
FAST TRACK BRIEF

May 20, 2009

The IEG report “Nepal Country Assistance Evaluation, 2003-08,” was discussed by CODE on May 20, 2009

Nepal Country Assistance Evaluation, 2003–08

- ◆ The FY03-08 evaluation period was one of tumultuous political turmoil, conflict, and dramatic change in Nepal; today, prospects for sustainable peace are brighter, though still fragile. In such difficult and unpredictable conditions, formulating and implementing an effective development assistance strategy and programs were great challenges for development partners, including the Bank. To its credit, the Bank managed to remain constructively engaged in Nepal despite a challenging political and security context and has achieved some significant results on the ground. Nevertheless, the Bank’s strategy was poorly adapted to the country’s conflict situation and political instability, and until recently (FY08) underwent little adjustment in response to the rapidly-evolving conditions on the ground.
 - ◆ Overall, the outcome of the Bank’s program is rated moderately unsatisfactory. Many of the outcomes targeted under the social development pillar, notably improvements in access to basic education, healthcare, and water and sanitation services, were achieved, despite difficult country circumstances. However, most of the outcomes targeted under the other three pillars—growth, social inclusion and governance – were not achieved.
 - ◆ Looking forward, IEG recommends that IDA introduce greater realism into its strategy and program design and keep these flexible against a backdrop of a clear long-term vision, applying frequent course corrections in response to changing circumstances and consulting widely with national stakeholders and development partners. Given their importance in improving the living conditions of the poorest, agriculture and rural development need to be the centerpiece of IDA’s assistance program. For the Poverty Alleviation Fund (PAF) to realize its potential, it needs to incorporate a mechanism to systematically track its impact on poverty and social exclusion, and its design needs to be adjusted to optimize benefits to the poor and socially-excluded. Finally, as long as prerequisites for policy lending are not met, SWAs can offer an alternative way of supporting public finance management and other institutional reforms.
 - ◆ Other than through its existing portfolio of two hydropower projects, IFC did not make a significant contribution to Nepal’s development over most of the review period. IFC’s gradual re-engagement beginning in 2006 was successful, resulting in two Global Trade Finance Program (GTFP) investments, an investment in a domestic airline in 2008, a pipeline of investment projects in the financial sector, and a constructive dialogue with the government on the business climate.
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Nepal is a small landlocked country with few natural resources and difficult terrain bounded by two giant and nascent economic superpowers, India and China. The country is largely dependent on low-productivity mostly subsistence agriculture for income and employment. Remittances from abroad have steadily increased over the last 15 years and now represent over 15 percent of GDP. After accelerating in the 1990s following democratization and economic liberalization, economic growth slowed, in part due to the decade-long Maoist insurgency that started in 1996 and intensified in late 2001 and to the lack of progress in implementing much needed structural reforms.

Nepal is the 12th-poorest country in the world and the poorest in South Asia with a GNI per capita (Atlas method) of US\$340 in 2007. It is plagued by substantial disparities by caste, ethnicity, gender, and geographic location. On the 2005 Human Development Index (HDI), Nepal ranked 142nd out of 177 countries, although the gap with South Asia has steadily declined over the last 20 years. Despite the conflict and modest economic growth after the mid-1990s, remarkable progress was posted on social well-being: income poverty incidence declined from 45 percent in 1996 to 31 percent in 2004 and most social indicators improved steadily. Moreover, although income inequality increased, disparities in access to basic services, based on gender, cast, ethnicity, poverty status and geographic location declined.

During the period assessed by this Country Assistance Evaluation (CAE), fiscal years 2003-08, Nepal experienced intense political turmoil, conflict, and change. This had major implications for the implementation of IDA's assistance strategy. Between 2002 and April 2006, democratic institutions were progressively suspended, and in February 2005 King Gyanendra assumed direct rule. In addition to the political instability of the period, the Maoist Insurgency, which had started in the 1990s, continued to escalate, with a serious deterioration of security. In April 2006, the King was forced to restore parliament by a pro-democracy movement and eventually a peace agreement was reached with the Maoists. In April 2008, successful elections were held for a Constituent Assembly and the monarchy was abolished. A Maoist-led coalition government assumed power in September 2008.

With this highly fluid political and security situation as a backdrop, IDA operated under three strategy documents during the period of FY03-08: the 2002 CAS Progress Report (CAS-PR) covering FY03-05, the 2003 CAS covering FY04-07, and the 2007 Interim Strategy Note (ISN) covering FY07-08.

During this period, the Bank's role in Nepal recovered from the low level of the early 2000s. As part of this renewed effort, IDA substantially contributed to the design of the government reform program. The 2002 CAS-PR initiated a significant shift in Bank strategy. Since the late 1990s, owing to the lack of progress in implementing governance and economic reforms, Nepal had been placed under the low-case lending scenario specified in the 1998 CAS. The 2002 CAS-PR shifted the program to a base-case lending scenario, and the 2003 CAS was prepared in its wake. Total lending commitments in support of IDA's strategy averaged US\$150 million per year over the evaluation period, albeit with large annual variations. About half of new commitments over the period were made in FY08 while there was none in FY06. In addition, IDA conducted extensive economic and sector work, engaged in policy dialogue, and provided substantial technical assistance.

Two elements were consistently part of IDA's strategy over the period. The first was fostering broad-based economic growth through strengthened public expenditure management, an improved environment for private sector development, and agricultural growth and rural development. The second was social sector development. This was to be accomplished through investment in education, health, and rural water and sanitation. Following the preparation of Nepal's first Poverty Reduction Strategy Paper (PRSP) in 2003, which coincided with the government's Tenth Plan, the strategy also increasingly emphasized two other themes: social inclusion and good governance. The Bank supported these through measures to strengthen public financial management and to promote decentralization.

Development Assistance Coordination. The Bank successfully led in strengthening government ownership of and leadership in development assistance coordination in 2002-03. However, its approach met with challenges as the conflict and suppression of democracy intensified. Increasingly, many development partners took issue with providing budget support against a backdrop of questionable legitimacy of government and implementability of government programs under the conditions of conflict and political instability. Despite the tensions among development partners, the Bank contributed to and led several productive partnerships: with DFID in financial sector restructuring, with the IMF in macroeconomic management, and at the sectoral level with Sectorwide Approaches (SWAs) in education and health. In addition, IDA, DFID, and ADB more recently initiated a promising rapprochement on the peace and development agenda that resulted in the preparation of a joint assistance framework in 2009.

Overall Assessment

Bank strategy was relevant in that it was geared to Nepal's longer-term needs and was based on several pieces of ESW. The strategy was also closely aligned with the objectives defined by the government in the Tenth Plan/PRSP. However, full ownership of the government's reform program was limited to a handful of technocrats in Kathmandu. The relevance of the strategy was further compromised by a lack of realism, above all with regard to political economy considerations. For example, IDA's strategy did not factor in such considerations as the environment of physical insecurity and political instability, which was not conducive to achievement of politically sensitive structural reforms; the ongoing Maoist Insurgency, which made project implementation difficult; and the difficulty of addressing governance issues when a majority of the population questions the legitimacy of the government.

Failure to account for the specific circumstances of Nepal (at least in formal strategy documents) during the review period goes a long way toward explaining the low efficacy (that is, the extent to which it achieved the outcomes that it had targeted) of the Bank's assistance strategy, except for social development and to some extent social inclusion. Bank assistance in basic service delivery, primary education, health, and rural water supply and sanitation, as well as its support for social inclusion in those same sectors, was characterized by substantial efficacy. Except for telecommunications, efficacy was weak on interventions supporting broad based-growth, including support to the private sector and agriculture. Efficacy was also negligible for the governance agenda.

Broad-Based Growth. The focus in this pillar was on public expenditure management, private sector development, and agriculture. IDA took the lead in the effort to improve the quality of public expenditure management through policy advice and technical assistance for establishing output-based budgeting and a Medium-Term Expenditure Framework (MTEF). These activities yielded some positive results in the early part of the review period and allowed for an increase in pro-poor expenditure, particularly for education and health. However, with the dismissal of the champions of that reform in 2005-06, and their replacement by officials new to the concept of medium-term expenditure planning, the process was almost entirely reversed. Due to political turmoil and lack of confidence in the government's budgetary process, at least half of capital spending by development partners remained off-budget. Negligible progress was made in restructuring state-owned enterprises and reducing their drain on the budget. Based on the failure to establish an improved public expenditure management system and inability to create fiscal space to increase social expenditure and public investment, the outcome of IDA support to improving public expenditure management is rated *unsatisfactory*.

The promotion of private sector development encountered some initial success and some financial deepening occurred during this period. This was assisted by moderately successful efforts to rein in the irresponsible lending practices of the two large state-owned commercial banks. However, from 2006 onward this healthy process of rationalization was partially rolled back as the political climate changed, the desire to use state banks to achieve social goals increased, and Central Bank leadership weakened. Despite strong and steady support from IDA, little improvement in Central Bank regulatory and supervisory effectiveness has occurred and the restructuring of the two main loss-making commercial banks has not been completed after seven years. Moreover, although the CAS had sought either privatization or liquidation of these banks, their disposition is now uncertain. Private investment failed to achieve the expected recovery, hampered by the impact of several factors, above all the negative impact of the conflict and related insecurity, and political instability and uncertainty on the investment climate. On this basis, the outcome of IDA's support to private sector development is rated *unsatisfactory*.

Although the Tenth Plan and PRSP had identified agricultural development as a priority for reinvigorating income and employment growth in rural areas, planned Bank support to agricultural development did not materialize. Given the centrality of agriculture to improving living conditions for the poorest, the failure to support agricultural growth constitutes a major setback to the growth and poverty reduction goals that were at the heart of IDA's strategy. On this basis, the outcome for IDA assistance to agriculture is rated *unsatisfactory*.

The 2003 10th Plan /PRS had laid out a range of environmental issues to be addressed, given the importance of environmental management for sustainable development and the well-being of the people of Nepal. IDA helped the government to articulate an effective strategy for environmental conservation and management. Thus far, however, the strategy has not been operationalized and there is little evidence of impact.

Overall, because of the limited relevance of IDA's strategy and very low efficacy, the outcome of IDA assistance for broad-based growth is rated *unsatisfactory*.

Social Development. IDA support was well aligned with the government's main objective of increasing access to and quality of basic education and health while also reducing disparities. Enrollment in primary education increased significantly, and the proportion of out-of-school children of primary age declined dramatically, particularly for girls and socially-excluded populations. However, there was little progress on quality of education. IDA's strategy relied on the assumption that community school

management would be sufficient to increase quality of education and the community school management committees would be able to monitor this quality. But this assumption remains untested as the evaluation of the pilot was delayed. The outcome of IDA's assistance for basic education is rated *moderately satisfactory*.

IDA assistance helped the government meet several of its goals for extending access to health services and reducing social disparities in access. The health SWAp has been successful in scaling-up cost-effective public health services, which are credited with contributing to sustained improvement of health outcomes over the CAE period. On this basis, the outcome of IDA's assistance in health is rated *satisfactory*.

Access to safe drinking water and sanitation services in rural areas continued to improve during the CAE period, and disparities were reduced. IDA support facilitated some improvements in sustainable access to safe drinking water and sanitation and in promoting social inclusion with regard to this service, but in the absence of a sound sectorwide monitoring and evaluation system, IDA's contribution is difficult to establish. Moreover, IDA support has not been successful in achieving sectoral institutional reforms. The outcome of IDA's support to rural water supply and sanitation is rated *moderately satisfactory*.

On balance, given that support to education represented more than half of total IDA resources allocated to social development, the overall outcome of IDA's support for social development is rated *moderately satisfactory*.

Social Inclusion. Through its lending, IDA helped improve access to basic services for those who were socially excluded based on gender, caste, or ethnicity. The efforts were especially effective in education, and to a lesser extent in the health and water and sanitation sectors. The outcome of IDA support in this area is rated *satisfactory*.

In the 2003 PRSP/CAS, the Poverty Alleviation Fund (PAF) initially aimed to support integrated infrastructure development (drinking water, small-scale irrigation, schools, health posts, and trails) for the most disadvantaged communities in remote rural areas, including the socially excluded. It also aimed to strengthen the capacity of local institutions and help the government to better coordinate support targeted to these populations. The PAF successfully placed money in the hands of socially excluded people, helped to improve incomes of PAF beneficiaries in many cases, and initiated a habit of savings among the poor. However, contrary to plans, the bulk of its financing was directed at private goods, mainly livestock, rather than focusing on providing better access to services. Also, it did not have the envisaged institutional development impact.

Moreover, in the absence of systematic tracking of outcomes, there is thus far little hard evidence that it has been an effective instrument for poverty reduction or that it has promoted greater empowerment and social inclusion. Partly as a result, other development partners have been reluctant to participate. On this basis, the outcome of IDA support through the PAF is rated *moderately unsatisfactory*.

Some progress was made toward the objective of improving the diversity of the civil service, through IDA support for an affirmative action policy. However, while it addressed the inclusion problem, a tremendous achievement, the 2007 amendment to the Civil Service Act did not include safeguards regarding pay-for-performance and risks of political interference. The outcome of IDA support in this area is rated *moderately satisfactory*.

On balance, given the weight of IDA resources allocated to the PAF, the overall outcome of IDA support for social inclusion is rated *moderately unsatisfactory*.

Good Governance. IDA's strategy of supporting decentralization was highly relevant but, given the political context and the fact that local elected governments had been suspended since 2002, it could not be implemented. The outcome of IDA support in this area is therefore rated *unsatisfactory*.

IDA's objective of improving the autonomy and accountability of the civil service was not met and little improvement occurred over the CAE period. Moreover, the 2007 amendment of the Civil Service Act carries a risk of significant unintended adverse consequences. Overall, the outcome of IDA support for civil service reform is rated *unsatisfactory*.

IDA's objective of improving accountability and transparency of public finance achieved some significant steps, such as passage of the Procurement Act, but it has had little impact on actually improving the quality and efficiency of public financial management. On the contrary, there has been some significant regression in the quality since 2005. Moreover, for most of the CAE period the Public Accounts Committee (PAC) at the parliament was suspended and could not oversee government accounts and end-of-year government financial statements were not disclosed. The outcome of IDA support for public finance is rated *unsatisfactory*.

Overall, the rating for governance is *unsatisfactory*.

Overall Rating. Progress was made toward improving access to basic services and reducing disparities based on gender, caste, or ethnicity. Diversity of the civil service is also expected to increase following the 2007 adoption of an affirmative action policy. More public resources are

reaching the rural poor through the PAF, but the objective of providing better services to this population has not been achieved and there is thus far little hard evidence on their poverty impact. In the other areas of IDA intervention, broad-based and governance, progress has been limited or negligible. Given the large share of IDA resources devoted to the broad-based growth pillar and the centrality of improving governance in Nepal's Tenth Plan and PRS as well as in IDA's assistance strategy, the overall outcome of IDA support to Nepal would, on balance, be rated *unsatisfactory*. However, given the 2003 CAS's explicit recognition that only two-thirds of IDA's objectives and outcome targets would realistically, be met, the adjusted rating is *moderately unsatisfactory*.

Findings

Among the findings of this evaluation of IDA's assistance program in Nepal over FY03-08, the following findings are worth highlighting.

Most of the economic and governance objectives targeted under the broad-based growth and good governance pillars were not achieved. This was mostly because the prerequisites for effective implementation were not met and the Bank's assistance strategy was not realistic and attuned to the country circumstances. Bank experience in Nepal confirms its experience in other fragile states. Specifically, it shows that continuation of Bank lending where there is a deteriorating political environment and weakening commitment to reforms does not achieve declared goals and does not serve economic development and poverty reduction.

IDA has been disengaging from the agriculture sector since the mid-1980s—a process that reached its nadir during the CAE period. Over the FY04-06 period, there were no active IDA projects in agriculture, including irrigation and forestry. Moreover, although the PAF targets the rural poor, it does not constitute an alternative for supporting agriculture growth. In a country where 85 percent of the population depends on agriculture for subsistence and employment, and poverty is predominantly a rural issue, and the 2003 Tenth Plan and PRSP had prioritized agriculture and rural growth, IDA's failure to support agriculture is a critical gap.

Despite Nepal's conflict conditions and political instability, progress was made in improving basic services (primary education, essential health care, and water and sanitation) for which demand is high in the country regardless of political dividing lines and in reaching the poor, particularly in rural areas. Moreover, this progress was achieved mostly through programs implemented by central government departments (education and health) whose administrations (central and deconcentrated) were strengthened over the period.

Over the past decade, Nepal made significant progress in reducing social disparities, despite difficult country circumstances. Although in practice IDA support focused more on economic than social inclusion, it contributed substantially to bringing social inclusion issues to the center of the development strategy. It accomplished this by raising awareness and understanding of those issues, as well as by supporting critical measures such as equal access to education, civil service diversity, and PAF targeting based on gender, caste, and ethnicity.

The Bank failed to tailor its assistance strategy to country circumstances. The Bank did not adequately account for the implications of Nepal's fragility in designing its strategy, and adjust it when major assumptions on which it was built were no longer valid. This undermined its effectiveness. In addition, the failure to formalize strategy and program shifts detracted from the Board's ability to exercise oversight.

Recommendations

Based on the analysis and findings of the evaluation, IEG recommends that IDA:

Inject greater realism into the country assistance strategy and program design, retain flexibility to adjust to changing circumstances and consult widely and continually with national stakeholders and development partners throughout program implementation. While the prospects for political stability and for sustaining peace look more promising today than in years past, the current government faces enormous challenges in the face of high popular expectations. In many areas, the details of the government's policy agenda, let alone the feasibility, pace and exact form of implementing that agenda and the likely repercussions, are uncertain. Under such conditions, the lessons of recent history suggest a need for IDA to inject more realism into strategy and program design and to be prepared for course corrections, yet with responsibility and accountability for signaling major shifts. Moreover, broad consultations on a regular basis would help ensure that IDA's strategy and program remain relevant.

Make agriculture and rural development the centerpiece of the assistance program. This calls for placing agricultural and rural growth, including issues of food security and malnutrition, at the heart of IDA's strategy, given the centrality of agriculture in any realistic plan to improve the lives of many of Nepal's poor and marginalized inhabitants. In parallel with the focus on economic growth in rural areas, IDA needs to step up its efforts to help increase poor and marginalized people's access to basic services (basic education, healthcare, safe water and sanitation, and roads), notably in traditionally

lagging regions. In striving to increase such access to basic services, the focus needs to be on delivery schemes that have worked and proved sustainable elsewhere in Nepal's rural environment. Finally, to have any significant impact, IDA's engagement in agriculture and rural development will need to be sustained over a long period of time, not follow the stop-and-go patterns of the past.

Design and implement a mechanism to systematically track the impact of the Poverty Alleviation Fund on poverty and social inclusion, and adjust its design as needed to optimize benefits to the poor and socially excluded. The major weakness of the PAF, despite its potential as an instrument for addressing social exclusion, is that it has not had a mechanism to track the extent to which its activities are effectively addressing the various dimensions of social exclusion. Given the importance that the PAF is now assuming as an outlet for IDA funds, this shortcoming needs to be remedied as soon as possible.

Support public expenditure and public finance management and other institutional reforms, preferably through policy-based lending coupled with technical assistance as needed, or SWAps (as was done in primary education and health), if the prerequisites for policy-based lending cannot be met. In Nepal, SWAps have proven so far to be the most promising vehicle for achieving gradual but lasting change. If conditions for policy-based IDA budget support do not come together, IDA could usefully explore the prospects for supporting such reforms through SWAp instruments.

Evaluation of IFC Activities

As the political and security situation deteriorated after 1999, IFC withdrew its local field presence and had very limited activities in Nepal between 1999-2006. Other than two existing IFC investments in hydropower generation that made important contributions to Nepal's domestic electricity supply, IFC's few other operations in Nepal were not successful. To a large extent, IFC's inability to develop successful investment projects through much of the decade can be attributed to the increasingly difficult investment environment. After 2006, IFC began a gradual reengagement in Nepal that involved advisory work with several local banks; development of GTFP facilities that enabled IFC to deepen its relationships in the financial sector; engagement in the investment climate, where no other donors were active, through small diagnostic studies that helped establish relationships with government counterparts; subsequent expansion of Advisory Services (AS) programs in the investment climate and financial sector; and establishment of a single-person field office within the WB office in Kathmandu. While it remains too

early to assess the long-term development contributions of these interventions, IFC's gradual re-engagement in the context of the difficult overall investment environment has resulted in two GTFP investments; an investment in a domestic airline in 2008, a pipeline of investment projects in the financial sector, and a constructive dialogue with the government on business enabling environment issues.

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