

Foreign Aid Policy, 2009



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1. Introduction

- 1.1 Developing countries all over in Asia, Africa and Latin America heavily embarked on foreign aid in the form of Official Development Assistance (ODA) in the aftermath of World War II. Since then, voices have been raised against its misperformance and non-performance from donors and recipients alike— it has led to dependency, eroded self-reliance, bred corruption, promoted inequality and “intoxicated” people with its short-term, myopic and unsustainable deliveries. That many of such criticisms in many instances have proved valid, strongly suggests the need for a critical re-look into its current concept, scope, motive, quality, utility and mobilization instruments.
- 1.2 Nepal with the launch of its First Five-Year Plan (1956-61) joined the league of aid-recipient countries for its development financing. A substantial portion of development expenditure, averaging about 55% per year, has since been financed through foreign aid. In terms of sectoral distribution, agriculture and forestry have been the largest recipients of aid followed by energy, transport, health, social services and human resource development. *(A Table could be presented in the Appendix or just overleaf, if considered needed, indicating the trend of aid over the past few years).*
- 1.3 Nepal passed through a period of great political upheaval after the Nepal Communist Party (Maoist) launched decade-long People’s War (1996-2006) with the aim of liberating the Nepali people from the clutches of centuries-long feudal, exploitative and suppressive political and socio-economic structure. Donors continued supporting Nepal even during this period. While remaining alert of the ongoing developments, they applied a number of collaborative and adaptive strategies and instruments such as Basic Operating Guidelines (BOGs), "Do No Harm" Policy and Conflict-Sensitivity Analysis (CSA) Approach. Through these approaches, Nepal in fact presented a unique example of how development partnership can be better managed even amidst the political conflict. During the inglorious royal stint (February 2005 to April 2006), however, when the people's democratic rights were snatched accusing the incumbent government of failing to secure peace and development in the country, donors at large withdrew their support and foreign aid dwindled.
- 1.4 A decade long peoples' war culminated into the historic People’s Movement II in April 2006 targeting the end of the feudal monarchy and ushered into a new era of peace and democracy after the signing of the landmark Comprehensive Peace Accord (CPA) on November 21 the same year. This was followed by the historic Constituent Assembly elections in April 2008 which overwhelmingly voted out 242 years-old feudal monarchy, and declared Nepal a federal democratic republic. A new government has since been formed led by the CPN (M) whose main priorities are to bring peace process to logical conclusion by writing a new constitution within two years and deliver a lasting peace and inclusive and equitable development to the people who have suffered for so long for no mistakes of their own.
- 1.5 The country is now engaged in charting out a course of development which stands on the plank of a two-leg economy. On the one hand, we want to embark on a high, inclusive and sustainable economic growth with high-return, massive investments in physical infrastructure coupled with the development of matching social capital. And on the other hand, we need to take great care of the distribution of such growth opportunities to the people who have always been at the bottom, by enforcing all necessary measures with a more proactive and assertive role of the state. In the process, transformation of feudal-based, subsistence agriculture into a modern, commercially vibrant agriculture would primarily be a priority, because such transformation alone will enhance agricultural incomes of the farmers as well as lead them toward off-farm employment. The National Development Strategy Paper (NDSP, 2009/10-2011/12), which will soon be adopted as a supplement to the TYIP taking a more doable and

realistic three-year transition focus, will form a basis for realizing these two pillars and take the country forward towards the targeted double-digit growth scenario in the next three to four years to come.

- 1.6 Recognizing the critical role that foreign aid occupies in the economy, this policy paper seeks to analyze and establish the guiding principles, objectives, priorities, policy instruments, institutional arrangements, problems and prospects of foreign aid in Nepal so as to maximize its impact and effectiveness in terms of achieving better development results. The paper begins with a brief review of the past performance of aid both from donor and national perspectives. It then outlines the steps the government is undertaking to address these concerns, including the incorporation of new guidelines, policies and strategies aimed at influencing or regulating the flow and composition of aid, and thus ensure better utilization of such assistance. It also includes a discussion about the new initiatives on aid effectiveness in the context of Paris Principles on Aid Effectiveness 2005 and Accra Agenda for Action 2008, in order to reorient donor support to Nepal's development efforts with reinforced commitment and resources on a more predictable and reliable basis.

2. Overview of the Past Aid Performance

- 2.1 There is a shared concern both among advocates and critics of Nepal's foreign aid that despite a significant flow of external resources into Nepal's development efforts over the years, the country has not been able to optimize the gains from aid. Discrepancy between what we indeed achieved and what we could have optimally achieved from aid resources is far too wide. It is generally realized that whatever growth impulses we had generated from past investments have remained too weak to impact aggressively on increasing the productivity of the economy, fundamentals of overall economic environment, in particular, those triggering investment from within and outside, continue to remain shaky and implementation capacity to mobilize aid has not significantly increased, and institutional capacity in many areas is still inadequate to respond to ever-growing demands and challenges. The key problems contributing to ineffective foreign aid management and poor development results seen both from the donor and country perspective are briefly outlined below.

Donor Perspective

- 2.2 Discussions abound about the mixed record of aid effectiveness in Nepal, as well as the factors contributing to this phenomenon and possible solutions to the problem. The major concerns expressed by the donor community in this regard are the following:
- lack of ownership, internalization and institutionalization by the government of development programs and projects, particularly those financed by donors;
 - lack of leadership and direction by the government, particularly in expenditure prioritization and also in taking required responsibility in designing, preparing and implementing the programs and projects;
 - often unrealistic, ill-suited and top-down planning and budgeting process with little involvement of actual stakeholders, including local institutions, community groups and beneficiaries in program preparation and implementation;
 - pressure to increase development programs and projects beyond such level that can be effectively handled within the constraints of the country's limited institutional and implementation capacity;
 - poorly functioning institutions, particularly inadequately trained and motivated civil service, with least innovation and service orientation.
 - weak public financial management, and procurement systems and poor program supervision and monitoring, leading, in turn, to lack of accountability and transparency, leakages and misuse of resources, and
 - weak governance, fragile political environment, lack of political consensus on economic agenda and absence of policy coherence and consistency.
- 2.3 The donor perspective of the foreign aid performance in Nepal is thus built on the assumption that aid works provided it is allowed to work in a better climate, for which the donors and the recipient are both responsible. Prompted by the inaction or delayed action on the part of the government, they have at times called for exploring alternate ways of service delivery such as through the community-owned, community-managed or community-driven development programs. They have equally been sensitive to the fiduciary risks presumably involved in implementing the programs and projects,

especially during the phase of political transition like that in Nepal, and pointed to the need for adopting a conflict-sensitive approach to mitigate such risks, among others. They have also begun to stress on such cross-cutting issues as inclusion, governance, accountability, transparency, predictability and political stability before committing to supporting any programs and projects. At times, as a response to these concerns, they have tended to work more directly with local bodies, Civil Society Organizations (CSOs) and community groups or to engage their own implementing agencies and consulting institutions. However, it is increasingly realized by them that there is no alternative to strengthening the country systems and enhancing the institutional capacity of the government to make aid work better, and in the interests of the people of the recipient.

National Perspective

2.4 The donor perceptions stated above are largely shared by the Nepalese recipients, but they also see donor behavior and practices as contributing to the problem of aid ineffectiveness. Following observations are often heard from the national counterparts of aid agencies:

- There is seemingly a mismatch of priorities between the recipient and donors. Each donor agency may have its own policies, perceptions and priorities of Nepal's development needs which at times are not only divergent but also contradictory to each other. As a result, foreign aid does not always flow into the sectors where it is most needed, leading to significant resource gaps in some sectors and acute overlapping and duplication in others.
- In the absence of prioritization based on identified sectoral and national needs established through an effective “donor mapping” exercise based on the doors' "division of labor", which recognizes donors' respective areas of comparative strength and priorities, avoids duplication, and matches them with those of the government, difficulties have been faced in ensuring complementarities between various aid channels.
- Perception prevails that many programs and projects are still excessively driven by donors rather than by the recipient. This perception is not entirely false, and its roots may in fact have gone to our own weaknesses in the system giving way to donor overplay. For example, lack of adequate project planning and management system that involves rigorous review of project formulation, implementation, supervision and evaluation, has also prevented us from deriving maximum benefits from aid-financed investments. As a consequence, most projects suffer from time and cost overruns.
- In many cases, sustainability and the operation and maintenance aspects of the projects have been conspicuously ignored.
- In the absence of adequate appraisal, foreign aid has frittered away on many smaller projects for which such aid may have been unnecessary or even undesirable from the country's long-term perspective. This has led to proliferation of projects leading to aid fragmentation and duplication.
- Technical assistance (TA) has fallen short of the contribution that it could have made, owing largely to excessive reliance on foreign expertise and technology. Even in freestanding technical assistance, there is a tendency to depend excessively on foreign expertise instead of tapping local technical capacities through enhancing the capacity of local institutions. Technical

assistance, especially when obtained through loans instead of grants, creates enormous burden to the recipient.

- Nepal still does not have an appropriate and effective mechanism to evaluate technology aspects of foreign assistance, particularly capital assistance. This is especially true for turn-key projects where the decisions with regard to technology to be used are almost entirely determined by donors. This has implications on the long-term sustainability of such projects and their repair and maintenance.
- A host of policy and process conditionalities that are often linked to aid by donors have reduced the effective impact of aid on the recipient countries, constrained the use of appropriate and less costly technology, materials and services, and ultimately, have run counter to the outcomes expected from themselves.
- Disbursing the aid committed to Nepal has been a slow process. The weaknesses in the country's institutional capacities may have contributed to this phenomenon. However, delays have also occurred as a result of the policies, practices and procedures of donor institutions themselves, which have not recognized the inherent implementation limitations of the country system. It is not only a matter of refining procedures at both ends, such as ensuring further delegated authority at the country offices of the donors, but also appreciating and acknowledging the country context and constraints, which should start right at the outset with devising and designing the projects.
- Sizeable amount of foreign aid has been flowing through various Non-Governmental Organizations (NGOs), meaning channeled outside of the government system and not recorded in the treasury. Notwithstanding their contribution to development of the country, policy priorities and operational modalities of NGOs often run in parallel with those of the government. Their resource use seldom reflects national priorities, nor are they transparent in terms of the sources and amounts of resources utilized by them.
- Aid resources available to GON have not all been reflected in the budget. Donors at times make direct payments to project accounts without informing the related Ministries or Departments. As a result, there are difficulties in updating the records and ensuring transparency and accountability in such transactions.
- Over the years, GON's stock of outstanding foreign debt and its debt servicing obligations have risen, as a result of utilizing foreign loans. Although these loans are concessional in nature with high degree of grant element, they still constitute a growing burden to the government treasury.
- There is a significant cultural gap between donor institutions and the country institutions. There is often noticed an insider-outsider phenomenon within the organizational space, sometimes creating a psychological distance between the domestic actors and their external corollaries.

2.5 Looking through the national perspective, it can be safely argued that aid has achieved success in a number of areas such as building physical and social infrastructures like roads, health, drinking water and education, in sectors such as agriculture, forestry and irrigation and also in erecting and empowering institutions needed for advancing economic reforms, though more empirical research and analysis will be needed to further substantiate this. However, despite the volume and magnitude of aid received by the

country in the past five decades, no commensurate improvement in public life has been noticed. In fact, going by the widespread popular perception, aid in most cases has led to concentration of wealth in certain pockets and even exacerbated income disparity among the people. It has become imperative, therefore, to conduct an independent evaluation of aid performance in Nepal to objectively and empirically suggest the fault lines as well as recommend the road ahead for moving in the path of post-transition New Nepal in three years.

- 2.6 Nepal's position on mobilizing foreign aid stands on the prime pillars of aid effectiveness such as country ownership, alignment and harmonization. It is indisputably viewed that in Nepal's context, as elsewhere, any external support should be driven by national demands rather than supplied on donors' discretion. To ascertain such national demands, country's national planning and policy framework as well as sectoral policies should be taken as guiding principles. Equally important, unilateral imposition of strings and conditionalities will not only delay and hinder the implementation, but also fuel anti-reform drive among the people, so they should be eliminated at all or kept at minimum, when agreed mutually. This, along with how we should address the concerns raised by the donors, will be elaborately described in Chapter 4.

3. The Changing Scenario

- 3.1 Nepal has so far launched its development programs and economic reforms in the context of a development framework which has largely evolved alongside international development experience and interactions with the global community. However, as the country is now intensely engaged in defining and designing its new political architecture after it was declared a federal democratic republic terminating the feudal monarchy, a new context of designing its matching economic architecture has emerged including on foreign aid front.
- 3.2 Nepal has come through a series of struggles against its own feudal, repressive political regime and exploitative socio-economic structure in the past sixty years or so, which took their toll on the country's economic development. However, the energies people spent during these struggles have by no means gone wasted; rather they have consolidated people's will and determination toward a total transformation of the country.
- 3.3 The political transition the country is currently passing through has clearly created a momentum in favor of peace, democracy and development in the form of a 'compact'. This has become necessary for moving the agenda of peace and development simultaneously, and not letting development take a back seat with reduced focus and priority. This compact will involve the government or the state and the people on one hand (defined by accountability framework), and development partners and the government or the state on the other (based on accountability and predictability).
- 3.4 Reflecting on Nepal's special context of transition to transformation, it can thus be safely concluded that peace, democracy and development need to be intertwined in a simultaneous sequence rather than treated in isolation. Foreign aid requires to reinforce this inter-linkage and donors need to heed this approach. It is satisfying to note that there is a growing convergence of opinions among donors regarding this approach.
- 3.5 In today's development interface, donors and recipients are both development partners and aid is an engagement in development partnership. However, in order to become equal and meaningful development partner, Nepal needs to join hands with the donor community for acquiring matching sophistication and resources, both technical and financial, in mutual cooperation and partnership.
- 3.6 The globally agreed principles, conventions, policies and frameworks have increasingly been guiding Nepal's development assistance from external sources. Nepal has been a party to most of the international agreements and arrangements. Nepal is committed to UN targets for poverty reduction, known as Millennium Development Goals (MDGs), aiming at halving poverty by 2015. Nepal has also been a party to agreements arrived at global conferences on the environment, women, children, human rights and at the Social Summit. Nepal has also firmly supported the initiatives taken both at regional and international level to improve aid effectiveness and donor harmonization, including, notably, the Paris Principles on Aid Effectiveness 2005 and Accra Agenda for Action 2008.
- 3.7 As also highlighted in the Paris Principles, there is a shift of paradigm in favor of mutual accountability of donors and the country partners for the utilization of aid. There is also an emphasis laid on managing for development results, known as MfDR, which points to the urgency to ensure that results in terms of wider outcomes or impacts rather than mere outputs of any development programs and projects are in place, and development partners need to be increasingly well aware of this new context.

- 3.8 Nepal attaches the highest priority to transforming the country and its people politically, socially and economically. This requires launching a matching economic revolution alongside the success achieved on political front. This would mean the country would have to leap-frog economically, growing at a double-digit rate with massive investment both in physical and social infrastructures soon after the current transition to lasting peace is complete. We cannot afford to wait tens of years to offer our people a decent, dignified and poverty-free life. To make our journey to progress faster, we want to learn from other countries' experiences and apply their successes in our context. This is our dream of building New Nepal, and our foreign aid policy will be directed towards that end. Donors need to clearly comprehend this determination of ours and extend all possible cooperation to make that happen. The subsequent chapters will tell what that new policy orientation will be.
- 3.9 Nepal is now heading toward state restructuring based on the agenda of federal system of governance which will have a great bearing on the structure, functions, responsibilities, authority, power, scope and limitations of all tiers of the government, including the center. It is too early to predict what shape the discussed agenda would take, but the donors and other stakeholders alike need to pay close attention to it and prepare themselves to fit into the emerging scenario.
- 3.10 It is a fact that Nepal's economy is characterized by structural bottlenecks such as feudal remnants of exploitation and discrimination, extreme poverty and destitute, subsistence agriculture, low industrial base, underdeveloped physical infrastructure, under-built social capital, inadequate market base, intermittent fiscal and external deficits and significant imbalance between savings and investment. Nepal's own efforts and initiatives alone will not be sufficient to overcome these bottlenecks and bail the country out of its low-income status, meaning foreign aid mainly as ODA will be needed until the country will reach the middle-income status in the next ten to fifteen years' time as it will, basically, :
- (i) supplement rather than substitute Nepal's domestic savings so as to mobilize additional resources for high, inclusive and equitable growth,
 - (ii) channel increased resources toward priority sectors of the economy to accelerate economic growth and development,
 - (iii) create an enabling environment for attracting foreign direct investment and private capital inflow by highlighting the areas of comparative and competitive advantages of the economy, and
 - (iv) enhance the nation's capability to envision, implement and sustain development programs through knowledge and technology transfer.
- 3.11 As the country now faces the challenge of successfully transforming itself into a peaceful and prosperous nation, foreign aid, when tailored to the ground realities and circumstances, will remain vital in that process. However, the government will ensure that foreign aid will not come as aid alone any more; it will be entwined with trade, investment and private capital inflow as far as possible and practical. All in all, foreign aid will thus be made to play a role of enabler and facilitator to the nation's development efforts and initiatives, rather than become a rescuer and reliever of the nation's ills in itself.

4. Guiding Principles, Objectives and Priorities

- 4.1 As noted earlier, Nepal's foreign aid policy will be guided by a new compact of peace, democracy and development involving all domestic and external stakeholders. Issues such as inclusion and equity are requiring sufficient attention by development planners and implementers. Issue of national ownership and leadership as well as other elements of aid effectiveness as signified in the Paris Principles also demand serious treatment in the course of foreign aid management. The foreign aid policy will take these factors into consideration.

Guiding Principles

- 4.2 Foreign aid policy will be directed towards attaining the over-arching national goal of lasting peace and all-out socio-economic transformation of Nepali society. This will involve fostering broad-based, sustainable and inclusive high economic growth by enhancing the productive capacity of the economy as well as building social capital of the country.
- 4.3 "A Peaceful, Prosperous, and Just New Nepal" is the vision of the currently adopted National Development Strategy Paper which is a sequel to the earlier Three-Year Interim Plan. The vision entails a notion of a Nepali society which is inclusive, self-sustaining, possesses social harmony, is free from absolute poverty, has substantially reduced inequality, is free from all discriminations and exploitations, enjoys all civic and political rights and freedom, is entitled to all basic socio-cultural and economic rights as well as equal rights and opportunities, lives happily with tolerance to diversity, and feels proud of its identity and dignity. Nepal's development efforts should be directed to realizing this vision, and foreign aid objectives, policies and strategies will be channelized to this direction. This will require donors and the country partner institutions to meticulously pursue the implementation of NDSP and other policy approaches adopted by the government time to time.
- 4.4 The foreign aid policy would form an integral part of the overall policy of mobilizing resources for development both at individual project level and economy-wide sectoral level. This requires foreign aid to be demand-driven rather than imposed at the will of the donor.
- 4.5 The foreign aid policy will ensure greater transparency, accountability and predictability both within and outside of the government system. As rightly stressed in the Paris Declaration on Aid Effectiveness and Accra Agenda for Action, greater attention will be paid to ensure that all tenets of these international commitments are well taken care of.
- 4.6 While pleading for the increased quality and quantity of foreign aid during the short and medium term, it will be the government's policy to strive to achieve self-reliance and sustainability in the longer term by enhancing domestic resources mobilization and optimizing the opportunities for trade, investment and private capital inflow in the country. This would mean that, while striking a balance between the reality of global interdependence and the ideal of national self-reliance through these measures, the government will begin to stop accepting grants, TAs and concessional loans within 2025 AD, i.e. 13 years after the completion of the current three-year transition period.

The Objectives

- 4.7 The broader objectives of foreign aid policy, 2009 includes the following:
- To reduce poverty by ways of effective utilization of foreign aid through high, inclusive, and sustainable economic growth with distributional equity, focusing on productive employment and improved linkages among public sector, cooperatives and private sector fostering Public Private Partnership (PPP).
 - To create conducive climate for investment and trade by ways of effective utilization of foreign aid so that the dependence on foreign aid will be reduced leading to self-reliant economy in the long run.
 - To define partnership between government and development partners in line with the principles of aid effectiveness committed and reaffirmed through Paris Declaration 2005 and Accra Agenda for Action 2008, respectively.
 - To affirm unfettered commitment to the inter-related themes of peace, democracy and development, fostering the compact between government and the people, and the government and the donors.

Priorities

- 4.8 Foreign aid mobilization needs to work on a short (or immediate) and medium to long-term priority setting. While the short-term priorities are to address the rapidly evolving short-term needs of the economy and the immediate imperatives of the country in order to bring the ongoing peace process to logical conclusion, the medium to long-term priorities need to focus more on development of the productive capacity of the economy so that high growth and employment will be achieved and equitably distributed.
- 4.9 While it may not be possible to tightly define the short-term, medium-term and long-term timeframe for setting aid priorities for the country, the government is of the view that next three years up to 2011/12 will wrap-up the transition and can therefore be taken as short-term timeframe, whereas the next 10 years onward will mark as the medium-term. The long-term timeframe, for the purpose of mobilizing aid, would be the further 20 years period which will lead Nepal gradually to the self-reliance and sustainability in terms of envisioning and executing its development roadmap.

Short-Term Priority

- The NDSP (2009/10-2011/12), which will be the development policy guideline for determining the country's aid priorities for the short-term, has fixed the quantitative target of spending NRs. 560 billion in three years, of which NRs. 300 billion will be borne by the government through domestic resources mobilization and the rest comes as a resource gap to be met by foreign aid. Leaving aside the aid that has already been committed or is in the pipeline for these three years, there is still a substantial resource gap of NRs. 116 billion. As a short-term aid priority of the government, all efforts will be made to channel foreign aid to meet this resource gap.

- In the next three years to come, peace funding will receive continued priority both from the government and the donors. The areas that will need resources under peace funding will include:
 - Relief, Rehabilitation, Reconciliation and Reintegration of Conflict Victims,
 - Security Sector Reforms,
 - Mine action,
 - Transitional Justice,
 - Cantonment Management, and
 - Physical Reconstruction and Maintenance.
- The government will be channeling substantial part of its resources to finance these activities, apart from funding its regular and hard budgetary demands. This would seriously impact government funding available for development activities. Therefore, the country would need more flexible budgetary support in the form of cash grants, supplemented with the sectoral or programmatic support.
- The country needs to prepare to take off toward double-digit growth in the next three years when the transition will have been completed. To meet this goal, NDSP has defined five Thrust Areas that will receive number one priority during this period. They are:
 - 1) employment-oriented and broad-based high economic growth;
 - 2) improvement in governance and service delivery system;
 - 3) investment in infrastructure development (Physical, social, economic);
 - 4) Social development; and
 - 5) inclusive development and targeted programs.

This clearly shows that the country should launch a number of 'flagship' or big mega projects to jumpstart economy and boost economic growth on a turnaround scale. For this to happen, aid should be optimized in transforming the agriculture and creating base for growth of manufacturing sector. This would require focus on infrastructure projects such as roads and power, along with investing sufficiently in social sectors like health, education and skills development.

Medium to Long-Term Priorities

- Nepal needs investments in longer-term infrastructure projects such as roads and hydropower sectors, without necessarily harming environmental sustainability. We need our trade sector to grow through mobilizing foreign aid in trade infrastructure sector, and we equally need the private capital inflow through FDI for commercially viable projects. Similarly, we need to mobilize external support for forming our social capital. Foreign aid in the medium to longer term will be channeled to these areas of productive investments.
- With regard to technical knowledge transfer, Nepal should gradually move towards self-reliance either through developing our own skills and competencies or through the adaptation of appropriate knowledge and technologies. Once developed and adapted, we should be able to utilize and sustain them by ourselves. Our human resources and

institutions will need capacity development interventions in a way that they are holistic and systemic, and take a long term view. Therefore, in the longer term, creating a pool of fungible TA projects through a rigorous filtering and appraisal methodology will be applied to choose the most appropriate type of assistance. TAs will be pooled into a TA basket, from where GoN will select the consultants and their services matching national development needs and priorities.

- There is a growing need for making aid more predictable based on longer-term partnership and commitment. Generally, grants will be preferred over loans in view of the long-term fiscal liabilities to be met. Means of fungible or flexible funding such as General Budgetary Support (GBS) and harmonized schemes such as programmatic support like Sector-Wide Approaches (SWAs) and Joint Financing Arrangement (JFA) will be encouraged and expanded. Similarly, "policy conditionalities" drawn from existing policy frameworks applying commonly to GON and donors will be negotiated and mutually agreed upon as well as untying of aid.
- Nepal has committed to achieving Millennium Development Goals (MDGs) declared by the UN at the Millennium Summit in 2000. The government is serious in meeting these goals through their 'localization' and formulation of commensurate strategies to meet them. This will require substantial foreign aid in the medium term.
- Nepal needs to achieve longer-term fiscal and financial sustainability to address any possible serious shocks and vulnerabilities. This would require strengthening domestic revenue base on the one hand and enhancing other sectors of economy such as trade, investment and private capital inflow on the other, so that the economy would increase its resilience and absorb any unwarranted shocks. Foreign aid in the medium to longer term will be channeled to building and sustaining such capability of the economy.

5. Major Policies and Policy Instruments

Major Policies

With a view to meeting above objectives and priorities, the following policies will be pursued:

5.1 Concessional Loans: Loan assistance would be utilized selectively, after careful scrutiny of the purpose, content and benefits of such programs and projects in order to reduce the burden of external debt, while contributing to accelerating growth and meeting socio-economic objectives. Nepal would encourage a closer partnership between the government and multilateral donors so that they can jointly examine the implications of these loans in terms of their contribution to economic and social development. Measures to be adopted in this regard include:

- (i) utilizing foreign loan assistance in national priority projects of agricultural transformation and infrastructure development promising high returns on investments,
- (ii) analyzing the implications of each new loan before accepting it,
- (iii) focusing loan assistance on areas that help generate private sector activities and promote external sector transactions that enhance the foreign exchange earnings capability,
- (iv) exploring ways of reducing the loan liability of GoN by protecting against exchange rate fluctuations. To reduce the potential debt burden, the government will also:
 1. stop the use of loans for higher studies, study visits, trainings, seminars, etc. held in foreign countries.
 2. stop the use of loan-funded vehicles for the persons and purposes other than related to the project, and keep their number minimum while procuring,
 3. minimize the expenditure on consultants and foreign experts out of loan assistance,
 4. not take any procurement-tied commercial and suppliers' credits (however, it will not preclude mixed credits and the concessional loans bilaterally negotiated with Export-Import Banks),
 5. not guarantee foreign loans for any public enterprises or other institutions except in case of high priority infrastructure projects.
 6. not accept any TA which will be changed later in the Loan-funded Projects.

5.2 Grant Aid: Since grants will not impose any fiscal burden on the future generations and also do not constrain the already tight fiscal structure of GoN, Nepal needs to encourage grants for short and medium terms and utilize them most effectively. Co-financing arrangements through grants shall also be emphasized for financing expenses of overhead and technical support of projects. However, no grant aid below USD 5 million will be accepted, and most notably, after 2025, no grants as ODA will be sought from donors.

- 5.3 General Budgetary and Programmatic Support:** Like in the short term, program support (as compared to project financing) will be necessary in the longer term also. Such support will be sought in the context of sectoral and/or macroeconomic programs, as well as for budgetary support under appropriate circumstances.
- 5.4 Sector-Wide Approach and Joint Financing Arrangements:** Nepal will encourage aid predictability and longer-term partnership from donors. To enhance harmonization both in terms of policy and process, measures such as SWAs and JFAs will be applied to a large extent.
- 5.5 Technical Assistance:** Technical assistance needs to make a sustainable contribution to Nepal's development process. Reliance on technical assistance and expatriate consultants shall be gradually phased out by building domestic institutional capacity through the appropriate use of human resources, facilitating the transfer of expertise and technical know-how, and making appropriate and selective use of technical assistance. Efforts will thus be made to transform technical assistance into knowledge support through knowledge dissemination and exchange. The following factors will be considered while considering the TAs:
- TAs will be especially focused on facilitating the implementation of large projects.
 - TAs will be used for carrying out reforms in the specific socio-economic sectors, and for developing strategic directions of the country. For example, in building capacity at various central and local levels for formulating, implementing and monitoring development activities.
 - Selectivity will be maintained while opting for technical assistance in other areas. Focus will thus be more on knowledge creation than the knowledge transfer, wherever feasible. Technology transfer and adaptation will be the priority.
 - Priority will be given more to local communities, user groups and clientele groups including focus on building the capacity of existing GON networks at the local level rather than regular dependent on consultants – local and international. For this, incentive system to encourage GON staff will be reviewed through appropriate mechanisms.
 - The government will discourage the use of loan for technical assistance. To ensure the sustainability of such assistance, before accepting any TAs, local mechanism for ownership and internal management will be ensured so as to utilize the knowledge imparted from the consultants to the country's institutions and personnel. The possibility of creating TA pool will be further explored.
 - Likewise, to discourage fragmentation and reduce the total size of the TAs, International Consultants will not be solicited for small projects, i. e. below USD 1 million.
- 5.6 Volunteers:** Nepal has been receiving the services of a large number of volunteers, and their contribution to the country's development process is well-documented. However, more efforts are required to improve the relevance and quality of volunteer involvement. The government will identify specific areas in which volunteers can be productive and, on that basis, donors will be approached to recruit volunteers. The government will also ensure that a local counterpart will be assigned to work with the volunteer so that the local personnel will carry out the volunteer's task after the volunteer leaves the country upon completion of his/her tenure. .
- 5.7 Regional Technical Assistance (RETA):** Another aspect of technical assistance is Technical Cooperation between Developing Countries (TCDC). The government expects to encourage the expansion of TCDC practices, and to obtain more technical support from regional institutions. Donors will be encouraged to utilize regional technical

resources, and to source their technical cooperation activities from third countries especially from the region. A review will be conducted to update and ensure the benefits of such RETA projects in Nepal.

5.8 It is to be noted that the main objectives of TAs are to help build longer-term capacity and create knowledge base, contribute to institution building and prepare the recipients for future vulnerabilities. However, as regards capacity building, and as regards choosing the areas for TAs, support for democracy, human rights, governance, decentralization, etc. are welcome but it must come through GON system.

5.9 Streamlining aid channeled through INGOs and NGOs: Given the large number and variety of INGOs currently operating in Nepal, also in view of their valuable contribution to contribution to country's development process, it is clearly vital to have effective monitoring and reporting of these operations. The external resources channeled through INGOs will thus be monitored, and their use will be made more transparent to both to GON and to the people who are being served. Following measures will be enforced in order for streamlining the aid channeled through INGOs and NGOs:

- In order to enhance transparency and accountability, INGOs will be required to deposit all their financial resources in a current account opened in any authorized commercial bank in Nepal. All the project transactions will be mandatorily carried out through such account. The statements of such accounts will be periodically submitted to the government through Nepal Rastra Bank. The procedural details regarding this provision will be worked out by the Nepal Rastra Bank and Financial Comptroller General's Office.
- Necessary provisions in the Social Welfare Act will be made in order to ensure the uniformity in the privileges and exemptions provided to the INGOs by signing agreements with the Government of Nepal or Social Welfare Council.
- INGOs will be required to submit the financial and physical progress reports to the relevant agencies of the Government of Nepal, through the Social Welfare Council, within the stipulated time.
- The Social Welfare Council will be entrusted to prepare the annual progress reports of Non-Governmental Organizations, carrying out their activities with the utilization of foreign resources, and forward it to the concerned agencies of the Government of Nepal.
- The INGOs and NGOs will be required to carry out the Annual Public Audit of the implemented projects/programs and publish such reports in National Newspapers for the purpose of enhancing the transparency and accountability in their financial transactions as well as informing the general public about their activities and the achievements made in the intervention area.
- A "Financial Transparency and Accountability Directive" will be issued for the purpose of carrying out the audit of the activities carried out by INGOs. Such directive will include, among others, the necessary compliances to be adhered by the auditors in the audit process.
- Social Welfare Council will act as a single umbrella organization to grant approval to the Non Governmental Organizations for mobilizing the external resources under the condition of imposing no liabilities on the Government of Nepal.
- All INGOs will be required to comply with tax laws and audit requirements.

- INGOs will have to maximize the use of local human and other resources. They will need to strive for greater participation of local NGOs, encouraging leveraging and cost-sharing arrangements, and
- INGOs will be encouraged more and more to work in rural and remote areas.

5.10 Role of Civil Society: Civil Society Organizations (CSOs) are vital partners in Nepal's development process. They interact and interface with foreign aid operations at various levels. GoN recognizes that aid channeled through civil society in a transparent manner provides is a significant resource, which may be additional to regular bilateral and multilateral funds. Therefore, in order for maximizing their contribution to Nepal's development, they will be further encouraged to operate more and more in rural areas of the country, building local partnership arrangements with foreign aided projects and programs.

5.11 Role of the Private Sector: Private sector will be expected to promote CSR (Corporate Social Responsibility) initiatives where feasible, including through supporting community development projects with or without foreign aid. Foreign aid would be utilized as an important tool for private sector development in consonance with the spirit and framework of economic liberalization. Foreign aid that would run counter to the objective of sustained development of the private sector and promotion of domestic and foreign private investments will not be encouraged.

5.12 Private sector will also be involved more in co-financing **arrangements of selected capital** assistance projects, including mobilizing resources from foreign investors, and in generating complementary investments to the infrastructure activities being funded through foreign aid. The early involvement of the private sector in projects and programs will be sought so that they can explore complementary investment opportunities. The policy stance would be to provide priority to the private sector in making investments. GoN should step in only when private sector alternative is not available. The government will demarcate specific and feasible roles for the private sector in Nepal to be intensively engaged in foreign aid processes.

Major Policy Instruments

5.12 Adhering to Prudent Resource Allocation and Management Procedures: Aid effectiveness depends, *inter-alia*, on realistic budgeting, prioritization of public expenditure programs and screening of projects. In this respect, special attention will be paid to the improvement of the budget formulation process as follows:

- (i) The linkages between annual budgeting and periodic plans will be further strengthened through coordination of activities among MOF, NPC and line ministries, through the MTEF process.
- (ii) Budget allocation will follow clearly defined priorities and ranking of projects in terms of their potential for achieving sectoral and national development targets. Adequate considerations will be given to forward planning for resource needs of on-going projects and programs so as to complete projects by stipulated times and to avoid cost and time overruns, and
- (iii) In order to avoid over-stretching of the development budget, rigorous project screening and evaluation of new foreign-aided projects will be made mandatory before they are included in the development budget.

- 5.13 Joint Programming and Trust Fund Approach:** Donors will be encouraged to undertake joint programming of development assistance in order to channel resources to priority areas on the basis of their preferences and excellence and to agree on joint funding in the case of large projects requiring multi-donor involvement. With regard to the program formulation, funding and implementation modalities of such programming consultation with and leadership of the government would be required. This approach is consistent with the Multi-Donor Trust Fund such as currently working Nepal Peace Trust Fund (NPTF) which has been successfully catering to the needs and priorities of the government based on commonly agreed upon joint funding mechanism. These approaches are useful in reducing the transaction costs, avoiding duplication of efforts as well as developing effective partnerships for development. In cases where disbursements of aid resources fall below expectations, joint recipient-donor investigations would be undertaken to look into the causes responsible and suggest remedial measures.
- 5.14 Effective Project Planning and Implementation:** Project planning exercises will be undertaken at the beginning of the project cycle. Such exercises would focus, among other things, on the justifications of projects, the extent of foreign aid resources required, implementation schedules, etc. and would cover all key aspects of project formulation, identification, selection, and monitoring and evaluation. Institutional capacity for project planning exercise would be strengthened.
- 6.15** GoN will redouble its efforts to improve implementation of projects financed by domestic and foreign resources by:
- making counterpart funds available in time,
 - decentralizing decision-making authority all the way down to the project or program managers in the field, and holding them responsible for performance, and
 - enforcing donor compliance to new GoN laws on procurement that clearly spells out new procurement procedures including standard bidding documents, implementing PEFA framework, and strengthening PPMO for effective monitoring.
- 6.16 Improvement in Project Evaluation, Impact Study, Supervision and Monitoring:** Rigorous project evaluation, as well as impact studies of at least major projects will be undertaken. A strong feedback mechanism capable of incorporating voices of stakeholders and interested parties will be established. A system of "public hearing" on impact study reports of the projects will be initiated. A reasonable number of aid projects implemented under each sector will be studied on a periodic basis by independent groups of experts. Supervision as well as monitoring of the project implementation will be strengthened and established wherever necessary in order to avoid problems and to deliver expected benefits. For making supervision and monitoring effective, efforts will be made to create project-monitoring committees at operational level.
- 6.17 Encouraging "Common Pool" and Joint Financing Approach:** GoN will encourage a "common pool" approach where co-financing arrangements are involved so that implementing agencies are not bound to submit separate reports as required by multiple donors and the limited capacities of institutions are not over-stretched. The recently developed basket-funding approach that has a simpler reporting format applicable to every individual donor in the consortium will be put into operation. In this model, the cost-sharing of individual project components has to be decided mutually between donors and GoN. It requires GoN to assume full ownership in program execution. GoN shall be made accountable for program outputs and the use of funds. However, the government would also allow separate stand-alone financing of projects, as usual. Hence, there would

be two windows modality for financing projects and programs. However, irrespective of the nature of funding windows, the project should fit in sectoral priorities.

6.18 Strengthening Financial Management: The financial management of foreign-aided projects will be strengthened as follows:

- (i) Financial disbursement will be closely linked to comprehensive reporting of expenditure by spending units, including indicators of physical progress of projects.
- (ii) In foreign-aided projects/programs, submission of reimbursement claims on a timely basis will be ensured.
- (iii) Audited financial statement will be made available within six months of the completion of the fiscal year. Delays in submission of expenditure statements will be penalized.
- (iv) Retroactive financing in foreign-aided projects will not be allowed unless and otherwise agreed with the concerned donor in advance, and upon agreeing with the donors, quick disbursements for such financing will be ensured to meet the objectives of the project,
- (v) Financial accountability system will be further strengthened with effective implementation of PEFA Strategy and Action Plan, enforcement of Social or Public Audit and other harmonization procedures,
- (vi) The budget release process and its criteria will be made fully transparent, and
- (vii) Results framework or MfDR that puts emphasis on broader outcomes and impact will be fully adhered to, going beyond reading and verifying the statistics to prove progress, while evaluating the performance and delivery of the project.

6.19 Improving Disbursements: Mechanisms will be identified to increase foreign aid disbursement in order to reduce the gap between the commitment and utilization of aid funds. In order to address this problem, GoN will make necessary arrangements to reduce delays that come up at various stages. In this respect, top priority will be accorded to making project management more efficient, by addressing bottlenecks and problems, which hamper project activities and schedules. Likewise, reimbursement procedures and practices will be reviewed and actions taken to speed up the process. Donors will also be expected to become flexible and responsive for quicker disbursements and debureaucratize and simplify their procedures, including through more delegated authority from to their country offices. This would indeed go along the spirit of the Paris Principles on Aid Effectiveness which emphatically highlights 'Mutual Accountability for Results' on account of a shared responsibility of donors and the country partners.

6.20 Improving Procurement: GoN recognizes that sound procurement policies and practices are essential to fully utilize funds. In pursuance to this recognition, a new set of procurement laws has been enacted and put into effect, which has incorporated the best global practices in the field, including on developing standard bidding documents (SBDs). The new rules are in consonance with those applied in the international agencies, and donors have already shared their inputs and extended support to them. Now the issue in hand is to ensure its effective implementation, by seeking full compliance to it from the donors as well. A high-level body under the Office of the Prime Minister and Council of Ministers (OPMCM) has been in place which of course needs necessary teething before it really takes off. The gap between the country's regulatory and financial framework for procurement and donors' procurement guidelines and rules will be reduced.

- 6.21** Donors will be required to fully align their financial management system including accounting, reporting, auditing and procurement with that of the government. Equally notably, they will also be required to accept the Auditor General of Nepal as the independent and legitimate auditing authority for auditing all accounts related to foreign-aided projects.
- 6.22 Promoting Aid Effectiveness through Implementation Reforms:** There is often a concern from donors that implementation aspect needs drastic improvement to enhance aid effectiveness. To address this concern, which is mostly valid, stress will be given on complying with the measures agreed jointly during the mutual donor-GoN dialogues, consultations and M&E meetings such as NPPR regarding the choice of implementation modality, flexibility for quick disbursements, simplification of the accounting, auditing and reporting procedures, adequate supply and retention of project staff during the project period, (and in case of transfer, timely replacement and proper handover-takeover mechanism in place), transparency in performance and transactions, timely review and monitoring of agreed activities will be conducted through joint mechanisms such as NPPR and other mutual consultations.
- 6.23 Procedural Improvements:** Several procedural improvements will be further introduced and strengthened to enhance the effectiveness of foreign aid, both grants and loans. These include, among others,
- (i) rationalizing and making uniform and consistent revenue exemptions and other facilities including immunities provided in relation to aid-supported activities;
 - (ii) introducing clarity in the terms and provisions of treaties, agreements and understandings previously entered into with the donor countries and institutions with a view to improving efficiency and effectiveness of aid through standardization, coordination and uniformity in external resource management; and
 - (iii) establishing criteria for the acceptance of external aid, in light of the country's rising public debt burden, as noted earlier.

6. Institutional Arrangement

6.1 The Ministry of Finance as a government focal point for aid coordination will play a lead role in overall aid coordination and management in Nepal. The Ministry of Finance, National Planning Commission and line ministries will abide by the established practices to improve the mechanisms of aid coordination. The following mechanisms will ensure the implementation of the Foreign Aid Policy 2009, including coordination and management of foreign aid in Nepal:

- **Meeting of Nepal Development Forum** held as and when needed will provide a platform for high-level dialogue between the Government of Nepal and the Development Partners. This forum will provide broader national and international policy directions customized to the context of Nepal and endorse the updates of aid policy as well as actions for mobilization of foreign aid in Nepal.
- **A High Level Committee** headed by the Finance Minister comprising Vice-Chairman of the National Planning Commission, Finance Secretary, and the Joint Secretary at the Foreign Aid Coordination Division of the Ministry of Finance will be formed to facilitate the foreign aided projects/programs. The Joint Secretary of the Foreign Aid Coordination Division of the Ministry of Finance will act as Member-Secretary. Secretaries of the Line Ministries will be invited to the Committee meetings as and when required.
- **Local Donor Meetings** will be held regularly on bi-monthly, pre-budget and post-budget basis. This institution will ensure better dialogue and coordination between donors and the GoN and review the progress made and challenges encountered during implementation of Foreign Aid Policy, 2009 and periodic National Action Plan on Aid Effectiveness.
- **Sectoral Donor Group Meetings** will be held regularly to address the sector-related Policy and implementation issues. This mechanism will also coordinate the donors at sectoral level.
- **The planning divisions** of the respective Line Ministries will be focal points for preparation of project documents, implementation, monitoring and evaluation of the foreign aided projects/programs under their respective fields.
- **Nepal Portfolio Performance Review (NPPR)** meetings will be conducted annually for joint stock-taking of the progress in the agreed actions and joint efforts to tackle the implementation issues.
- **"Economic Diplomacy"** cell in the Missions/Embassies abroad will be established to act as contact point for providing information regarding taxation and business/investment climate in Nepal to the concerned agencies.

7. The Road Ahead

- 7.1** "Foreign Aid" by its very nomenclature denotes a charity by donors who dole out money to the recipients. This orthodox notion of aid should be changed in favor of development cooperation and partnership whose terms and conditions are primarily defined by the recipient and, when mutually agreed, implemented with the recipients sitting on the driver's seat. Aid to an aggressively progressing country like Nepal would mean all forms of "external economic resources" which are entwined more in trade, investment and private capital infusion rather than be defined as conventional aid alone. This is the age of global interdependence, and aid in its redefined way would supplement rather than replace domestic initiatives and efforts globally on a necessary scale.
- 7.2** Our challenge now is to mobilize these external resources for Nepal's development to achieve self-reliance and sustainability. The country will gradually move to that direction with increased focus on domestic resources mobilization as well as all available economic resources externally available. The country will no longer receive aid on a never-ending basis. Our abundant natural resources and cultural endowments, our hardworking, honest and dedicated workforce, our diversity and tolerance, our resilience and patience and our guts and resolve to fight against all forms injustice are our invaluable assets which should be optimally utilized for country's development. These assets can by no means be substituted with any amount of foreign money or foreign knowledge.
- 7.3** International initiatives on enhancing aid effectiveness such as Paris Principles on Aid Effectiveness and Accra Agenda for Action have clearly defined basic elements of enhancing aid management and spelt out the measures to be undertaken. They have as well stated the obligations to be met both on the part of development partners (DPs) and the Country Partners (CPs) in that direction. GoN is seriously committed to complying with them, and would expect the development partners to reciprocate in the matching spirit. The Foreign Aid Policy, 2009 is guided by these international initiatives on aid effectiveness but customized to the national context currently defined by the ongoing agenda of overall socio-economic transformation with peace, inclusive development and democracy manifested in the NDSP (2009/10-2011/12).
- 7.4** A National Action Plan (NAP) on Aid Effectiveness will be developed and adopted jointly by the GoN and the development partners that will show the road map for future foreign aid management in the spirit of Paris Principles on Aid Effectiveness and Accra Agenda for Action. The NAP is meant to localize the principles of aid effectiveness. However, it will have references with the actions to be accomplished under this policy.
- 7.5** A survey of aid effectiveness was conducted jointly with the development partners in 2008 which pointed to a number of important areas to improve and suggested a host of measures. Such surveys will be regularly conducted and their recommendations will be implemented with utmost priority. Annual implementation review of such reports will be published.
- 7.6** In nutshell, this Foreign Aid Policy will help develop a common aid effectiveness platform as envisaged through NAP which will lead Nepal's aid regime toward being more selective, harmonized and self-led process to bring out more sustainable and self-reliant outcomes for the country. All necessary and possible efforts will be made to implement this policy including through full utilization of the proposed institutional arrangement prescribed in the previous chapter.
