic stability been maintained.* Although the fiscal situation remains weak (see below), government borrowing has been kept below 2.0% of GDP per annum and the overall budget deficit has been kept around 7.0-7.5% of GDP, financed largely by external aid; (iii) The *growth of domestic credit slowed down to around 15% per annum in the last three fiscal years,* in part reflecting low levels of investment and economic activity and imports. Overall liquidity growth in FY98 and FY99 remained somewhat higher than in previous years, reflecting the improvement of the reserve position and inadequate offsetting actions to mop up such liquidity by monetary authorities; and this in turn (together with poor crops and supply disruptions) contributed to a pick up in food prices in early FY99; and (iv) Since then, however, *domestic inflation has decelerated significantly to an annual rate of only about 2%* in December on a twelve month point-to-point basis, in line with price developments in India, due to improved supplies and crop outlook (para 1.11).

1.6 In parallel with these achievements, *there have been a number of less positive developments.* (i) *Economic growth decelerated* in the last two fiscal years to an average of 2.8% p.a. With population growing at 2.5% p.a., there has been little growth in per capita incomes. Although a rebound of economic growth is anticipated this fiscal year (FY2000), as discussed in para 1.11, given its fortuitous nature, a major challenge will be how to sustain such growth; (ii) *Investment levels in the economy declined* from the peak levels achieved in the mid nineties, with *both public and particularly private investment falling sharply* (para 1.10); while *national savings also fell,* though less rapidly; (iii) *A weak financial sector continues to be a serious impediment to private economic activities.* Inefficiencies of the two largest banks have helped to keep lending rates high in real terms and reduced the incentives for other banks to be competitive and efficient; (iv) *Fiscal management has continued to be unsatisfactory.* Fiscal management has focussed largely on maintaining macroeconomic stability. While this is undoubtedly important, it has *not been accompanied by strong efforts to maintain development activity.* Also, in the last few years, *governance issues have emerged as a major impediment constraining the effectiveness of public expenditure programs;* and (v) Finally, there has been little progress in addressing the structural weaknesses of the economy and protecting the financial viability of public sector institutions. All of these developments in the last few years add upto a less than steller economic performance. Indeed, *the economy has remained stuck in a low level equilibrium over the past few years; and its consequences for poverty reduction probably have been adverse.* The Nepal Living Standards Survey (NLSS) carried out in 1996 indicated that there has been little apparent progress in poverty reduction in the last two decades and that nearly half the population was living in poverty. Given the stagnation of per capita incomes since then, and the poor performance of the agricultural sector in particular (para 1.8), *it is highly likely that the poverty situation has deteriorated further.*

## Growth Performance

1.7 *Why has the economy slowed down despite the rapid improvement in exports and the balance of payments in the last 2-3 years*? This can be explained in terms of the structure of the economy and diverse factors affecting key sectors in the domestic economy.

1.8 Nepal's economy is highly dualistic, with a relatively modern non-agricultural/urban sector and a backward agricultural sector, which is still the backbone of the rural economy and accounts for two-fifths of the value-added in the economy. As Table 1.2 indicates, *agricultural growth has averaged only 2.3% p.a. over the past five years, and the production of food crops averaged only an increase of 1.1% p.a. over the last three years, i.e. significantly less than the population growth rate of 2.5% p.a. On the other hand, the non-agricultural sector grew at a more respectable rate of 5.0% p.a. which however represented a significant deceleration from the nearly 9% p.a. growth rate recorded in the early nineties*

**Table 1.2: GDP Growth, FY86 - 99**

| | FY86-90 | FY91-94 | FY95-99 |
|---|---|---|---|
| ***Rate of Growth (% p.a.)*** | | | |
| Agriculture | 4.1 | 2.0 | 2.3 |
| Non-Agriculture | 5.5 | 8.7 | 5.0 |
| **Total GDP** | **4.8** | **5.6** | **3.9** |
| ***Share of GDP (%)*** | | | |
| Agriculture | 49.3 | 44.7 | 40.8 |
| Non-Agriculture | 50.7 | 55.3 | 59.2 |
| Industry/a | (16.0) | (18.4) | (19.8) |
| Trade, Transport/b | (16.6) | (17.7) | (19.2) |
| Other Services/c | (18.1) | (19.2) | (20.2) |
| **Total GDP/d** | **100.0** | **100.0** | **100.0** |

a/ Includes manufacturing, mining, electricity and construction.
b/ Includes trade, transport and communications, hotels, restaurants, etc.
c/ Financial, real estate, community and social, and other services.
d/ GDP, at factor cost, in constant (1984/85) prices.
***Source*: Central Bureau of Statistics.**

1.9 The poor performance of *agriculture* can be attributed to several factors: (i) Despite considerable public investments in surface irrigation in the past, only about 40% of Nepal's cultivated land area is under irrigation, and only about 15% under year-round irrigation. Thus, *crop production is dependent on the vagaries of the weather to an unusual extent in Nepal.* The lack of irrigation in turn inhibits the effective use of critical inputs which can significantly increase crop yields; fertilizer usage in Nepal is only 33 kg per hectare, which is only about one-third of the level in Bangladesh and Pakistan. Against this background, *unfavorable weather* (alternating droughts and floods) adversely affected crop production in FY98 and FY99. Indeed, crop production has been adversely affected by the weather in 5 of the last 8 years; and (ii) Second, as discussed in the Public Expenditure Review, the *effectiveness of the public expenditure programs in the agricultural sector and the efficiency of public sector institutions providing key inputs and services to farmers has been low.* A large part of the agriculture sector's budget has been allocated for subsidies (for fertilizer and food distribution) and agricultural research and extension. And yet, the Agricultural Inputs Corporation (AIC) had consistently failed to provide adequate supplies of fertilizer to farmers on a timely basis. Similarly, the Agricultural Research and Extension Program has so far failed to deliver relevant crop research and technology needed by farmers in order to improve crop yields and cultural practices. The government has gradually reduced and then recently eliminated fertilizer subsidies in October 1999 in order to provide a level playing field for the private sector to encourage the latter to import and distribute fertilizer to farmers. While the initial results of this policy change are encouraging in terms of private sector participation, there are a number of related problems which need to be addressed to improve fertilizer delivery.

1.10 The relative stagnation of agricultural incomes has been a key factor affecting the demand for outputs of industries producing for the domestic market. Low levels of development activity (the latter is an important determinant of construction and related activities and services in Nepal) and private investment noted above, weak business confidence in an environment of political instability, and high costs of borrowing from financial institutions have been among the other important factors affecting the non-agricultural sector. Thus, a number of key sub-sectors which produce primarily for the domestic market recorded negative or marginal growth—textiles, beverages, cement, steel and other construction materials, non-metallic products, utensils etc. Thus, value-added in manufacturing grew by only 0.2% and in the non-agricultural sector by only 2.9% in FY98. The redeeming feature, particularly in FY99, for some domestic manufacturing groups however has been the strong external demand for some products—carpets, ready-made garments, vegetable ghee, soaps and cosmetics and some food products—which helped to raise manufacturing growth to around 4% in FY99. Nevertheless, trade, transport and related activities also were affected by the general business downturn, growing at 4 - 5% p.a. in the last two to three years, as compared to 8 - 9% in the early and mid-nineties.

1.11 *Preliminary estimates by the government suggest a strong recovery in economic growth to 6% in the current fiscal year (FY2000).* This is based on a strong rebound in food crops, raising agricultural growth to 4.5% this year; and a recovery in non-agricultural growth to about 7%, based on continued strong export performance, high levels of development spending by the government and a recovery of private investment and domestic demand. However, this forecast may turn out to be optimistic. Although, a *rebound in agriculture from two successive years of poor performance indeed seems likely* (mainly due to favorable weather this year), *the projected recovery in non-agriculture sector remains more open to question.* There is evidence that it may be difficult for the government to significantly increase development spending in real terms this year (para 1.20); and the negative impact of recent events will have to be overcome in order to revive the growth of tourist arrivals and earnings in the second half of the fiscal year. Even more important, *a revival of business confidence and private investment will depend largely on how far the new government will succeed in forging solidarity within its ranks and addressing key economic policy issues.*

**Balance of Payments Developments**

1.12 The external payments position had been a major source of weakness in the mid-nineties. However, *the strengthening of the balance of payments in the last few years has been an important positive development, with the current account deficit (before grants) improving from nearly 12% of GDP in FY96 to about 5% in FY99, and a significant improvement in the gross foreign exchange reserve position.* This improvement mainly reflects *a strong recovery of exports, some increase in recorded inflows of private remittances and a decline in imports* (Table 1.3).

1.13 The recent growth in *exports* (a 46% increase in US dollar terms between FY96 and FY99) has been impressive, and partly reflects increased exports of ready-made garments to third countries, and more importantly, increased exports to India (Table 1.4). In ready-made garments, Nepal has benefited from unsettled political conditions in Bangladesh and consequent diversion of some export orders to Nepalese manufacturers. Some of the increase in exports to India also reflect similar transitory factors. Nepalese manufacturers have taken advantage of prevailing tariff differentials between Nepal and India on imports in order to increase exports to neighboring Indian states, as in the case of vegetable ghee where exports to India have increased rapidly. However, there have also been more encouraging developments which hold out greater promise for the future. For example, recent improvements in trade, transit and investment arrangements with India appear to have stimulated interest among some Nepalese manufacturers in exploring opportunities in the Indian market (for noodles, beer, milk, some food products, soaps, toiletries etc.) through joint ventures and collaborative marketing arrangements.

**Table 1.3: Balance of Payments Summary/a, FY94 - FY99**
**(In US$ Million)**

| | Annual Data | | | | | Change /b | |
|---|---|---|---|---|---|---|---|
| | FY94 | FY96 | FY97 | FY98 | FY99 | FY94-96 | FY96-99 |
| Exports | 392.1 | 360.6 | 397.4 | 444.6 | 525.3 | -31.5 | +164.7 |
| Imports | 1048.1 | 1350.4 | 1642.3 | 1439.1 | 1290.6 | -302.3 | +59.8 |
| Of which Gold & Silver | 191.5 | 249.8 | 550.8 | 258.8 | 130.3 | -58.3 | +119.5 |
| **Trade Balance** | **-656.0** | **-989.8** | **-1244.9** | **-994.6** | **-765.3** | **-333.8** | **+224.5** |
| **Services (Net)** | **354.8** | **378.9** | **690.2** | **470.2** | **356.3** | **+24.7** | **-22.6** |
| Receipts/c | 609.0 | 673.3 | 932.5 | 702.1 | 588.3 | +64.3 | -85.0 |
| Payments | 254.2 | 294.4 | 242.3 | 231.9 | 232.0 | -40.2 | +62.4 |
| **Transfers (Net)** | **76.5** | **83.5** | **94.5** | **103.0** | **152.9** | **+7.0** | **+69.4** |
| Private | 66.5 | 67.2 | 76.8 | 84.3 | 135.1 | +0.7 | +67.9 |
| **Current Account Balance** | **-224.7** | **-527.4** | **-460.3** | **-421.4** | **-256.1** | **-302.7** | **+271.3** |
| **Official Capital (Net)** | **279.4** | **271.3** | **318.0** | **343.7** | **305.4** | **-8.1** | **+34.1** |
| Foreign Grants | 61.7 | 137.3 | 170.8 | 176.3 | 171.4 | +75.6 | +34.1 |
| Foreign Loans (net) | 217.7 | 134.0 | 147.1 | 167.4 | 134.0 | -83.7 | 0.0 |
| Foreign Loans (gross) | 263.4 | 186.2 | 197.0 | 229.8 | 195.2 | -77.2 | +9.0 |
| Amortization | 45.7 | 52.2 | 49.8 | 62.4 | 61.2 | -6.5 | -9.0 |
| Foreign Direct Investment | n.a. | 7.0 | 28.4 | 11.1 | 8.5 | +7.0 | +1.5 |
| Miscellaneous Capital Items (Net) | 72.8 | 229.5 | 170.1 | 243.7 | 87.0 | +156.7 | -142.5 |
| Change In Reserves/b | -127.6 | +19.6 | -56.1 | -177.0 | -144.8 | +147.2 | -164.4 |
| **Memo Items:** | | | | | | | |
| Current Account Balance/GDP | -5.6 | -11.7 | -9.4 | -8.8 | -5.2 | | |
| Total Gross reserves | 866 | 801 | 868 | 969 | 1128 | | |
| Total Res. In months of Imports/d | 8.0 | 5.8 | 5.5 | 7.5 | 8.9 | | |
| Official Res.in months of Imports/d | 6.6 | 4.5 | 4.1 | 5.5 | 6.2 | | |
| Non-Gold Imports | 856.6 | 1100.6 | 1091.5 | 1180.3 | 1157.6 | | |

a/ This table is based on NRB's traditional presentation of balance of payments data, in order to provide a data series which is consistent with national accounts estimates for the early nineties. Considerable work has been done recently to improve balance of payments data, but this new series is available only from FY97 onwards.
b/ Indicates effect on the balance of payments.
c/ The unusual increase in government receipts in FY99 (mainly representing inward remittances by foreign diplomatic missions in Nepal) has been treated as a miscellaneous capital inflow.
d/ Same year's imports of goods and services.
*Source*: Nepal Rastra Bank.

1.14 *Total imports*, on the other hand, declined particularly sharply (by some US$250 million) since FY97, mainly due to reduced imports of gold, much of which is smuggled to India. Gold imports into Nepal declined from a peak of $551 million in FY97 to $130 million in FY99, due to some tariff reductions and easing of restrictions on gold imports by India last year. *Excluding gold, all other imports have increased only marginally—by less than 2% p.a. in dollar terms*—over the last three years, reflecting the depressed economic activity and investment levels in the economy.

1.15 The rapid growth of exports and the slowdown in imports contributed to a significant *decline in the trade deficit in dollar terms and to a similar improvement in the current account deficit in the last two years.* With aid disbursements averaging over 7% of GDP per annum and continued inflows of unrecorded private inflows (mainly from India), *Nepal's gross foreign exchange holdings have* *also increased steadily (by about $330 million over the past three years, including a $145 million increase in FY99).* Total foreign exchange holdings ($1,128 million in July 1999) represented the equivalent of nine months of the same year's imports of goods and services, and official reserves over six months' imports equivalent – a comfortable level by historical standards. However, Nepal's export base is still small; and some of the exports (such as garments, vegetable ghee etc.) are likely to be of a transitory nature. Moreover, any reasonable recovery in the economy is likely to lead to increased imports, which may again put pressure on the balance of payments.

**Table 1.4: Composition of Exports, FY94 - 99 (US$ Million)**

| | FY94 | FY96 | FY97 | FY98 | FY99 |
|---|---|---|---|---|---|
| Exports to Third Countries | 342.8 | 293.3 | 305.3 | 297.9 | 340.6 |
| Carpets | 193.5 | 147.8 | 155.7 | 137.0 | 144.2 |
| Garments | 120.6 | 97.3 | 104.4 | 113.2 | 142.6 |
| Exports to India | 49.3 | 67.3 | 92.1 | 146.7 | 184.7 |
| **Total Exports** | **392.1** | **360.6** | **397.4** | **444.6** | **525.3** |

*Source*: **Nepal Rastra Bank.**

**Fiscal Developments**

1.16 *Poor fiscal management continues to be a major impediment to sustainable development in Nepal.* Although the overall fiscal deficit has been limited to around 7.5% of GDP, and domestic borrowing has generally been less than 2% of GDP, it has been *achieved at the expense of development activity.* Moreover, the *effectiveness of public spending has been low* in terms of delivery of public services and outputs. *To improve development results in terms of poverty reduction and accelerating economic growth, the management of the public expenditure program needs to improve significantly.*

1.17 The recently prepared *Nepal Public Expenditure Review* spells out the major problems of fiscal management in Nepal: (i) Nepal's *revenue performance is inadequate* in relation to its expenditure levels and development needs. With the revenue ratio stagnating around 11% of GDP in recent years, development activity is heavily dependent on external aid; and (ii) *But, public resources, including aid, have not been effectively utilized* for a variety of reasons: (a) *budget planning has been over-optimistic* with both revenue and aid targets set at unrealistic levels; (b) *too many projects are* included in the development budget, well beyond the actual availability of resources, in turn leading to *under-funding and implementation delays;* (c) Funding shortfalls apart, several other factors impede effective implementation: *limited institutional capacity, lack of ownership of (especially donor-assisted) projects by the government, excessive political interference particularly in procurement matters and transfers of senior officials/project managers, and governance issues;* (d) In addition, there are *serious deficiencies in resource allocation.* For example, O & M activities are heavily under-funded; much of the increases in allocations have gone to power generation and local development (where resources have not been well used so far); while the agricultural sector, which is critical for the wellbeing of the rural economy and poverty reduction, has received reduced funding; (e) Also, allocated resources are not efficiently used across sectors and sub-sectors; and (f) Budget management procedures are weak; and there is *insufficient monitoring and supervision* and enforcement of corrective actions to ensure accountability. The end result has been consistently poor development achievements.

1.18 The *fiscal outcome for FY99 has been disappointing*, continuing the trend of under performance of revenue and development spending. Government revenue, targeted at Rs. 39.5 million or 11.8% of GDP in the FY99 budget, reached only Rs. 37.2 billion or 11.1% of GDP. Collections from the VAT were below expectation due to resistance from the business community to its implementation and ineffective implementation arrangements (staffing); while low levels of economic activity and imports, a weak tax administration and leakages contributed to the revenue shortfalls; (ii) Similarly, aid disbursements which were projected in the budget at Rs. 25.5 billion, actually reached only Rs. 19 billion, reflecting both delays in the implementation of ongoing projects as well as in the preparation of new projects; (iii) To partly offset these shortfalls, the government increased its domestic borrowing by about Rs. 2 billion to 1.8% of GDP from the planned level of 1.3% of GDP; and (iv) Nevertheless the brunt of the fiscal adjustment fell on development spending, which was cut back from a planned Rs. 37.7 billion to Rs. 31.0 billion—a decline in real terms below the previous year's level.

**Table 1.5: Government Expenditure and Its Financing FY86 – FY2000**
**(Rs. Billion)**

| In Rupees billion | Annual Data | | | | | | | Period Average | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | FY94 | FY96 | FY97 | FY98 | FY99 Budget | FY99 | FY2000 Budget | FY86-90 | FY91-94 | FY95-99 |
| **Total Expenditures** | **33.6** | **46.5** | **50.7** | **56.1** | **69.7** | **63.2** | **77.2** | **14.6** | **27.8** | **50.9** |
| Regular /a | 12.4 | 21.6 | 24.2 | 27.7 | 32.0 | 31.8 | 35.4 | 4.9 | 10.3 | 24.8 |
| Development | 21.2 | 25.0 | 26.5 | 28.4 | 37.7 | 31.4 | 41.9 | 9.7 | 17.5 | 26.2 |
| **Government Revenue** | **19.6** | **27.9** | **30.4** | **32.9** | **39.5** | **37.2** | **44.5** | **7.0** | **14.7** | **30.6** |
| Tax | 15.4 | 21.7 | 24.6 | 25.9 | 30.9 | 28.8 | 34.7 | 5.5 | 11.3 | 24.1 |
| Non-Tax | 4.2 | 6.2 | 5.8 | 7.0 | 8.6 | 8.5 | 9.9 | 1.5 | 3.5 | 6.5 |
| **Overall Deficit** | **-14.0** | **-18.6** | **-20.4** | **-23.2** | **-30.2** | **24.7/b** | **-32.7** | **-7.6** | **-13.1** | **-20.3** |
| **Foreign Financing** | **11.6** | **14.3** | **15.0** | **16.5** | **25.5** | **18.7** | **27.2** | **5.8** | **9.8** | **15.1** |
| Grants | 2.4 | 4.8 | 6.0 | 5.4 | 7.8 | 5.8 | 8.7 | 1.6 | 2.5 | 5.2 |
| Loans | 9.2 | 9.5 | 9.0 | 11.12 | 17.7 | 12.9 | 18.6 | 4.1 | 7.3 | 9.9 |
| **Domestic Borrowing** | **2.5** | **4.4** | **5.3** | **6.7** | **4.7** | **6.0** | **5.5** | **1.8** | **3.3** | **5.2** |
| GDP at Market Prices | 199.3 | 248.9 | 280.5 | 296.5 | 334.7 | 334.7 | 383.0 | 77.8 | 160.1 | 276.0 |
| ***Key Ratios - In Percent of GDP*** | | | | | | | | | | |
| **Total Expenditures** | **16.9** | **18.7** | **18.1** | **18.9** | **20.8** | **18.9** | **20.2** | **18.8** | **17.4** | **18.4** |
| Regular | 6.2 | 8.7 | 8.6 | 9.3 | 9.5 | 9.5 | 9.2 | 6.4 | 6.5 | 9.0 |
| Development | 10.6 | 10.0 | 9.5 | 9.6 | 11.3 | 9.4 | 11.0 | 12.4 | 10.9 | 9.5 |
| **Government Revenue** | **9.8** | **11.2** | **10.8** | **11.1** | **11.8** | **11.1** | **11.6** | **9.0** | **9.2** | **11.1** |
| Tax | 7.7 | 8.7 | 8.8 | 8.7 | 9.2 | 8.6 | 9.0 | 7.0 | 7.0 | 8.7 |
| Non-Tax | 2.1 | 2.5 | 2.1 | 2.4 | 2.6 | 2.5 | 2.6 | 2.0 | 2.2 | 2.4 |
| **Overall Deficit** | **-7.0** | **-7.5** | **-7.3** | **-7.8** | **-9.0** | **-7.4/b** | **-8.5** | **-9.8** | **-8.2** | **-7.4** |
| **Foreign Financing** | **5.8** | **5.7** | **5.4** | **5.5** | **7.6** | **5.6** | **7.12** | **7.4** | **6.2** | **5.5** |
| Grants | 1.2 | 1.9 | 2.1 | 1.8 | 2.3 | 1.7 | 2.3 | 2.1 | 1.6 | 1.9 |
| Loans | 4.6 | 3.8 | 3.2 | 3.7 | 5.3 | 3.8 | 4.8 | 5.3 | 4.6 | 3.6 |
| **Domestic Borrowing** | **1.2** | **1.8** | **1.9** | **2.3** | **1.4** | **1.8** | **1.4** | **2.4** | **2.0** | **1.9** |

a/ The budget classification was changed in FY95 by transferring salaries of teachers and health workers from development to the regular budget. This added about 1.5 percentage points of GDP equivalent to regular expenditures from FY95 onwards.

b/ After "non-budgetary receipts" of Rs. 1.3 billion.

*Source*: Ministry of Finance.

1.19 *The objectives of the budget for the current year—FY2000—which was announced in early July 1999, are commendable.* It emphasizes poverty reduction as its primary objective, to be achieved through accelerating economic growth (especially in agriculture); creating employment opportunities; developing social and economic infrastructure; and promoting rural development, community participation and the empowerment of women and other disadvantaged groups. The budget also emphasized better mobilization and use of resources and encouraging private sector participation. It expressed a strong commitment to institutional and economic reforms, including among others, good governance, transforming the development administration into a service and results-oriented system, financial sector reforms, and privatization of public enterprises. However, *in regard to its approach to resource planning and allocation, the budget has not been different from the past.* For example, the budget projections for revenues and aid disbursements are optimistic (representing nominal increases of 20% and 45% respectively over last year's levels); and based on these assumptions, the development budget has been targeted at Rs. 41.9 billion—a 33% increase over last year's actuals.

1.20 On the basis of current indications, *achieving these targets will be a major challenge.* Data through mid February (i.e. the first seven months of the fiscal year) show that cash expenditures are rising at an annual rate of 18% so far (23% budgeted), with regular expenditures rising at 14% (16% budgeted, including a post-budget wage increase announced in August), and development spending at 26% (33% budgeted). A substantial part of the increase in development spending reflects expenditures on the recently concluded South Asian Federation (SAF) games held in October 1999. Moreover, government cash expenditures constitute only about one-third of the development budget, with the balance two-thirds expected to be financed by aid. But so far, inflows of cash loans and grants are running at only about *2% above last year's levels*; and indications from major donors suggest that total aid disbursements may rise far more slowly than the 45% nominal increase projected in the budget. In addition, government revenues are growing at an annual rate of only 12% so far (as against 20% budgeted), due to problems in implementing the VAT and new customs valuation procedures, among others. Moreover, security-related expenditures are expected to rise substantially over budget estimates. Already the government's cash position shows a deterioration of about Rs. 2.3 billion over last year's level. (Compared to a cash deficit of Rs. 253 million at this time last year, the government has already borrowed Rs. 2.6 billion this year so far). *This situation may worsen in the coming months as regular expenditures increase, unless foreign aid disbursements pick up sharply (which seems unlikely) and corrective steps are taken to increase revenues. Thus, once again the brunt of the fiscal adjustment is likely to fall on the operations and maintenance component of the regular budget and in particular on the development budget.*

**Progress in Economic Reforms**

1.21 The last few years have been conspicuous by the absence of serious efforts to address the major impediments to accelerating economic growth (and reducing poverty) through appropriate economic reforms. A reform program which was supported in the early and mid-nineties through an Enhanced Structural Adjustment Facility (ESAF) arrangement with the International Monetary Fund lapsed in October 1995. Since then, successive governments have found it difficult to forge a consensus to tackle difficult economic issues, in part because of differences of views among major political parties. Thus, despite stated commitments by successive governments to economic reforms, there has been little action to implement them. As noted, the FY2000 Budget includes similar strong commitments by the government to undertake bold economic reforms in a number of important areas. But, these have not been followed up by appropriate actions, except in a few limited areas:

- *Tax Reform.* The implementation of VAT—the centerpiece of government's revenue enhancement effort—started in FY98, with technical assistance from USA and DANIDA. But, its progress has been slow, initially due to opposition from the business community and subsequently to administrative problems. The VAT department is seriously understaffed; and its capacity to handle the large increase in the number of registered tax payers remains limited, with the result that VAT revenue collections so far have been disappointing. To make the VAT more effective, it is necessary to strengthen VAT administration, clear the filing backlog and enforce collections.

- *Financial Sector Reform.* The Nepal Rastra Bank has started preparatory work, with technical assistance from the World Bank and the Asian Development Bank, to prepare a reform program. Consultants are currently reviewing the operations of the two major banks and the supervision and regulatory requirements of the Central Bank. Overall progress so far has been slow, and the consultants' work has inter alia been hampered by inadequate support and staff resistance. Awareness of the need for these efforts among the top management of the banks concerned seems to be limited.

- *Privatization.* Progress so far has been painfully slow. The government had planned to privatize 3 enterprises over the past two years, out of which only one is nearing completion. In the case of the second—Butwal Power Company—both bidders have withdrawn following a government decision to call for rebidding. Although technical preparations have been going on for a number of years, the privatization efforts have suffered so far in the absence of a consensus among political parties and a strong government commitment to it outside the Finance Ministry. This in turn has enabled some corporations which have been undertaking preparatory work for inviting private sector involvement in some of their operations, (for example, telecommunications) to forestall or limit such initiatives.

- *Price Adjustments.* After a couple of years of inaction, some price adjustments have been made recently. Electricity prices have been raised by 30% in November, as well as diesel and kerosene prices by 48% and 24% respectively. Fertilizer prices were raised by 10-20% in October; and fertilizer subsidies have been eliminated, in order to encourage private participation in fertilizer distribution.

- *Public Expenditure Management.* Assistance has been provided for some time by donors, especially DFID and IDA, to strengthen financial monitoring and procedures in the Finance Ministry and its agencies and some key line ministries. This assistance however has been largely technical in nature, and has not led so far to significant changes in the way the budget is planned and managed, as discussed in the Public Expenditure Review.

1.22 Overall, the reforms have been few and far between; and the quality of economic management has not been satisfactory. Policy changes which are required to improve economic management are discussed in Chapter 2.

1.23 **Summary**. Nepal has been successful so far in maintaining macroeconomic stability, and strengthening its balance of payments position. However, economic performance has been less satisfactory in a number of key areas including economic growth, investment levels, fiscal management and sustaining development activities, among others. There are some encouraging signs with regard to exports and a rebound in economic growth in the current year. But, these positive developments to a large extent have benefited from fortuitous circumstances rather than from a fundamental improvement in economic policies and programs. And, given their transitory nature, there is little assurance that they can be sustained. There is therefore little room for complacency. To ensure sustainability of recent improvements in the economy and to make acceptable progress in reducing Nepal's widespread poverty, Nepal needs to make much stronger efforts to accelerate economic growth and development.

# 2 THE DEVELOPMENT AGENDA

## A. NEPAL'S DEVELOPMENT CHALLENGE

2.1 The preceding Chapter pointed out that, despite continued macroeconomic stability and recent gains in some important areas, Nepal's overall economic performance has not been good enough. *To reduce widespread poverty, Nepal needs to achieve faster economic growth, and vastly improved development outcomes* in terms of delivery of resources, outputs and services to rural communities. To attain sustained progress in these areas, *it will require concerted efforts over a long period.* For example, to simply double Nepal's exceedingly low per capita income of $210 p.a., with its population growth rate remaining at the current level of 2.5% p.a., it will take another twenty years, even with the economy growing at a relatively high rate of 6.0% p.a. (This is 50% faster than the average growth rate achieved in the FY94-99 period).

2.2 The *fiscal outcome for FY99 has been disappointing*, continuing the trend of under performance of revenue and development spending. Government revenue, targeted at Rs. 39.5 million or 11.8% of GDP in the FY99 budget, reached only Rs. 37.2 billion or 11.1% of GDP. Collections from the VAT were below expectation due to resistance from the business community to its implementation and ineffective implementation arrangements (staffing); while low levels of economic activity and imports, a weak tax administration and leakages contributed to the revenue shortfalls; (ii) Similarly, aid disbursements which were projected in the budget at Rs. 25.5 billion, actually reached only Rs. 19 billion, reflecting both delays in the implementation of ongoing projects as well as in the preparation of new projects; (iii) To partly offset these shortfalls, the government increased its domestic borrowing by about Rs. 2 billion to 1.8% of GDP from the planned level of 1.3% of GDP; and (iv) Nevertheless the brunt of the fiscal adjustment fell on development spending, which was cut back from a planned Rs. 37.7 billion to Rs. 31.0 billion—a decline in real terms below the previous year's level.Sustaining a 6% p.a. growth rate over a long period is an unprecedented challenge for Nepal. *High growth, though essential, is not a sufficient condition for meeting Nepal's needs for achieving relatively quick progress in reducing poverty. High growth needs to be accompanied by more equitable growth to have a significant impact on reducing poverty relatively quickly.* This is indeed one of the lessons to be learnt from the experience of the early nineties, when the non-agricultural/urban economy grew at a remarkable rate of 8-9% per annum. But, as the 1999 Nepal Living Standards Survey (NLSS) suggests, while such growth probably helped to stabilize or even to reduce urban poverty, it appears to have had little impact in improving incomes and living standards in rural areas where the bulk of Nepal's population and its poor live. It is therefore important that in accelerating economic growth, *efforts must also focus on speeding up the development of the rural economy through agricultural and rural development, and the provision of rural infrastructure and social services (such as basic education and health care); and special attention needs to be given to disadvantaged groups and backward regions of the country.*

2.3 In addition, Nepal's particular circumstances of enduring poverty and increasing social and political tensions have important implications for its development strategy, and especially for the timing and phasing of economic growth. As the NLSS indicates, there are considerable differences in incomes, consumption and poverty levels in Nepal between urban and rural areas, between regions, between genders and between social/ethnic groups; and these disparities are an important source of social and political tensions noted above. Indeed, such disparities and the slow pace of development have engendered considerable public expectations from democratic governments for tangible improvements in economic conditions and living standards, particularly with the transition to democracy in the early nineties. However these expectations remain largely unfulfilled; and as noted in the PER, poor development results, perceptions of misuse and waste of public resources and increasing corruption have led to considerable disenchantment with development policies and foreign aid. Against such a background, *it is essential for the government not only to deliver quick and tangible development results in terms of visible benefits to rural communities who are left behind by the ineffective development process so far, but also to be seen to be making the strong efforts which are needed in this regard.* In the absence of such efforts, it will be difficult to avert a further erosion of public confidence, which in turn could lend support to continuing challenges to Nepal's political, social and economic stability.

2.4 The **development strategy** which is needed to accelerate economic growth with better distribution of its benefits for reducing poverty is not new. It is well known, and is broadly articulated in the government's Ninth Plan. The latter recognizes that, in order to accelerate economic growth on a sustainable basis, *Nepal needs to develop/exploit its limited sources of economic growth—its water resources, its potential for tourism development and its considerable, but as yet largely uneducated and unskilled human resources.* However, the effective development of Nepal's water and human resources *will take considerable time and efforts as well as huge investments* (see below); and in the short to medium term, Nepal *needs to focus on a balanced development strategy aimed at exploiting the potential for growth in other sectors, particularly in agricultural and rural development, tourism and the services sectors, and developing manufacturing activities for export to niche markets* in India as well as third countries. Of course, given its long gestation periods, *human resource development (including the provision of basic social infrastructure) needs to be accorded high priority even in the short term*; while limited *poverty interventions*, to the extent that they can be accommodated within public resource limitations and can be well-targeted, may also be needed for reducing poverty among the most vulnerable groups.

2.5 Such a development strategy will need to be implemented against the backdrop of limited resources, particularly over the short to medium term. As discussed in the PER, the public expenditure program is heavily overcommitted; and there are considerable inefficiencies in the use of public resources, including foreign aid, leading in turn to considerable " aid fatigue". It is therefore *unlikely that substantial additional donor assistance will be forthcoming unless Nepal can demonstrate that it can use such assistance effectively* to produce better development results. This would also apply to government efforts to mobilize more domestic revenues through increased taxes. Indeed, additional taxation can be justified only to the extent that available public resources are efficiently used. *Thus in the short term, Nepal needs to put its house in order, and use available public resources efficiently and wisely in order to convince both the donor community and its own skeptical tax paying public that it can use additional resources more effectively.* This may mean that initially the government may need to formulate a manageable and prioritized development program and implement it quickly to produce measurable results. This should then provide a solid basis for a more ambitious development effort over the medium term with substantially increased donor assistance on the basis of well-articulated programs and credible (short term) performance. In addition, Nepal *will need to depend increasingly on private investment* in such areas as hydropower development, telecommunications, tourism and in any other areas (such as some infrastructure development), which may be commercially attractive to private investors. Given the small size of the domestic private sector, *this will require special efforts to facilitate private sector development.* Nepal will also need to make every effort to *promote foreign direct investment*, particularly since any large scale private investment (in such areas as hydropower) will be virtually impossible without direct foreign private investment in the foreseeable future. In this context, it is important to recognize that *recourse to foreign borrowing on commercial terms* (for example, through suppliers' credits to finance infrastructure investments) *is not a viable option for Nepal*. The cost of servicing such borrowing are likely to substantially increase the debt servicing burden, particularly in light of Nepal's limited export earnings capacity at present.

2.6 It is also important to recognize that significant inflows of foreign private capital are unlikely to materialize any time soon, unless strong efforts are made right now. This is because investments in such areas as hydropower require long lead times and may require protracted negotiations with potential investors and buyers for outputs (such as India). However, Nepal is a marginal player among many developing countries which are wooing foreign private capital; and to be successful, *Nepal will need to demonstrate that its legal and institutional framework is investor-friendly and that it indeed is willing to nurture and support such investment*. This is not the case at present.

## *B. THE DEVELOPMENT AGENDA*

2.7 To bring about the changes that are needed in the economy's structure and performance in order to accelerate economic growth and reduce poverty, *wide-ranging economic reforms are required in a number of key areas*.The background papers and documents prepared for the Development Forum meeting discuss these reforms in considerable detail. This report outlines the major elements of the reform/development agenda identified in these documents. These can be grouped into three broad and closely interrelated areas: (i) *Improving public resource management* through a re-definition of the role of the state and reforms to strengthen expenditure management and enhance revenue mobilization; (ii) *Promoting private sector development*, particularly by improving the enabling environment for both domestic and foreign investment, undertaking much-needed reforms in the financial sector, and further improving trade policies; and (iii) *Addressing a range of over-arching systemic issues which affect the performance of the economy at virtually every level*, including both the public and private sectors—such as governance, institutional capacity, ownership and participation, devolution/decentralization and internal law and order.

## I. IMPROVING PUBLIC RESOURCE MANAGEMENT

2.8 **Changing Role of the Government.** Efforts to improve public resource management in Nepal must begin with a *re-examination of the role of the public sector in the economy*. This is because, even under optimistic assumptions regarding revenue mobilization, the *government's resource position for financing development activities can improve only modestly over the next few years*. In a global environment of increasing competition among developing countries for limited external aid, many donors are linking external assistance levels to country performance; and without forcefully addressing the governance and other fundamental issues to increase aid effectiveness, there is little assurance that aid levels to Nepal will increase substantially over the short term or even continue at present levels. *Accordingly the government will need to focus its limited resources on key priority* areas where such resources can be put to most effective use: (i) Wherever the private sector can undertake economic activities and/or deliver goods and services competitively, there is little justification for public involvement in such areas; (ii) *Public involvement should be limited to those areas and activities which the private sector will not find attractive*, i.e. where social benefits exceed private costs, but are not adequately factored in by private providers; (iii) In terms of resource allocation, on a broad sectoral basis, *public resources should be channeled to such areas as agriculture and irrigation, human resource development* *(education, health, drinking water), rural infrastructure, poverty alleviation programs, and perhaps backward area development*, among others. Additional resources are also needed for *O & M activities virtually across the board. But areas such telecommunications, power generation and tourism should be left to the private sector*; (iv) Even within the priority areas identified above for public investment, there is *considerable scope for private involvement within specific sub-sectors*. Some notable examples include: fertilizer and seed supply and distribution, higher education, urban hospitals and air transport; (v) *There is also little justification for continued government involvement in many public enterprises*, particularly where these involve commercial activities. Thus, the protection currently afforded to public enterprises in several areas (for example, in power generation, telecommunications, the government-owned airline, etc.) will need to be eliminated. Where there might be justifiable social reasons for public involvement in some enterprises, the social costs of such involvement should be quantified and separated from enterprises' losses; and (vi) Finally, even where the government needs to remain involved, *alternative ways of carrying out these responsibilities and delivering outputs and services more efficiently to the public need to be examined.*

2.9 **Improving Public Expenditure Management.** To improve the efficiency of public spending, the *government will need to formulate a manageable and prioritized development program and implement it effectively to produce measurable results.* As a part of such reform, a number of actions are needed: (i) To improve budget allocations, it is necessary to *integrate the regular and development budgets*, to look at the resource needs for O & M, other recurrent activities and for ongoing development projects/programs in an integrated manner, and to provide the necessary resources for them in terms of priorities for growth, poverty reduction and service delivery objectives; (ii) To control the development budget and minimize the waste of resources associated with over-programming, it is essential to *ensure greater realism in resource forecasting*. Projections of revenue, aid inflows and the size of the development budget would need to be in line with recent performance and reasonable expectations; (iii) Such estimates, prepared for three years at a time, should *provide a medium term framework for the development budget*. This would help bring out the key trade offs that would have to be made, including the need for prioritization and limiting new project starts, and help persuade the political leadership about the need to rationalize or downsize projects/programs which are not working well in order to bring the development program to a more manageable level; (iv) This needs to be combined with *strengthening project screening and appraisal capacity* in the National Planning Commission and the line ministries so that greater discipline could be exercised over the process of initiating new projects into the development budget; (v) Once formulated, the expenditure program would need to be better managed, without resorting to ad-hoc expenditure cuts which disrupt project implementation. To strengthen expenditure management and control, a number of steps can be taken; (vi) The *mid year budget review* process could be used to reassess resource outlook during the year to make expenditure adjustments in a more systematic manner; (vii) To protect priority projects from any resource shortfalls, *a core program of priority projects would need to be formulated* and fund releases to projects/programs based on the core program; (viii) *Expenditure reporting by spending units need to be improved*, both in terms of timeliness and quality of reporting; and (ix) *The capacity for monitoring expenditures as well as physical progress of projects/programs needs to be strengthened* at various levels of the government, particularly the NPC and line ministries.

2.10 Recent experience of major donors suggests that the key to improving project implementation is to clean up the portfolio, focus attention and resources on a smaller number of projects/programs and to monitor their implementation closely. In addition to measures outlined above, other steps can be taken to address problems which currently hamper project implementation: (i) To reduce procurement delays, standard bidding documents have been recently adopted by the Government. This system needs to be made effective by familiarizing government staff with the new procedures through training; (ii) Even more importantly, political interference in procurement decisions need to be eliminated. Clearly defining the approval limits for procurement decisions that can be taken at various administrative levels, together with clarification of procedures to be followed and mandatory punishments for transgressions (through an anti-corruption program) may be needed for this purpose; and (iii) To encourage project managers to make project-related decisions and to hold them accountable, an atmosphere conducive to such decision-making needs to be created by reducing insecurities associated with frequent political changes. Strict implementation of the recently amended civil service rules regarding staff transfers would help reduce such insecurities.

2.11 **Revenue Reforms.** *If such actions are taken to improve the efficiency of public spending, then additional resource mobilization by the government will be warranted.* Increased revenue mobilization can help pay for rising current expenditures (including O & M and civil service reforms), for providing adequate counterpart funding for development activities and reducing the heavy dependence on foreign aid over time. The agenda for revenue enhancement is well known, since considerable analytical work has been done already, with technical assistance from donors: (i) The government has already introduced the VAT as the center-piece of its tax reform agenda; but, its implementation has been slow so far, initially due to political ambivalence and resistance from the private sector and more recently due to administrative weaknesses (lack of sufficient trained staff). To *improve the VAT*, actions are now needed to strengthen the administration, clear the filing backlog, collect arrears and intensify audit activity; (ii) Action is also needed to *improve customs valuation procedures and to reduce the scope for administrative discretion;* (iii) *Simplifying income tax legislation* in order to make tax assessment more transparent and predictable; (iv) *Developing an integrated tax payer information system* in order to broaden the tax base and reduce the scope for tax avoidance; (v) *Reducing pervasive leakages and improved supervision*; (vi) *Strengthening tax administration*, including adequate staffing, training, computerization and incentives for better performance, among others; and (vii) In addition to these technical reforms, what is even more necessary is the *Political will to implement the tax reform agenda on a sustained basis.*

## II. PROMOTING PRIVATE SECTOR DEVELOPMENT

2.12 **The Private Sector's Role.** As discussed, improved public resource management would help to get relatively quick results and to build development momentum in the short term. However, the public sector's financial and institutional capacity is limited; and *the private sector will need to play a greater role* in undertaking necessary investments and the provision of goods and services. Indeed *over the longer term, the private sector will need to be the engine of growth in the economy, with the public sector largely playing the role of a facilitator and regulator and provider of essential social and economic infrastructure* in areas where the private sector may not come in. Such a transition, however, will not happen automatically. Nepal's *domestic private sector, although it has come a long way during the last decade, is still small*; and to play a leading role in Nepal's development, it *needs to be nurtured and encouraged.* Moreover, although there are a number of recent examples of sizeable private investments (including joint ventures), the Nepalese private sector is unlikely to be able to undertake by itself the type of large investments that may be required in some areas, such as hydropower and telecommunications. To facilitate such investments, *Nepal will also need to attract foreign direct investment both as joint ventures and technical partners as well as majority investors.*

2.13 **Creating an Enabling Environment.** Since the transition to a democratic system in 1990, a number of measures have been undertaken to liberalize trade, investment and the financial system with the objective of stimulating industrial growth and private sector development. These measures have included, among others, reform of the trade and foreign exchange regimes, liberalization of investment policies, enabling legislation for private investment in hydropower projects, privatization/closure of a number of public enterprises, opening up of the commercial banking and insurance sectors to foreign investors, and the introduction of numerous concessions for domestic and international investors. Overall, these measures have had a positive impact on private sector development. Nevertheless, despite significant progress in some areas, private sector development suffers from a number of drawbacks, as pointed out in the working paper on private sector development. The chief among these include the following: weak implementation of announced policies; ambivalence of government attitudes towards the private sector and the role of the state; weak legal and institutional framework; governance issues both within and outside the private sector which impact directly on the private investment climate; and a weak financial sector which acts as a drag on the private sector.

2.14 To encourage private sector development, the government will need to take action to remove these impediments: (i) It is important to send clear signals to the private sector and the public at large about the private sector's role in the economy. In Nepal, the private sector is often perceived as "bad" because it is primarily motivated by profit-making. But the latter is an inevitable corollary of the incentive structure of a "market system," which generally provides strong benefits in terms of increased efficiency, cost reductions and better delivery of outputs and services to the public, including the poor; (ii) Where this is not happening due to market imperfections and other reasons, the government clearly has a role to play as a regulator and protector of public interest; but such a role is not consistent with mistrust and stifling of private sector development. What is thus required is a clearer definition of the role of the state. The latter should be a facilitator and regulator which can find ways to work effectively with the private sector for economic development; (iii) It is also necessary to provide a level playing field for the private sector vis-à-vis public enterprises. For this to happen, the protection currently afforded to public enterprises in several areas will need to be eliminated. There has been already significant progress in some areas in this regard, (for example, in fertilizer distribution); but in a number of other areas public enterprises continue to be protected (for example, in power generation, telecommunications, RNAC, etc.). Apart from their positive impact on private sector development and efficiency gains, the opening up of such pubic monopolies for private competition as well as the phased implementation of a privatization program will also help to conserve scarce budgetary resources; (iv) The provision of a clear and transparent legal and institutional framework for supporting private sector activities – "the rule of law" – is of paramount importance. This would require ensuring effective property rights and contract enforcement through the provision of clear and understandable laws, and an effective judicial system which can enforce such laws speedily; and (v) Strengthening of governance aspects affecting the private sector is also important. This would require actions both from the government and the private sector itself. The government will need to address the range of issues which currently add considerably to the hidden costs of doing business in Nepal, for example by reducing the discretionary powers of officials for tax matters, approval decisions, improving appeals procedures and, as noted above, providing an efficient legal system. The private sector, on its part, will need to develop reliable accounting, auditing and disclosure standards. In this regard, the private sector needs to share the blame as much as the government for the mistrust of the private sector which exists in Nepal. Strengthening accounting standards by permitting entry of international auditing companies (as has been announced recently, but not yet implemented), and revising the 1997 Company Act to establish clear legal standards and obligations of private companies would be helpful in this context.

2.15 *What applies to domestic businesses also applies to foreign investors.* Foreign Direct Investment (FDI) is extremely low in Nepal in comparison with most other countries. Principal constraints to increasing FDI include the lack of rule of law (contract enforcement, dispute arbitration), transparency (of the legal framework, rules and regulations, tax administration), predictability (of application of laws and regulations), lack of reliable professional services (legal, audit and accountancy professions), absence of satisfactory dispute arbitration mechanisms, and the absence of foreclosure and bankruptcy laws, among others. As the experience in many other countries shows, *what is important for attracting FDI is not fiscal and tax concessions, but ensuring an attractive enabling environment where the costs of doing business are transparent and predictable, and where business-related decisions can be transacted with efficiency and speed.* To be successful, as one of the late entrants into the competition, *Nepal needs to demonstrate that it can compete with, or even do better than, other countries in this regard.*

2.16 **Financial sector reform** is a critical issue which needs to be addressed, not only because of its importance for private sector development, but also for ensuring macro-economic stability. Although there have been a number of positive developments in the sector in terms of broadening and deepening of the institutional structure and the introduction of foreign partners into banking, insurance and leasing sub-sectors, the banking system (which is the major part of the financial system) remains inefficient. This in turn has stifled private sector development through relatively high real costs of borrowing and limited access to bank credit, particularly for new borrowers and for longer term investments. While financial sector reform has been under discussion for many years, *progress so far has been slow*. Given the complexity of the issues involved, *a consensus on the reform program still remains to be developed*; but it is generally agreed that the *strengthening of the financial system should be anchored on three broad themes*: (i) *Making the system stable and resilient to crises by effectively regulating and supervising banks, improving management and encouraging good corporate governance;* (ii) *Improving efficiency and cost-effectiveness* by supporting improvements in the legal framework for financial markets, increasing competition and the promotion of institutional investors; (iii) *facilitating broad access to key financial services* by creating diverse market instruments and developing domestic debt markets. *The priorities for the short term, given the current state of preparations, include the following;* (iv) *Restructuring of Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL),* to be followed in a further stage by that of the Agricultural Development Bank and the Nepal Industrial Development Corporation, with improved management, branch rationalization, and improved control mechanisms; (v) *Improved prudential regulation, accounting, and auditing practices;* (vi) *Strengthened regulatory and oversight functions of the central bank;* and (vii) *Strengthened legislative and institutional framework for loan recovery.*

2.17 Nepal's trade and foreign exchange regime is already quite liberal. Nevertheless further **improvements in trade and investment policies** can help stimulate exports, private sector activity and economic growth: (i) To take advantage of emerging opportunities through membership in World Trade Organization (WTO) and SAPTA and economic liberalization in India, Nepal will need to improve its competitiveness through technological upgrading, skill development, export and tourism promotion, as well as investments aimed at supplying the neighboring Indian market; and (ii) Nepal also needs to work out appropriate administrative arrangements with India and undertake the necessary investments in transport improvements, in order to take advantage of bilateral trade and transit agreements.

# III. OVER ARCHING SYSTEMIC ISSUES

2.18 **Governance**. Technical improvements such as those outlined above would help to improve the effectiveness of resource use and send strong signals to the private sector. However, they alone are unlikely to be sufficient to pull the Nepalese economy out of its present predicament without addressing the key over-arching problems afflicting the economy. Indeed, the central constraint on Nepal's development over the last few decades has not been the paucity of financial resources, but the *lack of effective governance* and well functioning institutions which can adequately perform the vital state functions which are essential for a coherent economic and social development process. As outlined in a recent working paper on governance, there are many manifestations of this problem, including weak institutions and procedures, lack of ownership of development projects and programs, lack of accountability and mismanagement of resources, failure to provide effective delivery of public services, including law and order, and the absence of a well-functioning judicial system, all of which are reflected in increased corruption.

2.19 While progress in all these areas is critically important, concerted action in two particular areas can help accelerate the development agenda and to get better development results quickly. These are: (i) Building a consensus within the Nepalese society and among major political parties and leaders on an economic development agenda which is suited to Nepal's current needs, together with strong actions to implement such an agenda; and (ii) developing and quickly implementing an effective anti-corruption agenda. Building such consensus is essential because there is little agreement at present among key stakeholders, political parties and leaders in Nepal on the actions that are needed to accelerate the development process. Political parties which support economic reforms when they are in power oppose them when they are in the opposition, for reasons of political expediency. As a result, it has been difficult for any government to take necessary actions, more so for fractious coalitions. It is therefore important to build support for key development actions that are needed through debate and discussions with the key political leaders and the public, and then to allow the government to implement the agreed agenda and to take responsibility for it. Similarly, decisive action to formulate an anti-corruption agenda, for example, to reduce revenue leakages and the misuse and waste of public resources, and to strengthen legal and institutional mechanisms to ensure greater accountability can have an important impact in terms of improving development effectiveness even in the short term. To be credible, however, such a program must involve the political leadership at the highest levels.

2.20 In addressing the governance issue, the *government undoubtedly needs to take the lead*; but it is not the responsibility of the government alone. All major political parties, authorities at different levels, the private sector, as well as external donors have contributed to governance problems in varying degrees over time. Indeed, the donors themselves also bear partial responsibility for the current state of affairs. As discussed in the PER, through their assistance they have made it possible for the government to continue its questionable governance practices while avoiding badly needed reforms. In addition, donors' assistance procedures and practices have at times contributed directly or indirectly to governance problems. Efforts are now underway by the donors to address such issues which are directly under their control; but as discussed below, more remains to be done in that area. Nevertheless, the *primary responsibility for addressing the governance issue will remain with the Nepalese themselves; and donors can play only a supporting marginal role* in this regard. It is also important to recognize that whether the governance situation in Nepal is getting better or worse than in neighboring or other developing countries is not the point. As one of the poorest countries in the world, Nepal can least afford the misuse and waste of its limited development resources through continued governance problems; and it needs to address these issues quickly without further semantic debate.

2.21 **Building Institutional Capacity**.*Persistent institutional weaknesses at virtually all levels are another major impediment to development effectiveness in Nepal.* As pointed out in the various documents prepared for the Development Forum, the existing mechanisms for budget planning, project design and selection, implementation, monitoring and ensuring accountability and expenditure control are deficient. At the heart of the problem is a weak, underpaid and unmotivated civil service. Increased political interference at key points in the project cycle, particularly in procurement matters and in appointments and transfers of key staff, has further undermined the efficiency and effectiveness of the civil service. Against this background, the government's efforts to transfer more resources and responsibility for local level programs to district and village committees in recent years have met with limited success, both because of the pervasive weaknesses cited above, but also because technical and institutional capacity is even more limited at local levels.

2.22 To enhance development effectiveness, improvements in two areas are particularly important: (i) Civil service reform; and (ii) Strengthening the decentralization process.

2.23 **Civil service reform** remains a controversial issue in Nepal; and there is little agreement yet within the government and among the key Nepalese stakeholders and external donors on what an appropriate reform strategy should be. While underscoring the need for the government to formulate an appropriate strategy in consultation with the key stakeholders, *some key considerations* which need to be taken into account in evolving a civil service strategy can be pointed out.

2.24 Civil Service Reform needs to be geared to the type of development administration that is needed to deliver public services more effectively in the future and to the severe local resource limitations hampering Nepal. First, with increased emphasis on transferring responsibility for development activities to local levels through decentralization, the role of the center, line ministries and supervisory agencies will need to change over time. For example, the NPC may need to transform itself into a planning agency responsible for setting overall development goals and priorities as well as sector strategies, while the Ministry of Finance (MOF) takes the lead in formulating and managing well integrated annual budgets consistent with these priorities. Similarly, the line ministries themselves will need to change from actual implementers of programs to facilitators; while taking on broader responsibilities for sectoral program formulation, provision of technical support to local bodies, and supervising and monitoring project/program implementation. Such a transition will obviously take considerable time, but will have important implications for skill needs, staffing levels and personnel management which need to be taken into account in planning civil service reforms. Second, there are major concerns about current incentive levels, efficiency, relevance and the size of the civil service. To provide adequate incentives, the overall compensation levels may need to increase significantly, together with a widening of salary differentials between lower and higher grades (i.e. decompressing the salary structure) and the introduction of a merit-based, performance-oriented reward/promotion system. This will, however, increase the salary bill which is already large in relation to the government's limited revenue generation and its current expenditures. How to pay for civil service reforms thus will be a major issue. Third, feasible alternatives therefore will have to be considered. Enhancing government revenue through tax reforms is one such option. While this will present its own challenges, it is also important to recognize that increased revenue will also be needed to support essential operations and maintenance (which is heavily underfunded at present) as well as for financing development activities in a number of important areas. Other alternatives therefore will need to be looked at, including downsizing, as well as donor funding for civil service reforms on a relatively short term basis. External assistance however is likely to be forthcoming only if a credible reform program is developed; and over the longer term, a substantial increase in resource mobilization will be needed to finance these expenditures on a sustainable basis.

2.25 **Decentralization** *is an important means in Nepal for delivering the benefits of development to rural communities*, particularly given the prevailing weaknesses of central government mechanisms. It can also foster greater involvement of local communities in the design and implementation of projects and programs at local levels, and enhance their participation in the development process. However, decentralization is not a panacea. Unless effectively supervised and monitored, and arrangements are in place to ensure transparency and accountability, mismanagement and corruption can also take place at local levels, as recent experience indicates. To make the decentralization process work better and to develop efficient management and delivery mechanisms at the local levels, a number of actions are needed: (i) First, it is necessary *to remove the political and bureaucratic impediments which currently hamper the decentralization* initiative; (ii) Second, it is necessary to *improve the technical capacity of local bodies* (DDCs and VDCs) for identifying their needs and priorities; resource mapping and planning; project design, preparation and implementation; accounting, record-keeping and expenditure reporting, resource mobilization through local level taxation, etc. Although some efforts have already been made by the government and external donors to build capacity at district and village levels, much more remains to be done; (iii) Providing more budgetary resources to the local levels is not an issue at present, since substantial resources are already allocated to local bodies, in addition to several parallel programs implemented by central government ministries and departments, (for example in health, education, drinking water, rural roads, etc. among others). What is needed is to streamline these centrally managed programs to ensure that they do not overlap with those that are locally managed, so as to avoid duplication and waste of resources, together with clearer definition of responsibilities of both local bodies and line ministries for these programs; (iv) The most effective way of promoting better management and accountability at local levels is by *enhancing the participation of beneficiary groups in the decision-making and implementation process.* Greater transparency (for example, through an "open-book system") in regard to the availability of budget funds, the nature of projects being financed and public access to financial records have permitted greater accountability and better use of resources. This would call for *greater efforts to promote community mobilization and empowerment*, particularly of the poorer and under-privileged groups in the communities; and (v) Finally, the respective roles of line ministries and government departments may need to change over time. As more functions and responsibilities are transferred to local governments, the role of line ministries and departments may need to change from implementers to facilitators, providing essential technical support for and monitoring and supervising the activities of local bodies. All of this will invariably take time; and the pace of change will depend on how quickly institutional capacity can be built up at various levels. And, as discussed below, the donor community also will have an important role to play in this regard.

2.26 **Promoting Ownership and Participation.** To improve the effectiveness of Nepal's development efforts, it *is necessary to promote greater local ownership.* This is particularly important *in regard to the reform agenda* as noted earlier, *as well as the public expenditure program* which continues to be the major vehicle for implementing the government's development initiatives. In Nepal, both economic reforms and the public expenditure program are perceived by many (within the government and outside) as largely "donor-driven", designed and pushed by donors without adequate consultations with, and participation of, local stakeholders. Not surprisingly, local support for such reforms and donor projects/programs has been lacking, in turn leading to poor implementation and unsatisfactory results. It is for this reason that, as discussed earlier, building a consensus for the development agenda is essential at this juncture, in order to ensure local ownership and commitment. Similar initiatives are also needed to improve the effectiveness of the public expenditure program. *This will require actions both from the government and external donors.* For example, the *government will need to take the lead in designing, financing, and implementing the development program and, even more importantly, in aid coordination* itself. It will need to decide what its own development priorities and programs are, and ask the donors to support such programs. Where donor aid does not fit its priorities and program objectives, the Government will need to reject such "donor-driven" aid. This will of course require building up its institutional capacity and a greater degree of self-financing/self-reliance through stronger efforts to mobilize revenues, which may take considerable time. And, *external donors will need to support this process. Similar efforts are needed in the case of fully government-financed programs also, in order to create greater synergies between institutions at the center and those at local levels and to build partnerships involving the private sector, NGOs and other stakeholders.* This can take place at many levels, for example through: (i) greater devolution of responsibilities by NPC to line ministries for program formulation (within sectoral guidelines and policies agreed with the National Planning Commission), monitoring and supervision; (ii) increased involvement of local bodies and beneficiary groups in determining priorities and designing projects to better reflect local needs and implementing such projects; (iii) developing alternative approaches to (currently centrally managed) project implementation and service delivery, for example, involving the private sector as an alternative to traditional government mechanisms, contracting out to NGOs specific tasks such as supervision technical services or program implementation on behalf of community groups; and (iv) strengthening the decentralization process(see above).

2.27 **Maintaining law and order.** Finally, the growing *law and order problem is an important issue which needs to be addressed as a high priority.* This has important political and economic implications. While the reasons and motivations for the current unrest are indeed complex, there is little doubt that widespread poverty; significant disparities in incomes, employment opportunities, and access to resources and basic social and economic services and infrastructure between urban and rural areas and between regions; frustrated public expectations from successive governments for better development results; and perceptions of increasing corruption/weak governance have contributed to these developments. And *solutions to the problem cannot focus only on security measures but will need to address the acute development needs of affected areas.* This will require substantial additional fiscal resources, which should provide a compelling argument for the government (and the donor community) to take stock of the fiscal position and prioritize the expenditure program.

2.28 **Conclusion.** The agenda outlined above is long; and would be a major undertaking for any government. It may not be possible to implement all of it, given the capacity and other constraints discussed above. But given the pervasive poverty and lack of progress in addressing the issue in recent years, a major effort is needed now. The challenge facing the government is two-fold: (i) Considerable work remains to be done in the coming months to develop the broad agenda discussed above into an implementable, prioritized action program consistent with institutional capacity and resource constraints; and (ii) Build up support among the key stakeholders including major political parties and the Nepali public for implementing such an agenda. This would need to be perhaps the most important undertaking for the government on the economic front in the months to come preceding and following the Nepal Development Forum meeting. And, the donor community will need to support this process, and the priorities which come out of it, as indicated below.

# IV. THE ROLE OF EXTERNAL AID

2.29 To implement far-reaching reforms such as those outlined above, *important behavioral changes will be required from external donors as well as the government.* The government will need to take the lead in, and ownership for, introducing critical reforms, while the *donors need to actively support this process.* Moreover, the *donors' role also will need to change from providers of "supply-driven" aid, implementers of projects, and purveyors of expensive technical assistance to facilitators who will provide financial and technical support that fit the country's needs and priorities in a way that fosters local ownership, institution-building, and longer term sustainability.* Towards this end, donors could support the government's reform process in several ways: (i) The government's technical capacity to undertake reforms is limited at present; and *donor assistance will be needed to help carry out this work in the short term, as well as for strengthening institutional capacity at various levels over the longer term;* (ii) *Donors will need to accept the consequences of reform programs,* (for example, downsizing/canceling poor projects, limiting new project starts for some time etc.); *and adjust their own aid programs to support only those projects and activities which fit the country's needs;* (iii) It will also require *stronger efforts among the donors themselves to coordinate their support without competing with each other;* (iv) It may also call for *changes in the way donors prepare and manage projects and technical assistance programs in order to promote greater local ownership.* For example, in regard to technical assistance, instead of extensive reliance on external consultants, they need to look at alternative, more cost-effective ways of providing technical support (for example, using teams of local consultants under the direction and supervision of expatriate advisors who could be hired for short periods of time); and (v) Similarly, *donors need to provide the kind of support that is warranted under present circumstances.* For example, program type assistance can be potentially useful, but only when it does not substitute for revenue generation by the government and where the public expenditure program is reasonably well prioritized, so that it actually supports such priorities and sound sectoral expenditure programs. This would mean that, *when the government is ready to move forward with a well-defined reform agenda, donors should be prepared to support such a process with increased assistance, including program aid. But if such a reform effort is not forthcoming, providing more assistance, particularly program aid, is likely to be counter-productive.* Such an approach will entail risks for both the government and the donors. Even so, such risks are worth taking if they lead to greater ownership, better development results and increased sustainability over the longer term.