



Strategy and Program Assessment

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NEP: Governance Risk Assessment Report prepared for the Nepal Country Partnership Strategy (2010-2012)

Asian Development Bank

List of Abbreviations

ADB	Asian Development Bank
ADDCN	Association of District Development Committees of Nepal
CA	Constituent Assembly
CBO	community based organization
CDO	Chief District Officer
CFAA	country financial accountability assessment
CIAA	Commission for Investigation of Abuse of Authority
CPA	comprehensive peace accord
CPAR	country procurement assessment review
CPI	corruption perception index
CPN(M)	Communist Party of Nepal (Maoist)
CPS	country partnership strategy
DAO	District Administration Office
DDC	District Development Committee
DDF	District Development Fund
DFID	Department for International Development
DOLIDAR	Department of Local Infrastructure Development and Agriculture Roads
DOR	Department of Roads
DTCO	District Treasury and Controller Office
DTO	District Technical Office
DUDBC	Department of Urban Development and Building Construction
DWSS	Department of Water Supply and Sanitation
EA	executive agency
EIA	environmental impact assessment
FAR	financial administration regulations
FCAN	Federation of Contractors' Associations of Nepal
FCGO	Financial Comptroller General's Office
FNCCI	Federation of Nepal Chamber of Commerce and Industry
FY	fiscal year
GACAP II	Governance and Anticorruption Action Plan II
GDP	gross domestic product
GON	Government of Nepal
GRA	governance risk assessment
ICB	international competitive bidding
ICAN	Institute of Chartered Accountants of Nepal
IMF	International Monetary Fund
IPT	integrated property tax
LB	local body
LB FAR	Local Bodies (Financial Administration) Regulations
LBFC	Local Body Fiscal Commission
LDF	Local Development Fund
LDO	Local Development Officer
LGCDP	Local Governance and Community Development Program
LIDP	local infrastructure development policy
LSGA	Local Self-Governance Act
LSGR	Local Self-Governance Regulations
MCPM	minimum conditions and performance measures
MIS	management information system

MOF	Ministry of Finance
MOGA	Ministry of General Administration
MOLD	Ministry of Local Development
MOU	memorandum of understanding
MPPW	Ministry of Physical Planning and Works
MTEF	medium-term expenditure framework
MUAN	Municipalities Association of Nepal
NAVIN	National Association of Villages In Nepal
NCB	national competitive bidding
NGO	non-government organization
NPC	National Planning Commission
NVC	National Vigilance Center
OAG	Office of the Auditor General
PAC	Public Accounts Committee
PEFA	public expenditure and financial accountability
PETS	public expenditure tracking survey
PFM	public financial management
PIU	project implementation unit
PMP	procurement master plan
PPA	Public Procurement Act
PPMO	Public Procurement Monitoring Office
PPR	Public Procurement Regulations
PRSP	Poverty Reduction Strategy Paper
RBN	Roads Board Nepal
RMP	risk management plan
SDC	Swiss Agency for Development and Cooperation
SOE	state-owned enterprise
SRN	strategic road network
SWAp	sector-wide approach
TYIP	Three Year Interim Plan
UG	user group
UNCAC	United Nations Convention against Corruption
UNDAF	United Nations Development Assistance Framework
UNDP	United Nations Development Programme
VDC	Village Development Committee
VDF	Village Development Fund
VDIS	voluntary disclosure information scheme
WB	World Bank

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I. Executive Summary

A. Main Vector of Risks

1. The main risks that can be identified in the assessment can be grouped as under four vectors:
 - a. capability-related (both at the central level and in local bodies (LBs); and for all three thematic areas);
 - b. laws and enforcement-related, particularly on whistle-blowing, and on the Public Procurement Act;
 - c. policies, procedures, controls, rules, and regulations-related, including the clear presence of collusion, threats, and intimidation in procurement; and
 - d. political-related (not only to do with political interference in public administration and procurement matters but also in matters of political commitment to needed reforms, such as on the medium-term expenditure framework – MTEF).

B. Key Measures to Mitigate the Risks

2. While there have been several actions that have been recommended for ADB in the CPS period, the five that can be highlighted here are:
 - a. Engage with government, political parties, development partners, civil society, professional groups, LBs, and others on introducing and maintaining risk mitigation measures in the various areas listed above;
 - b. Provide targeted technical assistance to build capacity of various relevant stakeholders, both at the central and local levels, in the three thematic areas;
 - c. Help review and revise relevant laws, particularly on procurement (i.e., the Public Procurement Act and its regulations), and corruption (such as on strengthening whistle-blowing provisions);
 - d. Work towards building up demand for reforms from the bottom up; in the move to a federal state, this will send a proper message to stakeholders at the local level; and
 - e. Focus on transparency and accountability in government, and provide needed technical assistance towards this end.

C. Recommendations for the ADB Country Partnership Strategy

3. The Governance Risk Assessment identifies four specific recommendations for consideration in the finalization of the ADB Country Partnership Strategy; these are: (i) all portfolio (particularly, ADB non-lending) in the CPS period should be aligned to the conclusions of the Governance Risks Assessment (GRA) and the recommended mitigative measures; (ii) project officers should be encouraged to adhere to the GRA and to conduct a GRA at the project level while programming their assistance; (iii) engagement should take place with Government, civil society, development partners, and others on all processes and across all areas on a continuing basis; and (iv) ADB is recommended to update the GRA in mid-stream in line with the review mechanisms inherent in the CPS itself.

II. Introduction and Methodology

A. Purpose and Methodology of Assessment

4. The purpose of doing this Governance Risk Assessment (GRA) is to ensure that necessary provisions and mitigative measures will be in place in the Country Partnership Strategy (CPS) (2010-2014) for Nepal to ensure that the risk of "reduced development effectiveness"¹ is adequately addressed in the portfolio of investments that the ADB wishes to make during the period. The assessment is being conducted subsequent to the requirements and guidelines of the Second Governance and Anticorruption Action Plan (GACAP II) issued in May 2008. In that respect, the assessment covers risks in the three thematic areas of priority: public financial management (PFM), public procurement, and combating corruption in Nepal. The GRA also includes risk assessment for the two sectors that the Government of Nepal (GON) has expressed an interest for the ADB to scale up its investments for this CPS period, i.e., urban development, and rural infrastructure.² A team of three governance specialists conducted the assessment.³

5. The approach used in the GRA consists of: (i) considering the *broader political economy* of the country as a backdrop to the assessment; and (ii) taking a *risk-based approach* by which the vulnerabilities existing in the system and processes are identified, their severity determined, and mitigative measures recommended.⁴

6. Both the broad thematic and the two sectoral assessments are based on three key sources of evidence:

- a. **Document review:** The assessment involved a comprehensive review of documents in the public domain and which were available either in hard copy or in electronic media. It also included documents published by the ADB and other development partners, and draft reports and analyses. Also reviewed were assessments of the public financial management (PFM) system, including the Public Expenditure and Financial Accountability (PEFA) assessment, the country procurement review, and fiduciary risk assessments (both generic as well as project-based). Other reports of international agencies, such as Transparency International,

¹ See ADB. *Guidelines on Implementation of the Second Governance and Anticorruption Action Plan*, May 2008, p. 2; the Guidelines state: "The risk is that country systems and/or ADB project systems will allow leakage or suboptimum use of national and/or ADB resources intended to promote growth and poverty reduction." DFID also echoes the need for putting in place an appropriate risk assessment and management system to ensure safe and effective development work in a conflict setting (of the type that exists in Nepal at the moment). See DFID, *Evaluation of DFID Country Programs – Country Study: Nepal*. Evaluation Report EV679, October 2007.

² This report, however, focuses primarily on the broader thematic areas and only integrates the main results of the risk assessment at the sector level (sectoral risk assessment reports are available from SAFM/ADB).

³ The team was led by Gambhir Bhatta, Principal Public Sector Management Specialist (SAFM/ADB); team members included: Mohan Mardan Thapa (Consultant, Urban Development Sector), and Santosh Bisht (Consultant, Rural Infrastructure Sector). The assessment of risks in procurement processes (at the macro level) was carried out separately by Terence Woods, Senior Procurement Specialist (COSO/ADB) and Narendra Chand, National Procurement Officer (NRM). The team wishes to thank everyone that provided substantial help in the completion of the assessments.

⁴ In considering the relevant vulnerabilities in the system/policy and identifying mitigative measures, the risk-based approach seeks to answer two key questions: (i) given a particular vector of risks in the program, with *x* level of severity of the risks, and *y* level of risk appetite of the government, should it proceed with the program? (ii) if so, how should the risks be mitigated?

Global Integrity Initiative, etc., were also reviewed. Appendix 1A documents the relevant documents that were reviewed.

- b. **Primary research:** The assessment team also held numerous consultations with relevant stakeholders both at the national level and in selected districts and municipalities. At the national level, the consultations were with government agencies, corporations, development partners, and others. At the local level, selected district development committees and municipalities were approached (see Appendix 1B).
- c. **Joint discussions:** The assessment team also had several rounds of joint discussions with Government and development partners on the risk assessment. This allowed the team to not only pick up on the perception of specific risks but also triangulate the observations made from the document review and field visits. Meetings were also held with relevant officers at the Nepal Resident Mission (NRM) on several relevant issues.

B. Context of the Risk Assessment

Issues in Political Economy

7. Any assessment of governance risks in Nepal has to be centered on the building block of the realization that it is currently at the cusp of being a failed state. While a period of uncertainty has ended (with the Comprehensive Peace Accord among the political parties that effectively ended the armed struggle), a new period of uncertainty has begun wherein there is a lack of clarity on how the move to frame a new constitution will impact the final shape of the polity, particularly with respect to the creation of a federal democratic republic. There is also lack of clarity on how the political parties will deal with each other in the run-up to the elections to come once the constitution is framed (currently scheduled for April 2010 but very likely to be delayed).

8. Other political changes include the incompleteness of political transformation that the CPA engendered, and the peace process itself has not come to its logical conclusion. This is because there are still some contested agendas among the political parties; these include, among others, the matter of army integration with the fighters of the People's Liberation Army (PLA), the return of seized assets appropriated during the conflict period, and the determination of the role of such non-state actors as the Young Communist Democratic League.

9. Nepal's political economy is also undergoing some paradigmatic shifts, which impinge on how government will address the broader governance problem. At present, the credibility of the current government appears to be low given that the largest party in the Constituent Assembly (CA), i.e., the Communist Party of Nepal, Maoist [CPN(M)] is not included in government, and consensus among the other parties has been hard to come by. Given this state of affairs, it is difficult to gauge the commitment of the government towards good governance.

State of Local Governance

10. Local governance until 1990 was always dominated by an administrative focus, and there was very little political space given to local bodies (LBs). This changed with the Constitution of 1990, and since then (and particularly after the end of the conflict in

2006) local governance reforms have been debated in the same breath as overarching political reforms in the country. Still, at the moment, the administrative divisions set up during the reign of the kings continue to be in place. In this set up, there are 75 districts (that are varied in terms of geographical characteristics and, more importantly, in terms of economic endowments),⁵ 3,915 villages, and 58 municipalities. For law and order purposes, the country was also divided into 14 zones, but this spatial demarcation does not currently hold any administrative or economic significance. The districts and villages are coalesced into development committees and there is at the local body level a development component in parallel to the administrative one.

11. Since 2002, Nepal has not had local elections, which has meant that there are no elected representatives at the local level. This has myriad consequences, the most significant of which is that because the local administration is then run by bureaucrats nominated by the central government (Local Development Officers in District Development Committees (DDCs), Secretaries in Village Development Committees (VDCs), and Executive Officers in municipalities), there has tended to be very little downward accountability. The purported move to a federal state also has other associative implications, including how local governments are to build their capacity, and how inter-governmental fiscal relationships will be structured.

12. Successive governments in Nepal have very clearly stated that in the new emerging political economy of Nepal, the state will play a key role in economic growth and development. This reiteration of the ideology of state-led growth has tremendous implications for the economy, and for the role of the private sector in it. While there is talk of a public-private partnership approach to help the economy grow, there has not yet been much by way of specific government policies and actions in this regard.

Other Changes

13. Other relevant changes in the political economy include:

- a. Increased public awareness of corruption and mismanagement in service delivery; this increased awareness is a result of sustained efforts by non-government organizations and the media itself in bringing to light instances of mismanagement of resources.
- b. The legislature (particularly, the Public Accounts Committee [PAC]) is reasserting itself after a hiatus of several years; even though the Constituent Assembly is not similar to a regular Parliament, PAC has managed to redirect attention to the huge amount of expenditure arrears that the Office of the Auditor General has pointed out in its reports.
- c. Finally, there is an increasing adherence in Nepal to the rights-based approach to development and political space; while this is necessarily good, it also poses constraints if it is not tempered by application of responsibilities, which does not seem to be the case in Nepal at the present moment.

⁵ For example, Ministry of Local Development (MOLD) estimates that Kathmandu district alone collects 40% of all revenue in the country; the district of Parsa (in which is situated Birgunj, the border city with India which handles much of Nepal's land-based imports) collects another 20%; and 64 districts collect only 14%. The remaining 9 collect the residual (26%).

III. Risk Assessment at the Thematic and Sector Level

A. Brief Review

1. Public Financial Management (PFM)

14. The 1990 Constitution requires the Ministry of Finance (MOF) to submit a detailed comparison of the financial results and budgets of all ministries to Parliament at the end of each fiscal year. The Office of the Auditor General (OAG) of Nepal is also granted complete legal and professional independence by the Constitution and its budget is exempt from parliamentary vote. Parliament's Public Accounts Committee (PAC) is also a very strong voice in PFM wherein its meetings and deliberations are open and receive full coverage in the media. It has also been proactive in recent years in instances where impropriety is suspected (e.g., in bank defaults).

Legislative Framework

15. Relevant legislation and regulations on PFM include the 1999 Financial Procedures Act and 1999 Financial Administration Regulations (FAR). These instruments enable provisions for: (i) budget preparation and approval; (ii) accounting and reporting on budget implementation every quarter; (iii) a detailed report (Schedule 2 of the FAR) that includes a statement, not only of expenditures, but also of physical results and goals achieved; (iv) elaborate procurement and internal control procedures; (v) annual financial statements at all levels, with a consolidated financial statement for the whole public sector at the end of each fiscal year; (vi) internal and external audits; and (vii) ministerial review of project implementation at regular intervals throughout the year, with rewards for good performers and explanations for poor performance.

16. The regulations for financial accountability at the local level are even more impressive than those at the center. They contain provisions and instructions for: (i) budget preparation; (ii) proper accounting and reporting; (iii) creation of an Accounts Committee in every local body to oversee financial management; (iv) internal and external audits; (v) project monitoring; and (vi) an elaborate system for 'ex-post' evaluation of projects which assesses not only the direct costs and benefits of each project but also the impact on employment creation and on the environment.

17. The Local Self-Governance Act (LSGA), Local Bodies (Financial Administration) Regulation (LBFAR), and Local Self-Governance Regulations (LSGR) are also together considered to be the basis for fund flows to LBs.

Institutional Basis

18. The institutional basis of the PFM system in Nepal revolves around the Ministry of Finance, its Budget Division, and the Financial Comptroller General's Office (FCGO). Spending units that comprise the central ministries and other agencies are also a part of the system. At the local level, the spending units (such as, for example, the line agencies that have a local presence) as well as the District Development Fund (DDF), Village Development Fund (VDF), and the District Treasury Control Office (DTCO) are at the core of the PFM system.

19. A Large Taxpayer Office has been in place since 2004, and to improve expenditure management, since 2004-2005, the Government has adopted a reclassification of expenditure into current and capital, along the lines of the Government Financial Statistics. Also, expenditures are fully prioritized by ministry and by objective (including sustainable broad based growth, social sector and infrastructure development, targeted programs, governance, and general administration).

20. Accounting and auditing of local bodies are maintained as per the LSGA and the LBFAR, and central-level audits are carried out by the Office of the Auditor General.

Fund Flow Mechanisms

21. In a decentralized system of governance, the need for inter-governmental fiscal transfers arises mainly due to fiscal imbalances between internal revenue and expenditure needs of LBs. Fiscal transfers from the center are the principal source of revenue of all LBs in Nepal. Of the total resources of LBs, it is found that municipalities generate more own source revenue (28.9%) than the VDCs (25.9%). In the case of DDCs, during FY2003/04, the proportion of own source revenue to total revenue was 55.2%. It is estimated that inter-governmental transfer constitutes more than 50% of the total income of DDCs.

22. Two major types of transfer from the center to the LBs are conditional and unconditional grants. For conditional grants (sometimes called specific purpose grants or categorical grants) the center specifies the purpose for which the recipient local body can use the fund. For an unconditional grant no restriction is posed on the use of funds.

23. The Government now has a new system of allocating unconditional grants to LBs. Called the Minimum Conditions/Performance Measures (MC/PM) system, it seeks to reward LBs that have performed well in terms of select indicators with greater resources. The basic pre-condition to receive funds is compliance with the minimum conditions (MCs). Once these are met, allocation under the MC/PM system is formula-based⁶ and the total actual allocation (TAA) of grants to LBs is thus (see also Figure 1):

$$\text{TAA: Entitlement} + \text{Basic Allocation} + \text{Performance Adjustment}$$

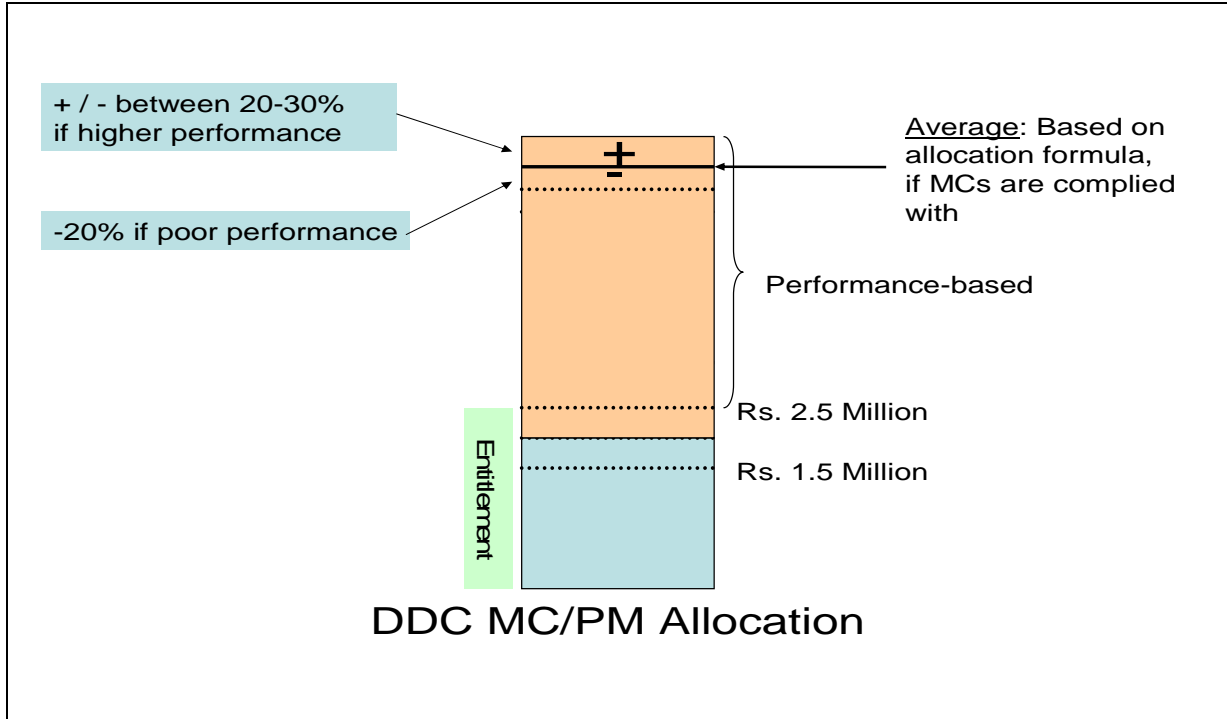
Set threshold applicable to all	Formula-based; given only if minimum conditions are met	Given only if performance conditions met

2. Procurement

24. Public procurement processes in Nepal have undergone major changes over the years. In particular, the legislative and procedural changes have been substantial since the enactment of the Public Procurement Act in 2007.

⁶ Details on the application of this formula are available from the Ministry of Local Development, Government of Nepal, or SAFM/ADB, upon request.

Figure 1: Grant Allocation at DDC level



Legislative Framework

25. Public procurement in Nepal is legislated by the Public Procurement Act (PPA) 2007, which was drafted with the help of development partners – the World Bank, in particular. The Act covers many provisions, some of which include: (i) specification of procurement terminology;⁷ (ii) responsibility for procurement and its procedures (including on preparing cost estimates, the procurement plan, and bid reviews); (iii) arrangements regarding tenders; (iv) provisions regarding consultancy services; and (v) arrangements regarding conduct of the officials involved in procurement.

26. Before the enforcement of PPA, procurement of goods, works, and services in Nepal had been done following the Financial Administration Regulations (FAR). However, the provisions included in the FAR were mainly fitted for accounting purposes rather than for procurement. PPA, on the other hand, includes a set of standard procurement provisions that should be followed in public procurement, and also includes provisions for executing construction works through user groups and delivering services through NGOs. Recently, involvement of user groups/beneficiaries and NGOs in development works including construction, supply, and services has greatly increased.

27. The application of public procurement at local level is governed by the provisions in the LBFAR; however, there have been reports of some confusion in the application of LBFAR vis-à-vis other legislation governing local body administration, in particular, the LSGA.

⁷ This is not a trivial matter in the case of Nepal where many government agencies and local bodies are not clear on what public procurement entails, or indeed what constitutes public procurement.

Institutional Basis and Administrative Provisions

28. The Public Procurement Monitoring Office (PPMO), in the Office of the Prime Minister and Council of Ministers, is responsible for establishing procurement policy and standards, providing training, providing no objections for certain procurements, and reviewing complaints from bidders. It has a website (www.ppmo.gov.np) which contains relevant information on the procurement law and guidelines (as well as tender information). However, there are also some gaps in the website (e.g., as yet, there is no procurement management information system).

29. Central and local government agencies (including DDCs) play a major role in procuring goods, services, and works, being as they are the primary users of public procurement. There are three specific ways in which public procurement for contracts for works and goods takes place at the central government level (with the choice of method to be used based on the value of the contract):

Table 1: Public Procurement for Contracts for Works

Type of procurement method	Criteria for use for contracts for works and goods
Open tendering	> Rs. 1 million
Sealed quotation	Rs. 100,000 – Rs. 1 million
Direct purchase	< Rs. 100,000

30. Other procurement provisions include: (i) for procurement of goods worth more than Rs. 10 million and works worth more than Rs. 60 million, prequalification is conducted; (ii) when awarding contracts for consulting services, quality and cost must be considered; (iii) to attract the greatest possible number of bidders, tender opportunities must be published at least twice in the national print media (and for transparency purposes, the selection criteria have to be clear in the advertisements); and (iv) no post-tender negotiations are permitted.

3. Corruption

31. The state of corruption in Nepal has tended to improve slightly over the years, although with a Transparency International (TI) Index rating of only 2.7 (as of 2008),⁸ it continues to rank as a country with rife corruption. The Finance Minister's budget speech in 2008 mentioned corruption as the biggest challenge in the country and stated that corruption was "rampant in various forms, and from the lowest to the uppermost level of the public machinery".⁹ Being acknowledged from the Finance Minister, this is a serious matter indeed. The literature on corruption in Nepal talks of the key problems of rent-seeking in privatization, natural resource extraction, and in foreign aid. The rent-seeking behavior is positively correlated to the rising cost of campaign financing, the costs of which candidates seek to recoup once in office (and given the primacy of the parliamentary system of government in a New Nepal, this attribute of the problem is likely to remain for some time to come). There is also a strong link between politics and business, and consequently a conflict of interest.

⁸ As against its rank of 131st with a CPI score of 2.5 in 2007, Nepal was 121st out of 180 countries listed in the CPI with a score of 2.7 in 2008. A score of 5.0 is the number Transparency International considers the borderline figure distinguishing countries that do and do not have a serious corruption problem.

⁹ Accessed at: <http://www.kantipuronline.com/kolnews.php?&nid=162406>.

Legislative Framework

32. The legal framework on anticorruption in Nepal is based on the following:
- a. The Prevention Corruption Act, 2002, which criminalizes attempted corruption, active and passive bribery, extortion and fraud, and which forms the most important piece of legislation that targets corruption in Nepal. While this Act deals primarily with private-public corruption, a private sector anti-corruption legal framework is established by the Competition Promotion and Market Protection Act, 2006. This Act defines and bars anti-competitive practices, such as tied selling, bid rigging, cartel formation, collective price fixing, undue business influences, as well as syndicate and exclusive dealing.
 - b. Commission for Investigation of Abuse of Authority Act, 1992 (Second Amendment, 2002), which includes provisions for sanctioning those found guilty of corruption, relating to statement of property by persons holding public posts, recognizing and protecting whistleblowers, etc.
 - c. The Right to Information Act, 2007, which entitles citizens to receive public information within fifteen days of applying to any government body or public enterprise.
 - d. Other relevant pieces of legislation including (i) Amendment of Special Court Act, 2007, (ii) Anti-Money Laundering Act, 2008, (iii) Good Governance Management and Regulation Act 2008, (iv) Customs Act, 2007, (v) Excise Duty Act, 2002, (vi) Value Added Tax Act, 1966, (vii) Foreign Exchange (Regulating) Act, 1963, (viii) Revenue Leakage (Investigation and Control) Act, 1993, and (ix) Prevention of Asset Laundering Act, 2008.
33. Apart from the laws in force there are also Regulations enacted to facilitate the execution of mandate of some important anti-corruption institutions and court decisions such as: (i) regulations pertaining to National Vigilance Center, 2009, and (ii) Constituent Assembly Regulations that make provisions for the Public Accounts Committee. It is safe to say, however, that despite these laws and acts, recent governments in Nepal have had to be more engaged in peace building, social inclusion, and constitution drafting, and thus focus on anticorruption has not necessarily remained high.

Institutional Basis

34. The institutional basis of anticorruption work in Nepal revolves around six key agencies:
- a. The **Commission for Investigation of Abuse of Authority (CIAA)**. This is the apex constitutional and primary body that investigates corruption by persons holding public office. The body has the right to access bank, financial, and commercial records when investigating public sector corruption; and it can also file cases in the Special Court (see below) against persons accused of corruption. The CIAA also now increasingly works with civil society organizations (such as Transparency International Nepal) to combat corruption, and it has delegated part of its authority to the heads of the five Regional Administration Offices.

- b. **National Vigilance Center (NVC).** NVC, established in 2003, is an independent institution whose Chief Officer is answerable directly to the Prime Minister (PM). Its primary function is to play a preventive role in combating corruption, mainly by monitoring asset declarations of officials and by conducting technical audits of projects and government operations to ensure that service delivery weaknesses in the public sector are dealt with promptly and effectively. However, while NVC may be located within the Office of the Prime Minister and Council of Ministers (OPMCM) it is anything but close to the PM (being physically located elsewhere from the Office of the PM, and with very little approach to the PM on a regular basis).
- c. **Office of the Auditor General (OAG).** The OAG is a constitutional body that carries out audits of the accounts of all public offices and public corporations, including government and ministries. Article 13 of the Constitution ensures the OAG complete independence. Staff members of the OAG are recruited through the Public Service Commission. Audit reports are required to be made public. OAG assesses whether expenditures made, and revenues collected, comply with prescribed rules and regulations, and whether they reflect due regard for efficiency, effectiveness, and propriety.
- d. **Public Accounts Committee (PAC).** PAC is one of the select committees of the present Legislature-Constituent Assembly. Its main function is to examine the Public Accounts and the Report of the Auditor General to reduce misuse and abuse of public funds. It is empowered to direct concerned departments to explain financial irregularities, and also to pursue the clearance of arrears, that might have been specified in the Report of the Auditor General.
- e. **Special Court (SC).** The Special Court is a separate bench of the judiciary mandated to effectively and swiftly dispense corruption cases that are filed with it. In particular, CIAA uses the Court to prosecute corruption cases. The Court is also mandated to consider cases of crimes against the state, and to hear appeals against the rulings of the CIAA.
- f. **Department of Revenue Investigation (DRI).** DRI is an important department under the Ministry of Finance tasked with making the control of revenue leakage in customs, excise duty, value-added tax, and income tax more effective, and also to control the misuse of foreign exchange. It also carries out investigation in tax revenue leakage and initiate action against those contributing to such leakages within the limits of the prescribed laws and regulations. The legislative framework under which it functions includes Revenue Leakage (Investigation and Control) Act, 1996; Value Added Tax Act, 1996; Customs Act, 2008; Excise Duty Act, 1999; Foreign Exchange Act, 1963; and the Money Laundering Act, 2008.

Policy and Administrative Framework

35. ***Strategy and Action Plan against Corruption, 2009.*** The most recent document on the matter issued by the Government is the Strategy and Action Plan against Corruption, 2009, which was recently made public. The document outlines

thirteen strategies and several working guidelines under each strategy. The primary ones include: (i) ensure effective implementation and enhance institutional capacity by bringing timely improvement in existing policies and laws against corruption; (ii) establish working procedures based on integrity systems through promotional campaigns, providing suitable incentives and rewards to institutions, and focusing on morals and integrity in public administration; (iii) make public works and public service delivery organized, competitive, transparent, and responsible, including through effective technical audits, transparent contracting, and encouraging competition in service delivery; (iv) regulate foreign aid and make it transparent to conform to national interest, and make transparent and accountable the activities being carried out by NGOs; (v) make economic activities of political parties more transparent, including auditing their financial records; and (vi) make the work being carried out by local authorities people-oriented, accountable, and conducive to development by strengthening local authorities and making them transparent.

36. **Accountability Mechanisms in Public Services.** There are no specific mechanisms established for accountability of public services as such. But NGOs active in the field of anti-corruption have been using several techniques to establish accountability, including:

- a. **Public Hearings** – used widely as a tool to make public servants answer for services they are rendering or for irregularities in a particular sector or service delivery office. There is a government circular which obliges all public service delivery offices in districts to hold at least one public hearing every month. This is being practiced in some districts yet civil society has to apply pressure often for this to take place.
- b. **Citizen Report Cards** – used in some districts; some public service delivery agencies have been open to this rather benign way of learning of their own weaknesses and rectifying them.
- c. **Social Audits** – being used widely by NGOs in districts and have been quite popular with service recipients.
- d. **FNCCI¹⁰ Code of Conduct** – meant for businesses, the Code of Conduct was a first attempt of its kind to deal with corruption from the ‘supply’ side. FNCCI has also set up ‘complaint hearing unit’ in some locations to deal with instances of violation of the Code.
- e. **Surprise checks initiated by NVC** – in pursuance of the directives issued by the Prime Minister, NVC has been carrying out surprise checks in public offices. It has also started following up on those who have not yet submitted property details.

B. Findings

37. This section of the report considers the findings of the GRA. It not only updates, where possible, the results from existing studies and analyses but also brings to bear the conclusions drawn from various field-based visits.

¹⁰ Federation of Nepal Chamber of Commerce and Industry.

1. On PFM

38. The legal and regulatory framework for PFM has been touted even by development partners as being of a good quality for a developing country.¹¹ However, problems with implementation remain. The World Bank's Public Finance Management Review of FY2005/06 (conducted in 2007; report published in February 2008) showed that while there have been some key achievements in PFM, there remain many more challenges. The achievements include: (i) maintenance of fiscal and macroeconomic stability (no small feat for an economy that has undergone considerable fiscal stress as a result of the conflict for more than a decade), (ii) expenditures aligned to sector strategies in two sectors (education and health) where a sector-wide approach (SWAp) is in place, and (iii) presence of some key features of a reasonably well-designed PFM system (see Appendix 2). At the central level, a PEFA steering committee has been established with PEFA units in about 20 central ministries. The Financial Comptroller General's Office (FCGO) is at the moment focused on: (i) a Single Treasury Accounts System, (ii) IPSAS Cash Based Accounting Standards, and (iii) Integrated Government Financial Management Information System. It is also preparing a PFM Strategy Document that will guide reforms in this area for the coming years.

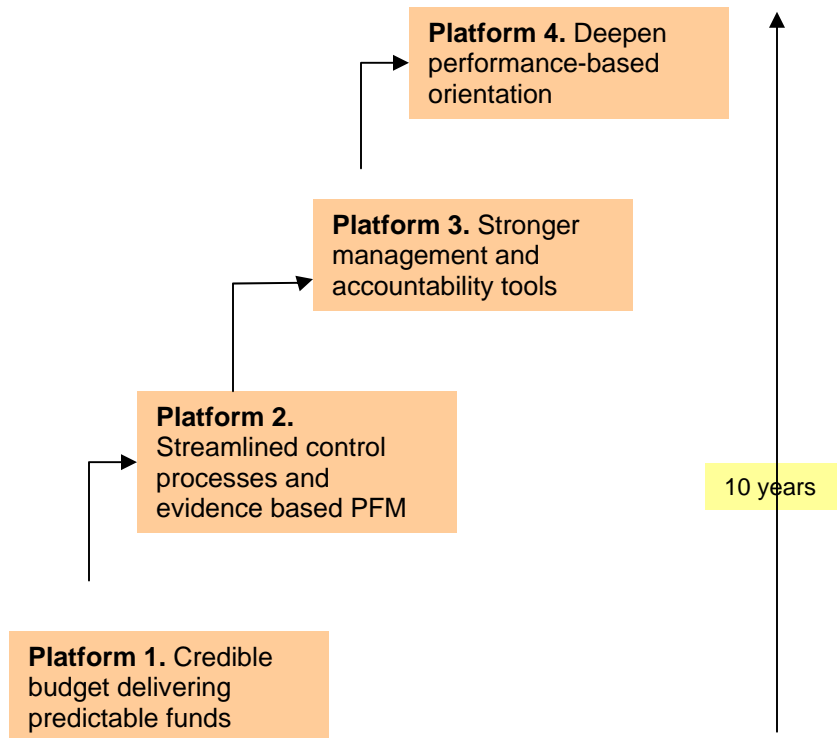
39. On the other hand, the major challenges that remain are enumerated by the World Bank as follows: (i) how to maintain greater fiscal space in light of the huge expectations of the public in the post-conflict period; (ii) how to further align expenditures to sector strategies in other sectors; (iii) how to ensure that the expenditure programs address the various types of disparities; (iv) how to reduce the gap between the rules and performance in the PFM system (i.e., how to better implement the rules that are rather well designed); (v) how to better utilize local public finances; and (vi) how to better manage external assistance.

40. Largely to start managing the implementation constraints, and to ensure that a long-term and sustained, as well as practical, series of steps are considered for strengthening the PFM system, the Government has embarked on what it calls a platform approach to upgrade the system (see Figure 2). What the platform approach seeks to do is to ensure that the Government reaches a particular level of reforms in PFM, sustains the reforms at that level, and then proceeds to initiate the reforms at the next level. This entire process to reach the highest platform (of performance-based PFM) is likely to take about 10 years, on the optimistic scenario that the Government (and future ones to come) is committed to sustainable PFM reforms.

41. While the platform approach is necessarily of long-term duration, its immediate priorities in the area of PFM are as follows: (i) provide greater realism to the budget and improve the credibility of the budget; (ii) continue with tax reform and tax administration improvement; (iii) focus on the institutional strengthening of PAC and OAG; (iv) provide exposure and training for various accountability institutions that include MOF, FCGO, PAC, OAG, etc., aligning with the capacity building program of each institution; (v) develop the concept for improving the internal audit system and gather information and knowledge from other countries to design a credible internal audit program; and (vi) strengthen the PEFA Secretariat to provide credible support in moving forward PFM reforms and in implementing and monitoring progress of the PEFA Action Plan.

¹¹ The legal and regulatory framework for PFM is "impressive for a country at its level of economic development", and "ranks amongst the best that can be found in developing countries"... but problems remain on implementation (see World Bank, Financial Accountability in Nepal: A Country Assessment, 2003, p. 1).

Figure 2: "Platform Approach" in Reforming PFM System



Source: Adapted from Government of Nepal, 2008.

DFID's Fiduciary Risk Assessment

42. Key components of the PEFA assessment of FY2005/06 were updated by DFID in 2008, which came up with three broad conclusions (see also Table 2):

- a. While fiscal discipline is reasonably good, fiscal risks remain high because they are not adequately monitored; and large amounts of spending are taking place outside mainstream reporting systems.
- b. The unsettled political environment has affected the time available to link policies into the budget formulation process; the Medium-Term Expenditure Framework (MTEF) process has stalled and these factors have impeded the strategic allocation of resources.
- c. While service delivery has benefited from more predictable cash releases, lack of procurement plans and limited competitive tendering, weak internal and external audit processes, and weaknesses in key constitutional bodies and oversight bodies make the system highly vulnerable to fraud and corruption.

Table 2: Comparisons of the PEFA Assessment (FY2005/2006) and the Follow-Up Fiduciary Risk Assessment (2008)

Indicator Groups	Assessment of Fiduciary Risk		Trajectory of change
	By PEFA, 2006	By DFID FRA 2008,	
A: Credibility of the Budget (Indicators 1-4)	Medium to High	Substantial	↔
B: Comprehensiveness and transparency (Indicators 5-10)	Medium to High	Moderate	↔
C(i): Policy-Based Budgeting (Indicators 11-12)	Medium	Substantial	↓
C(ii): Predictability and Control in Budget Execution (Indicators 13-21)	High	High	↔
C(iii): Accounting Recording and Reporting (Indicators 22-25)	High	High	↔
C(iv): External Scrutiny and Audit (Indicators 26-28)	High	High	↔

Note: The DFID Fiduciary Risk Assessment, 2008, used a 4-option opinion as to whether the fiduciary risk is low, moderate, substantial, or high; as compared to the previous assessment which used only a 3-indicator set (low, medium, or high). A downward arrow denotes that the risk has worsened since the PEFA assessment; and a horizontal arrow denotes no change in the severity of the risks.

43. In coming to these conclusions, the DFID study also highlighted the following features of the political and institutional environment that are most likely to affect fiduciary risks:¹²

- a. Instability in the coalition government¹³ which may limit its life and could thus stall any commitment to implement PFM reform;
- b. The heavy burden of responsibilities on government and the Constituent Assembly (CA) to deliver public services, prepare a new Constitution; address law and order, and developing a workable strategy for federalism;
- c. Inexperience of the new government in maintaining fiscal discipline and administration of public finance;
- d. The limited term of the new government and the impact that preparation for new elections may have on medium term public policy;
- e. Long term vacancies amongst the leadership of key national accountability and oversight institutions (for example the Public Service Commission, OAG, and CIAA);
- f. Ongoing insecurity and lawlessness is an overarching problem which will limit the effectiveness of technocratic PFM reforms.

44. In summarizing the updated results, DFID concluded that (i) the overall risk relating to public expenditure management in Nepal is high; (ii) the overall risk of corruption impacting on PFM systems is also judged to be high; and (iii) the overall fiduciary risk is also, therefore, high. In all these three indicators, there have been no shifts in the grades from those provided by the PEFA assessment two years back.

¹² DFID, *Fiduciary Risk Assessment: Nepal*, 2008, p. 7.

¹³ There has been no reduction in the degree of political instability in the period following DFID's assessment.

Areas of Progress

45. Since the follow-up report from DFID, there have been several areas of progress, including:

- a. Progress in the development of IPSAS Based Cash Accounting Standard through strong collaboration with the Accounting Standard Board and the ICAN (Institute of Chartered Accountants of Nepal),
- b. Institutional strengthening program for the PPMO with World Bank and ADB support,
- c. A MOU between the OAG and the Norwegian Supreme Audit Institute for capacity building of the OAG,
- d. Following a cabinet decision, initiating the implementation of the Treasury Single Account (TSA) regime for the improvement of the Public Financial Management System with commitment to pilot in Bhaktapur and Lalitpur in FY2009/10 (with technical support from IMF), and
- e. Working towards implementing the PEFA Action plan by:
 - i. creating a PEFA Steering Committee,
 - ii. setting up a fully operational PEFA secretariat at FCGO,
 - iii. establishing PEFA Units in various line ministries to oversee implementation of various actions, and
 - iv. highlighting the PFM agenda as a priority of GON and creating a separate budget line item in support of this agenda.

46. Other reforms that have been made are: (i) reconvening of the PAC from mid-January 2009 with active participation in public debate and in creating demand for public accountability, (ii) GON's strong commitment to improve efficiency in revenue and tax collection, and (iii) GON's commitment to move up the budget calendar by three months with an aim to streamline planning and fund release process as soon as the new fiscal year starts.

Medium-Term Expenditure Framework (MTEF)

47. In 2005, three districts piloted a district-level MTEF. DDC Morang was a pioneer in applying such a framework for 2006/07, 2007/08, and 2008/09, with DDC Kaski and DDC Bhaktapur following. The rationale for this initiative was to overcome some of the limitations of existing processes (fragmentation, weak connection between budgets and plans, and lack of medium-term perspective) and also to build on lessons learned with the central-level MTEF. The exercise produced two major findings:

- a. The first was the lack of predictability of resources – grants from the center are communicated late in the process and often change during the fiscal year while capacity to project revenue collection is limited, and firm commitments of donor resources are also highly uncertain.
- b. The second finding was the high level of constraints imposed on resources provided by the center and by donors – hence defeating the purpose of an integrated MTEF that seeks to make trade-offs across sectors.

48. In a broader context, however, the policy of a MTEF has indeed been useful. Public expenditure reforms did take place during the time that the MTEF was

emphasized. Critical actions in this area included prioritizing all development expenditures (through the MTEF) on the basis of the Poverty Reduction Strategy Paper (PRSP) priorities; and providing adequate funding for high priority activities. For this purpose, a realistic MTEF was adopted, projects/programs were ranked into three categories, (P1, P2 and P3), and 190 projects/activities which were considered low priority were either dropped or merged. The objective of public expenditure reform has been to accelerate the delivery of benefits to the rural poor through better targeting of expenditures.

MOLD Capacity

49. A continuing weakness in this area has been the low level of capacity of the Ministry of Local Development (MOLD)—the apex body responsible for overseeing progress of LBs—to effectively supervise and monitor them. MOLD does not have the staff, skills, mandates, or the capacity both to monitor local bodies and to implement a rapidly expanding program of activities. Part of the problem of non-compliance of reporting and accounting standards by local bodies lies in the fact that MOLD's own capacity to supervise and monitor them is limited (e.g., even where the DDCs have carried out their internal audits, such reports have not been reviewed by MOLD).

50. A 2008 review of MOLD's institutional capacity to manage the Local Governance and Community Development Program (LGCDP) found that the Ministry has severe capacity constraints to fully engage with all local bodies. This was specified as a key risk to the effective management of the LGCDP. Largely to address this risk, several development partners have provided technical assistance to the Program Coordination Unit of the LGCDP in 2008 and 2009.

PFM in Local Bodies

51. Given the fact that the country will move to a federal structure in the coming years, it is important to analyze the inter-governmental fiscal implications of such a political transition. At the local body level, PFM issues were found to be characterized by: (i) excessive involvement of political parties during selection and implementation of projects; (ii) increasing level of mismanagement; and (iii) lack of capacity to manage PFM protocols, including revenue generation. Though LB officials stress that need-based bottom up approach is followed through consultation with community leaders in the presence of local political leaders during the program planning stage, in reality, it is the representatives of political parties, who constitute an all party advisory body, that advise and support the executive heads of the LBs.

52. In most of the LBs visited by the team budgets were not in line with actual revenue generation. Programs tended to be selected to appease key stakeholders despite revenue constraints that fall short of budgetary requirements. Relevant data shows that municipalities, for example, were able to generate just a bit below 65% of the projected revenue in the fiscal year 2006/07. Thus, ultimately, projects that have the support of influential political leaders and pressure groups tend to gain precedence over other projects that are higher up in the priority ranking.

53. A similar situation also prevails in the expenditure front. Municipalities, for example, fall far behind when actual expenditures on major heads are compared to the projected ones. Data shows that in FY2006/07, the overall actual expenditure was short by about 45% in comparison to the projected expenditure. The situation was even worse

in the case of capital expenditure which fell short by some 56% when compared to the estimated budget amount.

54. Owing to weak financial management systems, most LBs are unable to link capital budgets to a multi-year perspective of project financing in alignment with periodic plans. The budget is also not used as a monitoring tool for financial performance. Likewise, LBs do not seem to have developed financial plans in line with their overall development goal.¹⁴ LBs also suffer from difficulties in predictability of government grants despite the fact that the MC/PM system of inter-governmental fiscal transfers is up and running now. The lack of predictability does not allow local bodies to engage in multi-year financial planning. Thus, it is not surprising to note that municipalities, for example, have to forego some planned development projects as they often overestimate the projected development grant to be received from the government.

55. Auditing weaknesses are also evident in LBs. In the LBs visited by member of the assessment team, it was found that the stock of unsettled accounts has accumulated over the years and appears to be growing.¹⁵ Long backlogs of accumulated unsettled accounts remain with less possibilities of the current leadership taking necessary initiative to settle this. The problem is evident even in central bodies. For example, the volume of accumulated unsettled account of the Ministry of Physical Planning and Works, the primary line agency responsible for urban infrastructure development, has increased substantially (its unsettled account rose from Rs. 1.675 billion at the end of FY2003/04 to Rs. 3.182 billion at the end of FY2006/07).

56. Transparency in financial management also varies among LBs. In most municipalities, for example, budgets are published on the municipal notice boards, while statements of accounts are not always made public. Information on key fiscal aspects such as documented annual budget, in-year budget execution reports, year-end financial statements, and external audit reports are also not generally publicized by most municipalities.

57. The use of participatory planning is not undertaken systematically by LBs, as required by the LSGA. This is partly a consequence of limited downwards accountability and lack of capacity to comprehend the planning system which has been aggravated by the absence of local elected representatives since 2002. The capacity to plan and formulate the budget varies according to LB size, and qualifications and number of staff. The link between the annual budget and the annual plan at the LB level is not always very clear: the budgets normally exceed the actual revenue collection of the LBs. In many LBs budgets are not passed on time.¹⁶

58. Multi year perspective in fiscal planning, expenditure and budgeting (preparation of multi-year fiscal forecast and functional allocations; scope and frequency and debt sustainability analysis; existence of sector strategies with multi-year costing of recurrent and investment expenditure; linkages between investment budget and forward estimates) are not being practiced by all municipalities and LBs. For example, only ten municipalities have produced periodic plans, and in most cases they have not been

¹⁴ This was evident in all the 6 municipalities visited by the members of the assessment team.

¹⁵ All the executive officers in the municipalities visited reported that accumulated unsettled accounts remain for a long period and it would be very difficult for them to settle them, in the absence of the Municipality Council, as they have remained unsettled for a long period of time.

¹⁶ For example, three out of the six municipalities visited (Biratnagar, Lalitpur and Kathmandu) had not passed their budget for the current fiscal year and program selection was still going on while the budget of Bhaktapur municipality was passed recently by the Executive Officer.

passed by the Council and are not used as a guiding document for their annual programs.

Emerging Issues in PFM

59. There are some emerging issues in the PFM system in Nepal that are relevant to this risk assessment:

- a. How to recalibrate fiscal relationships with LBs¹⁷ since given the low own-source revenue of LBs, there is a strong reliance for resource transfer from the center;¹⁸
- b. The main fiduciary risks are from:
 - i. public procurement (see below),
 - ii. support to state-owned enterprises (SOEs) the subsidies to whom far outweigh the dividends they provide to the treasury,
 - iii. contingent liabilities, which result from the increasing level of guarantees being made by Government for borrowings by SOEs; and
 - iv. weak monitoring of both physical and financial progress at the local level (please refer to the sector fiduciary risk assessments for details);
- c. How to enhance oversight by, and accountability to, citizens;¹⁹
- d. High transaction costs for LBs in having to respond to all the procedures and bureaucratic requirements imposed by the center; this has not been helped by some inherent conflicts between the LSGA and LBFAR;
- e. As the DFID updated PFM study has shown, the policy-based budgeting risk has worsened, and outcome-based long-term budgeting has been hampered;²⁰ and
- f. The risk of the staying power of recent governments for long-term PFM goals is high; given the attention of successive governments on political issues such as the constitution-drafting process, and concluding the peace process, this is not surprising.

60. Finally, there are also several related challenges that have emerged, which need to be handled with urgency:²¹ (i) risk of reversal of PFM reforms due to the current political transition; (ii) deteriorating procurement environment resulting in growing cases of collusion, coercion, and intimidation exacerbated by weak law and order situation (see analysis later on in this report); (iii) significant weaknesses in the implementation of the

¹⁷ At the moment, inter-governmental fiscal transfers have increased in volume but are still not based on stable principles. The MC/PM system has managed to establish some rigor to the transfer but this is not yet widely used across all tiers of LBs (e.g., municipalities are still not subject to this performance-based system). In light of the impending federal structure of governance in Nepal, it is essential that the system be thoroughly reviewed and recalibrated. One promising step has been the decision to transfer resources to the DDCs directly from the Treasury to the District Development Fund (DDF) bypassing MOLD.

¹⁸ The fiscal structure in Nepal is mainly organized around the central government, which still collects 95% of all domestic revenues. And while the basis of the block grants is reasonably transparent, more than 90% of them by value is conditional and ring-fenced. (DFID, *Fiduciary Risk Assessment: Nepal*, 2008)

¹⁹ The Open Budget Index 2006 lists Nepal as one of the countries where there is minimal information to citizens on the budget (others listed include Bangladesh, Uganda, Ecuador, etc.) (source: The International Budget Project, 2006, http://www.transparency.cz/pdf/tsr_dstudie_06.pdf)

²⁰ This lack of engagement is due more to a failure in commitment of the political leadership to the MTEF than gaps in the technocratic exercise (World Bank, *An Assessment of the Public Financial Management Performance Measurement Framework (FY2005/06)*, p. vii).

²¹ See the letter from DFID and World Bank (dated February 24, 2009) to the Secretary, MOF.

MTEF and budget formulation process affecting realism and overall credibility of the budget; (iv) lack of a credible system in the PEFA Secretariat to monitor implementation of the PEFA Action Plan and measure its performance; and (v) growing need for enhancing capacity at various levels of all accountability institutions to align capacity with new initiatives in PFM reforms.

2. On Procurement

Introduction

61. Public procurement in Nepal can be described as being the one area that is the most susceptible to corruption. Leakages from the system are considered to be significant: even as far back as 2006, it was estimated that the level of annual public procurement was \$650 million²² (which has surely increased substantially since then), and it estimated that there is a normal 10-25% of this amount lost in corruption (with as much as 40-50% in some instances). This is a staggering loss. As a result, Nepal regularly ranks low on all surveys and studies on procurement matters.

62. Recent reports in the media, along with donor experiences, have indicated that public procurement related fraud/collusion in Nepal is on the rise. Suspected fraud cases have mostly been reported in sectors that undertake high value procurements. Reports of intimidation of bidders (including use of violence to prevent bidders from submitting bids), and fraud in procurement have also been reported.

63. A Country Procurement Assessment Review (CPAR) was conducted by the World Bank and Government of Nepal (GON) in 2002. The ratio of projects at risk was estimated then to be 44 percent, which was much higher than a 20 percent Bank-wide average. The main problems identified included: (i) insufficient capacity to undertake procurement efficiently, and (ii) an outdated system of procurement rules, many of which did not provide for transparent and competitive public purchasing of goods, works, and consultant services. The report recommended the following: (i) enact a modern, transparent, and competitive public procurement law (based on the United Nations Commission for International Trade Law (UNCITRAL) to apply to public procurement by all public entities in Nepal at all levels, as well as to parastatals; (ii) create a small, independent procurement agency, with functions defined by a Public Procurement Law; (iii) pending the enactment of such a law, amend the Financial Administration (Related) Rules (FAR) to change anti-competitive rules and practices; (iv) review and develop, as needed, standard bidding documents; (v) develop and accelerate procurement training at all government levels; (vi) instruct OAG staff to assist in applying the donors' procurement rules and not local procurement ones; and (vii) amend the anti-corruption legislation to impose harsh penalties and encourage reporting acts of corruption.

64. The CPAR findings formed the basis of a government action plan for improving the system, in particular, the requirement for a public procurement act (PPA), which was subsequently enacted in January 2007. The PPA was followed by promulgation of Public Procurement Regulations (PPRs) in May 2007. A Public Procurement Monitoring Office (PPMO) was established in August 2007 which reports directly to the Office of Prime Minister and Council of Ministers.

²² ADB & OECD. *Country Reports: Systems for Curbing Corruption in Public Procurement*. Manila, and Paris, 2006.

65. In February 2008, the PEFA report reviewed and provided recommendations for public financial and procurement management. The same year in November, MOF—in response to a growing number of reports of procurement fraud, cartels, and intimidation—appointed a Joint Working Group comprising GON, DFID, ADB, and World Bank to review procurement issues, laws, regulations, and procedures that are impeding efficient and transparent project implementation, and to define solutions to address these issues. The Joint Working Group presented its findings in early May 2009.

2007 Procurement Assessment

66. Since the CPAR was conducted in 2002, the underlying recommendations have been implemented: (i) adoption of a modern procurement law (PPA) in January 2007 with provisions that are generally in line with UNICITRAL model law; (ii) establishment of PPRs in August 2007 in support of the PPA; (iii) establishment of a PPMO; (iv) some procurement training; and (v) amendments of anti-corruption laws to enable harsher penalties for fraud and corruption.

67. Following implementation of the above, a joint GON-World Bank team applied the OECD-DAC Tool for Benchmarking and Assessing Procurement Systems to define levels of achievement of Nepal's procurement system against a set of pre-determined benchmarks. That analysis was incorporated in the PEFA report. Table 3, adapted from the PEFA report, provides a summary assessment of procurement reform progress.

Table 3: Summary of Procurement Benchmark Indicator Assessment

Pillar and Indicators		Score	Assessment
I. Legislative and Regulatory Framework			
1	Nepal's procurement legislation and regulatory framework are internationally compliant?	3	Substantially achieved
2	Availability of implementing regulations in Nepal, documentation, etc., in support of regulatory framework?	2	Partially achieved
II. Institutional Framework and Management Capacity			
3	Nepal's public procurement system is mainstreamed and integrated into the public sector governance system?	1	Not achieved
4	Nepal has functional procurement management?	2	Partially achieved
5	Nepal has procurement institutional capacity?	2	Partially achieved
III. Procurement Operations and Market Practices			
6	Nepal's procurement operations and practices are efficient?	2	Partially achieved
7	Nepal's public procurement market functions well?	1	Not achieved
8	Nepal has contract administration and dispute resolution provisions	3	Substantially achieved
IV. Integrity of the Public Procurement System			
9	Nepal has effective control and audit systems	2	Partially achieved
10	Nepal has efficient appeals mechanism	2	Fully achieved but still to be tested
11	Nepalese public have broad access to information	2	Partially achieved
12	Nepal respects ethics and anti-corruption measures	2	Partially achieved

Source: *Nepal: Managing Public Finances for a New Nepal - Public Finance Management Review*, World Bank, Report No. 43384-NP, July 5, 2007.

Note: Based on OECD/DAC baseline indicator methodology. A score of 1 means that the trigger is not achieved, with serious procedural deficiencies; 2 means the trigger is partially achieved, with procedural deficiencies but benchmarks partly met; 3 means the trigger is substantially achieved, with some procedural deficiencies but most benchmarks met; 4 means the trigger is fully achieved.

68. While recognizing progress, the above assessment highlighted the need for further actions, including:

- a. Review of some problematic provisions in the PPA, in particular, the requirement for cabinet approval of all contract variations exceeding 15%;
- b. Requirement for subsidiary documents in support of the PPA/PPRs including standard bidding documents and manuals;
- c. Mainstreaming and integrating the procurement system into the financial management system;
- d. Ensuring full autonomy for PPMO;
- e. A system for documenting and disseminating procurement information to the public;
- f. Strategy for training procurement professionals;
- g. System for collecting and monitoring national procurement statistics;
- h. Procurement skills in the recruitment of consultants requiring significant enhancement, including preparation of terms of reference, requests for proposal, evaluating expressions of interest, and technical proposals;
- i. Managing cases of collusion on works contracts, high bid rates; etc.;
- j. Dispute resolution system in procurement needs to be strengthened;
- k. Timely auditing of issues by FCGO needs significant improvement; the same applies to performance auditing; auditors need to be trained in procurement-related issues in order to conduct quality audits, etc.; and
- l. Accountabilities and penalties to be enshrined in the public procurement system.

More Recent Developments (since 2008)

69. Despite the enactment of the PPA, and subsequent PPRs, there is general consensus that the national procurement environment is deteriorating. At the central level, the PPMO is under-funded and under-resourced; as a result, staff are demotivated, and procurement capacity development, in general, has been inadequate and ineffective. Of greater concern are reports of PPMO's authority being undermined (e.g., there are reports of changes being made to the PPRs by higher authorities without the Office being consulted). At district level, instances of collusion, physical intimidation, and obstruction of bidders have become more frequent. The fundamental issue here that is undermining public procurement is related to a general decline in law and order and inadequate security. A Joint Working Group²³ (of which ADB was a member) concluded this very strongly as a result of its extensive field-based work.

70. The Joint Working Group reported its findings to GON in May 2009. The Group ascertained that procurement in Nepal has been compromised mainly due to the following practices:

- a. Collusion by Contractors and Contractors Association: Usually between an individual contractor and/or central/district level contractor association that collude in bidding. They are either coordinating/facilitating or intimidating others in order to bid at a higher price or to secure work in their own area of influence. They have used money and/or threat to institutionalize collusion. The problem of collusion in public procurement is substantial at the moment. This takes place at different phases of the procurement process,²⁴ and with varying degree of intensity. This

²³ The Group consisted of GON, World Bank, DFID, and ADB.

²⁴ The joint study has found that possible collusion is possible at any one of the following stages: (i) design or pre-solicitation phase between the bidder and the designer, (ii) bidding stage, among the bidders, (iii) bid

collusion can be by the contractor and the contractor association, mostly at the local level, and often forced by local goons or political followers directly/indirectly; or by the major contractor in the area by threatening other competitors so as to submit an uncontested bid; or even contractors taking turns to submit bids. Collusion is said to be institutionalized in the construction industry, in particular.

- b. Intimidation and collusion by goons or local unemployed or self-declared political followers: There has been a sharp rise in intimidation by goons/local unemployed/self-declared political followers in Nepal for several years now. No tender in the last several years was reportedly free from the involvement of goons/local unemployed/self-declared political followers. The groups usually threaten the bidders to give them money in exchange for which they are allowed to submit bids without competition.
- c. Works through User groups/Beneficiaries:²⁵ On the basis of a provision in the PPA, user groups are eligible to take, and are taking, construction contracts at district and lower level. The user groups are not required to compete with others and to submit performance security, and no retention money is deducted. The user groups are signing contracts at schedule rates without competition. Further, political influence has been playing a major role in breaking a project into small sub-project (contracts) and awarding them to user groups. Quality of work done by user groups has also often been questionable.
- d. Works through NGOs: The involvement of NGOs in delivering works/services has reportedly increased in the last few years. It has been reported that a majority of the NGOs have political interest, and use political influence/pressure in order to get a contract. There tends to be no standard qualification and screening system in selecting an NGO and awarding a contract at DDC and VDC level. Similarly, DDCs and VDCs are not equipped with the necessary tools and skills in monitoring and supervising the NGOs' work.

evaluation and acceptance stage, between the winning bidder and approving authority, and (iv) contact execution stage, between the contractor and construction supervising agency. The study also details specific prominent indicators of collusion at different phases. There are several documented cases highlighted in the joint study. For example, in the Rural Access Program where intimidation tactics were used against bonafide bidders; instances of collusion are also rampant. Over-contracting is also a problem. In one case in 2007 (in the APPSP programme in Rautahat district, 95 contracts worth Rs 37,306,000 were issued against a budget of only Rs 13,728,000, and in all instances 15% advances were paid due to mismanagement by government and programme staff.

²⁵ The selection of projects to be executed through a users' committee is guided by the LSGA; generally, some of the criteria are: (i) projects which are production-oriented, (ii) projects which can be operated with low costs and larger peoples' participation, (iii) projects providing direct benefits to women as well as backward class and children, (iv) projects that can contribute to protection of the environment, etc. PPA has allowed a public organization to execute a construction work or related service without competitive bidding through user groups of value upto NRs. 6 million. Unlike a contractor, a user group is not required to submit securities for the bidding and performance, and is not allowed to claim any overhead and profit for the work. There is no provision for keeping retention money from the interim and final payments to the user groups and no provision for compelling the user group to maintain the project in the defect liability period. In a contractual sense there is no provision which makes the user group committee accountable for its work nor does it allow the employer to make a claim for the user group's non-performance. Thus the user group is not contractually bound to deliver a work or services at the desired quality and efficiency.

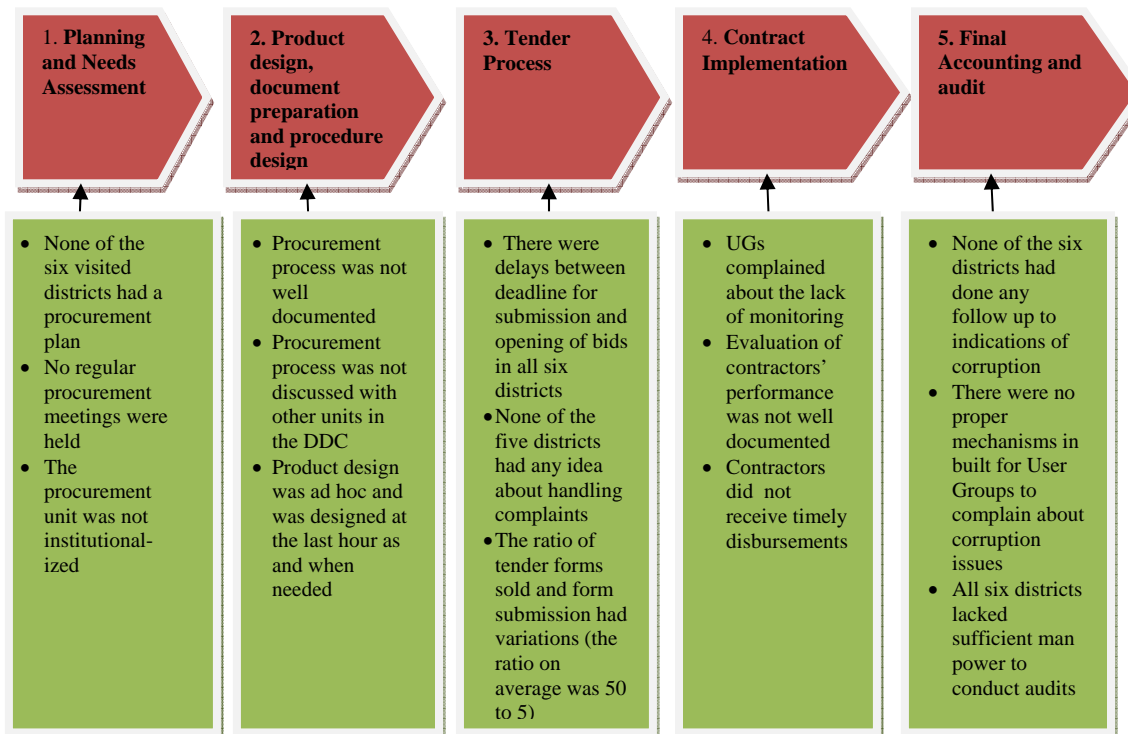
Procurement in Local Bodies

71. LBs follow the PPA but rarely have a proper procurement plan nor guided by specific procurement manuals. More worryingly, awareness of the basic elements of the Act and the improvements made in procurement procedures is low in LBs (e.g., procurement functions in municipalities are normally carried out by the official who is in charge of the store section). Practically none of the LBs, including municipalities, have a separate procurement unit with trained procurement officers on board.

72. There is also a relatively limited degree of integration of procurement plans in the overall financial management system at the local level. Many problems related to transparency and corruption in procurement are apparent there: (i) the ratio of bids submitted to documents distributed is very low, usually with submissions just meeting mandatory requirements;²⁶ (ii) collusion is rampant with successful bids very close to the budgeted provision; (iii) the practice of technical audits is nominal and there is low level of monitoring of procurement works; (iv) threats, intimidation, and extortions are common practices; and (v) bribes and corruption are accepted and taken for granted.

73. In general, Government and LB officials lack knowledge on procurement related issues. Figure 3 provides the findings in six districts as to where the gaps are most prevalent in various stages of procurement.

Figure 3: Gaps in each Stage of Procurement in five DDCs²⁷ (Kathmandu, Bhaktapur, Lalitpur, Morang, and Banke)



²⁶ The officials of Auditor General Office, who conduct performance audit on sample of local bodes, and officials of municipalities visited pointed out that though a large number bid documents are bought, submission come down to three, which is the mandatory requirement.

²⁷ Adapted from *How to Fight Corruption Effectively in Public Procurement in SEE Countries*, OECD, 12 November, 2007.

74. The risk associated with procurement at the local level is considerably high because the application of the new framework as stipulated in the revised LBFAR results in many weaknesses in implementation due to the failure to attach personal responsibility and apply sanctions that are provided in the existing regulations.²⁸

Continued Weaknesses

75. Despite all the efforts to date, PPA continues to expose some weaknesses, including the lack of teeth to enable Government to sanction firms that are involved in collusion.²⁹ Traders have also sought changes in the PPA saying many provisions in it are not impartial to them. Donors themselves are still not fully satisfied with the existing provisions on international competitive bidding in the PPA because of its various weaknesses in ensuring more international bidders, and have, to date, refused proposals to adhere fully to government processes in public procurement.

76. In addition to the four difficulties listed in paragraph 61, other vulnerabilities that continue to be evident in this arena include:

- a. Capacity gaps not only in the PPMO³⁰ but also other central government departments, and most seriously in the local governments. As the country moves to a federal structure and there is greater devolution of political and economic functions, the capacity of the local governments to manage their own procurement will be a critical component of how successfully they manage to operate within the devolved political space.
- b. There is also a general absence of procurement plans at central and local levels, and procurement often takes place with no plans to back it up.
- c. Lack of acceptance by the domestic construction industry; cumbersome procedures for modifying contracts; and lack of incentives in the executing agencies for implementation.
- d. Other vulnerabilities are inherent in minimal monitoring, lack of technical audits at the procurement stage, weak internal and external audit processes, and inadequate application of the PPA, particularly in the area of sanctioning. The PPMO is currently working on developing a system that will enable such a sanctioning process to be in place soon.

77. In light of these problems in procurement, the joint study has recommended some measures, including:

- a. The capacity of executing agencies on procurement and monitoring should be strengthened. The monitoring section of the executing agencies should be made accountable and responsible in ensuring that proper guidelines are used in practice. In order to enhance the capacity of executing agencies on procurement and monitoring, a comprehensive

²⁸ Department for International Development, August 2007, Fiduciary Risk Assessment for the Rural Reconstruction and Rehabilitation Sector Development Program.

²⁹ Which is why corruption in public procurement in Nepal is penalized according to the Prevention of Corruption Act, and the Competition Promotion and Market Protection Act.

³⁰ Gaps in the PPMO are also evident in the area of monitoring procurement processes at sub-national level. This point is discussed further in the sectoral assessments further on in the report.

training should be designed and delivered, and it should be made available domestically. It should also be made mandatory for the procurement officers of executing agencies to have attended the training. A certification system should gradually be introduced.

- b. E-bidding should be explored as an option to avoid physical obstruction in submitting tenders and thus reduce the chance of collusion. Tender submission at multiple locations would also reduce the chance of collusion.³¹ The tender selling and submitting locations should adequately be protected by security forces. Law and order should be maintained in order to control the intimidation of the goons/criminal groups.
- c. A practice of awarding a contract to a user group on the basis of value of work, irrespective of the nature of work, should immediately be stopped. The user group committee should be made a labor supplier but not a contractor. Similarly, an NGO should not be awarded any work without proper qualification and screening.
- d. A criterion for blacklisting the contractor/supplier/user groups/NGOs should be developed and enforced if they are found involved in collusion, fraud, corruption, and malpractice.
- e. Minimum qualifications for the people involved in the management of a construction company and NGOs should be recommended and strictly enforced.
- f. Standard of Practice (SOP) including the code-of-conduct that should be followed by the members of professional societies such as engineers' associations, contractors' association, consultants' association, and NGOs should be developed and enforced. Because many NGOs have political linkages, it is essential that they be "weeded" out of the procurement process. Thus it is necessary to introduce a system of qualification and screening of NGOs before awarding a contract.
- g. There should be key performance indicators for the project depending upon its size. Any project exceeding the threshold value should inform the funding agency of the key decision such as evaluation of bids, award of contract, and completion of the contract.

78. Over and above these steps that should be taken, two related steps of the government might point a positive way forward:

- a. Attempts to revise civil service rules and guidelines so as to clearly define the roles and responsibilities of civil servants and those of the political leadership (such as Ministers) in order to insulate the former from undue interference and prevent the usurpation of their functions and decision-

³¹ However, the recommendation that relates to multiple drops of the bids and opening is prima facie unacceptable, as it is contrary to good international procurement practice. Added to this are the bidders' apprehensions about the sanctity of the bid submission and opening at places far away from their physical presence. The Federation of Contractors Associations (FCAN) also advocates for such multiple drops which is supposedly to be an antidote of intimidation. There is however no guarantee that so called goons would not multiply and aggravate the problems

making by the latter. Although legislation has been drafted to this end and submitted to the Cabinet recently, it remains to be seen whether it will be approved any time soon.

- b. MOLD has also drafted procurement guidelines for purposes of local governance (as part of its efforts under the Local Governance and Community Development Program [LGCDP]).³² These guidelines are in line with the LBFAR. All public procurement done in Nepal (be it at the central or local level) will have to conform to PPA and PPR, and at the local level the procurement also has to be as per the LBFAR.³³

79. Whether these steps and recommendations will work or not depend squarely on the government's political will to address the ever-growing problem in public procurement processes; this is largely because of the vested interests of political parties in the procurement process.

3. On Combating Corruption

80. The single-most obvious conclusion about the state of corruption in Nepal has been uniformly stated as "corruption is endemic and institutionalized".³⁴ This is despite the fact that the Government, over the years, has publicly stated that one of its top priorities is to fight corruption. In recent years, it has signed the United Nations Convention against Corruption (UNCAC) but has yet to ratify it.

81. The interim constitution provides for a Judicial Council to take measures to control corruption in the judiciary. However, the UN's 2007 Common Country Assessment for Nepal asserts that "very few cases have been lodged against judges, even though it is widely suspected that corruption has an undue influence on many criminal and civil cases." The Assessment also states that "there is growing concern about the lack of accountability of many civil society organizations" as well.

82. The immediate past government, headed by CPN(M), had come to power in May 2008 with a pledge to do something about the problem of corruption. However, even though there was good intent, nothing much happened.³⁵ Indeed, it has been reported, for example, that expenditure arrears in government now constitutes 2-10% of total expenditure, and, more worrisome, there appears to be little evidence of it being significantly reduced.

³² Government of Nepal. Procurement Guidelines: Part A – General Directives, LGCDP, Kathmandu. 2009.

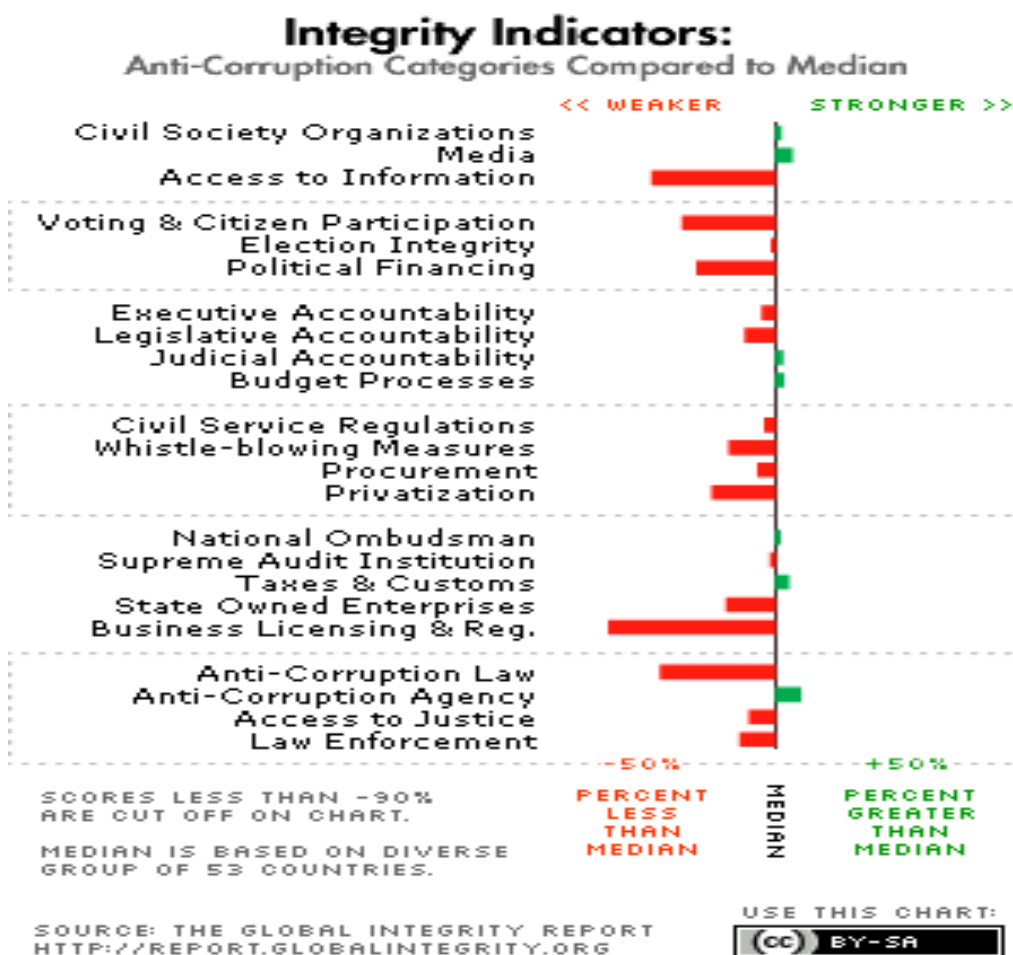
³³ For procurement at local level, as per Rule 62, when a project is to be executed over a period of more than a year or when the total procurement to be done in a project is more than Rs. 1 million, the concerned authority or local body shall prepare a Procurement Master Plan (PMP). For these types of procurement, the concerned local body also has to prepare an annual procurement plan, which is in consonance with the PMP. The annual procurement plan is to be prepared separately for works, goods, consulting services and other non-consulting services. Prior to proceeding with any type of procurement, the local body has to prepare the cost estimates and get them approved from the concerned authority. The PMP is approved by the Local Body and will be amended annually, or as and when necessary.

³⁴ Business Anti-Corruption Portal. 2008. *Nepal Country Profile*. Copenhagen (<http://www.business-anti-corruption.com/index.php?id=601>).

³⁵ For example, on 17 September 2008, the *Gorkhapatra* (a daily vernacular newspaper) carried two headline stories: (1) Excepting the Minister of Finance, no other ministers have submitted their statement on property declaration; that they have promised to do so through explicit code of conduct, within a week, after assuming public office. (2) The Supreme Court has issued an order to the Executive to clear backlogs of financial irregularities of NRs 13 billion (the figure has now reached more than NRs 30 billion).

83. A useful indicator set to consider in analyzing the enormity of the problem in Nepal is to look at the ranking offered by the Global Integrity Report, 2007. The results are summarized in Figure 4.

Figure 4: Integrity Indicators for Nepal



Note: The chart is from the Global Integrity Report 2007 (<http://report.globalintegrity.org/Nepal/2007>). It shows Nepal's anti-corruption performance in several categories, when compared to the other countries studied in 2007. Bars on the right hand side of the vertical line indicate performance better than the median score; conversely, bars on the left side indicate performance worse than the median.

84. The particular Global Integrity Report gave Nepal a score of 60 (highest score was 87, lowest 45), (rank: 35/48) on the Global Integrity Index with an overall rating of "weak" for country performance related to its fight against corruption. The score for legal framework was higher than the overall score (73), and the situation from 2006 was described as "improving".

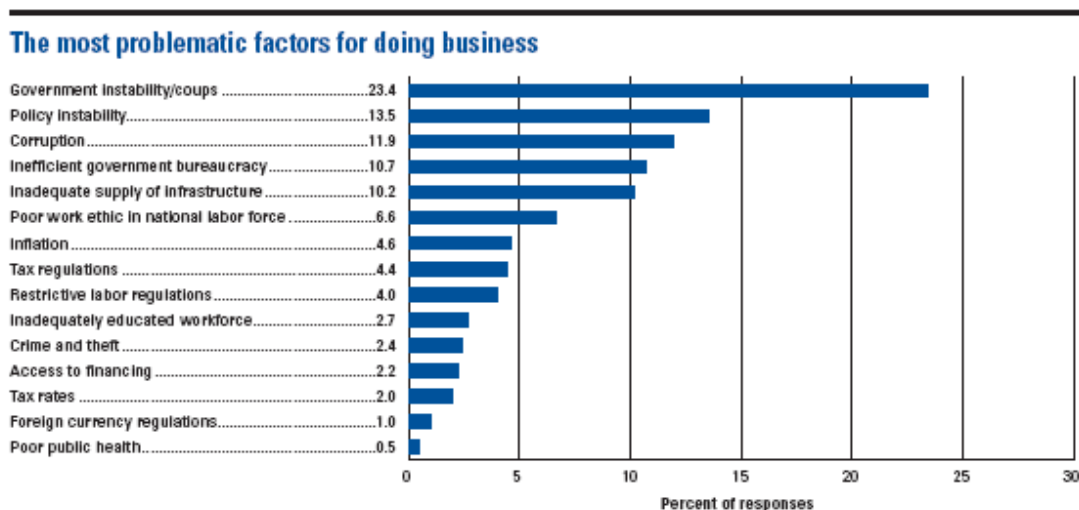
85. Key weaknesses and vulnerabilities in combating corruption in Nepal include:

- a. A heavy backlog of audit hearings at PAC.
- b. Inadequate institutional provisioning at the local levels to combat corruption; the central agencies do not have much presence in the districts and regions.

- c. Weak whistle-blowing provisions although the Prevention of Corruption Act does contain a provision for the protection of informants. The existing act makes provisions for information disclosure but the provisions in the act are meant more to discourage false reporting than to encourage and protect accurate reporting. While, in general, informant confidentiality and anonymity is granted, in practice there is no protection measure for whistleblowers and they are penalized strongly if found out by superiors. According to Global Integrity 2007, people who file a complaint to CIAA generally prefer to protect their identity because of fear of facing negative consequences.

86. Relevant international integrity-related and transparency-related indicators are readily available and show that by far the most problematic factor for doing business in Nepal is government instability and policy instability followed closely by corruption (see Figure 5).

Figure 5: Problematic Factors for Doing Business in Nepal



Note: From a list of 15 factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

The Global Competitiveness Report 2008-2009 © 2008 World Economic Forum

Government Steps in Combating Corruption

87. Successive governments in recent years have taken a number of steps to combat corruption and improve governance in the public sector, the results of which are still yet to be very clear. These steps include:

- a. Opening up some of the accounts that were opaque in the past, e.g., the Nepal Army Welfare Fund.³⁶
- b. Introducing some legislative changes, such as the Governance Act, 2008.³⁷

³⁶ See, e.g., The Himalayan, "NA welfare fund spending made transparent", 27 January 2009. The Nepal Army Welfare Fund currently has approximately Rs 11 billion in the account.

- c. The Federation of Nepalese Chamber of Commerce (FNCCI), which is involved in targeting business-related corruption in the country, has instituted a business code of conduct and the Corporate Ethics Forum.
- d. The previous government in early 2009 unveiled the Competition Promotion and Market Protection Act, which deals with anticompetitive practices, including unethical ones, of businesses.³⁸
- e. CIAA has asked Government to set up good governance units in land revenue and survey offices to collect grievances from the public. This grievance redress mechanism is not very strong across the public service.
- f. The Administrative Restructuring Commission has also instructed Ministry of General Administration to start collecting the property details of government employees that are working in state organs that are "perceived to be prone to corruption". There are also plans to "keep surveillance over their activities".³⁹ These state organs include: customs, land revenue, and transport management departments.
- g. The previous Government's Voluntary Disclosure Information Scheme (VDIS) was well received for purposes of revenue collection; however, the CIAA itself says that foregoing a proper investigation of income sources in the name of tax collection is not right.⁴⁰
- h. There is a degree of external pressure now from the media and civil society on making corruption scandals and losses public. There is considerable freedom of the press in Nepal today.⁴¹
- i. Successive governments have laid out a strategy for service delivery as part of good governance that aims to: (a) transfer local services to local bodies; (b) continue to emphasize citizens' charters and public hearings and give civil society a greater monitoring role largely through a more comprehensive social mobilization policy; (c) disseminate information more effectively by, for example, computerizing all information in public

³⁷ The law is designed to ensure a public administration that is essentially people-oriented, transparent, inclusive, participative, free of corruption, and effective, among others. It also provides for a delineation of the roles and responsibilities of the bureaucrats and the politicians.

³⁸ With the enactment of this law, tied selling, bid rigging, cartel, collective price fixing, market restrictions, undue business influences, syndicate and exclusive dealing has officially become illegal. Sanctions include, e.g., a penalty of Rs. 300,000 to firms that resort to rigging bids. Concern has been expressed, however, that the proposed Market Protection and Market Promotion Board (which is to oversee implementation of the Act) is weak, and a weak regulatory body will not be able to fulfill its role effectively (thus emulating the Consumers Rights Protection Act, which was enacted almost 10 years ago but which has not been operative effectively).

³⁹ See P. Acharya, "Bid to rein in corruption in state organs," *The Himalayan Times*, January 18, 2009.

⁴⁰ See "CIAA raps income declaration scheme," <http://www.kantipuronline.com/kolnews.php?&nid=166545>. The VDIS was introduced by the government in October 2008 to broaden the tax net by giving taxpayers a one-time opportunity to pay up property and income taxes irrespective of their source of origin. The government had called upon taxpayers to pay 10 percent tax on the price of the properties giving an opportunity to tax evaders to pay all outstanding dues and divulge earned assets and income to the proper authorities. Despite ongoing opposition from the private sector, the government had, through VDIS, collected, as of mid-February 2009, Rs 350 million (well below the targeted Rs 1 billion, but nonetheless substantial). The government, in turn, ended up identifying 10,000 potential new taxpayers. It hoped to collect more revenue largely through tightening the tax net and revising bureaucratic processes, including putting in place a performance-based incentive scheme for customs officials (see "I am not frustrated, and no one should be..." Interview with Finance Minister Mr. Baburam Bhattarai, *Nepali Times*, issue 433 (9-15 January), 2009 (<http://www.nepalitimes.com.np/issue/2009/01/09/Interview/15544>)). However, with the change in government in May 2009, the Scheme has been put on the back-burner for now.

⁴¹ The interim constitution promulgated in January 2007 provides for press freedom and specifically prohibits censorship, although these rights can be suspended during an emergency. A media commission has been formed to review media laws and practices. Nepal ranks 138th out of 173 countries on the Reporters Without Borders Worldwide Press Freedom Index 2008, while it ranks 122nd out of 195 countries on Freedom House's Global Press Freedom Ranking 2007, and is described as 'partly free'.

agencies involved in service delivery and enhanced communication among service providers, and make available to the public all information on services delivered by the state; (d) give greater authority to institutions that deliver services and equip them adequately; and (e) place greater emphasis on consumer rights.

- j. The immediate past government took a firmer stand against willful bank loan defaulters. In February 2009, it publicized the names of 339 willful defaulters, each owing at least NRs 10 million to the banks. As of early 2009, banks were owed about NRs 16 billion (about 12 commercial banks bear the brunt of this offence), and double that when interest is calculated. Actions against the defaulters have included seizure of passports, and barring them from taking company directorships.

Corruption and Mismanagement at Local Level

88. Several inter-related factors contribute to the growing corruption problems at the LB level, the most significant of which are: (i) a lack of transparency and access to information that surrounds many LB functions and undermines nearly all aspects of accountability; this has generally hindered citizens' participation in policy discussions and oversight of LB functions; (ii) highly politicized administration even in the face of an absence of locally elected representatives; (iii) limited political will and leadership at the LB level to actually implement required reforms in accordance with the law; and (iv) weak internal control systems⁴² within LBs. These systemic shortcomings have allowed corruption and mismanagement to be ingrained in the manner in which administration is run at the local level.

89. The CDOs interacted at the district level opined that they are overworked and cannot spare much time and have nominal resources (human as well as financial) for corruption cases. As the top priority is accorded to maintaining law and order, corruption cases usually take a back seat. The district administration has not been allocated additional funds for this new responsibility. Expenditure on corruption cases are not accounted under a separate heading.

90. The CDO reports to the CIAA on cases that are referred to by the CIAA, but not on cases that originate in the district. There is a monthly reporting system to the Home Ministry (the district administrations' parent Ministry) but this is not comprehensive and is primarily limited to stating the number of complaints and their current status. Responsible officers at the district level are seldom provided training on the investigation of corruption cases. There is no system of periodic visits by the CIAA to provide guidance or oversight.

91. No serious effort to encourage the public to report corruption cases is made by the District Administration Office. It appears likely that many people are unaware that complaints can be registered at the CDO office. The responsibility for public education is generally taken by civil society organizations who work on good governance issues. Many requirements that user groups need to follow are not being adhered to. Mechanisms such as public hearings, social audit, community audit, and public audit are being initiated by civil society organizations but are yet to be institutionalized by

⁴² Some of these are: i) ineffective internal audit; ii) no incentives for staff who perform well and punishment for those who abuse authority or do not perform their duties; iii) absence of performance and evaluation systems; iv) absence of effective monitoring systems for procurement of works and services etc.

municipalities though the pressure to do so is increasing on account of donor-funded projects that make these processes mandatory.

92. Mismanagement of resources at the local level has for some time now been a source of concern. In spite of various mechanisms being in place, auditors still find worrying financial irregularities. Table 4 provides an insight of the depth of financial irregularities in DDCs and LDFs.

Table 4: Fiscal Year 2007/08 DDFs and LDFs Total Misappropriated Fund (Rs. Thousand)

Description	District Development Fund	Local Development Fund	Grand Total
Account Settlement	90,109	38,801	128,910
Loss Incurred	32	0	32
Other Amount to be Recovered	90,077	38,801	128,878
Misappropriated Fund to be Regularized	423,743	21,972	445,715
• Irregularities	270,116	3,910	274,026
• Supporting Documents not Submitted	140,502	16,046	1,565.48
• Balance not Carried Forward	0	0	0
• Amount not Reimbursed	1,31,25	20,16	15,141
Advance	268,396	12,099	280,495
Total	782,248	72,872	855,120

Source: OAG's 45th Annual Report 2008 part 4 (DDCs). Babarmahal, Kathmandu.

93. A particularly vexing issue has to do with the increased roles played by user groups (UGs) in development at the local level, and while that is a positive development, there are also vulnerabilities inherent in it which do not seem to have been fully appreciated by Government. While the role of UGs has increased, due to lack of monitoring capacity of the DDCs and VDCs the quality of the UGs' work has been compromised. For example, during the visits to community organizations by members of the assessment team, it was noticed that the many requirements that UGs needed to follow were not being adhered to. Mechanisms such as public hearings, social audits, community audits, and public audits are well known but their actual implementation is lacking. In the districts visited by the assessment team, not a single district could produce sufficient documentation of such processes actually being implemented.

Activities of, and constraints, in anticorruption agencies

94. **Commission for Investigation of Abuse of Authority (CIAA).** As of 2007/08, the Commission had managed to recover monies worth Rs. 90 million;⁴³ and it lodged 2,732 corruption complaints in 2007/08 (compared to 4,759 three years earlier). The proportion of cases filed against complaints received by the CIAA has gone down in recent years, with 2.6% cases filed in FY2007/08 as against 3.7% in FY2002/03. The conviction rate of high profile corruption cases filed in the Special Court remains very low with the CIAA often moving the Supreme Court for review of the Special Court verdicts. One particular lapse in its work has been the delays in government agencies responding to its requests for information.⁴⁴ A large part of its current work has been sorting out complaints in delays in service delivery at the ministry level. However, the Commission has been criticized for not prosecuting top officials, and allegations have been made that some of its cases have been politically motivated. The CIAA lost all 18 corruption cases

⁴³ CIAA. 18th Annual Report (for Fiscal Year 2007/08). Kathmandu.

⁴⁴ Last year (2008), for example, of the 180 directives to the government, 143 were never implemented (see "CIAA tells secys to help check graft," <http://www.kantipuronline.com/kolnews.php?nid=167335>).

it brought against top-level officials in the Special Court during 2008⁴⁵ and almost six in ten of its directives to departments have are not implemented.

95. In recent times, the Commission's focus has been more on prevention activities (such as initiating awareness programs at community level, and having frequent interactions with government bodies, secretaries, etc.). It is also aggressively pushing for ratification of the United Nations Convention against Corruption, formation of good governance units in offices, internal reforms within the Commission itself, and for a code of conduct in the public sector.

96. It also seeks to expand its presence outside Kathmandu, and in that regard, it has set up units in 10 districts to coordinate the anti-corruption efforts within the government ministries and departments. At the district level, the district administration, with the Chief District Officer (CDO) at the helm, has been vested with the authority to act on the CIAA's behalf. Though the CIAA has delegated its authority on preliminary investigations to the five Regional Administrators and the seventy five CDOs and deputed legal officers to some districts, reported cases of corruption remain low and mostly unresolved at the local level. Cases are generally forwarded to the center as the staff are overworked, lack investigation skills, and are subject to constant political pressure. Though no sectoral data is available and the reporting of procurement cases is low, corruption in municipality and urban infrastructure sector appears to be increasing and largely unchecked.

97. Technically it is extremely difficult for the CIAA to investigate corrupt officials at the local level by relying on the District Administration Offices, which are accountable to their own ministry rather than to the CIAA and lack the institutional capacity to investigate cases of corruption.

98. **National Vigilance Center (NVC).** The Center may have been designed to have had some clout but, in reality, human resource and capacity gaps (and some amount of conflict over its mandates) have meant that it has not been able to play as strong a role as originally envisaged. It has a very small budget (less than \$500,000 for 2008/09, only 1.7% of which is for capital expenditure), and while it is located in Kathmandu, it works at the local level through the District Administration Office, thus having to poach resources from other agencies in that process.

99. Other weaknesses of the NVC which impinge on its capability to address corruption problems include: (i) lack of authority to investigate and prosecute; (ii) absence of strong follow-up, and given the lack of punitive action on non-compliance, its technical auditing is not as effective as it could be; (iii) lack of cooperation, and indifference, among agencies on sharing information regarding technical audits; (iv) its presence in the national scene does not match the high profile it was given; (v) there is a lack of an effective working strategy in the organization where preventive and promotional measures could be effectively utilized jointly; (vi) it lacks means or tools to match its requirements to fulfill wide-ranging mandates; and (vii) the turn-over of chief officers has been very high which has impacted the leadership of the center.

⁴⁵ Cases to the Commission peaked in 2004/5 at 4,759, and fell to 3,564 in 2006/7. Some 2,967 cases were "resolved" in 2006/7, some 115 cases were filed against public officials, 26 officials faced Departmental Actions, another 16 were warned, 13 had their attention drawn to the problem, and 96 received "suggestions" from the Commission. The CIAA claims a 80% success rate, but this is primarily true in the case of petty corruption.

100. **Special Court.** Even though the 1990 Constitution of Nepal makes a provision for a Special Court that could be established only for hearing of cases of a specific nature, it has not been able to play as strong a role as originally envisaged. For one, it is not very well resourced (for 2008/09, it has been allocated a budget of a mere \$150,000, out of which only a little over 7% is for capital expenditures). The Court also has only one active bench, and is based in Kathmandu alone. There are no plans to expand the Court's benches to other parts of the country; however, the Special Court Act (the First Amendment), 2008, has authorized the Chairman of the Special Court to establish one additional bench within the Court's structure in Kathmandu. The Court has a total staff strength of 48 persons.

101. Weaknesses in the Special Court include: (i) lack of Working Procedural Rules in support of the Act; (ii) less sensitized judges and staff members about technical concepts (e.g., the VDIS, revenue leakages, money laundering, etc.); (iii) a wide gap between the objectives set and the operational arrangements made for the Court (e.g., the procedures to be followed in the Special Court are quite different from those are followed in other Courts); (iv) lack of staff capacity (and capacity development plans) keeping in view the specific nature of the Court; (v) confusion in "ownership" of the Court in matters of staffing and budget (i.e., lack of clarity on whether it is under the purview of the Supreme Court or the Ministry of Law, Justice, and Constitutional Assembly Affairs); and (vi) lack of skilled manpower to maintain the available equipment and technology.

102. **Department of Revenue Investigation (DRI).** While DRI is a very important organization with the responsibility of preventing and controlling revenue leakage, it faces many challenges in fulfilling its duties. For all its important functions, the Department has been allocated less than \$400,000 for the 2008/09 fiscal year (although it does have a much higher share than the other anticorruption agencies for capital expenditures, at over 25% of the budget). DRI is based in Kathmandu but covers the entire country through a network of regional and unit offices.

103. The Department's weaknesses include: (i) lack of relevant regulations on revenue investigation and money laundering (even though related acts exist); (ii) frequent turnover of trained staff which contributes to information leakage, especially on investigative procedures/methods; (iii) technologically not well equipped (for example, there is no financial management information system in place); and (iv) there is no effective utilization of data from the Department of Customs and Inland Revenue Department. Some technical assistance from ADB has been targeted at upgrading its information system.

104. **Office of the Auditor General (OAG).** The Office of the Auditor General also suffers for internal capacity gaps although not to the extent that the others are. It does suffer from a low level of resources (its budget is less than \$2 million a year (for 2008/09), and of this amount, only about 10% is for capital expenditures; the bulk is spent on recurrent expenditures, such as salaries). OAG also has no offices outside Kathmandu, and while it sends auditing teams to sites outside Kathmandu during the audit process, its lack of a permanent field presence does provide some constraints to its effective functioning. At the moment, internal capacity constraints are the greatest risks at OAG. The Office also lacks audit standards in some sectors or fields (such as local government and public corporations), and as the country moves towards federalism, this absence will prove to be extremely detrimental. The Office also continues to rely on traditional methods of auditing and needs to urgently upgrade its business processes.

105. **Public Accounts Committee (PAC).** The Committee has a budget of less than \$1.5 million (for 2008/09), of which only a mere 3% is for capital expenditures. While the Committee works from the Parliament in Kathmandu, its members regularly visit various parts of the country in connection with the investigations of irregularities that have been reported. It has 63 members, and is assisted in its work by a Secretariat comprising civil servants (8 in all). Some weaknesses at PAC include: (i) lack of skills and capacity of PAC members; (ii) decisions of the committee tend to be mostly guided by political consensus meaning they tend not to be too aggressive on any issue; (iii) committee members do not necessarily rise above their party affiliation while discussing issues of irregularities, arrears, etc.; (iv) too big an agenda and often lack time to discuss issues in depth;⁴⁶ and (v) there is often repetition of the same work between OAG and PAC.

C. *Climate Change Issues and Risks*

106. Nepal's ecosystems are increasingly threatened by a rapidly growing population that is putting pressure on its fragile natural resource base including land, water, and forest resources. As rural population rely heavily on natural resources for their livelihood, the deterioration of environmental and natural resource base has contributed to chronic rural poverty and migration to urban areas in Nepal and out migration to India and other countries. Uncontrolled urbanization has contributed to environmental degradation associated with the poorly managed disposal of solid and industrial wastes and other forms of pollution. This is further aggravated by increased intensity and frequency of extreme weather events attributed to anthropogenic climate change, making it extremely difficult to ensure environmental sustainability and human security.

107. In general, successive governments have been rather silent on climate change related risks although they have alluded to the relevant issues in successive plan documents. In the Sixth Five Year Plan (1980-85) there was incorporation of environment and land use policies in the plan documents. From the Seventh Five Year Plan the government started considering environmental aspects in preparing development and construction programs. The Tenth Plan acknowledged the importance of influence weather can have on overall economic performance.

108. Despite that, an analysis of the sectoral MTEF papers for some vulnerable sectors underlines the impression that climate change is ignored, and climate risks in general tend to be neglected in the country's development policy. For example, the MTEF paper for the power sector does not recognize risks to hydropower plants due to the variability in runoff, floods, and sedimentation. The MTEF paper for the road sector also does not discuss flood and landslide risks, nor does the MTEF paper for water supply and sanitation discuss variability in rainfall, which may strongly affect the success of measures in this sector.⁴⁷

109. The ongoing climatic changes and changes that are projected to occur are likely to have impacts on different sectors in Nepal, some (such as rural infrastructure) more severe than others. Government should be mindful of the issues and risks that these

⁴⁶ Indeed, while PAC has to review OAG reports for instances of irregularities in public expenditures, because of the backlog at the Committee, this has not happened on an upto-date basis. For example, the OAG identified a staggering billion dollars in irregularities in government in 2004/05 and urged that they be cleared immediately. To date, PAC has not been able to fully address the concerns of the report.

⁴⁷ OECD and OCDE, Development and climate change in Nepal: Focus on Water Resources and Hydropower, 2003.

pose, and should strengthen, e.g., community resilience to impacts, possibly through insurance schemes, information, and pilot adaptation measures in critical areas. Also, critical infrastructure (e.g. roads, water works, and dams) that are vulnerable to damage from extreme events need to be designed with climate change predictions in mind.

110. Climate change should also be adopted as an overarching cross-cutting theme for the various sectors because it poses crucial challenges for the country's sustainable development. This should include adjusting sector strategies to climate change impact realities; safeguard critical infrastructure; strengthen climate change risk assessment and management capacity within key institutions; promote environmentally sensitive and energy conscious procurement; finance sector climate change risk management; and provide relevant capacity building to central and local level institutions.

D. Summary Risk Matrix

111. As per the Implementation Guidelines of GACAP II, a summary risk matrix is prepared for the three thematic areas (i.e., PFM, procurement, and combating corruption). The matrix summarizes some of the key risks that have been identified, or alluded to, in the report (see Table 5).

Table 5: Summary Risk Matrix⁴⁸

Risk identified	Likely	Relatively serious	Not mitigated over CPS period	Major risk
<u>Public Financial Management</u>				
Lack of political will to sustain focus on MTEF	X	X	X	X
Lack of capacity of relevant central level bodies in adhering to sound PFM protocols	X	X	X	X
Lack of capacity of LBs in all aspects of budget execution, including managing their finances	X	X	X	X
Little follow-up on regularizing financial irregularities	X	X		
Ineffective internal controls, audit, monitoring and evaluation systems	X	X	X	X
Unrealistic budget based on programs to appease key stakeholders	X			
Fiscal transparency low at all levels	X	X	X	X

⁴⁸ See the two sectoral assessments for a more complete review of the governance risks associated with PFM, procurement, and combating corruption as evident on the ground.

Procurement

Gaps in Public Procurement Act, including political commitment to it	X	X	X	X
Low capacity of all relevant institutions at the central and local levels	X	X	X	X
Rampant collusion, threats, intimidation, and extortions	X	X	X	X
Nominal consultation with key stakeholders in all aspects of procurement	X	X		
Procurement contracts are affected by political influence/interference and conflict of interest	X	X	X	X
Low transparency in procurement decisions	X	X		
Little quality control system and performance evaluation for procurement works, including weak monitoring protocols	X	X	X	X
Non-adherence to procurement plans	X	X		

Combating Corruption

Backlogs at Public Accounts Committee	X			
Low capacity of central agencies and LBs to investigate corruption cases and to implement the rules and regulations in place	X	X	X	X
Weaknesses in audit provisions and follow-up at all levels of administration	X	X	X	X
Political interference in public administration	X	X	X	X
Culture of reporting corruption cases and complaining against irregularities is low	X	X		
Bribes and corruption are accepted and taken for	X	X		

granted by the society

No institutional presence of anticorruption agencies at the local level	X	X	X	X
Weak whistle-blowing provisions	X	X	X	X

112. It is clear from Table 5 that the range of major risks and vulnerabilities that are present in the three thematic areas are varied and cover a gamut of concerns. They can be grouped, however, into four main vectors of risks:

Vector 1:

Capability

- Low capacity of LBs and central agencies with respect to combating corruption
- Low capacity in procurement of agencies at central and local levels
- Lack of capacity of LBs in all aspects of budget execution, including managing their finances
- Lack of capacity of relevant central level bodies in adhering to sound PFM protocols

Vector 2:

Laws and Enforcement

- Weak whistle-blowing provisions
- Gaps in Public Procurement Act

Vector 3:

Policies, Procedures, Controls, Rules, and Regulations

- Weaknesses in audit provisions
- Little quality control system and performance evaluation for procurement works, including weak monitoring protocols
- Collusion, threats, intimidation, & extortions in procurement
- Fiscal transparency low at all levels
- Ineffective internal controls, audit, monitoring and evaluation systems
- No institutional presence at local level

Vector 4:

Political Considerations

- Political interference in public administration
- Political interference in procurement
- Political commitment to procurement reforms
- Lack of political will to sustain focus on MTEF

113. The implications of the specification on the vectors are two-fold:

- a. First, it implies that Government should ideally take on a holistic approach to addressing the vulnerabilities and risks if any meaningful impact is to be sought of its mitigative actions.
- b. Second, some vectors of risks are amenable for short-term intervention, some for continuous and long-term engagement, while others are products of actions in other vector of risks.

114. While there should be a concerted approach to the management and mitigation of the risks, the specific risk management actions that ADB can take can be specified as follows.

E. Risk Management Plan

115. The specific risk management actions for the major risks identified in Table 5 can be presented as follows.

Table 6: Risk Management Plan for the Major Risks

Major Risks	ADB Actions	Selected Indicators
Public Financial Management		
Lack of political will to sustain focus on MTEF	<ul style="list-style-type: none"> Engage government on the need to revive the focus on the MTEF Work together with interested development partners in pushing government for the MTEF Begin to engage local bodies to build demand up for the MTEF 	<ul style="list-style-type: none"> Explicit government commitment to the MTEF MTEF provisions specified in relevant budget and other documents
Lack of capacity of relevant central level bodies in adhering to sound PFM protocols	<ul style="list-style-type: none"> Provide targeted technical assistance (TA) support to relevant bodies Help finalize the PFM protocols and assist agencies to finalize relevant capacity building plans Assist in following through on capacity building plans 	<ul style="list-style-type: none"> TA in place Capacity building plans in place Follow-up action plans on impact of capacity building initiatives
Lack of capacity of LBs in all aspects of budget execution, including managing their finances	<ul style="list-style-type: none"> Provide targeted TA support to all LBs as needed Help finalize necessary budget-related documentation, and assist LBs to finalize relevant capacity building plans Assist in following through on capacity building plans 	<ul style="list-style-type: none"> Targeted capacity building action plans are in place Noticeable improvement in financial management at LB level
Ineffective internal controls, audit, monitoring and evaluation systems	<ul style="list-style-type: none"> Provide support to strengthen capacity of internal auditing system Build capacity of OAG and Public Accounts Committee to follow up irregularities Develop sanctions mechanisms for local bodies that do not settle irregularities Revise MC/PM system to provide for such sanctioning 	<ul style="list-style-type: none"> Losses reduced and audits on time and well adhered to Internal audits are regular Effective monitoring and evaluation systems are in place and applied Revised MC/PM system
Fiscal transparency low at all levels	<ul style="list-style-type: none"> Ensure timely and regular public access to budget documents Build demand for seeking fiscal information Provide TA support for enhancing fiscal transparency on a sustainable basis 	<ul style="list-style-type: none"> TA in place Action plan on transparency protocols Support on implementation of Right to Information Act Number of inquiries on budget, and government response received within a specified time period

Procurement

Gaps in Public Procurement Act (PPA), including political commitment to it

- Revise relevant provisions in the PPA
- Engage with government at the highest level to ensure its political commitment to the PPA
- Provide TA, as needed
- Engage with other interested development partners (DPs) to ensure PPA is strengthened

- Revised PPA
- Public expression of government support to the PPA and reforms within it
- TA in place
- Involvement of interested DPs

Low capacity of all relevant institutions at the central and local levels

- Strengthen PPMO, including introducing performance based incentive structures
- Improve public procurement environment (procurement capacity development in line ministries and agencies; procurement training program in all line ministries; accreditation of Government staff as 'procurement specialists', etc.)

- Increased number of investigations referred to DAO resulting in convictions
- Qualified procurement staff in PPMO
- Relevant training plan in place in selected institutions

Rampant collusion, threats, intimidation, and extortions

- Initiate e-procurement system and procurement monitoring system
- Improve law and order (ensure political party cooperation, enforce punitive actions)
- Provide sufficient training to procurement professionals
- Blacklist and disqualify contractors involved in poor practices
- Raise awareness through seminars and workshops on the importance of transparent procurement process to the political leaders
- Assist and support Federation of Contractors Association to help: (i) raise awareness against poor and corrupt procurement practices, (ii) familiarize contractors on e-bidding, and (iii) develop simple instruction manual

- Training plans of local bodies reflect procurement trainings
- List of blacklisted contractors is made public
- FCAN reports published and made public
- Multiple place bidding (if e-bidding is not immediately deemed feasible or necessary)
- Targeted familiarization programs are carried out
- Instruction manual prepared

Little quality control system and performance evaluation for procurement works, including weak monitoring protocols

- Train officials in bid preparation, the development of technical specifications and TORs, and in quality control and performance evaluation for procurement
- Provide assistance in developing monitoring systems and effectively implementing them
- Involve user groups and community members in project design
- Ensure public auditing before final payments is made
- Ensure performance audit is a precondition for relevant ADB investments
- Develop detailed criteria for black-listings
- Help develop a national database for information on public procurement

- Procurement staff with skills in quality control in procurement
- Reports of public audits are satisfactory
- Performance audits are in place and complied with
- Improvement in the quality of goods, works, and services procured
- Procurement monitoring system in place in agencies and LBs, and evidence of their application
- Criteria for blacklisting are used by central agencies and local bodies

Procurement contracts are affected by political influence/interference and conflict of interest

- Engage government and political parties on a continuing basis
- Coordinate with development partners to present a united front against political influence in procurement
- Help organize and convene public awareness on ethics and integrity and the long term impacts of corruption
- Help build demand up for voicing against political interference in procurement
- Set up committee at LB level, including membership of user groups to decide on payments on procurement that does not comply with requirements

- All Ministries and agencies assess the impact of corruption and adopt anti-corruption action plan
- TA provided to raise awareness
- Number of interactions with political parties and other stakeholders
- Close interaction among development partners
- Local level committees are in place and functional

Combating Corruption

Low capacity of central agencies and LBs to investigate corruption cases and to implement the rules and regulations in place

- Targeted technical assistance to agencies at the center and to LBs on fulfilling their mandates
- Engage with government to maintain political support for the anticorruption agenda
- Ensure some level of support to LBs to review good governance practices in ADB projects and programs
- Coordinate with development partners on provision of needed technical assistance so as to maximize impact

- TA in place
- Interaction with government on good governance and anticorruption agenda
- Good governance and anticorruption considerations in ADB projects and programs
- No duplication of assistance to anticorruption agencies and LBs on anticorruption

Weaknesses in audit provisions and follow-up at all levels of administration

- Provide needed technical assistance on audit provisions to relevant agencies (OAG, PAC, LBs, etc.)
- Review MC/PM guidelines to assess how to integrate audit provisions in block grant decisions
- Engage with government to continue to emphasize follow up on audits

- Increased number of audits prepared and made public
- MC/PM guidelines are revised as needed and are complied with by LBs
- Settlement of unsettled accounts are as targeted

Political interference in public administration

- Support anticorruption agencies and civil society to launch public awareness campaigns
- Build demand up to create lobby against politicization
- Engage with political parties on a continuing basis to raise awareness
- Coordinate across development partners to present a united front on minimizing political interference
- Help review relevant acts and provisions on minimizing political interference in public administration

- Significant increase in activities of relevant agencies and civil society in anticorruption
- Number of local level entities that are part of an integrity system
- Reviews of relevant acts and provisions
- Close interaction among development partners
- Coordinated support from development partners to government

No institutional presence of anticorruption agencies at the local level

- Help assess the extent of need of institutional presence of relevant anticorruption agencies, particularly CIAA, at the local level
- Assess existing provisions on DAO work on anticorruption, and provide technical assistance as needed

- Increased CIAA and others' presence at local level (as evidenced by operations in LBs)
- Stronger DAO (as evidenced in resources available to combat

Weak whistle-blowing provisions	<ul style="list-style-type: none"> • Strengthen existing auditing and other control provisions at local level • Ascertain, and support as needed, alternative provisions on combating malfeasance, mismanagement of resources, etc. • Review existing provisions and ascertain gaps • Assess whether similar provisions can be built into other existing laws • Strengthen grievance handling mechanisms in government institutions and in service delivery agencies • Organize seminars and workshops on ethical values and provide technical assistance to establish public complaint systems 	<ul style="list-style-type: none"> corruption) • Level of resourcing for audit provisions compared to the need • Reduction in the level of malfeasance and mismanagement of resources • Revised laws • Greater application of right to information act • Number of government institutions and local bodies where grievance handling mechanisms are in place • Increase in the number of whistle-blowing instances
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116. The risk management plan in Table 6 touches upon some of the actions that ADB can take in order to mitigate the risks. These actions are only for the major risks specified and should not be viewed as the only actions that need to be taken. Taking into consideration the results of Table 6 and the vectors of risks identified earlier, a few actions that should prove to be of impact in the immediate term can be specified as follows:

Range of Risk Mitigation Actions

- Engage Government on a range of issues, including (i) need to revive focus on MTEF, (ii) improving audit system and protocols, (iii) reviewing the need for new acts and regulations in the three thematic areas;
- Coordinate across development partners to better work with Government on issues related to: (i) PFM reforms, (ii) existing procurement protocols and how to revamp the procurement system, and (iii) how best to channel targeted assistance for anticorruption work;
- Engage civil society, unions, professional bodies, etc., to the extent possible, to build up demand for good governance;
- Engage political parties as needed on, for example, ethics and integrity in governance and public administration;
- Provide targeted assistance on a range of needs-based areas, including (i) supporting LBs to respond to the demands for good governance and to fulfill their mandates related to the three thematic areas; (ii) procurement skills enhancement; etc.;
- Support policy measures that support good governance, such as on reviewing and revamping the MC/PM system;
- Focus on sanctioning mechanisms in PFM (such as loss of top-up grants for failures in audit systems) as well as procurement (such as blacklisting and making it public);
- Focus on targeted capacity building for central level agencies in the three thematic areas;
- Focus on transparency and accountability to the public of the budget, for example; and
- Enforce improvements on law and order situation (through enforcing, as needed, political party cooperation and punitive actions).

IV. Concluding Remarks

A. Summary of the Main Risks

117. The main risks that can be identified in the assessment can be grouped as under four vectors:

- a. capability-related (both at the central level and in LBs; and for all three thematic areas);
- b. laws and enforcement-related, particularly on whistle-blowing, and on the Public Procurement Act;
- c. policies, procedures, controls, rules, and regulations-related, including the clear presence of collusion, threats, and intimidation in procurement; and
- d. political-related (not only to do with political interference in public administration and procurement matters but also in matters of political commitment to needed reforms, such as on MTEF).

B. Key Measures to Mitigate the Risks

118. While there have been several actions that have been recommended for ADB in the CPS period, the five that can be highlighted here are: (i) engage with government, political parties, development partners, civil society, professional groups, LBs, and others on introducing and maintaining risk mitigation measures in the various areas listed above; (ii) provide targeted technical assistance to build capacity of various relevant stakeholders, both at the central and local levels, in the three thematic areas; (iii) help review and revise relevant laws, particularly on procurement (i.e., the Public Procurement Act and its regulations), and corruption (such as on strengthening whistle-blowing provisions); (iv) work towards building up demand for reforms from the bottom up; in the move to a federal state, this will send a proper message to stakeholders at the local level; and (v) focus on transparency and accountability in government, and provide needed technical assistance towards this end.

C. Summary of Assessment for Inclusion in CPS

119. **On PFM**, ADB assessment and other studies done by various development partners show that: (i) the overall risk related to public expenditure management in Nepal is high; (ii) the overall risk of corruption impacting on PFM systems is also judged to be high; and (iii) the overall fiduciary risk is, therefore, also high. Some broad mitigation measures that will need to be in place during the CPS period include: (i) engaging the political leadership to recommit to the Medium-Term Expenditure Framework (MTEF) at the central and local levels; (ii) incentivizing, and strengthening, the capability of government departments to adhere to PFM standards, including strengthening treasury systems at the central and local levels; (iii) reconfiguring the Minimum Conditions/Performance Measures (MC/PM) system to reward generation of own-source revenues in local bodies and delegate greater responsibilities for accountability of funds usage; (iv) enhancing the transparency of the budget and of expenditures; and (v) engaging with government and other development partners to develop a sector-wide approach (SWAp) in urban development and rural infrastructure sectors, under stringent and agreed upon fiduciary provisions.

120. **Regarding procurement**, while specific improvements have been made in the public procurement system in the last few years, this area is widely considered to be the most susceptible and vulnerable to fraud and corruption. Three noteworthy risks are identified here: (i) rising instances of collusion/carteling/intimidation; (ii) low capacity of relevant government agencies, including at the local level; and (iii) misuse of specific provisions in the Act, particularly related to reliance on user groups for procurement. Assessments done by development partners have shown that the following mitigating measures may be effective in addressing the risks identified here: (i) putting in place an E-procurement system with E-bidding features; (ii) developing, and fully supporting, a comprehensive capacity building plan for the Public Procurement Monitoring Office and other relevant agencies, including at the district level; (iii) more aggressively engaging stakeholders such as the domestic construction industry; and (iv) strengthening the capacity of local bodies to better engage with, and monitor the work of, user groups, on whom there has tended to be greater reliance to undertake procurement.

121. **Risks and vulnerabilities with regards to corruption include:** (i) lack of voice opportunities for citizens, including weak whistle-blowing provisions; (ii) low capacity, and heavy workload, of relevant anticorruption institutions; (iii) inadequate institutional provisioning at the local level to combat corruption; and (iv) unclear and duplicative institutional mandates at the central level. The fight against corruption has to be holistic in order for it to be effective. In this regard, the following mitigating measures are recommended: (i) developing, and fully supporting, a comprehensive capacity building plan for all anticorruption agencies, including at the district level; (ii) providing greater voice opportunities for citizens, including through greater transparency in the budget process; (iii) emphasizing an anticorruption policy that focuses as much on preventive as punitive measures; and (iv) considering development, and implementation, of a National Integrity Strategy, that introduces anticorruption measures, including a code of ethics in government, and greater partnership with civil society and media.

D. Recommendations for the ADB Country Partnership Strategy (CPS)

122. The Governance Risk Assessment identifies four specific recommendations for consideration in the finalization of the ADB Country Partnership Strategy; these are: (i) all portfolio (particularly, ADB non-lending) in the CPS period should be aligned to the conclusions of the Governance Risks Assessment (GRA) and the recommended mitigative measures; (ii) project officers should be encouraged to adhere to the GRA and to conduct a GRA at the project level while programming their assistance; (iii) engagement should take place with Government, civil society, development partners, and others on all processes and across all areas on a continuing basis; and (iv) ADB is recommended to update the GRA in mid-stream in line with the review mechanisms inherent in the CPS itself.

Note: The assessments for governance risks at the sector level (for the urban development and rural infrastructure sectors) are sent separately from this overarching assessment although they form part of the assessment report.

APPENDIX 1. REFERENCES

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B. LIST OF AGENCIES MET⁴⁹

Central Government Agencies

Financial Comptroller General's Office

Ministry of Finance

Ministry of Local Development

Ministry of Peace and Reconstruction

Office of the Prime Minister and Council of Ministers

PEFA Secretariat, FCGO

Public Procurement Monitoring Office

Commission for the Investigation of Abuse of Authority (CIAA)

Secretariat of Local Bodies Fiscal Commission, MLD

Local Bodies and Administrations

Bhaktapur Municipality

Dhangadhi Municipality

Dhulikhel Municipality

DDC and District Administration Office, Bhaktapur

DDC and District Administration Office, Kailali

DDC and District Administration Office, Kathmandu

DDC and District Administration Office, Kavrepalanchowk

DDC and District Administration Office, Lalitpur

Kathmandu Metropolitan City Office

Development Partners

CIDA

Department for International Development (DFID)

Embassy of Denmark

Embassy of Norway

German Technical Cooperation (GTZ), Urban Development Through Local Efforts (UDLE)

SDC

United Nations Capital Development Fund (UNCDF)

United Nations Development Programme (UNDP)

World Bank

Others

Association of District Development Commission Nepal (ADDCN)

Municipality Association of Nepal (MUAN)

⁴⁹ See the final sectoral risk assessments for a detailed list of the individuals that the study team met in the course of conducting the assessment.

APPENDIX 2. PEFA ASSESSMENT RESULTS, 2006

Assessment Areas	Specific Indicators	Assessment Grade
A. PFM OUTTURNS: Credibility of the budget Result	PI-1 Aggregate expenditure outturn compared to original approved budget	B
	PI-2 Composition of expenditure outturn compared to original approved budget	C
	PI-3 Aggregate revenue outturn compared to original approved budget	A
	PI-4 Stock and monitoring of expenditure payment arrears	D+
B. KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency	PI-5 Classification of the budget	C
	PI-6 Comprehensiveness of information included in budget documentation	B
	PI-7 Extent of unreported government operations	C
	PI-8 Transparency of inter-governmental fiscal relations	C
	PI-9 Oversight of aggregate fiscal risk from other public sector entities	D+
	PI-10 Public access to key fiscal information	B
C. BUDGET CYCLE		
C(i) Policy-based Budgeting	PI-11 Orderliness and participation in the annual budget process	C+
	PI-12 Multi-year perspective in fiscal planning, expenditure policy and budgeting	C+
C(ii) Predictability and Control in Budget Execution	PI-13 Transparency of taxpayer obligations and liabilities	C+
	PI-14 Effectiveness of measures for taxpayer registration and tax assessment	C
	PI-15 Effectiveness in collection of tax payments	D+
	PI-16 Predictability in the availability of funds for commitment of expenditures	C+
	PI-17 Recording and management of cash balances, debt and guarantees	C+
	PI-18 Effectiveness of payroll controls	C+
	PI-19 Competition, value for money and controls in procurement	C
	PI-20 Effectiveness of internal controls for non-salary expenditure	C
C(iii) Accounting, Recording and Reporting	PI-21 Effectiveness of internal audit	D+
	PI-22 Timeliness and regularity of accounts reconciliation	C+
	PI-23 Availability of information on resources received by service delivery units	C
	PI-24 Quality and timeliness of in-year budget reports	C+
	PI-25 Quality and timeliness of annual financial statements	C+
C(iv) External Scrutiny and Audit	PI-26 Scope, nature and follow-up of external audit	D+
	PI-27 Legislative scrutiny of the annual budget law	D+
	PI-28 Legislative scrutiny of external audit reports	D+
D. DONOR PRACTICES	D-1 Predictability of Direct Budget Support	D
	D-2 Financial information provided by donors for budgeting and reporting on project and program aid	D
	D-3 Proportion of aid that is managed by use of national procedures	D

Source: World Bank, PEFA Assessment, Nepal, 2008.

The PEFA assessment tends to show, among others, that while Nepal is a fiscally responsible state:⁵⁰ (i) it is good at planning but bad at implementation, (ii) it is good at collecting revenues but bad in spending (particularly capital expenditures), (iii) it is good at auditing but bad at accounting, reporting and recording, and (iv) it has good systems but implementation is ineffective. At the moment, less than 50% of the donors' resources are off-budget, i.e., not reflected in the national accounts. And the fact that every year almost half the total budget is spent during the last trimester is a sign of improper planning.

⁵⁰ See N. Manandhar, "Nepal PEFA Assessment," <http://www.kantipuronline.com/kolnews.php?&nid=139598>.