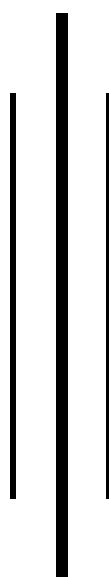


Foreign Aid Policy, 2002



**Ministry of Finance
His Majesty's Government
Kathmandu, Nepal**

Table of Contents

1.	Overview: Role of Foreign Aid	1
2.	Aid Performance: Key Issues	3
3.	The Changing Context of Foreign Aid Policy	9
4.	Guiding Principles and Objectives	13
5.	Aid Priorities for the Short Term	16
6.	Aid Priorities for the Long Term	19
7.	Major Policies	21
8.	Major Strategies	29
9.	Major Policy Instruments	33
10.	Government-Donor Interaction and Dialogue	37
11.	Agenda Ahead	39

1. Overview: Role of Foreign Aid

- 1.1 Foreign aid as an instrument of financing socio-economic development dates back to mid-fifties, when Nepal embarked on the process of planned development with the launching of the First Five Year Development Plan, 1956-61. Since then, a substantial portion of development expenditure averaging about 55 percent per annum has been financed through foreign aid. Currently, foreign assistance remains around 5-6 percent of Gross Domestic Product (GDP) annually, and finances about 25-30 percent of total government expenditure. In terms of sectoral distribution of foreign aid, agriculture, forestry and fisheries have received the largest share followed by energy, transport, health, social development, and human resource development.
- 1.2 Foreign aid continues to play an important role in Nepal's development. Apart from its contribution to sustaining public investment, foreign aid is crucial to meeting the objective of poverty reduction, as articulated in the recent government Five Year Plans, through achieving high and sustainable rates of economic growth and through underpinning critical sectoral programs and activities. In the context of the Nepalese economy, which is characterized by structural bottlenecks, large fiscal and external deficits and significant imbalances between savings and investment ratios, the role of foreign aid is particularly significant. It helps to: (i) supplement and enhance Nepal's meager domestic saving so as to mobilize increasing resources for poverty alleviation, (ii) channel increased resources towards priority sectors of the economy to accelerate development activity, (iii) create an environment for attracting foreign direct investment and promoting private sector investment, and (iv) improve the nation's capacity to identify, evaluate and adapt technology to accelerate production and productivity of the economy, which is one of the basic conditions for achieving the poverty alleviation objective.

1.3 Nepal's foreign aid structure has undergone significant changes in recent years. The share of bilateral assistance in total aid has declined to around one-fourth currently. Similarly, the share of grant assistance in total aid continues to dwindle, while that of loans has recorded a significant increase to around three-fourth of the total aid. Another striking feature of the current pattern of foreign aid is the increasing share of technical assistance in total foreign aid. Over 40 percent of all aid now is technical assistance; and free standing technical assistance, which accounts for the bulk of technical assistance, has increased during the 1990-1999 period at an annual average rate of 17 percent. With the steady rise in the ratio of loans in total aid, the outstanding external debt stock of the government currently reaches around 55 percent of GDP, which is not particularly high by the standards of developing countries, but nevertheless a growing burden for Nepal.

1.4 Recognizing the critical role that foreign aid occupies in the economy, this policy paper seeks to analyze the processes, problems and prospects of the foreign aid so as to maximize its impact and effectiveness in terms of achieving better development results and to meet increased aid requirements to help finance development activities. The paper begins with a brief review of past performance of, and problems associated with, aid from both donor and national perspectives. It then outlines the steps the government is implementing to address these concerns, including the incorporation of new guidelines, strategies and policies aimed at influencing/regulating the flow and composition of aid and for ensuring better utilization of such assistance. It also includes discussion about the implications of the new policy for donor assistance, and what adjustments donors themselves will need to make in their assistance programs and policies in order to support Nepal's development effort.

2. Aid Performance: Key Issues

2.1 Nepal is considered a late starter in development in the South Asian region. The country was opened to the outside world only in the early fifties; and planned development efforts and aid inflows began almost simultaneously. Over time, foreign aid has proved to be an effective instrument contributing to significant improvements in the socio-economic development of the country; and much of the physical infrastructure such as roads, irrigation facilities, hydropower as well as education and health services, drinking water and sanitation facilities have been built with foreign assistance. It has also contributed to the development of policy dialogue, catalyzed economic reforms, enhanced the capability of public policymakers; and provided financial assistance for public services. A longitudinal relationship can be observed across foreign aid, economic reform and development in Nepal. Notwithstanding these achievements, foreign aid in Nepal has had its shortcomings as well. Progress in economic growth and poverty reduction has not been commensurate with the inflow of aid into the country. Foreign aid has thus become very effective in some areas but less effective in others. This perception of mixed results is strongly shared by the donor community as well as the Nepalese recipients.

2.2 Of course, general problems associated with foreign aid are not unique to Nepal. Elsewhere, both recipient and donor countries have expressed major concerns regarding the policies, practices and procedures that govern foreign aid. Although there are common issues that concern most recipient countries, there are also problems unique to individual countries. In Nepal's case, there are many country-specific constraints, such as shortcomings in institutional capacities, its geographical location and mountainous terrain, widespread poverty, its high rate of population growth and urgent environmental concerns, among others, which pose daunting challenges to development and the effective absorption of aid. When examining the problems relating to foreign aid, it is essential that these special challenges confronting Nepal be borne in mind. Sometimes this is not the case, suggesting that there is probably need for enhanced mutual understanding among some of Nepal's development partners with regard to these problems.

2.3 Despite an increasing flow of external resources for Nepal's development, the country has not been able to optimize the gains from aid. Discrepancy between the results achieved from aid resources and their potential for enhancement is still wide. There are many reasons for this. The growth impulses generated from past investments have remained weak, fundamentals of overall economic environment continue to remain shaky, absorptive capacity has not significantly increased and institutional capacity in many areas is inadequate to respond to development needs. It is rather disappointing that such a situation continues to persist, despite efforts spanning almost five decades and the increasing inflow of financial and technical assistance into the country. The key problems contributing to ineffective foreign aid management and poor development results from both the donor and country perspectives are briefly outlined below.

Donor Perspectives

2.4 Over the past few years (leading up to the Nepal Development Forum (NDF) meeting held in Paris in April 2000 and thereafter), there has been considerable discussion about the mixed record of aid effectiveness in Nepal, the factors contributing to this phenomenon and possible solutions to the problem. Among the major concerns identified by the donor community have been the following: lack of ownership by His Majesty's Government (HMG) of development projects and programs, particularly those financed by donors; lack of leadership and direction by HMG, particularly in expenditure prioritization and taking more responsibility in designing, preparing and implementing projects and programs; a poor, often unrealistic, and top-down planning and budgeting process with little involvement of other stakeholders, including local level institutions, community groups and beneficiaries in program preparation and implementation; pressure to increase development projects and programs beyond the levels that can be effectively handled within the constraints of the country's limited institutional and absorptive capacity; poorly functioning institutions, particularly a dysfunctional and under-paid civil service, with little incentives and motivation to improve its performance; poor program supervision and monitoring, in turn, leading to lack of accountability and transparency, leakages and misuse of resources; and so on. To circumvent these problems, while urging the government to take more ownership and leadership, some

donors have reduced their aid levels and formulated strong conditions in their aid programs; others have begun to work more directly with local bodies, Non-governmental Organizations (NGOs) and community groups; or to engage their own implementing agencies and consultancy companies.

National Perspectives

2.5 These donor perceptions are largely shared by the Nepalese recipients, who also see donor behavior and practices as important factors contributing to the problem of lack of aid effectiveness.

2.6 As seen by the Nepalese, there is a mismatch between development priorities as determined by Nepal and the priorities of donor countries and institutions. Considerable efforts have been made to reconcile Nepal's priorities and those of its donors. Despite these efforts, there is the perception that many projects and programs are still excessively driven by donor demands. As a consequence, the effectiveness of foreign aid is reduced. The solution to this mismatch, as widely recognized now, lies in the government taking the lead, in consultation with local stakeholders, in setting national priorities (on the basis of the needs of local people and of the country), taking note of their values and capacities and what is manageable and feasible in the particular circumstances of the country. This needs to be accompanied by an improvement on the part of the donors in matching their priorities with those of Nepal.

2.7 The lack of an adequate project planning and management system that involves rigorous review of project formulation, implementation, supervision and evaluation, has also prevented the economy from deriving maximum benefits from aid-financed investments. This has led to the implementation of many projects, which do not reflect people's requirements, values and capacities, resulting in inefficient resource allocation and ineffective use of aid resources. In many cases, sustainability and the operation and maintenance aspects of the projects were altogether lost sight of. A large number of projects, as noted, suffer from the lack of ownership by the government and by

the people whom the projects are intended to benefit. Further, in the absence of adequate appraisal, foreign aid has been frittered away on many smaller projects for which such aid may be unnecessary or even undesirable from the country's long-term perspective.

2.8 Nepal receives aid from a large number of donor countries and organizations. In the absence of prioritization based on sectoral and national needs and effective donor coordination on the basis of such prioritization, there have been difficulties in coordinating and establishing complementarities between these aid channels. Each donor agency may have its own policies, priorities and perceptions of Nepal's needs which at times are not only divergent but also are contradictory to each other. Foreign aid does not always flow into the sectors where it is most needed; and, as a consequence, there are significant resource gaps in many sectors. It is quite difficult and, at times, time-consuming to bring about a convergence in donors' diverse perceptions. Thus, aid coordination has become a burdensome and cumbersome task.

2.9 An increasing concern especially from the Nepalese perspective is the changing composition of foreign aid. Of the total foreign aid received in 1999, capital assistance accounts for only half, and technical assistance accounts for around 40 percent, with the residual 10 percent being balance of payments support and emergency and relief assistance. The share of technical assistance has increased rapidly, whether this is the most appropriate allocation of foreign aid resources is a matter that needs to be reviewed by both donors and Nepal.

2.10 Technical assistance has fallen short of the contribution that it could have made, largely attributed to excessive reliance on foreign expertise. Technical assistance linked to capital assistance has so far not made optimal use of technical manpower available in the country. A result of this, there has been the adoption of inappropriate technologies. Even in freestanding technical assistance, there is a tendency to depend excessively on foreign expertise instead of tapping local technical capacities, with a view to upgrading local institutions. Technical assistance, especially when obtained through loans instead of grants, creates enormous burdens for the future in least developed countries like Nepal.

- 2.11 Foreign aided projects often involve choices in the types of technologies utilized at various levels of their operation, whatever the sectors they are in. Nepal still does not have an appropriate and effective mechanism to evaluate technology aspects of foreign assistance, particularly capital assistance. This is especially true of turnkey projects where the decisions with regard to technology to be used are entirely determined from outside. This has implications on the long-term sustainability of such projects and their repair and maintenance. There is inadequate or no provision for Research and Development (R&D), which is essential for minimizing costs and improving the quality of the products.
- 2.12 The conditionalities that are linked to the provision of foreign aid vary between donor institutions and projects and programs. The practice of enforcing conditionalities tied to aid present another set of problems in terms of making best use of available foreign resources. Further, the practice has constrained the use of appropriate and less costly technology, materials and services. On account of various policy-related and procedural conditionalities, which are at times not compatible with the prevailing situation and the needs of the country, aid has had not only a limited beneficial impact but has, at times, run counter to the outcomes expected from some projects. While donors need some conditionality, they need to be looked at and agreed jointly by the donors and the government. The formulation of, and adherence to, sectoral program frameworks, as suggested below, would help to minimize and rationalize such conditionalities.
- 2.13 Disbursing the aid committed to Nepal has been a slow process. The weaknesses in the country's institutional capacities 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 limitations inherent in Nepal. Taking account of institutional capacities within the country and planning projects on that basis would provide for more realistic disbursement patterns. It is not only a matter of refining procedures but also streamlining problems, which starts with the conception and design of projects themselves; and these aspects need improvement.
- 2.14 Sizeable amounts of foreign aid have been flowing through various Non-Governmental Organizations. While these organizations

are making an important contribution, some of them have also established their own priorities and methodologies of operation, without adequate regard to development priorities of the country, and also to the overriding need to create sustainability. Their resource use seldom reflects national priorities, nor are they transparent in terms of the sources and amounts of resources utilized by them. To ensure greater consistency with national priorities, better use of aid resources, and greater transparency, it is necessary to improve the reporting and monitoring of resources channeled to such organizations. A similar problem is that the aid resources available to HMG 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.

2.15 Project implementation capacity of the economy is less than satisfactory. Lack of sound information system and the absence of regular supervision and monitoring are major deterrents to the smooth implementation of programs and projects. As a consequence, most projects suffer from time and cost overruns.

2.16 Over the years, HMG'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 budget. Therefore, Nepal needs to be highly selective and productive in utilizing such loans as discussed below.

These are some of the major problems, which have hampered the efficient and effective utilization of foreign aid. A major reason for this state of affairs has to do with the lack of policies and guidelines required for streamlining aid activities. It is natural that, in the absence of such national perspectives and policies, development projects may at times be heavily influenced by donors' priorities and perceptions; and not fully related to local needs and requirements. The new foreign aid policy seeks to address these issues.

3. The Changing Context of Foreign Aid Policy

3.1 Nepal has been implementing development programs and economic reforms in the context of a development framework, which has evolved largely on the basis of international development experience and interactions between global community and the government of Nepal. In the last decade, many major changes were evident, nationally and internationally, in the milieu and circumstances in which development cooperation is practiced. Notably, development paradigms themselves have undergone significant changes, with the phenomenon of globalization; the dramatic transformation in the role of the state, markets and civil society organizations; and increased emphasis on cross-cutting issues such as gender, governance, transparency and decentralization, and so on. There is also recognition that economic and social issues can only be addressed effectively through linking up activities across sectors and themes, instead of compartmentalizing them through isolated projects and programs. These perceptions, in turn, have heightened the need for aid recipient countries to formulate carefully designed holistic strategies to combat poverty, focusing more on (poverty reducing) outputs and outcomes and more closely linking development projects/programs and activities to national and sectoral goals. To complement these initiatives, holistic approaches to foreign aid policy and development cooperation have become imperative for external donors also.

3.2 These trends, in varying ways, shape the nature and content of development cooperation and foreign aid. Given these new trends and perceptions on the part of the international development community, and also of the development community in Nepal, it behoves the government to analyze and examine the fundamental premises that underpin the foreign aid policy of the country. Ineffective aid policies and practices, be it on the part of government or donors, can be damaging to economic development and good governance, while also having other major deleterious effects. Conversely, a foreign aid policy, which reduces compartmentalization and improves efficiency

and transparency, should make an important contribution to the development process.

3.3 Current development parlance has laid stress on partnerships in development between donors and recipients. Unfortunately, least developed recipient countries - such as Nepal – need to strive hard to match the sophistication and resources, both technical and financial, available to the donor community, in order to become equal and meaningful development partners. In the case of Nepal, donors claim donor fatigue and are also, to some extent, disillusioned by the slow and imperfect outcomes from development cooperation. This aspect is well documented. Similarly, though less documented, there is also disillusionment among the government and local stakeholders with the policies, processes and practices of foreign aid. Therefore, it is necessary that the foreign aid policy process be reinvigorated, so that there is greater mutual understanding between and among development partners and that realistic solutions are sought to a range of entrenched problems.

3.4 The government recognizes that globally agreed principles, conventions, policies and frameworks increasingly guide development assistance from external sources. There is a large area of consensus and agreement on the development policies to be pursued, at national and international levels. Nepal has been a party to most of the international agreements, arrangements, and consensuses so far agreed upon. Nepal is committed to UN targets for poverty reduction, 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. In developing Nepal's development policies, and in utilizing foreign assistance, Nepal aims at achieving these internationally agreed measures and targets.

3.5 Nepal attaches the highest priority to reducing poverty. Almost half the people of the country are below the absolute poverty line; and, as a democracy, the government is deeply committed to reducing poverty among those who are absolutely poor. Sustainable reduction of poverty can only be achieved through balanced strategies of development, which attach equal importance to economic growth and social investment. The aim is to make an impact in reducing both income and human poverty. Economic growth is an essential

precondition to poverty reduction. Without it, other forms of public actions will not be productive. Equally, economic growth has to be accompanied by increasing social welfare. Social improvements in education and health themselves will make an important contribution to economic growth. The government has predicated its public interventions on the basis of creating a virtuous cycle of economic and social enlistment. Economic and social investments can both be productive and yield high returns within such a development framework. Especially for the reduction of poverty, foreign aid will have to be mobilized and utilized within such a framework.

3.6 The government also recognizes the importance of adapting its development policies in line with the evolving development paradigms as well as the critical need to address the weaknesses and shortcomings identified earlier, which hamper aid effectiveness in Nepal. Accordingly, Nepal has undertaken several initiatives since the NDF meeting in 2000. Of direct relevance to aid policy is the formulation of an Interim Poverty Reduction Strategy Paper (I-PRSP) in July 2001, the ongoing preparation of the Tenth Plan (government's full PRSP), which will be finalized in September 2002 and the establishment of Poverty Alleviation Fund. The Tenth Plan is expected to be a significant departure from past plans in that: (i) it focuses far more sharply in a holistic manner on poverty reduction as the primary goal of government's development efforts; (ii) It seeks to link development activities more directly with national and sectoral goals and targets and poverty reducing outcomes (rather than focusing simply on targets, inputs and commitments as in the past); and (iii) It also seeks to achieve a greater degree of realism in terms of setting targets and aligning the resource framework and annual budgets in line with financial and implementation capacity.

3.7 While external assistance inflows need to be largely guided by longer-term development perspectives, it is also necessary to take into consideration the short-to-medium term imperatives Nepal is facing. Two major elements in this regard are: (i) The challenge to internal security. Apart from slowing down development activity in remote areas, it has created new demands for security-related expenditures in an unprecedented scale; (ii) The downturn in the economy, which is partly a bi-product of the global recession and partly the result of a

constellation of unfavorable domestic events, of which the security threat is a major element. As a result, Nepal is now facing unprecedented budgetary pressures. Despite the government's efforts to generate additional revenues, domestic resources available for financing development activity is being severely constrained. This has necessitated adjustments in the Tenth Plan's macroeconomic framework, even as the Plan is being finalized. Accordingly, to align the Plan with the realities of current fiscal situation and to protect its key priorities, the government is now preparing, for the first time in Nepal's history, a Medium Term Expenditure Framework (MTEF). The MTEF needs to be viewed: (i) Not as an alternative to the Tenth Plan, but as an operational tool to implement the Tenth Plan, by providing a bridge between the annual budget cycle and the Tenth Plan framework; (ii) It also represents the first genuine attempt by the Government to prioritize the public expenditure program and to bring much needed realism to the annual budget allocation process; (iii) Equally important, it represents the government's own initiative to counter the fiscal crisis. The key sector programs underpinning the MTEF being prepared and owned by the line ministries themselves, in collaboration with the Ministry of Finance and the National Planning Commission; and are finalized after extensive consultations with local stakeholders, to serve as the basis of sectoral programs in the Budget. (iv) The I-PRSP, the Tenth Plan and the MTEF would collectively represent a new poverty-focused approach to public resource management; and in turn is expected to be the basis for a new compact between the donor community and the government on future assistance to Nepal.

- 3.8 The role of the government is changing elsewhere in the world and in Nepal, too, the government would not possibly be functioning the way it is now. Therefore, a review of government's role in economic and social activities in the changing environment would periodically be done. If opportunities for the government to devolve or contract out the provision of many public goods and services for their effectiveness were identified then the government resources would be used to engage civil society, local bodies and private sector in such activities. The government will increasingly present itself as a facilitator and enabler.

3.9

It is against this backdrop that the present foreign aid policy document has been prepared. This document is expected to shape the evolving pattern of Nepal's relationship with her development partners while, at the same time, guide all -- HMG, the civil society, and the donor community -- in making the best use of scarce resources for development. The policy is relevant both for the short as well as for medium-to-longer term. But, as changes in the structure and in the important variables of the economy take place, the policy paper have to incorporate them from time to time, in order to be responsive to changing needs and circumstances.

4. Guiding Principles and Objectives

4.1 Foreign aid policy is largely an integral part of a country's development policies and priorities. Unless the two are closely integrated, effectiveness and efficiency are bound to suffer. Foreign aid is received from many donor institutions, each one of them with its own approaches, policies, procedures and practices. Unless there is greater consistency and compatibility among the diverse sources of foreign aid, recipient countries such as Nepal will be confronted with serious problems. Although there has been considerable progress in reconciling varying donor policies and practices, there are many aspects that need to be improved. Nepal cannot afford parallel aid systems in various sectors, operated through compartmentalized projects and programs. The policy elements that follow are primarily aimed at improving the current aid and development situation. Ensuring consistency within and between all policies with regard to the involvement of civil society organizations is also essential.

4.2 The policies and strategies that are outlined in this document have been drawn from accumulated experience of foreign aid projects and programs in Nepal. There is a significant cultural gap between donor institutions and those of Nepal. What works in one country may not in another. As a least-developed country, Nepal lacks the capacity, both institutional and personnel. Therefore, project and program design and implementation methodologies have to take full account of these institutional weaknesses as well as the tremendous challenges that confront implementing authorities. The policies that are outlined here is an attempt to take realistic account of these problems.

Guiding Principles

4.3 The objectives and priorities elaborated in subsequent paragraphs with regard to foreign aid are guided by five broad principles:

(i) Foreign aid will need to be directed towards achieving the overarching national goal of poverty reduction. This will involve fostering

economic growth by enhancing the productive capacity of the economy as well as supporting critical social infrastructure needs. It should also include appropriate support for making the best use of the infrastructure base, which has already been created and will be created, to further promote, expand and sustain the development process.

- (ii) The role of foreign aid should not be viewed only in the context of supporting individual projects. It needs to be related to the needs and priorities at economy-wide and at sectoral levels, recognizing that sectoral policies constitute integral elements of the economy-wide policy; and individual donor assisted projects/operations need to be consistent with the sectoral objectives.
- (iii) The foreign aid policy forms an integral part of the overall policy of mobilizing resources for development.
- (iv) The foreign aid policy will ensure greater transparency at both the official development assistance supply and user levels within and outside the government system.
- (v) While increasing quality and quantity of foreign aid during short and the medium term, the government would try to achieve self-reliance in the longer term by enhancing domestic resource mobilization.

The Objectives

4.4 HMG recognizes that foreign aid policy has to be guided by a long-term vision, but should also incorporate the short-term imperatives of the country. For the longer term, this would imply that foreign aid would be effectively integrated into the overall resource mobilization framework of Nepal, to help finance and support Nepal's development endeavors, particularly to achieve poverty reduction goals. This is also important in the short term; but, as discussed below, there are other considerations also which should guide the composition of aid.

4.5 The broad objectives of aid policy, which are to be achieved through the adoption of policies and strategies outlined below, include among others, the following:

- (i) To ensure the compatibility and convergence of foreign-aided development activities with nationally determined development priorities. Through greater convergence between foreign-aided projects and national priorities, aid-supported activities become an integral part of the overall development process.
- (ii) To improve the quality, effectiveness and efficiency of foreign aid operations. A broad range of appropriate policies and practices on the part of Nepal and donors – in project selection, design, management, review, monitoring and evaluation – are imperative.
- (iii) To enhance the contribution to poverty reduction through enabling higher rates of economic growth while ensuring distributional equity. This would require improved linkages with civil society organizations and the private sector, and also establishing complementarities between aid and other economic policies, and utilizing foreign aid more effectively to address issues such as governance, gender and the environment, among others.
- (iv) To facilitate the transition to a more equal partnership between Nepal and donor institutions. This objective is aimed at transferring the spirit of development partnership emerging at the global level to the country level dialogue and operations.

4.6 In light of rapidly evolving short-term needs of the economy and the importance of mitigating the constraints undermining the effective use of aid resources, short-to-medium term aid policy priorities are discussed in the next section. The longer-term considerations, which should guide external aid policy, are discussed in later sections.

5. Aid Priorities For The Short Term

5.1 The foregoing discussion highlights the challenges facing the donors and the Nepalese counterparts for improving the performance of external aid in Nepal. As noted, the government has launched important initiatives to address these concerns particularly through the formation of a PRSP and MTEF, and associated changes in the budget allocation and management process. The PRSP/MTEF clearly tries to improve the focus of the public expenditure program, with the government taking the leadership in, and ownership of, the process. As noted, the MTEF is driven by a realistic assessment of resource availability -- the hard budget constraint -- in contrast to the previous “needs-based” approach; with the objective of avoiding over-programming, (which has plagued the previous budgets and plans), for achieving a significant degree of rationalization and prioritization of development programs and activities. Although much remains to be done in the coming months, this is clearly a new beginning on the part of the government to tackle boldly the major impediments hampering the effectiveness of public expenditure and aid programs. In particular, winning support for expenditure prioritization among the political leadership and other stakeholders who might be affected by the process remains a challenge.

5.2 The MTEF process will have important implications not only for the Nepalese counterparts but also for the donor community. At this time, it is possible to briefly point out what the short-term implications for foreign aid are likely to be. These would be discussed fully in the MTEF documentation when they are finalized.

- (i) The priorities in the MTEF will closely reflect the national priorities identified in the Tenth Plan/ PRSP. The donor community will need to respect and adhere to these priorities, if the persistent problem of “donor driven” nature of development in Nepal is to be overcome. Where there are differences of views, donor community and the Nepalese counterparts will need to enter into a pro-active and productive dialogue in the coming months to resolve these differences.

- (ii) The key message of the MTEF process is that Nepal needs to consolidate its development program at this time in line with the realities of resource availability. This would mean that few new projects can be accommodated, i.e. what is needed at this time is not simply more project aid. As the resource situation and implementation capacity improves over the following year and as ongoing projects are completed, there will be scope for new projects, provided they are within the national priorities identified by the government.
- (iii) There needs to be greater emphasis on sectoral programs, since an important goal of the MTEF and the PRSP would be to undertake those activities, which have a more direct impact on national and sectoral, poverty alleviation and growth objectives. In funding sectoral programs, basket-funding approach would be encouraged. However, it will still be possible for individual donors to take up stand-alone projects, so long as they fit within the sectoral priorities.
- (iv) The MTEF and the PRSP focus more on outcomes and outputs and service delivery aspects of key programs, instead of the traditional input-focused approach. A major feature of the new approach is that it emphasizes better use of existing capital/investments through adequate funding of essential operational and maintenance activities instead of focusing simply on new investment. (To facilitate such a shift and to monitor the effective utilization of funds for recurrent activities, the government will be introducing important changes in budget classification). External aid would be expected to assist such a shift by providing support for essential operational and maintenance expenditures and similar recurrent components, which would maximize benefits and service delivery.
- (v) The most important shift that would need to occur in the short-term is in the composition of aid. In the present fiscal situation, the government will be channeling a substantial part of its revenue to increased regular and hard-budgets. This would seriously reduce government funding available for development activities. The need of the hour, therefore, from Nepal's perspective, is budget support in the form of cash grants and loans, and sectoral/program support.

- (vi) The government is quite aware that it would need to reassure donors about fungibility concerns. Indeed, it recognizes that improving the budget allocation process through the MTEF is only one side of the coin, and that it needs to improve implementation and expenditure monitoring at all levels. Over the coming months, the government is expected to finalize such arrangements, in consultation with, and support from, donors. A Country Financial Accountability Assessment (CFAA) with assistance from multilateral institutions, together with budget classification improvements noted earlier, has been completed for this purpose. In addition, technical assistance programs will need to be strengthened, with support from donors, at critical levels – for example, in line ministries and at the levels of districts and local institutions-for enhancing the implementation, monitoring and accountability aspects.

6. Aid Priorities For The Long Term

- 6.1 In view of limited human, economic and other resources relative to persistent and growing claims on them, Nepal cannot afford to undertake an unlimited number of investment programs. Hence, as a matter of policy, the country has to be extremely cautious and selective in making investment decisions. In this context, the guidelines for aid policy for the longer term will not be significantly different from those applicable for the short term.
- 6.2 Foreign aid has to be channeled to those sectors and sub-sectors, which have been identified by the government as national priority areas. In broad terms, these include infrastructure development (energy, transport, tourism, science and technology), agriculture, irrigation and forestry including the environment, human resource and social development, education, health, population, and to specific activities focusing on poverty alleviation, employment promotion and development of backward regions. Within these broad sectors and issues, emphasis will be placed on areas such as rural infrastructure development including rural electrification and rural roads and transport, minor irrigation and agricultural extension and crop diversification, and basic and technical education, public health, access to drinking water and addressing the population problem. Foreign aid will be utilized in these sectors and sub-sectors to improve primarily the outlook of economic growth and poverty reduction as well as capacity building.
- 6.3 Foreign aid would also need to be channeled within the priority sectors/sub-sectors, toward those activities that have relatively high economic and social returns. Efforts would be made to keep the inflow of foreign aid consistent with, and reinforcing, economic reform programs. Priority projects would be selected on the basis of predetermined objective criteria.
- 6.4 There are obvious linkages between and among priority sectors and related issues. Assistance for priority sectors/sub-sectors/activities would be identified in a manner that could maximize the gains from such assistance, keeping in mind the spillover effects

on others also, so that assistance in one area would also provide benefits to other sectors/sub-sectors/areas. In utilizing foreign aid, an essential policy consideration would be to ensure that the complementarities and inter-relationships between projects and programs are clearly established and that the synergies, which can be derived from collaborative approaches, are fully realized. Channeling of aid has to a large extent been compartmentalized and fragmented through focusing on individual projects and programs. Such compartmentalized approaches would be overcome through a more holistic and integrated approach. In doing so, cross-cutting issues which impinge largely on current poverty patterns -- gender, environment, and efficient forms of governance and management -- will also be given close consideration in the design of projects and programs. However, the government will not encourage developing discrete or individual projects around such cross-cutting issues. However, this will not preclude targeted programs and specific intervention to address the cross-cutting issues. And, rather than making such aspects the major investment components of assistance, all cross-cutting issues would be built-in within the priority investment programs. An important policy consideration in channeling foreign aid will be to explore inter-linkages between development issues.

- 6.5 Efforts will be made to look at the aid needs in the priority areas/sectors within the context of sectoral frameworks, which will take into account not only “development/investment” needs, but also recurrent expenditure requirements to maximize the benefits from existing assets. Donors will be encouraged to finance sectoral needs, while the government will strive to increasingly shoulder recurring overhead expenditures. As noted, key projects/activities in each of the priority areas will be identified and ranked in terms of sectoral priorities, and will be subjected to careful scrutiny and evaluation, so that donors who would wish to take up free standing projects would be able to do so within a sectoral context.

7. Major Policies

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

7.1 Concessional Loans: Loan assistance would be utilized selectively, after careful scrutiny of the purpose, content and benefits of such projects and programs 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 projects and infrastructure development promising high returns on investments, (ii) analyzing the various 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 HMG by protecting against exchange rate fluctuations. To reduce the potential debt burden, the government will also: (v) stop the use of loans for higher studies and study visits, (vi) minimize the expenditure on consultants and foreign experts out of loan assistance, (vii) not take any commercial and suppliers' credits. (however, it will not preclude mixed credits), and (viii) not guarantee foreign loans for HMG-owned or other institutions.

7.2 Grant Aid: Since grants will not constitute the burden for the future generations and also do not constrain the already tight fiscal structure of HMG, Nepal needs to encourage aid more in such form and utilize them most effectively. So, the government's policy will be to seek grants first and, in the event grant assistance is not forthcoming, seek highly concessional loans. Action will be taken to facilitate arrangements to associate concessional loans

with grant finance whenever that is appropriate. Many project and program components are more appropriate for grant financing than concessional financing in least developing countries like Nepal. Technical assistance for project design, institutional and capacity building, technical backstopping, and project monitoring and review are more suitable for grant financing than for concessional loans. Co-financing arrangements through grants shall be emphasized for financing expenses of overhead and technical support of projects.

7.3 Budget Support: As 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 budget support under appropriate circumstances.

7.4 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 reduced 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. Technical assistance would be especially focused on facilitating the implementation of large projects, carrying out reforms in the specific socio-economic sectors, and on the functions related to 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 would be pursued while opting for technical assistance in other areas. The government will discourage the use of loan for technical assistance.

7.5 There are broadly two types of technical assistance – free standing technical assistance and project-related technical assistance. In regard to the former, many donors have increased the local component in sourcing such assistance. Through increased recourse to local talent and expertise, technical assistance helps to build the capacities of local institutions and personnel, in addition to providing financial support to the country. However, this process has further to go, and donors will be encouraged to hire

local resources wherever possible for free standing technical assistance to build up local institutional and technical capacities.

7.6 With regard to project-related technical assistance, the policy of the government will be clearly to stimulate and encourage the greater use of local consultancy expertise when designing projects. Apart from building their capacities, this would also contribute to enriching the quality of projects and programs, by taking account of local circumstances, local needs and capabilities, and by selecting more appropriate forms of technology that are sustainable in the longer term. Donor institutions should view this as an effort by government to enhance the quality of the development process and for ensuring more cost-effective and higher-yielding investments through the appropriate use of relevant personnel and technologies.

7.7 Two other aspects of technical assistance need to be addressed. Nepal has received the services of a large number of volunteers, and their contribution to the country's development process is appreciated. 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. 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.

7.8 **Revenue Mobilization:** For a low-income country such as Nepal, opportunities for increased revenue mobilization are limited. In this context, foreign aid can make an important contribution to augment the resource available to the country for development purposes: It can directly supplement government revenues, as noted earlier. It can also indirectly help the government to mobilize additional revenues in several ways: (i) Technical assistance can help to improve capacity of the tax administration is one way. (ii) It can help expand the revenue base through its contribution to accelerating economic growth. This explicitly calls

for policies by government to select projects, which will stimulate economic growth in the short and medium term. This will be an important aspect of the policies determining the selection of projects. (iii) Foreign aid can also be used to finance projects that directly bring increased government revenues. Accordingly, consideration will be given to using foreign aid to finance projects, which will bring about improvements in the domestic revenue mobilization capacity by raising GDP and employment, and achieving high economic growth targets.

7.9 Under-utilized Capital Stock: Investment activities in the public sector have not generated returns and revenues at an appropriate level. For many reasons – scarcity of financial resources, shortcomings in management, delays in repair and maintenance, inappropriate investments – the capital stock owned by the public sector is under-utilized. Foreign aid can be a catalyst to improve the efficiency in utilization of the country's capital stock, especially by financing critical inputs, supplies and other relevant recurrent expenditure items, excluding however, general recurring overhead. Small-scale interventions at critical points in sectoral operations can also have immediate benefits. Foreign aid will be sought for activities aimed at increased efficiency and better use of the existing stock of capital. Promoting program and commodity assistance of this kind will be an important aspect of the foreign aid policy.

7.10 Building National Capacity and Partnership: Foreign aid would be utilized to strengthen national capacity by encouraging the Nepalese to assume leadership role in project management. Special attention will be given to strengthen the planning cells of line ministries. Coordination between the stakeholders will be strengthened through the establishment of an effective communications network. Partnership among the government, private sector, the civil society (mainly Non-governmental Development Organizations - NGDOs and community-based organizations) and the donors would be fostered to strengthen domestic aid management capacity. Building effective partnership with stakeholders in each stage of project planning and implementation will help maximize the benefits from projects, enhance their sustainability, reduce corruption, and strengthen

governance. In addition, the public-private partnership helps develop the private sector and eventually raise national capacity in managing development activities.

7.11 A Framework for International Non-governmental Organizations (INGOs): INGOs are valued development partners of the country. They have capacities and experiences elsewhere, which can be transmitted to Nepal, especially in support of HMG's development programs in rural and remote areas of the country. INGOs bring many resources and expertise to Nepal from sources such as foundations, the private sector and the general public in other countries. They also use bilateral, multilateral and other sources of official development assistance. In addition, INGOs contribute greatly to raising positive awareness about development issues and about Nepal in their respective countries. They also have a comparative advantage in various areas. However, given the large number and variety of INGOs currently operating in Nepal, it is clearly vital to have effective monitoring and reporting of these operations. The government has a right to know the source and amount of resources being brought in Nepal by INGO as well as their uses, both for reasons of transparency and for planning sectoral programs and activities. The external resources channeled through INGOs will thus be monitored, and their use will be made more transparent to HMG and to the people being served. This would be achieved by: (i) simplification in administrative systems in matters relating to INGO registration, renewal and use of facilities, (ii) utilizing the social welfare council as a single umbrella organization through which INGO registration and other administrative support can be provided, (iii) enhancing the capacity of the social welfare council to coordinate and monitor INGOs activities, (iv) ensuring that all INGOs register with the Social Welfare Council. Arrangements would be made to enter into project agreements with the relevant agencies under the framework of INGO registration, (v) ensuring INGOs establish linkages with local bodies and stakeholders as per the Local Self-Governance Act, as applicable, (vi) requiring INGOs to comply with tax laws, exemptions and audit requirements, (vii) ensuring INGOs maximize the use of local human and other resources, (viii) ensuring that bilateral funds made available within Nepal for local NGDOs initiatives are available primarily for the use of local

NGDOs and community-based organizations, (ix) striving for greater participation of local NGDOs, and partnerships between INGOs and local NGDOs, on open development assistance competitive processes, (x) encouraging leveraging and cost-sharing arrangements, (xi) emphasizing the importance for INGOs to carry out their programs in partnership with local bodies and local NGDOs, instead of doing it directly by themselves, (xii) providing equal treatment to local NGDOs by the INGOs and selecting local NGDOs for partnerships on the basis of transparent and objective criteria, and (xiii) encouraging INGOs to work in rural and remote areas.

7.12 Ensuring Leadership and Ownership of HMG: Ownership of foreign-aided development activities by HMG and beneficiaries will be ensured for enhancing the effectiveness of aid. In this context, the role of donors will be promoted as facilitators and supporters in the development process. Measures would include: (i) transferring responsibility to the national stakeholders for project preparation and implementation, (ii) providing equal treatment to fully HMG-funded projects and donor-assisted projects in terms of budgeting, ownership and implementation, as well as expenditure reporting and accountability, (iii) streamlining project implementation by avoiding the establishment of parallel Project Implementation Units (PIU) or Development Boards or Committees, (iv) encouraging donors to help enhance national ownership, and (v) expanding and strengthening the decentralized planning and implementation system. Through increased ownership of development activities and proper repair and maintenance of projects, sustainable development would be ensured. Such an arrangement would also help reduce corruption, build capacity and strengthen governance.

7.13 The Private Sector: The last decade has witnessed a major change in the role of private sector in the national economy. It now plays a leading role in stimulating economic growth. Foreign aid has largely assisted the public sector. However, this should not preclude the greater engagement of the private sector in the design and implementation of foreign-aided projects and programs. Particularly in capital assistance projects, the private sector can play a more extensive and expanded role in making technology

choices, through consultancy and sub-contracting arrangements. 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. The private sector would 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. HMG 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.

7.14 Role of Civil Society: Civil society organizations are vital partners in Nepal's development process. They interact and interface with foreign aid operations at various levels. HMG recognizes that financial grant aid channeled transparently through civil society provides for significant and important aid resources, which may be additional to bilateral and multilateral funds. They are key interlocutors between the people of Nepal and government and donors on many foreign aid issues such as on the environment. They are also partners in various aspects of foreign aid operations especially in the rural areas. Large numbers of community groups are involved in various parts of the foreign aid structure in Nepal. They have built up local partnership arrangements with foreign aided projects and programs. The role of the United Nations (UN) System in stimulating social mobilization and involving civil society has been an important feature. INGOs have established multifaceted linkages with NGDOs, and community-based organizations, although improvements are required. The government expects to stimulate greater involvement of NGDOs and community-based organizations in the foreign aid process, from the time of project selection to project implementation. Their views will be encouraged through a greater transparency and

sharing of information. They will be facilitated to contribute their views on development priorities and opportunities and implications of foreign aid to their communities.

7.15 International Policy Dimension: Policies and practices of donor institutions in Nepal are also a reflection of the various recommendations, prescriptions, and decisions arrived at global and multilateral forums. While there have been major improvements in the direction and quality of the development dialogue and of development cooperation in these forums, the influence of ideas and experience of developing countries, and particularly, of least developed countries have not been so far evident to any strong degree. Least Developed Countries (LDCs) such as Nepal lack the capacity similar to that of the developed donor countries and of donor-led institutions. However, Nepal has the opportunity to make a more important and decisive contribution to international and multilateral deliberations on these issues, drawing on its accumulating experience with development cooperation. Nepal's contribution, to be effective and relevant, will have to be made on the basis of objective analysis of the successes and the shortcomings of the development experience in the country. This will be an aspect of development cooperation policy that needs to be stressed. Local experts and institutions will be enabled to play a more active role in evaluating Nepal's experience and formulating their ideas, which can then be provided as inputs into the multilateral system of deliberations.

7.16 Soliciting an Increased Level of Cooperation from Donors: HMG would pursue a policy of enlisting strong support from donor communities for achieving its development objectives. HMG believes that an enhanced level of mutual understanding can further strengthen the process of development cooperation. While Nepal on her part would try to present its needs, aspirations, performance and problems to the donor communities through, but not limited to, a series of institutional linkages that currently exist, the understanding of the donor community is solicited particularly with respect to the following: (i) Sensitivity: Greater sensitivity to Nepal's unique geographical and other characteristics which will have an impact on an independent development policy Nepal wishes to pursue. (ii) Selectivity: HMG wishes to be selective and

focused in favor of areas that contribute to enhancing the living standards of people. Donors' mutual coordination and specialization on the basis of their respective comparative advantages could greatly facilitate HMG effort in "internalizing" the development process. (iii) Avoiding Trial and Error Methods: HMG wishes to avoid costly practices of experimentation and tests in technology or in other fields. However, it will not preclude innovative efforts by the government, beneficiaries and development partners that may involve piloting of new approach on a small scale. (iv) Maintaining financial discipline: As a part of an ongoing effort toward transparent reporting, internationally recognized accounting, monitoring and auditing practices would be pursued to maintain financial discipline. Auditing the activities financed by donor funds by the Auditor General of Nepal would be ensured; (v) Transparency in Fund Transfers through INGOs/NGOs: HMG wishes to be informed and reported to on a mandatory basis, about the aid mobilized and utilized through the INGOs/NGOs; (vi) Reflection of Financial Sources in the Annual Budget: Cooperation is also solicited to ensure that all aid resources are made transparent and are reflected in HMG annual budgets; and (vii) Improving Donors' Procedures: An important part of the overall strategy for more effective foreign aid will be the reform and improvement of donor procedures. Negotiations will be undertaken with donors to harmonize and standardize treaties and agreements entered into with them in line with contemporary laws of the country.

7.17 The above policies are important to achieve the objectives of the foreign aid policy as well as to deal with problems that have been impediments to the effective utilization of foreign aid. Foreign aid policy is an important element of the overall policy planning of the Tenth Plan. Accordingly, appropriate strategies and policy instruments will support these policies.

8. Major Strategies

In order to achieve these objectives, the following strategies would be deployed for implementing the policies enumerated above.

8.1 **Formulation of Economy-wide and Sectoral Perspective Plans:**

For proper allocation of resources, it is desirable to formulate economy-wide and sectoral perspective plans. These plans will clearly identify sectoral priorities as well as internal and external financing needs at sectoral levels, and relate them to the overall economy-wide plan and financing policy. HMG will encourage the sector program approach to address the needs of specific sectors or sub-sectors. As noted, the sector plans are expected to encompass: (i) an approach that is truly sector-wide in nature, which is consistent with national goals and covers all relevant public expenditure components; (ii) a clearly articulated sector strategy; (iii) appropriate role for, and assistance from, donors; (iv) implementation arrangements made in consultation with relevant donors to the extent possible; (v) long-term technical assistance needs; (vi) acceptance by partners of joint accountability for program outputs; and (vii) commitment of donors to finance the program either through program support or project support, as discussed above.

8.2 **Ensuring Transparency and Accountability:**

Transparency in foreign aid management will be ensured to enhance the benefits of aid-supported activities, reduce inefficiencies and distortions, combat corruption, assist in sound decision-making and make policymaking accountable. Similarly, financial discipline with respect to aid-related activities would be strictly followed to enhance the confidence of the people in foreign aid management, realize maximum benefits and control the misuse of resources. The relevant mechanisms are: (i) make information available to the interested people about the cost and source of finance of each activity and component of foreign-aided programs and projects; (ii) facilitate public flow of information on decisions made with respect to the selection of experts, consultants and key project staff, procurement, sale or auction, pre-qualification, contract awarding, and with respect to criteria used, individuals involved and processes followed in decision-making; (iii) make

available to the interested people pre-feasibility, feasibility, audit, evaluation, performance and other reports of aid-supported activities; (iv) reflect all aid resources in the budget and utilize them through the budgetary process as applicable; (v) facilitate and assist public inquiry, and set specific time periods for handling requests, dissents and complaints; (vi) strictly enforce legal measures on corrupt practices, administer reward and punishment rules, and fully observe codes of conduct in public services; (vii) comprehensively prepare, strictly implement and effectively monitor action plan to prevent economic irregularities in aid-supported activities; (viii) select clean, capable and bold personnel for key positions; (ix) make mandatory disclosure of information on commissions paid to agents; (x) encourage the role of media, civil society organizations and individuals in controlling corruption and exerting pressure to take action against culprits; (xi) eliminate discretionary powers embedded in rules and laws; and (xii) make no exception to taking legally prescribed actions against corrupt persons.

- 8.3 **Enhancing the Quality of Aid:** One of the major objectives of the government is to enhance the quality of aid. Regular investigative studies, for example, joint reviews with the concerned donors, would form part of this strategy so as to learn from experience and disseminate the best practices. Further, the productivity and benefit of aid shall be maximized to enhance its impact on economic growth and poverty alleviation. While accepting aid, a through scrutiny of associated conditionalities needs to be made to ensure that these help and not hinder the smooth implementation of the projects. In this context, sufficient analysis and consultation with stakeholders will be carried out. Some necessary steps to be taken are: (i) to examine conditionalities with respect to critical goals of the project, development strategies, policies and the country's realities, (ii) to obtain support and commitment of all stakeholders to fulfill proposed conditionalities, (iii) to secure formal approval of the competent authority in the case of policy-related conditionalities, and (iv) to design conditionalities in compatibility with the executing agency's institutional capacity.
- 8.4 **Strengthening Aid Coordination:** Effective aid coordination constitutes another important element of the strategy in order to channel aid in accordance with development policies and priorities,

and increase efficiency, effectiveness, and coherence in aid management. The Ministry of Finance as the focal body of the government will play the lead role in overall aid coordination and management in Nepal. The Ministry of Finance, National Planning Commission and line ministries will abide by established practices to improve the mechanisms of aid coordination. Coordination of donor activities will be undertaken at the national level, sectoral level, at the regional level and also in relation to key development issues. In this context, joint chairing of sectoral coordination meetings by the MOF, the concerned line ministries and donors will be encouraged. The MOF and the NPC will improve their systems of record keeping of donor funded activities, classified on the basis of appropriate categories, which will enable the provision of information for policy analysis and management of projects and programs. Databases will be set up, building on current available information within the various units of government. The capability of MOF would be strengthened to enable it to efficiently play the lead role in donor coordination, and to secure support from all stakeholders in aid coordination activities.

- 8.5 Project/Program Identification, Selection, Design and Securing Sustainability:** Sustainability of foreign-aided projects will be ensured by paying greater attention to considerations of appropriateness, ownership and sustainability. Rigorous project analysis would be undertaken to establish appropriateness and sustainability. All projects shall be examined from social, economic, financial, managerial, technological and environmental perspectives. Some relevant measures would be: (i) to eliminate unproductive and redundant projects and focus on key development areas; (ii) to select only those projects that meet development and sustainability criteria; (iii) to establish sector-wide and nationwide merit order of projects on the basis of relevance, potential benefits, efficiency and effectiveness; (iv) to allot aid resources according to the order of merit of projects; (v) to link new projects to utilize the stock of past investments, (vi) to reconcile donors' priorities and comparative advantages with program needs in mobilizing aid; (vii) to design projects at an appropriate level of technology that can be adapted and mastered in Nepal; (viii) to base project design on existing and potential strengths of local institutional and administrative capabilities, (ix) to make activities environment-friendly; as well as cognizant of gender issues and cultural and institutional sensitivities; (x) to involve beneficiaries, stakeholders and

civil society at every stage of the project cycle; and to obtain their full support and commitment for implementation, particularly in relation to local level projects.

- 8.6 **Create a Foreign Aid Management Information System:** Keeping in view the importance of foreign aid-related information for monitoring and evaluation and for policy planning purposes; an information base would be created, regularly updated and disseminated. The database would include information, among others, on the costs, sources and types of aid financing of each activity and component of foreign-aided programs and projects, disbursement performance, terms of assistance, debt-servicing obligations, and so on.
- 8.7 **Promoting Institutional Effectiveness:** Measures would be undertaken to promote institutional effectiveness of foreign aid-related institutions. Such measures include strengthening project implementation capacity of institutions; preparing and implementing human resource development plans based on the objectives and work characteristics of each aid-supported activity, deploying personnel in key positions strictly on the basis of expertise, integrity, capability and commitment; defining clearly the authority and responsibility of project staff, and so forth.

9. Major Policy Instruments

- 9.1 Policies and strategies can only be made operational through a series of policy instruments that are pragmatic and implementable. An important requirement in this regard is that there is clear linkage between policies, strategies, instruments and the institutional framework required for translating policy objectives into reality. In the absence of proper identification of appropriate policy instruments and the institutional framework, these policies and strategies would largely remain unimplemented.
- 9.2 **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 discussed above. (ii) Budget allocations 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.
- 9.3 **Joint Programming 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 also useful in 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.
- 9.4 **Effective Project Planning and Implementation:** Project planning exercises would 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.
- 9.5 HMG will redouble its efforts to improve implementation of projects financed by domestic and foreign resources by (i) making counterpart funds available in time, (ii) decentralizing decision-making authority all the way down to the project or program managers in the field, and holding them responsible for performance, and (iii) standardizing bidding document to avoid procurement problems.
- 9.6 **Improvement in Project Evaluation, Impact Study, Supervision and Monitoring:** Rigorous project evaluation, as well as impact studies of at least major projects would be undertaken. A strong feedback mechanism capable of incorporating voices of stakeholders and interested parties would be established. A system of "public hearing" on impact study reports of the projects would 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 would be made to create project-monitoring committees at operational level.
- 9.7 **Encouraging a "Common Pool" Approach:** HMG 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-taxed. 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 HMG. It requires HMG to assume full ownership in program execution. HMG 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, disregard of the nature of funding windows, the project should fit in sectoral priorities.

- 9.8 **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) Audit reports will be prepared within six months of the completion of the fiscal year. Delays in submission of expenditure statements will be penalized. (iv) Retrospective financing in any foreign-aided project will not be allowed unless and otherwise agreed with the concerned donor in advance, (v) Financial accountability system will be developed, and (vi) The budget release process and its criteria will be made fully transparent.
- 9.9 **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, HMG 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.
- 9.10 **Improving Procurement:** HMG recognizes that sound procurement policies and practices are essential to fully utilize funds. HMG will make the procurement procedures more transparent. It will work toward establishing effective country procurement systems consistent with internationally accepted principles and practices as set out, for example, in the UNCITRAL Model Law on Procurement, the

European Directives, and the World Trade Organization Agreement on HMG Procurement. The gap between the country's regulatory and financial framework for procurement and donors' procurement guidelines and rules will be reduced to the extent possible.

- 9.11 **Procedural Improvements:** Several procedural improvements would be introduced during the period to enhance the effectiveness of foreign aid, both grants and loans. These include, among others, (i) an effort to rationalize and make uniform tax exemptions and other facilities including immunities provided in relation to aid-supported activities; (ii) introduce 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; (iii) establish criteria for the acceptance of external aid, in the light of the country's rising public debt burden, as noted earlier.
- 9.12 A detailed manual would be prepared to implement policies and strategies outlined above, to guide the use of policy instruments and institutional framework to assist in the effective utilization of foreign aid. This would simplify and improve the decision-making process with regard to aid.

10. Government-Donor Interaction and Dialogue

- 10.1 The quality of dialogue between the government and donors will be enhanced through several measures. Already, the formal consultative group for Nepal has been transformed into the Nepal Development Forum. Further action will be taken to make the forum the central venue for high-level policy discussions on development issues. Particular attention will be focused on linking up foreign aid issues with the broader development concerns of the country and of donors. The local aid group meetings, both at the general and the sectoral levels, will be organized to take up key policy, strategy and implementation issues. Similarly there will be improvements sought for discussion at the thematic and sectoral levels by promoting government's leadership role.
- 10.2 An important aim of the dialogue between government and donors will be to introduce at the country level the sense and spirit of a development partnership that is advocated at the global and multilateral levels, but that has so far not been realized at the country level. To enable such a development, actions of both donors and that of the government will be made more transparent with significant improvements in the flow of information between and among concerned stakeholders.
- 10.3 **Exploiting the Potential of Institutional Arrangements:** Several institutional arrangements currently exist, which have relevance for enhancing the effectiveness of the foreign aid management in the country will be reshaped to cater the need of changed context of foreign aid management. These include: (i) The existing Foreign Aid Coordination Division would be upgraded to External Economic Relations Department in view of the need to address concerns like improving aid resource management, and raising the efficiency in the use of aid resources and serve as “central mechanism” to coordinate all external resources. (ii) A high level committee headed by the Finance Minister will be constituted to facilitate approval of foreign aid financed projects. The Committee will be comprised of Vice Chairman of the National Planning Commission; Secretary of Ministry of Law, Justice and Parliamentary Affairs; Secretary of

concerned ministry related to the project; Finance Secretary and the Joint Secretary at the Foreign Aid Coordination Division, Ministry of Finance as the members of the Committee. Foreign Aid Coordination Division will work as the secretariat of the Committee. (iii) The effectiveness of economic diplomacy will be increased through more fruitful and effective participation of competent HMG agencies in the process. (iv) In order to effectively implement the foreign aid policy, planning divisions of the relevant ministries will be strengthened, particularly in areas of project preparation, evaluation, supervision and monitoring capacity. (v) The Social Welfare Council would be strengthened so that it could provide "one window" services to NGOs/INGOs, and serve as their focal point for all practical purposes.

- 10.4 **Review Mechanism:** The National Planning Commission will take the lead role in the progress review of the development projects and programs. The efficient implementation of projects would only be ensured through continuing systems of supervision, monitoring and evaluation and through undertaking impact studies. The problem so far has been that these have been undertaken only at random. The importance of these aspects of overall project management will be given due recognition. There will be strong feedback mechanisms, and opportunities provided for a wide spectrum of stakeholders to voice their views on these projects. Reporting systems will be streamlined and, on the basis of these reports, there will be close interaction between policymakers and project implementers. A plan will be prepared to undertake regular and joint evaluation studies of foreign funded project and programs.

11. Agenda Ahead

- 11.1 HMG is seriously committed to this foreign aid policy, which it will implement with sincerity and determination that it deserves, with the conviction that the smooth implementation of the policy will pave the way for meeting the development objectives and targets for poverty reduction envisaged in the Tenth Plan/Poverty Reduction Strategy Paper.
- 11.2 HMG recognizes that this aid policy lays out an important and realistic agenda. It believes that, to address the long-standing concerns of both the donor community and the Nepalese stakeholders, such a comprehensive effort is required. This is clearly an undertaking which will take time, as well as commitment, understanding and will on the part of all development partners. If successful, the new approach would constitute the basis for a new and much more productive compact between Nepal and its development partners and lead to a critical difference in Nepal's efforts to reduce poverty. To translate this policy into a reality is the challenge ahead for both Nepal and its development partners.
