ADB

South Asia
Working Paper Series

Fiscal Decentralization and Fiduciary Risks: A Case Study of Local Governance in Nepal

Gambhir Bhatta

No. 5 | June 2011

Asian Development Bank

ADB South Asia Working Paper Series

Fiscal Decentralization and Fiduciary Risks: A Case Study of Local Governance in Nepal

Gambhir Bhatta

No. 5 June 2011

Gambhir Bhatta is Principal Public Management Specialist in the Public Management, Financial Sector and Trade Division (SAPF), South Asia Department, Asian Development Bank.

Asian Development Bank

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
www.adb.org

June 2011
Publication Stock No. WPS113654

The ADB South Asia Working Paper Series is a forum for ongoing and recently completed research and policy studies undertaken in ADB or on its behalf. The series is a new knowledge product and replaces the South Asia Economic Report and South Asia Occasional Paper Series. It is meant to enhance greater understanding of current important economic and development issues in South Asia, promote policy dialogue among stakeholders, and facilitate reforms and development management.

The ADB South Asia Working Paper Series is a quick-disseminating, informal publication whose titles could subsequently be revised for publication as articles in professional journals or chapters in books. The series is maintained by the South Asia Department. The series will be made available on the ADB website and in hard copy.

The author would like to thank Shikha Jha and other commentators at the 2010 SARD Economists' Conference, as well as peer reviewers who provided feedback on the document. The author also wishes to thank Mr. Gopi Khanal, Ministry of Local Development (MLD), Government of Nepal, for clarifying many issues in the paper, particularly those on the grant taxonomy; and Mr. Khimlal Devkota, also of MLD, for his assistance in making available the updated dataset used.

CONTENTS

ABBREVIATIONS AND ACRONYMS

ADB	–	Asian Development Bank
CLMCC	–	central level monitoring and coordination committee
DDC	–	district development committee
DDF	–	district development fund
DFID	–	Department for International Development of the United Kingdom
DTCO	–	District Treasury Control Office
EBG	–	expanded block grant
FCGO	–	Financial Comptroller General's Office
FY	–	fiscal year
HDI	–	human development index
JFA	–	joint financing arrangement
LBFAR	–	Local Bodies (Financial Administration) Regulations
LBFC	–	Local Bodies Fiscal Commission
LGAF	–	local governance accountability facility
LGCDP	–	Local Governance and Community Development Program
LSGA	–	Local Self-Governance Act
M&E	–	monitoring and evaluation
MC/PM	–	minimum conditions and performance measures
MLD	–	Ministry of Local Development
OAG	–	Office of the Auditor General
PEFA	–	public expenditure and financial accountability
PFM	–	public financial management
SWAp	–	sector-wide approach
TA	–	technical assistance
UN	–	United Nations
VDC	–	village development committee

NOTE

The fiscal year (FY) of the government ends on 15 July. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2008 ends on 15 July 2008.

I. INTRODUCTION

1. There have been significant political changes in Nepal in recent times, key among them the abolition of the monarchy and the call for a federal structure of government. The Constituent Assembly, in its first session in late May 2008, declared Nepal a federal democratic republic, thus effectively ending the 250-year old monarchy. All major political parties have now accepted or voiced support for this move. This means that the country will soon frame arrangements for transforming the hitherto unitary state into a federal system. A primary consideration of this system will then focus on the nature of local government.

2. **2007 Interim Constitution.** The political basis of governance in Nepal at the moment rests on the Interim Constitution of 2007 which, among other things, incorporates several references to the local government system. The objective of local government, as stated in the Interim Constitution, is to avail services at the local level and to attain "institutional development of democracy from the very lowest level". The Interim Constitution also makes several provisions on devolution, including that (i) interim bodies are to be created locally as per consensus among political parties, (ii) a balanced approach is to be taken in resource mobilization and allocation and in the equitable distribution of development results, and (iii) the roles and responsibilities of local bodies are to be delineated to make them more accountable in the planning and implementation of local services (with special attention given to uplift socially and economically backward communities in revenue mobilization and allocation). Finally, the Interim Constitution also provides for priority to local communities in the mobilization of natural resources, and in making the system inclusive.

3. **Administrative structure.** Despite phenomenal political changes, the administrative structure set up during the royal regime is still in place. In this set-up, there are 75 districts that vary in geographical characteristics and, more importantly, in economic endowment;[1] 3,915 village development committees (VDC); and 58 municipalities. Development committees exist in all districts and are mandated to lead development work in the district. The Ministry of Local Development (MLD) provides administrative oversight of the development committees, including for staffing decisions now for some key positions.

4. **Legal and policy environment.** In addition to the 2007 Interim Constitution, the legal and policy bases for decentralization are the provisions of the Local Self-Governance Act (LSGA), 1999. This act was preceded in 1992 by the VDC Act, the Municipality Act, and the DDC Act, which effectively abrogated the bases of local governance inherent in the various acts that had been in place until 1990. The LSGA gives VDCs, municipalities, and district development committees (DDCs) greater political, administrative, and financial powers to lead, facilitate, and manage local affairs. It also adheres to the district as a primary unit of local government. But the various districts, which differ widely in size, were not designed as economic units or to provide services to citizens efficiently and effectively; they were set up more for law and order and administration. As such, the present district structures neither conform to the demographic composition of the areas nor serve as economically viable units.

5. Other relevant legislative, institutional, and policy instruments on local governance include (i) the Local Bodies Fiscal Commission (2002), (ii) the Local Bodies (Financial Administration) Regulations (2007), and (iii) the Governance (Management and Operation) Act, 2008. Finally, the government's emphasis on decentralization, as it relates to planning, is best contained in the Three Year Interim Plan (fiscal year [FY]2008–2010), which, while necessarily

[1] For example, the MLD estimates that Kathmandu district alone collects 40% of all revenues in the country; the district of Parsa (in which is situated Birgunj, which handles much of Nepal's land-based trade) collects another 20%; and 64 districts collect only 14%. The remaining 9 collect the residual 26%.

transitory in nature in line with the interim political arrangements currently in place, is very specific about the vision, objectives, and methodologies for strengthening local governance.

6. In 2007, the government prepared a White Paper on Local Development and Self-Governance, which encourages (i) functional devolution to local bodies for greater self-governance; (ii) awareness raising to transform the state machinery to become more participatory, responsive, accountable, inclusive, and transparent; (iii) a purification process from the leadership to eradicate corruption, unfair norms, favoritism, partisanship, delays, and misappropriation; and (iv) targeted programs for poor areas and communities to make service delivery more equitable and accessible.

7. A substantial component of the local governance system has to do with the nature of the intergovernmental fiscal framework, wherein protocols on how resources are shared with local government are determined. As in other jurisdictions, local governments rely on several revenue sources to fund their mandates, including own-source revenues, block grants, and loans and borrowings. The Government of Nepal recently substantially revised its fiscal transfer system to local governments, and there is now considerable interest in ensuring that this system is adequately strengthened and institutionalized.

II. METHODOLOGY

8. This study critically analyzes the risks around the fiscal transfer system, particularly those related to block grants. It argues that the nature and severity of these risks with respect to the government's flagship Local Governance and Community Development Program (LGCDP)[2] are such that they need to be understood in the broader context of the general public financial management (PFM) system as well as the constraints inherent in local governance.

9. **Research parameters and approach.** While the issue of federalism is at the core of the subject matter at hand, the study does not consider its political genesis (thus, for example, views of the various political parties on federalism or matters such as social exclusion are outside the study parameters). The study employs a risk-based approach to assessing vulnerabilities in the PFM system at the central and local levels, helping to identify the risks and determine their severity. It also helps in the analysis of residual risks, that is, risks that are sustained, and/or that develop, even after the mitigative measures have been put in place.

10. The study also takes a systems perspective to understanding the issues of fiduciary risks at the local level. A systems perspective puts forth an argument that risks need to be considered in the public sector in a manner that takes into account the environment that the public sector operates in.

[2] In July 2008, the government formulated the LGCDP, which focuses on inclusive, responsive, and accountable local governance and participatory, community-led development. LGCDP outcomes include: (i) citizens and communities engage actively with local bodies and hold them accountable; (ii) better management of resources and delivery of services in an inclusive and equitable manner by capable local bodies; and (iii) strengthened policy and national institutional frameworks, including legal frameworks, for decentralization, devolution, and community development. The LGCDP is currently directly supported by several development partners, six of which (ADB, the Canadian International Development Agency, the Department for International Development of the United Kingdom, the Swiss Agency for Development and Cooperation, Norway, and Denmark) have agreed to a Joint Financing Arrangement (JFA); the United Nations agencies provide support outside the JFA framework.

11. **Definitions.** As understood in this study, relevant terms are defined as follows:

a. *Decentralization.* At its core, decentralization is widely taken to mean redistribution of powers, functions, and responsibilities to the lower levels of an organization or government (that is, local authorities).[3] To be meaningful, decentralization has to be accompanied by delegation of commensurate authority, for example, to raise resources, allocate them, and plan for their expenditure. All decentralization is based on the notion of subsidiarity, whereby the operating principle is that all matters have to be managed by the lowest level of authority competent to do so.

b. *Federalism.* A system of government wherein political and economic powers are divided among the central government and constituent sub-national governments. It is important to note that decentralization and federalism are associated terms, although while federalism generally results in a fairly high level of decentralization the reverse is not necessarily always true. The application of federalist principles in different jurisdictions has been based on two key lessons: (i) to prevent domination by the center, and (ii) to best provide for services in an efficient and effective manner (in keeping with the principle of subsidiarity).[4]

c. *Fiscal decentralization*. The devolution of revenue generation and spending powers to local levels of government for fulfilling their mandates.

d. *Horizontal imbalance.* Mismatches in the resource capacity of local governments; it is a function of different spatial, resource base, and other factors.

e. *Local bodies.* In Nepal, these refer to the 75 DDCs, 58 municipalities, and 3,915 VDCs.[5]

f. *Performance-based grants.* Grants given to local bodies based on their performance on indicators defining thresholds that the local bodies need to meet before central resources as grants are allocated (almost always tied, but sometimes untied).[6]

g. *Risks.* Stated simply, the probability of an event that could hinder the attainment of goals. Fiduciary risks, as understood in the public sector context, are risks inherent to the domain of fiscal arrangements and processes where fund flows and management are key areas of concern.

h. *Vertical imbalance.* A mismatch between expenditure functions that local governments have been assigned and their access to locally generated finances to fund activities to meet their mandates. A vertical imbalance thus leads to resource transfers from central government to help bridge the gap.

---

[3] See, for example, United Nations Economic and Social Council. 2006. *Compendium of Basic Terminology in Governance and Public Administration: Definition of Basic Concepts and Terminologies in Governance and Public Administration – Note by the Secretariat.* New York: E/C16/2006/4.

[4] See, for example, Andreas Follesdal. 2008. On Federalism, Ethnicity and Human Rights in Nepal. *Nepalnews*. www.nepalnews.com/archive/2008/others/guestcolumn/nov/guest_columns_06.php

[5] The term 'local bodies' is preferred to 'local government' in Nepal's current context as there have been no local elections since 2002 and local administration is managed by bureaucrats nominated by the central government (that is, secretaries in the VDCs, executive officers in municipalities, and local development officers in DDCs).

[6] Tied grants have to be used for particular purposes specified by the central government whereas untied grants do not (that is, local bodies can decide the usages of the grant funds).

12. **Research methods.** The research for this study was carried out as part of the program processing work of the Asian Development Bank (ADB) for the Governance Support Program (Subprogram 1) in Nepal in 2007 and 2008. It also includes the results of numerous field monitoring visits to Nepal and reports of the Program Coordination Unit of the LGCDP at the MLD, as well as risk assessments done for the LGCDP by various development partners and ADB (most recently in mid-2010).[7] The dataset used was made available by the MLD. In citing examples where relevant, the study also focuses on the issue of fiduciary risks with respect to the top and bottom decile of districts as measured by the degree of poverty incidence[8] (that is, the top and bottom eight given that there are 75 districts) (see Table 1).

13. **Caveats.** This study delves into the nature and severity of the risks inherent in the extended block grant system (as a form of performance-based grant) in Nepal. In so doing, however, it does not purport to cover all specific areas related to performance-based grants or indeed local governance. It is focused neither on issues of fiscal decentralization and fiduciary risks in developed jurisdictions, nor on the full range of the federalist issues presented by different political parties and others in Nepal. In that regard, it stays away from a political perspective on federalism in general and on fiscal federalism, in particular. Finally, the study is not meant to be a theoretical treatise on the subject of fiscal federalism nor one with a substantial literature review.

Table 1: Top and Bottom Decile Districts by Poverty Index

	Rank	District	HDI[a]	Poverty Index[b]	Population[c]
Top decile districts	1	Kathmandu	0.652	0.348	1,314.9
	2	Bhaktapur	0.595	0.405	259.7
	3	Kaski	0.593	0.407	43.8
	4	Lalitpur	0.588	0.412	389.9
	5	Rupandehi	0.546	0.454	824.7
	6	Kavrepalanchok	0.543	0.457	433.6
	7	Syangja	0.535	0.465	348.1
	8	Morang	0.531	0.469	961.1
Bottom decile districts	68	Humla	0.367	0.633	45.5
	69	Achham	0.350	0.650	258.7
	70	Jumla	0.348	0.652	100.1
	71	Jajarkot	0.343	0.657	151.3
	72	Bajhang	0.331	0.669	188.2
	73	Kalikot	0.322	0.678	118.6
	74	Bajura	0.310	0.690	122.1
	75	Mugu	0.304	0.696	49.6

[a] human development index; based on Nepal Human Development Report, 2004; [b] poverty index = 1-HDI;
[c] projected population, 2007 (medium variant).
Source: Government of Nepal (various publications).

[7] This study draws particularly from the fiduciary risk analysis ADB did for the LGCDP in mid-2010, and a joint donor review team's mid-term review report of the LGCDP in October 2010.

[8] This dataset closely matches the ranking in the Poverty and Development Index, Socio-economic and Infrastructure Sector Development Index, and Women's Empowerment Index. Indeed four districts (Achham, Bajhang, Humla, and Mugu) in the lowest decile appear in all the indices of least developed districts.

III. GOVERNMENT POLICIES AND PERFORMANCE ON DECENTRALIZATION

14. It is generally believed that in Nepal previous rulers turned to decentralization more in the pursuit of administrative simplicity than effective public service delivery.[9] Nepal's experience with decentralization can be divided into four major eras: (i) pre-1990, when the Panchayat system created a hierarchy of local level bodies, but devolved little authority to them, instead relying on the center to provide impetus for local government work; (ii) 1990 to 1999, when the central level experimentation with political openness was mimicked at the local level and vestiges of the Panchayat policy were done away with; (iii) 2000 to 2007, when the LSGA enacted in 1999 set the basis for present-day government work;[10] and (iv) 2007 to present, during which provision for local governance work has been based on, and contains, an all-party mechanism in the absence of locally elected representatives.

15. Of late, however, the government has put in place policies and strategies on various aspects of work related to local bodies, including:

a. provisions to be made for public accounting, public hearing, and making monthly expenditures public; and indicators for minimum compliance and work accomplishment to be enforced and made public;

b. priority to be given to undertaking local development programs through user groups under the leadership of local bodies (that is, the actual work is to be done by others, not the government);

c. fiscal delegation to local bodies to enable them to execute development and construction works as part of public expenditure management at the local level;

d. gender considerations to be taken in the preparation of government policy, programs, projects, and resource allocation (in this regard, for purposes of resource allocation, government now classifies the budget as directly gender specific, indirectly gender specific, and neutral); and

e. as part of its arrangements on local bodies (and particularly pursuant to LSGA, 1999) the government has also allocated functions across different levels of these bodies although the central government continues to possess several responsibilities in local governance.

16. Despite Nepal's decades of experience in instituting decentralization, a review of the existing situation shows that performance is patchy. Box 1 shows unsatisfactory performance on various benchmarks of decentralization.

[9] Local Body Fiscal Commission. 2000. *Local Body Fiscal Commission Report 2000*. Kathmandu, p. 25.

[10] The dissolution of elected local bodies in 2002 was a major setback to local governance, and the current system of engagement between nominated local body officials and representatives of political parties has put a strain on efforts to enhance accountability at the local level.

Box 1: Performance on Some Decentralization Benchmarks

Benchmark	Status	Remarks
Elected local officials and council	No	Local body officials are elected for a 5-year term, but since 2002 there have been no local elections, and MLD-deputed local body officials serve in local administrations.
Locally appointed officials	Partly yes	Executive officers of local bodies and line agency heads are deputed from the central government. Others at the technical and clerical level are locally appointed/recruited.
Mandate of local body on employment and salaries	Partly yes	Local bodies can hire staff and set salaries, except for the chief executive officer and the accountant.
Control by local bodies over revenues and resources	Partly yes	Local bodies are given some authority for tax collection and resource mobilization within criteria fixed by the central government.
Borrowing power of local bodies	Partly yes, but not exercised	Some municipalities have, however, obtained loans from the Town Development Fund; in general, local bodies do not tend to borrow to augment their resource base.
Clear expenditure assignment	No	Considerable overlapping between local bodies and the central government persists.
Capacity of local bodies to collect tax and deliver services	Very low	There is no overall policy framework, strategy with goals, or time frame for capacity building in local bodies. However, LGCDP mandates a capacity building plan for local bodies (now evident in practically all local bodies).
Adequate books of account	Partly yes	All DDCs have books of account, but not all of them have an internal audit section.

DDCs = district development committees, LGCDP = Local Governance and Community Development Program, MLD = Ministry of Local Development.
Source: Asian Development Bank. 2008. *Technical Assistance to Nepal for Preparing the Governance Reform and Decentralization Cluster Program I*. Manila.

IV. INTERGOVERNMENTAL FIDUCIARY RELATIONSHIPS

17. The need for intergovernmental fiscal transfer arises mainly to manage fiscal imbalances (both vertical and horizontal) between the internal revenue and expenditure needs of local bodies. In order to better understand the nature of intergovernmental fiduciary relationships in Nepal, it is first relevant to consider the differentiated mandates as per the 1999 LSGA along with the nature of revenue assignments among tiers of government. Also relevant are: (i) the types of fiscal flows to local bodies, (ii) the specific fund flow arrangements; and (iii) fiscal accountability provisions.

A. Differentiated Mandates

18. As per the 1999 LSGA, the mandates of the local bodies are clear (although in several instances, there has been duplication of functions). The provisions in the act are categorized as in Table 2.

Table 2: Broad Mandates of Local Bodies

Local Body	Broad Mandates
VDCs	Functions related to: socio-economic development, human resource development, self-employment and social welfare, resource mobilization, preparation of annual and periodic plans, and judicial powers and powers relating to punishment.
Municipalities	Mandatory functions related to: financial resources; physical infrastructure development; water sources; environment and sanitation; education and sports; management of cultural, historical, and archaeological objects and establishments; transportation and construction; health services; and industry and tourism. In addition, 26 other miscellaneous functions which mostly relate to the functions above are also specified. Finally, municipalities also have judicial powers and powers relating to punishment and penalty.
DDCs	Functions related to: socio-economic development covering all sectors; and other functions related to statistics, natural calamity protection, movable and non-movable property, and preparation of rules.

DDC = district development committee, VDC = village development committee.
Source: Local Self Governance Act, 1999.

Revenue Assignments

19. The existing revenue assignment arrangements for local bodies are generally consistent with international practice. However, there are some deficiencies, one of them being double taxation (that is, local bodies are assigned revenue sources also assigned to the center). Tax on rental income from house and land is one such source. The center charges 10% tax on such rental, whereas the Local Self-Governance Regulations permit municipalities to charge 2%. There is confusion as to whether or not the central tax rate of 10% includes the 2% share of municipalities. Due to this confusion, municipalities have not been able to collect this tax effectively.

20. Also, although the assignment between the center and local bodies is fairly rational, there is some inconsistency with the assignment among different tiers of local bodies. Revenues from sale of sand, stone, and aggregates fall under this category because, following the benefit principle, such sources are better suited to municipalities and VDCs. Another type of assignment problem is that most buoyant sources of revenue are kept by the center itself, leaving little incentive to local bodies to collect revenue. The autonomy of local bodies is also severely hindered due to excessive central control over the revenue base and rates, leaving them next to no autonomy to fix either. There are only few sources of revenue for which local bodies are free to determine rates.

21. The arrangements for vertical sharing of revenues among local bodies require VDCs and municipalities to share 25% of total land revenue with DDCs. DDCs are obliged to share with VDCs and municipalities 35%–50% of tax revenue collected from the export of materials beyond the district boundary and from taxes imposed on recyclable and waste materials. Similarly, the DDCs also have to share the same percentage earned from the sale of sand, soil, aggregates, and boulders and wood swept by rivers.

22. As is evident above, Nepal's fiscal structure is organized mainly around the central government, which collects almost 95% of all domestic revenues.[11] And while the basis of the recently revamped block grants is reasonably transparent, more than 90% of them by value are

[11] The 58 municipalities collect about 1.2%, DDCs about 2.1%, and VDCs 2.5%. The share of total revenue generation internally by selected DDCs is as follows: (i) Kathmandu (41.2%); (ii) Parsa (24.8%); and (iii) Morang, Rupandehi, and Jhapa (14.2% each) (source: Government of Nepal. *Economic Survey of 2063/064* (2006–07). Kathmandu).

conditional and "ring-fenced",[12] constraining the scope for local bodies to manipulate their uses as they see fit.[13]

Nature of Vertical Imbalance

23. The discussion on differentiated mandates goes to the core of the issue of vertical imbalance. This imbalance denotes the degree of dependence that local bodies have on the center to be able to fund their assigned mandates. One way to measure vertical imbalance is to ascertain a local body's share of total revenue derived from transfers as central grants and as revenue sharing with central government (Box 2).[14] Table 3 shows the degree of vertical imbalance for selected districts of the top and bottom deciles (by poverty) in Nepal.

Box 2: Determination of Vertical Imbalance

$VI_{lb} = (CG + RS)/TR$

where: VI_{lb} = vertical imbalance for local body
CG = transfers as central grants
RS = transfers as revenue sharing
TR = total revenue of local body

Decision Rule: The higher the coefficient of vertical imbalance derived, the higher the degree of dependence on the center.

Source: Luiz de Mello, and Matias Barenstein. Fiscal Decentralization and Governance: A Cross-Country Analysis. *IMF Working Paper*, *WP/01/71*. Washington, D.C.

24. Of particular interest in Table 3 is that a rather high level on the human development index (HDI) does not necessarily mean that reliance on the center will be lower (even though the correlation coefficient between the poverty index and the indicator of vertical imbalance for the top and bottom decile districts is 0.73). However, districts that have a low HDI level—and thus, a high poverty index, since poverty index is defined as 1-HDI—for obvious reasons, show a greater degree of dependence on the center. Note that Humla (a relatively poor district) shows a degree of dependence on the center that more or less mirrors that of some of the richer districts (such as Lalitpur, Rupandehi, Kavrepalanchowk, and Morang).

[12] This term refers to specified parameters for usage of resources, which cannot fund any other activity. In that sense, ring-fencing ensures that local bodies have dedicated resources for particular activities/functions.

[13] DfID. 2008. *Fiduciary Risk Assessment: Nepal*. Kathmandu.

[14] There are limits in applying this measure of vertical imbalance to a country such as Nepal. In more developed countries, total revenue can be a proxy for what the local bodies are mandated to perform. In Nepal, even with the resource transfers from the central government, there is a wide gap between what the local governments are mandated to do and what they actually do, and hence, a severe shortfall in the service delivery by local bodies. Other measures, for example, ascertaining the share of local body resources in total public expenditure and in total tax revenue can also be applied; for an application, see Bharat Many Pandey. 2008. *Causes and Consequence of Fiscal Imbalance in Nepal.* The Hague: Institute of Social Studies.

Table 3: Degree of Vertical Imbalance in Nepal
(selected districts of top and bottom deciles; Rs '000)
FY2007/08

HDI Rank	District	Total Revenue (TR)	Transfers As Central Grants (CG)	Transfers As Revenue Sharing (RS)	Vertical Imbalance Indicator [(CG+RS)/TR]
2	Bhaktapur	58,431.00	14,048.00	38,931.00	0.91
4	Lalitpur	91,130.00	15,713.00	52,922.00	0.75
5	Rupandehi	150,479.17	78,508.66	36,386.81	0.76
6	Kavrepalanchowk	63,379.00	24,527.00	23,755.00	0.76
8	Morang	255,869.00	174,239.00	22,385.00	0.77
68	Humla	26,822.05	18,248.00	3,149.27	0.80
69	Achham	93,737.57	91,713.28	473.70	0.98
70	Jumla	170,356.00	168,877.00	678.00	1.00
72	Bajhang	23,356.89	19,730.66	3,143.43	0.98
75	Mugu	120,331.20	115,236.20	46.00	0.96

Source: Local Body Fiscal Commission. 2010. *Analysis of Local Body Finances*. MLD, Kathmandu.

Nature of Horizontal Imbalance

25. It is also relevant to consider issues of horizontal imbalance among local bodies because that has also determined the magnitude and nature of intergovernmental fiscal transfers. Since local bodies differ in endowments and their consequent ability to provide public goods and services, it is critical that the center transfer resources in varied amounts to different local bodies using a uniform and well-accepted transfer formula that more or less equalizes their ability to provide public services. Differences among the DDCs, for example, can be seen in the set of statistics which the government, in part, uses to calculate levels of block grants (Table 4).

Table 4: Cross-District Variation
(top and bottom five districts; ranked by poverty index)

Rank[a]	District	Poverty Index[b]	Area (sq. km.)	Population		Remoteness[e]	Percent Unemployed[f]	Cost Index[g]
				Level[c]	Density[d]			
1	Kathmandu	0.348	395	1,314.9	2,739	944.3	7.1	1.5
2	Bhaktapur	0.405	119	259.7	1,895	254.3	11.1	1.5
3	Kaski	0.407	2,017	43.8	189	646.3	7.9	1.5
4	Lalitpur	0.412	385	389.9	877	358.1	8.2	1.5
5	Rupandehi	0.454	1,360	824.7	521	362.4	11.9	1.0
71	Jajarkot	0.657	2,230	151.3	60	34.0	5.5	2.5
72	Bajhang	0.669	3,422	188.2	49	108.0	4.6	2.0
73	Kalikot	0.678	1,741	118.6	61	64.0	28.9	3.5
74	Bajura	0.690	2,188	122.1	50	16.0	3.6	2.5
75	Mugu	0.696	3,535	49.6	12	0.0	0.9	3.5

[a] Top five and bottom five districts by Human Development Index (HDI); [b] poverty index = 1-HDI; [c] projected population, 2007 (medium variant); [d] persons/sq km; [e] proxied by total length of roads (in kilometers); [f] of usually economically active population (10 years of age and above); [g] based on Local Body Fiscal Commission, *Designing Intergovernmental Fiscal Transfer Formula* (2005), which uses 1.00 as the baseline for costs of providing similar services in the districts; the higher the index value, the greater the level of costs.
Source for all variables except cost index: Ministry of Local Development. 2009. *Nepal's Choices in Fiscal Federalism*. Kathmandu (citing several official sources); cost index data as received from LGCDP Program Coordination Unit (PCU).

26. Table 4 documents the range of variation in the spatial, demographic, and economic characteristics of the top and bottom five districts. This points to the need of the central government to come up with equalization grants to ensure that less-endowed and less-resourced districts have the same capability to fulfill their mandates and thus minimize the horizontal imbalance among local bodies.

B. Fiscal Flows to Local Bodies

27. Resources for local bodies come from different sources (see Box 3): (i) own-source revenue (revenues that local bodies can themselves generate and for which there are legal provisions for them to do so); (ii) central grants—both conditional and unconditional; (iii) revenue sharing with central government; (iv) sectoral budgetary allocation made by central sectoral ministries and meant for projects and programs at the local-body level managed by the ministries; and (v) loans (albeit at low levels for many local bodies).

Box 3: Sources of Revenue for Local Bodies

$\mathbf{TRes_{(lb)} = \sum OSR, [CG_{(c)}+CG_{(u)}], RevSh_{(cg)}, \sum Sb_{(a...n)}, EG, L+B}$

where: (i) $\mathbf{TRes_{(lb)}}$ = total resources of local body; (ii) **OSR** = own-source revenue;[1] (iii) $\mathbf{CG_{(c)}}$ = central grants (conditional);[2] (iv) $\mathbf{CG_{(u)}}$ = central grants (unconditional);[3] (v) $\mathbf{RevSh_{(cg)}}$ = revenue sharing with central government;[4] (vi) $\mathbf{\sum Sb_{(a...n)}}$ = sum of budgetary allocation to different sectors;[5] (vii) **EG** = external grants (such as from donors); and (viii) **L+B** = loans and borrowings[6]

[1] Comprises local taxes, service charges, fees and royalties, and sale of fixed assets; the level of OSR is generally low for local bodies: (i) less than 30% for municipalities; (ii) less than 50% for district development committees (DDCs); and (iii) about a quarter for village development committees (VDCs).

[2] Conditional grants are specific purpose grants or categorical grants where the center specifies the purpose for which the recipient local body can use the funds.

[3] Unconditional grants, on the other hand, have no restrictions imposed on their use (in effect, a lump sum amount provided to local bodies). In most cases, this grant is provided to equalize fiscal capacity of local bodies to ensure that a minimum standard and level of public service is provided to the public.

[4] Central government shares with DDCs a number of centrally-managed revenues (land revenue, royalties on natural resources, etc.). Shared revenues are earmarked for development expenditures.

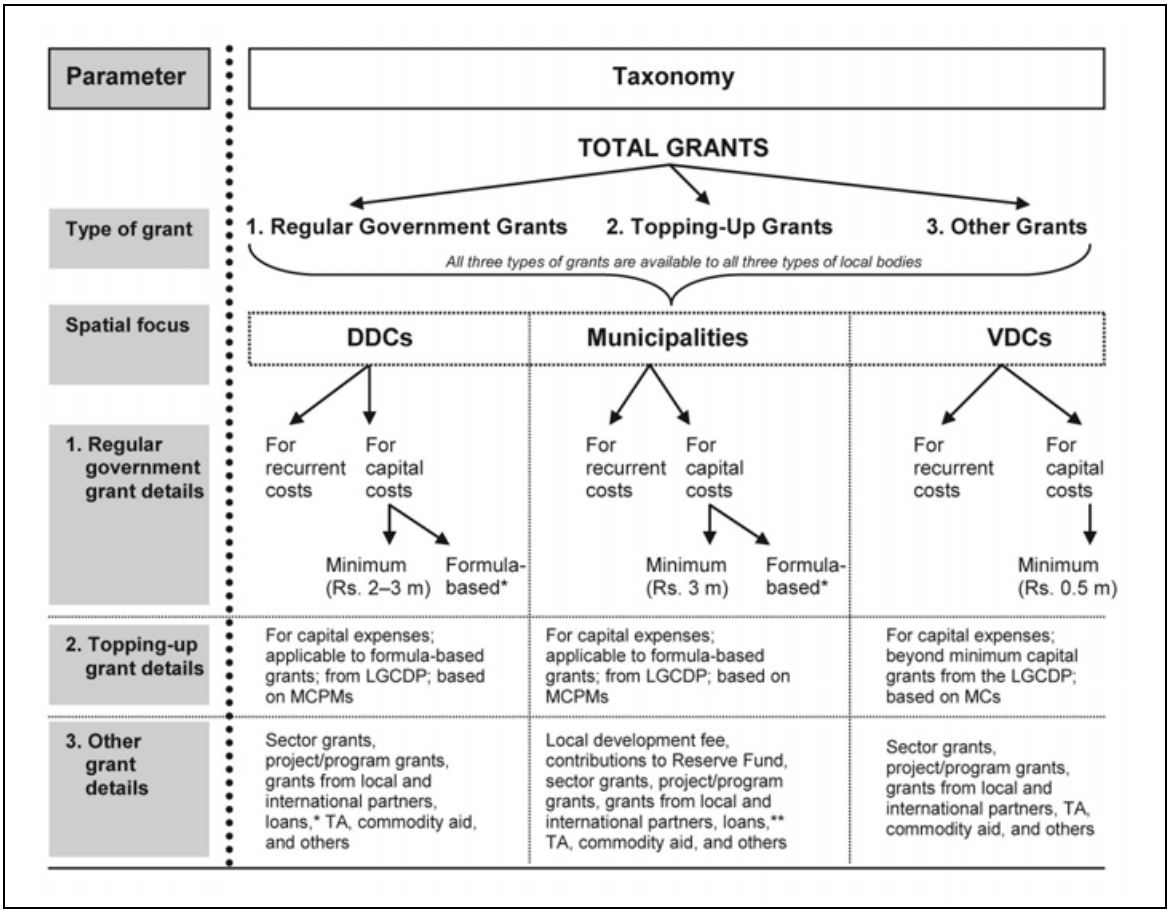
[5] Resources that are released by central level sectoral ministries through the local-based agencies of these ministries (such as, for example, in education, health, transport); these are largely appropriations for salaries for local level central agency staff members.

[6] For example, from the Town Development Fund by municipalities. Local bodies have, however, not generally taken on a heavy loan burden in Nepal. But when they have done so, the general operative rule is $L \leq (Y-E)$ (that is, loan resources (L) should be less than or equal to, but not exceed, the difference between the income (Y) and expenditure (E) needs of local bodies).

Source: Author.

28. Of the types of fiscal flows to local bodies,[15] block grants play a significant role. Fiscal transfers to local bodies as grants can be either for recurrent or capital expenditures and can be sector specific or not. The total grants (i.e., $CG_{(c)}+CG_{(u)}+EG$ in Box 3) to these bodies can be shown schematically as follows (Figure 1):[16]

Figure 1: Grant Taxonomy



*See para 29 for the grant allocation criteria.
**While loans are strictly not grants, the 2010 guidelines for DDCs and Municipalities term them as such.
DDCs = district development committees, K = capital, LGCDP = Local Governance and Community Development Program, m = million, MC = minimum conditions, MCPM = minimum conditions/performance measures, Rs = rupees, TA = technical assistance, VDC = village development committees.
Sources: *Grants Operational Procedures, 2010, for DDCs, VDCs, and Municipalities*. MLD: Kathmandu; author's discussions with the MLD.

[15] Any fund flow mechanism to local bodies must satisfy four criteria that the government has asked development partners to be mindful of: (i) money should reach communities quickly, (ii) there should be no system loss (that is, no leakage due to inefficiencies in the fund flow system), (iii) there should be few paper requirements, and (iv) there should be low-cost and effective mechanisms of financial accountability (see Rameshore P. Khanal. 2008. *CBG Funds Flow–Some Thoughts*. Kathmandu: Ministry of Finance).

[16] From 2012, the topping up capital grants will be merged with the regular government grants, to which the MCPMs will apply.

C. Grant Allocation Criteria

29. Allocation criteria for these grants are specified as follows for the various spatial units:

a. For DDCs: (i) population–40%, (ii) weighted poverty–25%, (iii) area–10%, and (iv) weighted cost–25%;
b. For municipalities: (i) population–50%, (ii) weighted poverty–25%, (iii) area–10%, and (iv) weighted tax effort–15%;
c. For VDCs: (i) population–60%, (ii) area–10%, and (iii) weighted cost–30%.

30. In addition to these grants, since 2008, the practice of extended block grant (EBG)—almost two-thirds of which is externally funded—has been initiated in Nepal. The current EBG system is a result of an exercise implemented on a limited scale (20 districts out of 75) since FY2004/5.[17] The roll-out to all of Nepal relies on a system of minimum conditions and performance measures (MC/PM),[18] discussed below.

a. **Minimum condition (MC) indicators.** These are the basic fiduciary safeguards in the system, that is, non-compliance with any MC means that no EBGs will be received in the coming fiscal year. For the DDCs, there are 15 minimum conditions in four functional areas: (i) planning and budgeting; (ii) financial management; (iii) functioning of political committees; and (iv) transparency. (Since functional area (iii) hinges on the presence of political representatives—and there are none at the moment—only 13 MCs currently apply).

b. **Performance measures (PM) indicators.** A total of 62 indicators covering eight functional areas have been fixed for PMs; these areas include: (i) planning and program management, (ii) budget management, (iii) financial management, (iv) fiscal capacity, (v) budget release and program execution, (vi) communication and transparency, (vii) monitoring and evaluation, and (viii) organization, service delivery and property management (see Appendix 1).

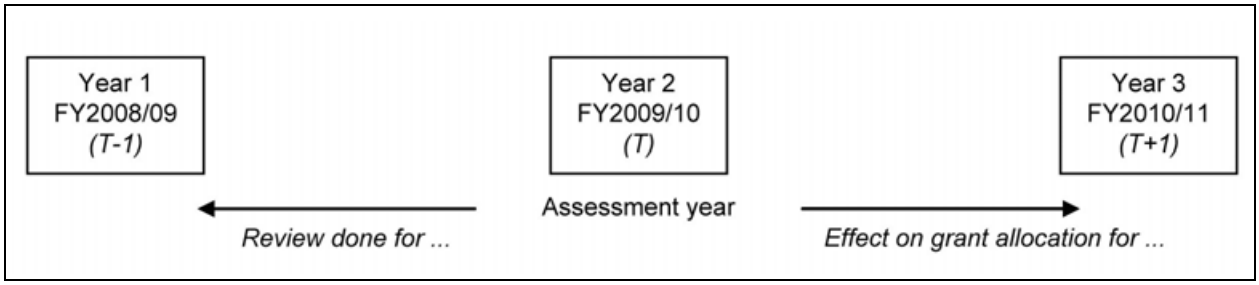
31. Out of the 62 indicators in these areas, 57 are currently applied. Others can be applied only after the appointment of political representatives in DDCs. In order to receive the performance-based allocation, DDCs must pass all MC indicators. In order not to be sanctioned, they must achieve a minimum score in each of the functional areas, subject to performance assessment.

32. The application of the MC/PMs is lagged, that is, the results of the assessments of year 1 will be evident in the allocations for year 3. Thus, for example, the assessment of the performance in FY2008/09 will be done in 2009 with impact for FY2010/11. The assessment of the performance in FY2009/10 will be done in 2010 with impact for the allocations in FY2011/12 (see Figure 2).

[17] Supported by the Department for International Development of the United Kingdom (DFID) and United Nations Capital Development Fund.

[18] The performance assessment distinguishes between ‘minimum conditions’ that need to be met by local bodies before any funds can be received and ‘performance measures’ that are used to determine whether they will receive a reward on top of their basic allocation or a deduction. The system is thus referred to as the ‘MC/PM system’.

Figure 2: Assessment and Applicability Periods for MC/PMs



FY = fiscal year, MC/PMs = minimum conditions/performance measures, T = time.

33. Box 4 summarizes the effect of the performance rating on allocation.

Box 4: Performance Rating and Effect on EBG Allocation for DDCs

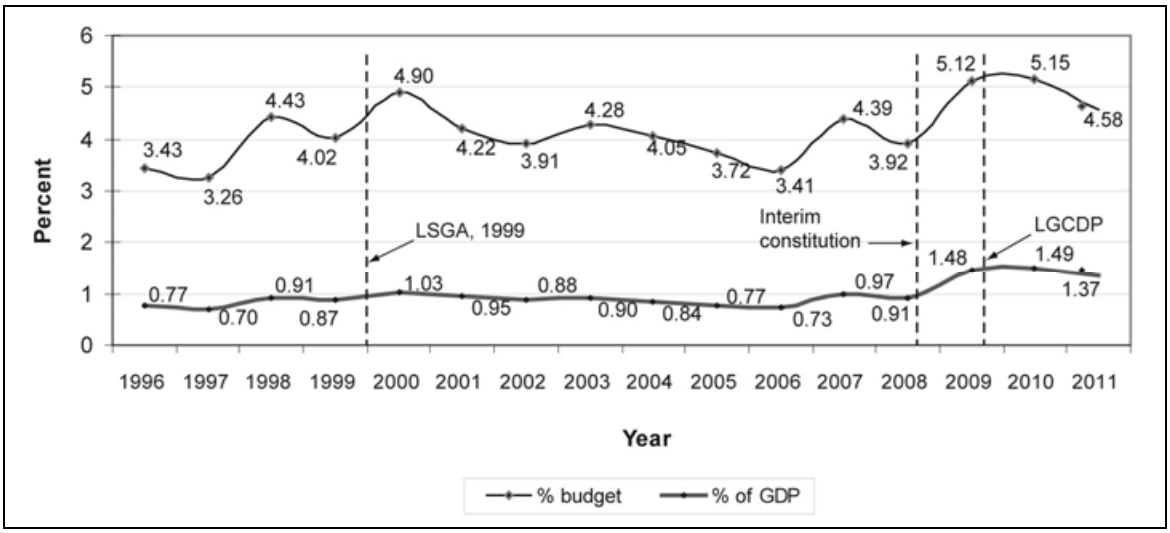
Performance 'Rating' and Conditions	Reward/Sanction	Staff Incentives
Non-compliance with minimum conditions (MCs)	Lose all formula-based capital grants	–
MCs met but failed in any one of the areas of the performance measures (PMs)	Lose formula-based capital grant by 20%	–
Met all MCs and PMs, and obtained score between 36–50 points in PMs	Static—neither increase nor decrease in formula-based capital grant	–
Met all MCs and PMs, and obtained score between 51–65 points in PMs	Reward 20% increase in formula-based capital grant	Rs 100,000
Met all MCs and PMs, and obtained score between 66–80 points in PMs	Reward 25% increase in formula-based capital grant	Rs 125,000
Met all MCs and PMs, and obtained score higher than 80 points in PMs	Reward 30% increase in formula-based capital grant	Rs 150,000

DDC = district development committee, EBG = expanded block grant, – = none.
Sources: Ministry of Local Development. 2010; Government of Nepal.

34. The historical levels of grants for local bodies are documented in Figure 3, which shows uneven trends, including after implementation of LGCDP in 2008.

35. The breakdown of local bodies receiving topping-up grants in FY2009/10 reveals that, of the percent of local bodies receiving such funds, the far-western region performs best (with 100% of DDCs and municipalities, and 95% of VDCs successfully receiving EBGs). This has important implications for how local bodies need to be engaged in order to enhance receipt of much-needed central level resources.

Figure 3: Share of Local Body Grants to National Budget and Gross Domestic Product (GDP) (FY 1996 to 2011)



LGCDP = Local Governance and Community Development Program; LSGA = Local Self-Governance Act.

Table 5: Breakdown of Local Bodies Receiving Topping-Up Grants

Cluster	Receiving Expanded Block Grants[1] (in fiscal year 2009/10) DDCs	Municipalities	VDCs[2]	Remarks
Eastern	14 (out of 16)	13 (out of 14)	793 (out of 893)	Of the 100 remaining, the MC assessment for 23 VDCs yet to be done (as of late 2010); the others failed because they had not updated their vital registration database (as required by MC)
Central	16 (out of 19)	19 (out of 20)	738 (out of 1,199)	Ironically, Kathmandu DDC failed the MC/PM test; a large number of VDCs failed due to the deteriorating security situation in the region
Western	15 (out of 16)	12 (out of 12)	531 (out of 866)	Almost 40% of VDCs failed because many of them continue not to be staffed full-time by secretaries
Midwestern	13 (out of 15)	6 (out of 6)	537 (out of 575)	A much-better performance by VDCs as compared to the national average (of 75%)
Far-western	9 (out of 9)	6 (out of 6)	362 (out of 383)	(same as above)

DDC = district development committee, MC = minimum conditions, MC/PM = minimum conditions/performance measures, VDC = village development committee.
[1] To be used for infrastructure development and/or capacity development.
[2] VDCs are eligible for expanded block grants based only on MCs and the classification of the VDCs vis-à-vis the presence of disadvantaged groups.
Source: Annual reports of the 5 Local Governance and Community Development Program Cluster offices of the Ministry of Local Development, 2010.

D. Assessment Process and Quality Assurance

36. The EBG's defining feature is that its allocation is never an entitlement, but subject to compliance with the MCs and then further attuned in accordance with the outcome of an annual performance assessment. The actual size of the grant is thus adapted to proven performance

capacity in key functional areas (mainly relating to PFM) and so provides fiscal incentives for compliance with the existing legal and regulatory framework that guides the operations of the local bodies. This means that, by design, the MC/PM system substantially mitigates fiduciary risks at the local level.

37. The assessment process for MC/PM is rather rigorous. DDCs are informed at least one month in advance of its timing and its effect on block grant allocations. In addition, the assessment manual is shared with all DDCs. The Local Bodies Fiscal Commission (LBFC) then contracts independent and qualified consultants to carry out the assessment, who receive extensive orientation on all aspects of the assessment process. For the assessment, the country has been divided into 22 clusters, each assessment team covering one cluster of districts only. The assessment process is considered transparent and credible, and assessors are reminded that all assessments must be substantiated by evidence/documents. LBFC publishes the estimated cost per cluster during the tendering process, and the consulting firms, consequently, compete and lower the cost to that estimate (which has the result of reducing the assessment cost). Where the quality assurance team finds weaknesses in the assessment of any one district, a re-assessment is done for all districts of that cluster, the additional cost recovered from the consultant(s), and the consultant(s) blacklisted.

38. LBFC collects and analyzes the assessment reports prepared by the assessment teams, prepares a separate single summary report, and submits it to the supervision committee chairperson. The report also includes the recommendations to make formal decisions on sanctions or rewards on grants for individual districts. The committee makes final decisions on grant implications and informs the Ministry of Finance accordingly.

39. The assessment reports are also sent to individual districts and widely disseminated in the local media (using national and local newspapers, radios, workshops, and public hearings). If DDCs are not satisfied with the results they can appeal within a given time period (generally 15 days). In such cases, the LBFC will send another independent assessment team to verify complaints. If the complaints are found valid, then the result will be changed accordingly and action will be taken against the consultants or consulting firms. If the DDCs' complaints are determined to be unfounded, the entire cost of the additional assessment will be deducted from their EBG allocation.

E. Fund Flow Modalities

40. In the LGCDP, the following fund flow mechanisms have been adopted:

a. The program budget (including funds from the various donors) is incorporated in the annual budget (Redbook) of the government and is released to the district development fund (which is a non-operating account, that is, only used for disbursement and not expenditure) and the municipal development fund from the central treasury. The DDC then facilitates the release of funds to the village development fund and/or community development fund or community-based organizations and then to the communities.

b. Top-up grants from donors are blended with the government block grant in the form of capacity development grants and capital expenditure grants. A minimum of 33% of the VDC capital expenditure is allocated to projects selected by disadvantaged groups, including availability for use by community groups to strengthen their own capabilities.

c. For the EBG, one common consolidated system for the flow of funds through the national treasury system (FCGO ➔ DTCO ➔ local bodies)[19] is used for all funds as well as consolidated reporting, monitoring, and accountability.

d. The procedures for the flow of funds are characterized by: (i) funds transfer to be linked to the submission of financial as well as physical output reports—no reports from the local bodies will mean no future transfers until all problems have been resolved; (ii) support to be provided for strengthening local body audits and Office of the Auditor General capacity building; and (iii) funds to be transferred in three equal installments on the condition that reports from the last four-monthly period, but one, have been submitted correctly and on time.

41. The fund flow for the capacity building grant uses the same route as the development block grants (through the national treasury system). Donors supporting the joint financing arrangement make funds available to the government through a foreign exchange account in the name of the Ministry of Finance in the central bank, to be used exclusively to finance LGCDP.

F. Fiscal Accountability Arrangements

42. Fund flows to local bodies and local fiduciary accountability arrangements are governed by the LSGA, Local Bodies (Financial Administration) Regulations, and Local Self-Governance Regulations. These legislative instruments are also the basis for program and budget management as well as accounting and auditing at the local level. The laws stipulate that central-level audits and audits of DDC books are to be carried out by the Office of the Auditor General (OAG). DDCs themselves are to audit VDC books, with the final audit of DDC accounts conducted by the Auditor General and, in the case of municipalities and VDCs, by registered auditors. The internal audit of the VDCs is to be done by the DDC and the internal audit of DDCs and municipalities by the Internal Audit Section.

43. Other accountability arrangements include the need for local bodies to carry out social audits and public hearings; indeed, these are indicators of performance measures. The LSGA stipulates that a local body ought to have carried out a social audit within four months of the end of the fiscal year. Similarly, before the settlement of all works operated and completed by local bodies, they should have been audited by the public. Prior attempts at improving accountability at the local level have included ensuring that as much information as possible about annual grant allocations to local bodies is made publicly available. Part of the social audit process is to ensure that all micro-projects have signboards indicating their designation, budget, and the user committee or group responsible for implementation. The committees and groups themselves have to keep project books that record all relevant information about project implementation, including the cost levels. Disbursements to these committees and groups are then conditioned upon public meetings, at which progress in implementation can be widely discussed.[20]

44. Thus far, the primary method of promoting transparency in local body affairs has been the attempt to make relevant financial information public through notice boards, etc. But this has

[19] That is, flows emanate from the Financial Comptroller General's Office (FCGO) to the District Treasury Control Office (DTCO), and, from there, to the local bodies.

[20] Experiences from the DFID-funded Decentralized Financing and Development Program showed that use of signboards, project books, and social auditing can make project implementation more transparent, and that this at times leads to greater efficiencies through fewer "leakages". However, transparency based on written media/methods has its limitations, particularly when the poorest are usually the least literate.

generally had limited impact[21] since citizens living outside the DDC headquarters rarely have access to the information. Moreover, the information is not necessarily presented in a simple and understandable manner. External agencies, such as the National Vigilance Center, are also responsible for periodically reviewing the performance of local bodies.

V. ASSESSMENT OF FIDUCIARY RISKS

A. Overall Fiduciary Environment

45. The assessment of fiduciary risks in local governance in Nepal has to be seen from the perspective not only of the nature of PFM at the macro level as well as the operating context for local bodies, but also the inherent fiduciary weaknesses in the government's flagship LGCDP. The assessment in this study relies on: (i) government's own self-assessment of progress in PFM and its risks and vulnerabilities, and (ii) ADB's Strategy and Program Assessment of the country's PFM system.[22] The two reports list several weaknesses in the country's PFM system, several of which relate specifically to that of intergovernmental fiscal transfers. This study also draws on the risk assessment done for the LGCDP.

46. The latest Public Expenditure and Financial Accountability assessment shows that there is general agreement between the government and donors regarding the strengths and weaknesses of Nepal's PFM systems and procedures.[23] Its legal and regulatory framework for PFM ranks among the developing world's best, but the gap between the framework and its practical implementation is large at all stages of the budget cycle. The resulting fiduciary risk environment is generally assessed as "high".

47. In assessing and responding to fiduciary practices and risks at the local body level, it is useful to take into account the following context: (i) financial management practices at the local body level are constrained by the overall functionality of central PFM systems and procedures; (ii) given the current state of the decentralization efforts (including the lack of elected representatives) the degree of budget autonomy at the local body level is fairly limited with planning and financial management practices dominated by central government structures, requirements, and processes; and (iii) local bodies are constrained by vertical imbalance, that is, a mismatch between assigned (administrative) responsibilities and available fiscal and human resources.

48. In addition, challenges pertaining to the predictability, transparency, and equitability of intergovernmental fiscal relations significantly impact on PFM practices at the local body level. In light of the above, there appears to be a high degree of convergence between systemic features in PFM and prevailing practices at the local-body level.

---

[21] For example, see Mohamed El Mensi. 2006. *Review of the Local Public Financial Management*. Kathmandu: UNDP, p. 19.

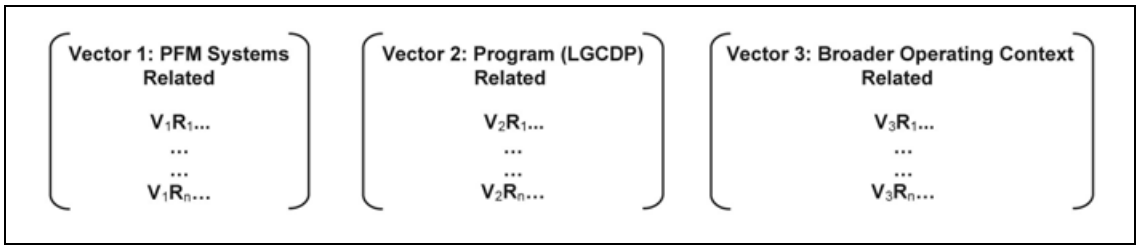
[22] Government of Nepal. 2007. *Public Expenditure and Financial Accountability: Public Financial Management Performance Measurement Framework*; and ADB. 2005. *Nepal: Public Finance Management Assessment*, ADB, Strategy and Program Assessment, December 2005.

[23] The main findings of the PEFA assessment have been confirmed in a 2008 progress report on fiduciary risks in Nepal, commissioned by DFID.

B. Risk Specification

49. The specification of fiduciary risks at the local level can be seen as contained in three vectors (or clusters) as follows (Figure 4):

Figure 4: Different Vectors of Risks



where: V_{1-3} = vectors 1 to 3; and R_{1-n} = risks 1 to n (where n is any positive integer).

Vector 1: PFM Systems Related Risks

50. Risk specification in public expenditure is drawn substantially from the vulnerabilities in the national PFM system. While Nepal's legal and regulatory framework for PFM ranks among the best, as stated, the gap between that solid framework and its practical implementation is large at all stages of the budget cycle. The resulting fiduciary risk environment is thus assessed as high.

51. The Public Expenditure and Financial Accountability assessment tends to show, among other things, that while Nepal is fiscally responsible: (i) program implementation is weaker than planning, (ii) capital expenditures tends to be slow, and (iii) accounting, reporting, and recording are universal problems at local and central levels. At the moment, a bit less than 50% of donors' resources are still off-budget, that is, not reflected in the national accounts. And the fact that every year almost half the total budget is spent during the last trimester of a fiscal year is a sign of improper planning.

52. Table 6 highlights the macro-level Public Expenditure and Financial Accountability indicators relevant to fiscal devolution.

53. The World Bank's Public Finance Management Review of FY2005/06 showed that while there have been some key achievements in PFM, there remain many more challenges, including: (i) how to maintain greater fiscal space in light of the huge expectations of the public in the post-conflict period; (ii) how to further align expenditures to sector strategies; (iii) how to ensure that the expenditure programs address the various types of disparities; (iv) how to reduce the gap between the rules and performance in the PFM system (that is, how to better implement the rules that are rather well designed); (v) how to better utilize local public finances; and (vi) how to better manage external assistance.

Table 6: Risks Associated with the PFM System

PEFA Area and Identifiers	Key Issue	Remarks
Key crosscutting Issues (PI-7 and PI-8)[a]	Off-budget funded activities not under FCGO and OAG	There remain several items that are still off-budget; these pose specific risks to fiscal transparency.
	Lack of transparency in intergovernmental fiscal relations	The lack of transparency is evident across both the central and local levels, despite the work of nongovernment organizations and civil society.
Budget cycle Budget preparation and formulation (PI-11)	Top-down approach to budget formulation process needs to be replaced by bottom-up approach	While a bottom-up approach is specified in the LSGA, it is not uniformly followed through, and the center continues to lead in budget formulation.
Budget credibility (PI-16)	Unpredictability in availability of funds for committed expenditure	This is a serious issue as local bodies are kept hanging for funds release for successive tranches in a fiscal year. Having said that, the MC/PM system does allow some degree of predictability of funds availability.
Procurement (PI-19)	Concerns about competition, value for money, and controls in procurement	Procurement risks abound in Nepal and key development partners (DFID, ADB, and World Bank) have jointly assessed this as one of the most serious vulnerabilities in the PFM system.
Expenditure control, cash flow and releases (PI-20)	Concerns about the effectiveness of internal controls for non-salary expenditure	Given the rather weak reporting system, this is identified as a risk which is being addressed through the introduction of appropriate information technology.
Internal audit (PI-21)	Concerns about the effectiveness of internal audit	Many local bodies do not have internal audit mechanisms or have not relied on them for impartial findings and so accountability suffers.
Accounting (PI-22)	Concerns about the timeliness and regularity of account reconciliations	There has been recent evidence from the field that account reconciliations take an inordinate amount of time.
Financial reporting (PI-25)	Concerns about quality and timeliness of annual financial statements	While this is a requirement in the MC/PM system, financial reporting deadlines and quality standards are generally flouted.
External audit (PI-26)	Concerns about scope, nature, and follow-up of external audit	As with internal audit, local bodies have not been seriously taking up the findings of external audits (even when these audits are actually carried out by OAG). (OAG does not audit VDCs).
Donor practices (D1-3)	Concerns about (i) predictability of budget support, (ii) financial information provided by development partners, and (iii) use of national procedures	While this has been an issue of some concern, increasingly donors have tried to follow national systems where they can do so without aggravating the vulnerabilities.

[a] The PI numbers are taken from the PEFA assessment report.
ADB = Asian Development Bank, DFID = Department for International Development, FCGO = Financial Comptroller General's Office, LSGA = Local Self-Governance Act, MC/PM = minimum conditions/performance measures, NGO = nongovernment organization, OAG = Office of the Auditor General, PFM = public financial management, PI = performance indicator, VDC = village development committee.
Source: Asian Development Bank.

Vector 2: Program (LGCDP) Related Risks

54. The specification of risks can also be made at the programmatic level, that is, risks that are evident in the LGCDP and that are more centered on the local level financial management system. The following risks can be highlighted (Table 7).

Table 7: Risks Associated with the LGCDP

	Risks	Explanation
1.	Fund flow processes prove ineffective and inefficient	• While the fund flow process is well documented, it is ineffective given that there are always delays in the release of funds to local bodies. This is partly due to a lack of capacity in relevant central agencies and local bodies, and partly to a lack of controls in the system. • Funding is also not normally dedicated for specific outcomes, which diminishes the effectiveness. • Fund flow mechanisms also need to be better streamlined and the number of agencies involved in the process minimized. • Financial progress is often taken as a proxy for physical progress; there is need to change this thinking.
2.	Weak financial management capacity in local bodies and the MLD	• As alluded to earlier, this is a serious risk evident in the system. The capacity weakness is not only for local bodies, but also for central ones. • The vulnerability here is the lack of effective capacity to implement the various rules and regulations to manage the fiduciary risks. • The vulnerability also relates to local bodies not possessing the capacity to mobilize own-source revenue.[a]
3.	Poor capacity to audit and lack of follow-up on audit, including poor internal audit and absence in some local bodies	• This is a serious vulnerability at the local level, and is evident in the absence of updated local body audit guidelines and relevant training to local body staff members. Quality assurance of VDC audits is also missing. • In some local bodies, there are no formalized internal control policies and procedures shared by all concerned bodies; and internal auditors are either not in place or are not adequately skilled. • Even though there are rules about making financial transactions public knowledge through public audits—requiring that final payment to Users' Committees for project implementation is released only after the completion of public audits—a review by the Central Level Monitoring and Coordination Committee (CLMCC)[b] in early 2010 in 10 districts found that many local bodies have not adhered to the rule. Also, many local bodies have been lax in making Statement of Expenditure of projects implemented by Users' Committees.[c]
4.	Weak procurement capacity and experience in the MLD and local bodies	• While procurement may not have direct relevance to fiduciary risks, there is a strong correlation between improving procurement matters and managing the fiduciary risks at the local level. If procurement were to take place in the manner stipulated by law, then the risks of fiduciary loss to the local bodies would not necessarily be so severe. • The lack of capacity of the District Technical Office to support the work of the DDCs is very evident at the moment. There is also lack of clarity on the role of the District Technical Offices—are they part of the DDC structure or a deconcentrated organ of the MLD?
5.	Weak monitoring and non-streamlined monitoring processes	• Local bodies, in general, have low capacity to monitor financial transactions. This affects the central government's degree of comfort about the ability of the local bodies to manage finances. • This also means that mechanisms—such as public and social audits, and public hearings—have minimal impact. The M&E framework in the LGCDP is still rather rudimentary and evolving, and while the National Planning Commission has, on paper, a more rigorous M&E framework, it is not uniformly enforced. • There is a high-level monitoring committee (CLMCC) but the mandates of that committee extend much beyond the technical confines of LGCDP. The committee also serves on an intermittent basis. • Finally, it has been observed that even the low reporting capacity of local bodies has been compromised by the multiplicity of required financial records which impose unwarranted burdens and transaction costs on already overloaded district staff.
6	Weak transparency and accountability framework	• While the framework exists on paper, it is not rooted in practical realities. For example, while public notification of resources received from the center, or local resource allocation results, is mandated to be made available, the information is not easily made so to the largely illiterate (or semi-literate) public. • M&E is also not rigorously enforced by the MLD given the significant transaction costs and despite the establishment of the five regional cluster offices of the LGCDP. • The lack of elected representatives at the local level has severely compromised downward accountability in the program.

continued on next page

Table 7 (*continued*)

	Risks	Explanation
7	Resources not used for the purposes they were intended (with specific reference to corruption as well)	• The PEFA assessment concluded that one of the fiduciary risks in Nepal was that "resources may not end up being used for either the stated plans/priorities of government or in accordance with detailed budget allocations due to weak budget implementation". And not having in place a strong regime of auditing and audit requirements will have a debilitating impact on fiscal devolution. Corruption in the sector is also a serious vulnerability, and existing provisions for social audits, public hearings, etc., need to be substantially enhanced. • There are frequent reports of massive misappropriations. In August 2010, for example, it was reported that about Rs 3 billion had not been accounted for in local bodies.[d] This has been investigated by the Nepal Rastra Bank (central bank), NVC, Office of the Prime Minister and Council of Ministers, and Ministry of Finance. • There have also been recent reports about large amounts of money being kept in non-freezing accounts by local bodies rather than being reverted to the central treasury. For example, local bodies have yet to return Rs 15 billion to the respective District Treasury Control Office.[e] The NVC reported that about 13 municipalities have not returned around Rs 140 million while 24 various DDCs have not returned nearly Rs 400 million.

[a] In May 2010, for example, it was reported that 34 DDCs (45.3%), 26 municipalities (44.8%), and 245 VDCs (6.2%) had yet to hold council meetings to approve the budget and programs for the coming fiscal year, even though only three months remained in the previous fiscal year. This seriously affects fund flows. Indeed, in DDCs, little is known about revenue potential (there is no database and no office in the DDC in charge of revenue mobilization). There is thus no incentive to improve revenue collection.
[b] The CLMCC has been charged with ensuring that risks associated with governance work at the local body level are properly documented and mitigating measure are put in place. It is also mandated to review the status of political mechanisms in local bodies.
[c] The OAG in early 2011 was conducting a performance audit of 5 DDCs and 50 VDCs; these issues were expected to be addressed in that exercise.
[d] Bhadra Sharma. 2010. Rs 3b more missing from coffers. *The Kathmandu Post*, September 8.
[e] The NVC estimates that Rs 3 billion a year does not get transferred and that this has been going on for five years now. See also Bimal Gautam. 2010. Local bodies yet to return Rs 15b to center. *Republica*. August 24. www.myrepublica.com/portal/index.php?action=news_details&news_id=22484. And in mid-2010, CIAA halted transfer of Rs 970 million for three programs after finding that they were created to serve the interests of ministers, lawmakers, and politicians (see Prithivi Man Shrestha. 2010. CIAA cans budgets for new projects. *ekantipur*. www.ekantipur.com/2010/06/27/top-story/ciaa-cans-budgets-for-new-projects/317343/).
DDC = district development committee, LGCDP = Local Governance and Community Development Program, M&E = monitoring and evaluation, MLD = Ministry of Local Development, NVC = National Vigilance Center, OSR = own-source revenue, PEFA = public expenditure and financial accountability, Rs = rupees, VDC = village development committee.
Sources: Asian Development Bank and the Ministry of Local Development.

55. As is evident from Table 7, the risks associated with the national program are multi-faceted. In particular, based on extensive field reviews, it has been determined that financial management system weaknesses in the LGCDP are manifested in the following:

a. The existing financial reporting system does not enable information to be easily gleaned (for example, on annual capacity development spending at the DDC and VDC level).

b. The late production of financial reports, uniformly across local bodies, has implications for impact evaluation and, in the shorter term, for proper allocation decisions for the forthcoming fiscal year. In some instances, VDCs may have submitted financial reports to DDCs, but their books of account are not closed by balancing the books/ledgers.

c. Disbursements of funds are made on an output basis, whereas reports from local bodies are received and consolidated on government budget heads. This persistent dichotomy negates the very basis of a strong reporting system which helps ascertain the true usage of the resources.

d. The central government itself is known to take some time to issue authorization letters for local bodies to receive funds. There is a consistent delay in such issuance, often of three to six months, and if the last tranche of funds is received with only a few months or even weeks remaining in the fiscal year, there is every perverse incentive for local bodies to move the funds to a non-freezing account so that they do not revert to the central treasury. Other than placing funds in a non-freezing account, coping strategies for late disbursement have included: (i) advances to user groups or contractors, and (ii) pre-financing or incurring liabilities by user groups or the local body before project final approval.

e. The central government also rarely carries out a budget versus actual analysis, which cumulatively yields a situation in which the information asymmetry between what is needed and what is allocated adversely impacts the ability of the local bodies to fulfil their mandates efficiently and effectively.

f. The weaknesses in the financial management system have also exacerbated the vulnerability at the local level of malfeasance/corruption. This is most evident in: (i) continuation of projects without clear planning and completion milestones; (ii) receiving grants for work done in the previous year but not recorded; (iii) multiple sources of funding for the same project (double funding); and (iv) abuse of DDC level co-signing authority with the VDC Secretary.

g. The vulnerability cited in (f) is also manifested in cases of payoffs to counter threats to safety by, for example, sister organizations to political parties 'asking' for donations; extortion by criminal elements, of which there seems now to be a rising number across the country, particularly in the south; and political parties muscling in on funds from local bodies.[24]

56. A recent assessment by the central level monitoring and coordination committee (CLMCC) found, among other things: (i) DDCs were spending more than the allowable 1% of own-source revenue for financial assistance; (ii) financial assistance funds were going to political groups;[25] (iii) a considerable level of advances and arrears were not settled (as high as 100% in Bara and 99.7% in Morang districts in FY2008/09) (see also Table 8); (iv) internal audits were not carried out regularly in any local body; (v) there was poor record-keeping in all areas;[26] (vi) there was lack of a multi-year plan for large projects (that is, budgets were allocated on an annual basis alone); (vii) there was evidence of delays in fund flows[27] (for example, of internal revenue raised) from DDCs to VDCs; (viii) local bodies were in non-compliance with Local Bodies (Financial Administration) Regulations (for example, exceeding the allowable ceiling (25%) for operational costs); and (ix) budget release rules were not adhered to (e.g., funds given to Users' Committees in installments rather than all at once).

[24] For example, it was recently reported that political personalities and institutions have misused funds at the Kathmandu Municipality Council to the tune of Rs 120 million (see *The Himalayan Times*. 2010. CIAA seizes KMC files: Huge amounts in unreturned debts found. 13 October). The National Vigilance Center, after a thorough assessment, has shown that such misuse is more the norm than the exception in local bodies across Nepal. Indeed, it concludes that Kathmandu district is currently the most corrupt local body in the country.

[25] In Bara district, the level of such assistance in FY2008/09 was more than 25 to 30 times the allowable limit of Rs 50,000 (actual amount awarded was Rs 1.427 million).

[26] For example, in Bara district, the arrears amount as of FY 2007/08 was Rs 41.690 million as per DDC records whereas it was Rs 58.7598 million as per MLD's.

[27] In 2009, the government had allocated Rs 36 billion; only 22% had been used in the first nine months. There are several reasons behind the delays, one of them being untimely release of the budget by the Ministry of Finance.

Table 8: Status and Settlement of Irregularities
(in selected districts, Rs 000s)

District	Irregularities FY2006/07	Settlement up to FY2007/08	Percent of Settlement
Dang	24,702	165	6.71
Kanchanpur	29,137	7,723	26.51
Sarlahi	21,400	11,768	54.99
Solukhumbu	4,127	2,090	50.63
Tanahu	42,469	13,410	31.58

Source: Annual Report of the Auditor General, FY2007/08 (cited in National Council for Economic & Development Research, 2009, p. 39).

Vector 3: Broader Operating Context Related Risks

57. The third vector of risks revolves around the broader context within which local bodies operate, and within which LGCDP is implemented. The risks here are generally outside the control of the local bodies—two in particular that merit mention are:

a. *Political instability*—this is a generic risk in the operating context of local bodies, and also associated with fiduciary risks as evidenced at the local level. There is a risk of deficiency in political commitment to making fiscal devolution successful and not being serious about the fiduciary risks.[28] The political instability at the center also plays out at the local level, wherein local chapters of political parties—taking their cue from the center—vacillate in their positions and make decision-making difficult for the bureaucrats who are mandated to liaise with the all-party mechanism. Finally, the fact that there are no locally elected representatives currently (and for the foreseeable future) means that accountability to the service recipients at the local level (that is, downward accountability) is practically non-existent.

b. *Local body staffing*—there is at present no local government service legislation in Nepal. As such, staffing processes in the local bodies are still dominated by the center (including the Public Service Commission). This is particularly so with respect to staff skills associated with financial management and management of fiscal risks, and most glaringly evident in the work of the District Technical Office, which does not have full capacity to support the work of DDCs.

C. Risk Severity

58. The fiduciary risks highlighted above are not all equally severe. Figure 5 provides a risk severity matrix, which gives an indication of the four types of risk based on severity.[29]

[28] Indeed, the major cause of fiduciary risks at the local body level in Nepal stems from the absence of elected representatives; without such representatives accountability has been eroded, which has consequently affected the proper and effective management of local resources.

[29] The calculation of risk severity is given by the product of the impact of the risk should it not be mitigated and the likelihood of the risk occurring. The severity ratings are defined thus: (i) Type I risks require urgent attention; (ii) Type II risks, although less urgent, still require attention and monitoring; (iii) Type III risks should be regularly reviewed; and (iv) Type IV risks are generally left to be managed by routine controls in agencies. The determination of risk severity is an arbitrary exercise although it is based on discussions with stakeholders at all levels of government, development partners, and others.

Figure 5: Risk Severity Matrix[a]

Likelihood of event occurring (L)			Impact (I)				
			5	4	3	2	1
			Very High	High	Moderate	Low	Very Low
	5	**Very likely**	**Type I** • Weak local bodies • Delays in fund flows • **Weak internal expenditure controls in local bodies** • **Low procurement capacity at local body level**	• Weak capacity of the MLD • **Weak internal audit in local bodies** • *Weak political buy-in in the long-haul* • *Continued political instability at the center*	**Type II** • **Weakness related to government business process, such as on treasury operations, fund flow, etc.** • Lack of transparency in local body work		**Type III**
	4	**Likely**	• Funds not used for intended purposes	• Local bodies not able to use capacity development funds well • Delayed accounts reconciliation	• Overburdened reporting requirements • **Top-down approach to budgeting** • Weak monitoring systems and follow-up		
	3	**Moderately likely**		• Fiscal transfer formula may be weak • **Unpredictability in funds availability**	• Perverse donor practices • *Local body staffing weaknesses*		**Type IV**
	2	**Unlikely**	• **Unsustainable funds transfer to local bodies over time**		• **Weak external audits at local body level**		
	1	**Rare**					

MLD = Ministry of Local Development.
[a] This table is for illustration purposes alone.
Note: All risks in bold are of vector 1 type, in regular font of vector 2 type, and in italics of vector 3 type.
Sources: Government of Nepal, and the Asian Development Bank.

D. Discussion on Residual Risks

59. The discussion of fiduciary risks would not be complete without a brief assessment of the residual risks inherent in the EBG system. Several merit mention here.

a. *Management of expectations.* It is possible—and there is some evidence of this already in the LGCDP—that the expectations of the local bodies and the MLD are such that neither donors nor government are able to fulfill the continued need for resources to sustain the EBG system at the level that is currently envisaged. The donors themselves are cautious about putting in more resources without seeing some tangible results on the ground, the most obvious one being the proper/effective management of existent fiduciary risks. As local bodies begin to adhere increasingly to the thresholds of the performance measures, the centre will

be compelled to make a greater level of resources available, which it has not amply demonstrated to date.

b. *Ring-fencing.* There are specific areas of the LGCDP that are ring-fenced (such as ADB support for local peace committees). While ring-fencing can help serve specific purposes, it can also lead to a situation where fungibility of funds is compromised. Further, if ring-fencing is done for specific components of an overall program, but there is no clear link between the ring-fenced activities and the overall program, residual risks can crop up, as is also the case when ring-fenced funds are not used properly (or are delayed in usage).

c. *Drive of the MLD.* The LGCDP—and broad-based PFM reforms related to local bodies—rest on a strong MLD. With two years elapsed in the LGCDP, there is still evidence of strong bureaucratic ownership of the capacity building agenda of the organization. However, with five changes in the top leadership of the MLD in three years, it is questionable how sustainable the ownership will be in the short to medium run. As the media hammers the government over a few negative stories—without a strong and commensurate response from the MLD on the success stories—a greater degree of wariness and reform fatigue may set in at the MLD. This is a serious residual risk that government—and donors—need to be particularly mindful of.

d. *Transaction costs.* PFM reforms carry substantial transaction costs, particularly where so many local bodies are concerned. While the MLD has cluster offices in five different regions of the country, the level of central control and coordination needed to ensure LGCDP success means that resource constraints are bound to dominate the business model of the MLD with respect to the management of the EBG system. One particular area of transaction costs is already evident in the implementation of the expanded monitoring and evaluation (M&E) system of the program.

e. *MC/PM indicators.* It is possible that as the government decides to revise the MC/PM indicators to better respond to the operating context on the ground, the whole EBG system may make it increasingly complex. This will add to the costs of its application, further yielding a call to scale it back. This has yet to happen, but some of this is already evident in the appeals of the local bodies that have failed to cross the thresholds of increased performance-based funding.

60. In discussing the residual risks, it is also important to assess the implications of the continued and over-riding problem of lack of elected political representatives at the local level. These include:

a. *Low level of downward accountability at the local level.* With no elected representatives in local bodies, the appointed officers from the MLD dominate the local administration process. Given their Kathmandu focus, there is little incentive for enhancing accountability with the service recipients.

b. *Weak planning direction.* The lack of elected representatives also means that local bodies do not get the full range of planning direction that is usually possible. While local body officials (secretaries in VDCs, local development officers in DDCs, and executive officers in municipalities) have to liaise with an all-party committee at the

local level, the committee is not a fully-functioning entity[30] that meets regularly. And in some instances, officials have liaised with committee members at a personal level to get the required approvals. This reduces the quality of the planning exercise.

c. *Out-of-place bureaucrats.* On the other hand, civil servants—appointed by the MLD and in almost all cases a non-native of the areas in which they serve—thus find it difficult to deal with local complexities and withstand political pressure. They thus cede the right to take decisions regarding the allocation of grants to the political party mechanisms.[31]

d. *Low engagement with the population.* Local bodies, then, are not engaging with the local population and often fail to adequately reflect the range of their development aspirations. The electorate itself is forgotten and individuals in positions of local power tend to take over the governance process. This also leads to a political vacuum at the local level, which—given the continued political uncertainties at the central level—only compounds the complexities at the local level.

e. *Meddling politicians at the central level.* Perhaps not so paradoxically, this lack of elected representatives at the local level has translated into a situation at the central level in which ministers have sought to barge in on, and politicize, the EBG system and others.[32]

E. Unintended Consequences

61. A particular facet of residual risk analysis has to do with the concept of unintended consequences. These refer to the unplanned for developments (both positive and negative, although more likely the latter) that emerge from risk mitigation measures that may have been put in place (Table 9):

Table 9: Unintended Consequences of the LGCDP

Aspect of program	Positive Consequences	Negative Consequences
Performance-based evaluation	Incentivized local bodies to attain—and exceed—the performance thresholds.	Developed a checklist mentality among local body officials keener to be seen as doing the right thing rather than actually doing it.
Greater flow of resources to local bodies	This has immensely improved the scope of the local bodies to be involved in providing public services.	Without a commensurate increase in the absorptive capacity of the local bodies, such as a flow of more resources has meant that funds are not utilized at all, at best, or are being misused by the local bodies whose officials are being threatened/cajoled to release the funds for non-development activities as well, at worst.

continued on next page

[30] The all-party mechanism consists of members simply nominated by the political parties; they are not elected representatives.

[31] It does not help that there is frequent transfer of local staff members. Every year, the MLD transfers staff members who have served two years in one office to other departments. According to the ministry, more than 100 VDC secretaries have applied for transfer (up to early 2011), and 60% of officers in 75 districts and executive officers in 58 municipalities are transferred every year. There are about 5,500 civil servants and 23,000 local staff in all 75 districts, 58 municipalities, and 3,915 VDCs across the country. Of the civil servants, a quarter gets relocated annually (see *The Himalayan Times*. 2011. Development works hit by staff transfer chaos. 9 March).

[32] The best substantiation of this occurred earlier in 2010 when the Minister of Local Development asked the MLD Secretary to release funds to local bodies in contravention of MC/PM standards. The Secretary, who declined, was then moved out.

Table 9 (*continued*)

Aspect of program	Positive Consequences	Negative Consequences
Donor involvement	The fact that there are six JFA partners—in addition to the others that are not part of the JFA (such as the UN), and others that are indirectly associated with the LGCDP—has meant that: • government (the MLD in particular) has been the greatest beneficiary in terms of opportunities for capacity building in program management and in other areas with all its derivative benefits; • development partners have also been actively helping the government manage the fiduciary risks by serving as peer reviewers of the steps taken; • The MLD has an incentive to approach local bodies with dire consequences if programmatic requirements are not adhered to (the fear of external monitoring and cessation of support has indeed galvanized local bodies, at least for the short term).	• On the other hand, the scope for greater involvement of donors in the LGCDP has also meant that there is considerable intervention from them which has, in a few instances, inhibited the full development of the MLD as an executing agency for the program. • There have also been cases where individual donors have exhibited poor interface skills with the MLD, which has further sullied the environment in which a harmonious working environment ought to have been created.

JFA = joint financing arrangement, LGCDP = Local Governance and Community Development Program, MLD = Ministry of Local Development, UN = United Nations.
Source: Asian Development Bank.

VI. CONCLUSION

62. There is no turning back on fiscal devolution and decentralization in Nepal, not after the expectations of the local bodies and the ethnic groups have been ratcheted up by central level politicians. In any event, decentralizing the delivery of public services, generation of resources and their allocation, and being accountable for their usage to the ultimate stakeholders cannot in and of itself be deemed to be negative at all. As governments continue to seek a more efficient and leaner public sector, and as disenchantment at the local level rises about the inability of the center to continue to provide much-needed services effectively and inclusively, there is bound to be a grassroots swell of opinion for greater decentralization. This is, in essence, at the core of the federalism debate in Nepal.

63. It is clear that, until federalism is firmly in place, efforts to strengthen local body fiduciary processes will continue to sputter along. To deal with this, and to ensure that a workable—if not ideal—system is in place until then, several areas of focus may be highlighted based on the analysis in this report.

64. ***Continual and real-time review of MC/PMs.*** Given that the MC/PMs play such a central role in the EBG system in Nepal, and given that there is a lag effect of its application (see Figure 2), it is necessary that for the integrity of the system to be maintained, the MLD should ensure that the underlying bases of the assessment are constantly reviewed with respect to feedback from the ground. This can only make the assessment system more credible to the local bodies and also make it more accountable.

65. ***Focus on M&E.*** Risk monitoring will also be critical for the duration of the LGCDP, and even beyond. This exercise, as much as anything else, will determine the manner in which the government gets a firm handle on the matter of residual risks. As the political situation continues to be unstable, and as the exact specification of the federal form of government continues to be debated, this risk review and monitoring exercise will play a critical role in giving comfort to the donors, as well as to the local bodies, that the program will continue to be on track and that the various risks mentioned here can indeed be mitigated to a fair degree.

66. The focus on M&E itself needs to be done at three levels: (i) at the macro level through the work of the CLMCC so that broad guidance on the policy aspects dealing with fiduciary risks is clear; (ii) at the program level through the work of the Program Coordination Unit at the MLD and its monitoring regime; and (iii) through the independent efforts of the donors supporting the national program through the work of the Local Governance Accountability Facility (LGAF).

67. ***Sector-wide approach.*** It is noteworthy that the government has completely mainstreamed and internalized LGCDP into MLD operations. All sixteen sections of the ministry have been entrusted with specific tasks related to LGCDP outcomes. This is the first step, and one of the more vital ones, towards a sector-wide approach (SWAp) to local governance work. The government is currently (as of early 2011) finalizing an approach paper for a SWAp on local governance which will help in, among other things, giving greater clarity to fiduciary matters at local body level, particularly as they relate to the fiduciary arrangements to be finalized at the center and pursuant to the transition to a federal system of governance.[33]

68. With respect to a SWAp, donors and the government would have to be prepared to take a long-term view and make a long-term commitment to establish it. For this, work on some initial activities (such as a code of conduct among donors and government) would have to commence at the earliest. Finally, it must be recognized that whatever the nature of the final SWAp to be so developed it would have to be framed in the context of the move to a federal state; given that this debate has not begun in earnest in Nepal it is difficult to ascertain how the SWAp itself is then to be structured. A SWAp in a state restructuring context is a vastly different enterprise than a regular SWAp.

69. ***Enhance accountability mechanisms.*** The genesis of the fiduciary risks that are currently in evidence in the national program (see those of vector two) is the absence of a strong accountability mechanism (whether of the local administration to the citizenry politically or of the same in terms of service delivery). Accountability constraints have also been observed in local governance in Nepal with respect to internal and external fiduciary control, and most of the fiduciary risks in evidence at the moment center on accountability gaps. Hence, focusing on enhancing accountability mechanisms, such as the LGAF, should be the primary consideration of the government.

70. ***Enhance capability to manage PFM-related processes.*** In view of the nature of fiduciary risks inherent in the macro level PFM and the LGCDP at the moment, it is clear that only a sustained and deliberate policy of capacity building at all levels will begin to yield the desired results. At the central level, this capability building is targeted at institutions such as the FCGO, OAG, and the MLD, and at the local level at staff members of DDCs, VDCs, and municipalities. Areas where capacity needs are most felt include: internal audits, expenditure controls, financial management and reporting, procurement, budget preparation, and financial and physical planning.

[33] However, the independent team that did the mid-term review of the LGCDP has questioned the need/suitability of doing a SWAp in this sector at the moment. The government and the donors are currently discussing this issue.

71. ***Greater political engagement.*** One of the glaring weaknesses in the national program at the moment is the fact that the EBG system is seen purely as a technocratic exercise with a well-designed formula and assessment process but what is missing is an attempt at contextualizing the system within the existing political realities of the country. These realities include: (i) no elected representatives at the local level, thus depriving local bodies of an appropriate resource allocation mechanism (i.e., one where the constituencies' revealed preferences are subordinated to decisions made by centrally appointed bureaucrats); (ii) no commonality of purpose among local chapters of political parties so that there is no unified voice in local bodies to effectively channel resource allocation decisions to the revealed preferences of the service recipients; (iii) no political stability at the central level so that a consistent and politically well-grounded system of local governance fails to emerge and malfeasance tends to be largely tolerated as a result; and (iv) the tendency of the government to graft complex concepts (e.g., on performance-based grant system) to a system that is clearly not suited for them.

72. Given this, unless there is greater engagement of the donors with the top leadership of the political parties in which the political leaders are made to understand—and respect—the technical rigor of the EBG system, it is futile to expect the LGCDP to do anything more than tinker at the margin of what used to be an unworkable system. Getting the political leaders to appreciate the context of MC/PMs, in particular (and the LGCDP, in general) is thus an extremely important and strategic activity for now. To date, this has not happened to any significant degree. Unless this is done, mitigation of PFM and programmatic risks in local governance in Nepal will be nothing more than minimally effective.

APPENDIX 1

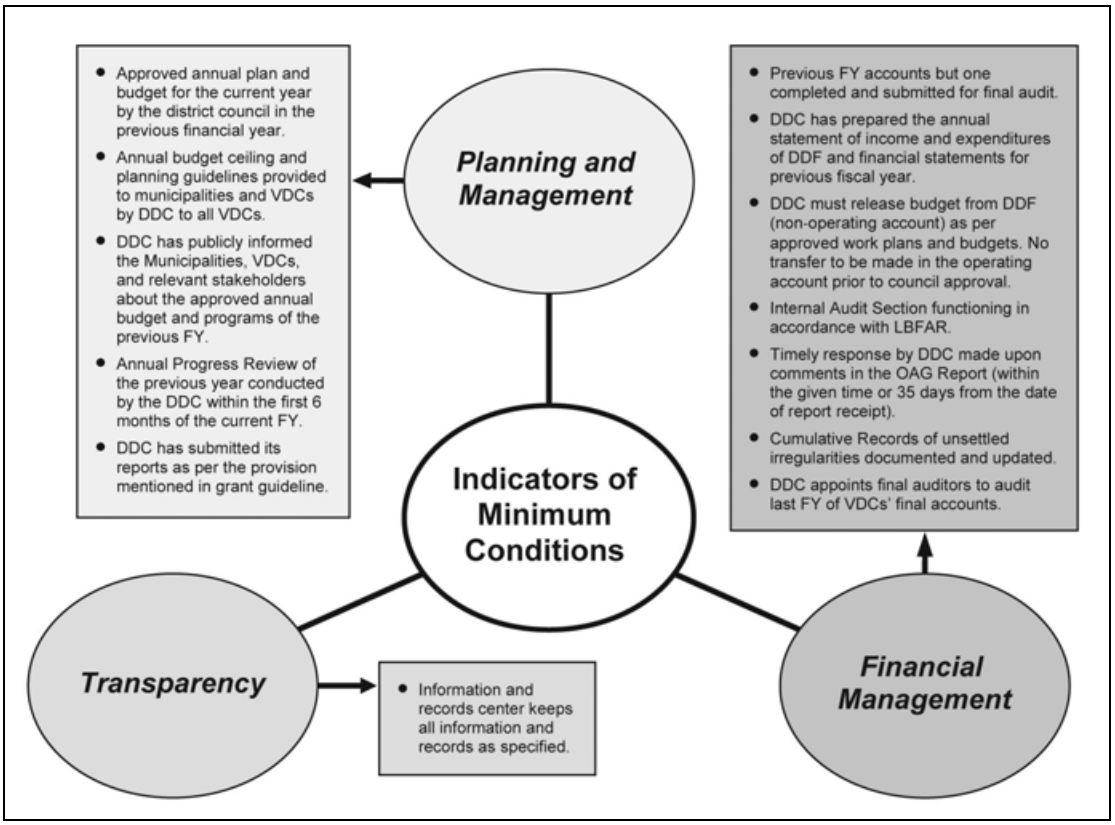
Minimum Conditions/Performance Measures on Grant Allocations

1. The government has put in place a system of minimum conditions (MCs) and performance measures (PMs)—collectively known as the MC/PM system—to assess the threshold of extra capital grants to be allocated to local bodies. The performance based grant allocation system was introduced to put pressure on the local bodies to comply with rules/regulations; improve service delivery; and improve accountability, transparency, and good governance. The system provides incentives to local bodies for the improvement of institutional performance; change in functions, systems, and procedures; and enhance accountability to citizens.

Indicators of MCs

2. The MC/PMs assessment manual consists of 15 MCs indicators, which cover four functional areas. However, only 13 indicators within three functional areas have been applied. Other indicators would not be applicable unless political representatives are in place in the district development committees (DDCs). The functional areas and indicators of MCs are as follows.

Figure A1.1: Indicators of Minimum Conditions



DDC = district development committee, DDC = district development fund, FY = fiscal year, LBFAR = Local Body (Financial Administration) Regulations, OAG = Office of the Auditor General, VDC = village development committee.

Indicators of PMs

3. A total of 62 indicators covering eight functional areas have been fixed for PMs. Out of those 57 indicators representing eight functional areas have been applied; the rest can be applied only after the appointment of political representatives in DDCs.

Table A1.1: Summary of PM indicators and Score

Performance areas	Number of Indicators	Maximum Score	Minimum Score Required
Planning and Program Management	8	15	6
Budget Management	6	11	4
Financial Management	9	15	6
Fiscal Capacity	6	11	4
Budget release and Program Execution	7	12	4
Communication and Transparency	8	14	5
Monitoring and Evaluation	5	10	3
Organization, Service Delivery and Property Management	8	12	4
Total	**57**	**100**	**36**

4. In order to receive the allocated full capital grant, each DDC must pass all indicators of MCs; and also achieve the minimum score in all functional areas of PMs in order not to be sanctioned. A 20% sanction on allocated grant will be applied if DDCs fail to achieve the minimum score in any one of the functional areas of PMs (Table A1.2).

Table A1.2: Indicators of Performance Measures

I. Planning and Program Management	II. Budget Management
• Budget ceiling and planning guidelines issued by the DDC to the VDCs, municipalities, and sector agencies should mention pro-poor policy, national and district development priorities, and project selection criteria • Participatory planning process followed. • Compliance with the procedures and checklists for selection of investment proposals are applied as an integral part of the planning cycle. • Annual plan is prepared using the resource map and poverty information and district sectoral plans. • Representatives from nongovernment organizations, civil society, and organizations related with women and children and disabled groups are invited in the sectoral meetings of the plan formulation committee. • Pre-feasibility of projects is done before plan approval (in case of projects bigger than Rs 1.5 million). • Plan and budget is clearly linked, especially in terms of infrastructure projects (limited to infrastructure projects that have total cost of Rs 500 thousand or more). • The plan specifies operations and management arrangements (responsible body, costs, funding sources, etc.) for all projects (limited to those approved projects larger than Rs 1.5 million).	• Percentage of infrastructure projects completed within the approved cost estimate and budget. • Percentage of previous fiscal year's internal revenues collected against budgeted revenues. • Budget for target groups considers the needs and concerns of disadvantaged groups, ethnic groups, the disabled, and the elderly. • Annual plan allocates budget directly benefiting women and children from internal resources. More emphasis is given to allocation of resources for women and children from internal sources. • All eight special fund accounts established and budget provision has been ensured according to Local Bodies (Financial Administration) Regulations (LBFAR). • DDC has deposited matching funds as per agreement with the government and other donor-supported programs/projects.

continued on next page

Table A1.2 (*continued*)

III. Financial Management	IV. Fiscal Resource Mobilization Capacity
• Status of outstanding advances at the end of the fiscal year. • DDCs provide economic support or donation within the limit as mentioned in the financial rules/regulations. • Quality of audit report for the previous fiscal year. • Volume of cumulative audit irregularities up to the end of previous year but one, settled during the previous fiscal year. • Liabilities of previous fiscal year not paid within the same fiscal year as compared to total expenditure of that fiscal year (these liabilities will impact on the next fiscal year). • DDCs prepared annual procurement plan. • Utilization status of deposit account. • Computer accounting package installed and financial report prepared. • Documented all recoverable amount as recommended by the Office of the Auditor General in the audit report and made due effort to recover such amount.	• DDC has done study/estimation of potential internal revenue sources and projections are done accordingly. All possible internal revenue sources are identified and estimation has been done considering the capacity of the DDC to mobilize them. • Fiscal Effort: Percent increase in internal revenue (tax, service charge, rent, sale, fee levied) as per Local Self-Governance Act and LBFAR compared to previous year (except for the revenue shared by the central government). • Adherence to the regulations on transfer of funds to municipalities and VDCs of the applicable internal revenue sources. • Budget arrangement is done for the development and sustainability of the internal revenue sources. • Revenues shared by the central government are spent on those priority sectors (from where such revenue is obtained). • DDC has established an internal revenue section and it is functional.
V. Budget Release and Program Execution	**VI. Communication and Transparency**
• Percentage of actual expenditure against planned development budget in the previous fiscal year. • Percentage of actual capital development expenditure against capital development budget in the previous year. • Expenditure made on programs addressing the need and concerns of women, children, disadvantaged groups, ethnic groups, disabled, and old people. • DDC has complied with the limit regarding administrative/regular expenses as specified by law. • Income received from revenue sharing is not spent for administrative purpose. • Expenditures on operational and maintenance of larger investments (projects larger than Rs 1.5 million) made as per budget. • Inventory of projects (larger than Rs 500 thousand) completed in the past 3 consecutive years maintained.	• DDC provides information about project selection criteria, and approved annual plan and budget. • DDC provides information to the public about its annual statements of incomes and expenditures. • Project information board/hoarding boards are maintained at project sites in projects exceeding Rs 300 thousand. • Reports of Auditor General submitted to the Council and decision is made. • Information/record/documentation centers operational and opened to the public. • Public hearing system implemented about the services and development activities of DDC. • DDC should publish the results of the MC/PM-assessment result through media, notice boards, or public meetings. • Social audit conducted within four months after the end of fiscal year.
VII. Monitoring and Evaluation	**VIII. Organizations, Service Delivery, and Property Management**
• Implementation status of monitoring and evaluation system. • Reporting: Submission of monthly and annual statement of income and expenditure within the time limit and in the specified format. • Final inspections and clearance by DDC of projects within one month after completion report is received. • Impact studies/analysis of the DDC level projects about their implications on the poor. • DDC has carried out annual review about the status and budget of programs/projects implemented with donor support within first trimester of the fiscal year. • Functioning of DDC supervision and monitoring sub-committee.	• DDC has carried out study on organization development. • DDC has prepared and updated the inventory/record of its assets/property. • Inspection (physical verification) of stores carried out during the previous year. • Internal control and audit procedures elaborated, disseminated and enforced. • Establishment and functioning of staff recruitment committee. • DDCs organize regular staff meeting. • Provision of help-desk in the DDCs. • Capacity building plan of DDC is formulated.

Fiscal Decentralization and Fiduciary Risks
A Case Study of Local Governance in Nepal

This study analyzes the risks inherent in the existing fiscal transfer system to local bodies in Nepal, particularly those related to block grants. It argues that the nature and severity of these risks with respect to the government's flagship Local Governance and Community Development Program are such that they need to be understood in the broader context of the general public financial management (PFM) system as well as the constraints inherent in local governance. The study concludes that mitigating risks in intergovernmental fiscal transfers should focus on, among others, continual and real-time review of performance benchmarks, upgrading the risk monitoring protocols, enhancing accountability mechanisms at local body level, and enhancing local body capability to manage PFM-related processes.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
www.adb.org/poverty
Publication Stock No. WPS113654

Printed on recycled paper

Printed in the Philippines