

Linking the forestry sector financial system with local government institutions

Frank H.J. van Schoubroeck¹, R.N. Sah and H. Sigdel²

The forestry sector is seriously underutilising its potential to contribute to national development objectives such as poverty alleviation, gender equity, economic development and environmental integrity. Since decades, realised revenues are but single-digit percentages of the value of the actual timber extraction. The Ministry of Forests and Soil Conservation can increase Terai forest revenues up to thirty times by establishing an efficient forestry governance system. The presently dominant productive forestry models are either extremely centralised (National Forest Management) or extremely decentralised (Community Forestry), and they represent a parallel governance structure in the country. Both management models are poorly linked to local government bodies. The latter could help rationalising forest management by providing necessary checks-and-balances in forest management.

This paper proposes to financially underpin on-going experiments with District Forestry Co-ordination Committees, Collaborative Forest Management, and other institutional reforms; in which local bodies, line agencies and civil society organisations jointly plan and implement forestry programmes. A decentralised financial system will allow local partners to co-operate for optimising productive and ecological functions of forests. Local bodies could allocate forest revenues for forestry-related programmes as well as general development. All major players can win: the local government can increase the local development budget, the Forestry Line Ministry can align with local bodies for sustainable forest management, Civil Society Organisations can influence planning and involve in implementation, and the Ministry of Finance can reduce central forestry budgets. The Ministry of Forests and Soil Conservation is the best positioned institution to co-ordinate the forestry financial system reform, which is a complicated but rewarding process.

The need to review the forestry sector financial system

Nepal's Forestry Sector needs better governance

Nepal's forestry sector has a long tradition of contributing to the economy and the central treasury. However, over the last decades, forest-based economic growth slowed down (Hill, 1999, Gyawali, 2004). The sector's contribution to national development objectives like poverty alleviation, economic growth and environmental integrity are at best anecdotal (such as in Community Forestry) or a serious failure (such as in Terai and Chure forest management). The development of participatory institutional frameworks and acceptable forestry management models in the Terai is delayed (Kanel, 1994, Gyawali and Koponen, 2004). This paper is

meant to shed some light on a possible sector-wide taxation and re-investment policy, keeping in mind the growing demand for transparency and regularity in society, the need to reconcile environmental and livelihood objectives, and the on-going national decentralisation policy. It starts with estimating possible benefits to the nation and a brief analysis of the present financial system, and then proposes a vision for a system to suit the needs of the forestry sector, for which relevant ministries should join hands.

An efficient forestry sector financial system will pay off

When discussing the financial system of the forestry sector, an indication of the potential volume of fund flow is useful. The following calculations are only

¹ Dr. Frank van Schoubroeck is Senior Forestry Sector Advisor, Central Support Unit, BISEP-ST, e-mail frankvanschoubroeck@yahoo.com

² Harihar Sigdel and Ram Nandah Sah are Programme Managers of the Central and Regional Support Units, BISEP-ST, respectively.

indicative. For reason of simplicity, the estimated figures are based on timber production in the Terai alone. Potential production of fuel and NTFPs; and environmental effects as well as subsistence production in mid-hill and mountainous areas are not discussed here.

In 2003, the Ministry of Forests and Soil Conservation (MFSC) carried out four small-scale inventories in Rautahat, Bara and Parsa districts, showing that in all four plots of around 1500 ha each, the growing stock had declined (Rural Development Foundation, 2004; Innovative Development Associates, 2004). Decline ranged from 5 to 26 % between 1994-95 and 2003; rather than an expected increase from annual incremental growth. Sustainable incremental growth of Terai forests is taken as three cubic meters (107 cft) per hectare per year (Department of Forests, 1995), of which around half is of timber quality, worth NRs 450 per cft. Based on these figures, Box 1 presents a rough calculation of economic potential and losses in Sabhaiya range post in Parsa³.

Based on measurements in Sabhaiya range post in 1995 and 2003, annually NRs 9.5 crore worth of timber is not accounted for. The potential sustainable production under proper management is estimated

as NRs 3.3 crore per year. Sabhaiya range post is not exceptional; there are areas where degradation is worse, and there are areas where protection is better.

To indicate the monetary dimension of Terai-wide timber flows, as well as potential sustainable production from Government-managed forest, Table 1 provides the valuation of sustainable production of timber extrapolated over three districts, and over the nation. Potential sustainable production is only calculated for production forest; protection forest (which accounts for 71% of the Terai-Siwalik forest area) is not taken into account either for loss calculations or for potential production. The table shows that, on an annual basis, the annual economic turnover for timber sales of Terai production forests could be around NRs 13 arab (around 176 m US\$). This figure is close to a figure of US\$ 160 m calculated earlier (Hill, 1999). The realised annual revenue for the same area is around NRs 27 crore. If the revenue values about half of the turnover (which is a realistic estimate), then the realised annual revenue is less than 5 % of its sustainable potential, and even less of the estimated actual extraction.

The figures indicate that an institutional framework to efficiently manage Terai forests can improve both forest revenues and protection.

Box 1 : Financial analysis of the Sabhaiya range post forest in Parsa

Sabhaiya range post takes care of a production forest situated just south of the Parsa Wildlife Reserve, bordering the densely populated southern belt, ten kilometres west of the Patlaiya-Birgunj highway. The forest area is 1,383 hectares. During the preparation of the 1995 Operational Forest Management Plan, the growing stock was estimated at 6,111 cubic feet per hectare. In 2003, the growing stock is reduced to 4,512 cft per hectare; a decline of 26%. In the same period, the growing stock should have increased (at 107 cft per hectare per year) to up to 6,964 cft per hectare.

At a market rate of NRs 450 per cft for timber, and a ratio of 50-50% timber-fuel per hectare, the standing value of Sabhaiya forest was NRs 13.8 lakh per hectare in 1995; NRs 10.2 lakh in 2003. Expected value under no-harvesting would have been NRs 15.7 lakh per hectare. Should we consider the difference of NRs 5.5 lakh per hectare; the stock reduction between 1995 and 2003 is NRs 76.3 crore, which means a value reduction NRs 9.5 crore (equivalent to US\$ 1.3 m) per year. The realised average sale proceeding 1995-2003 for an area equivalent to Sabhaiya range post in Parsa district was NRs 9 lakh, so less than 1 % of the expected value should all timber have been harvested. This loss is split between the reduction in growing stock (NRs 6.2 crore annually) and the potential sustainable harvesting level (NRs 3.3 crore annually). Thus, on an annual basis, Sabhaiya range post has the potential to sustainably produce timber worth NRs 3.3 crore – if an effective management structure is operational. Additional benefits would come from fuelwood, herbs and leaves, and environmental effects such as a stable water table in nearby agriculture areas.

³ In 2003, 1 US\$ was equivalent to around 75 NRs. 1 lakh = 100,000; 1 crore = 10,000,000; 1 arab = 1,000,000,000.

Table 1. Financial valuation of loss and potential timber and fuelwood production

Command area	Production Forest Area (ha)	Timber value growing stock 1994-95 (in lakhs NRs)	Timber value growing stock 2003 (in lakhs NRs)	Annual reduction in timber value of growing stock (in lakhs NRs)	Annual potential sustainable timber production (in lakhs NRs)	Realised average annual revenue in 1995-2003 (in lakhs NRs)
Sabbhaiya range post	1,383	19,016	14,041	954	332	9
Maduban range post	1,815	21,828	16,563	1,093	435	12
Tamagadi range post	1,935	17,789	16,937	571	464	12
Rangpur range post	1,450	16,460	13,232	751	348	8
Average per hectare		11.41	9.23	0.27	0.24	0.01
Parsa	13,606	125,583	125,583	3,674	3,263	84
Bara	30,607	349,226	282,503	8,264	7,340	196
Rautahat	15,870	181,077	146,480	4,285	3,806	88
Central region	79,283	904,619	731,782	2,1406	19,014	678
Nation	550,000	6,275,500	5,076,500	148,500	131,905	2,721

Source: Based on OFMP production figures, 2003 prices and Department of Forests sale figures for 1995-2003. Figures in italics are extrapolated and should be taken as indicative only.

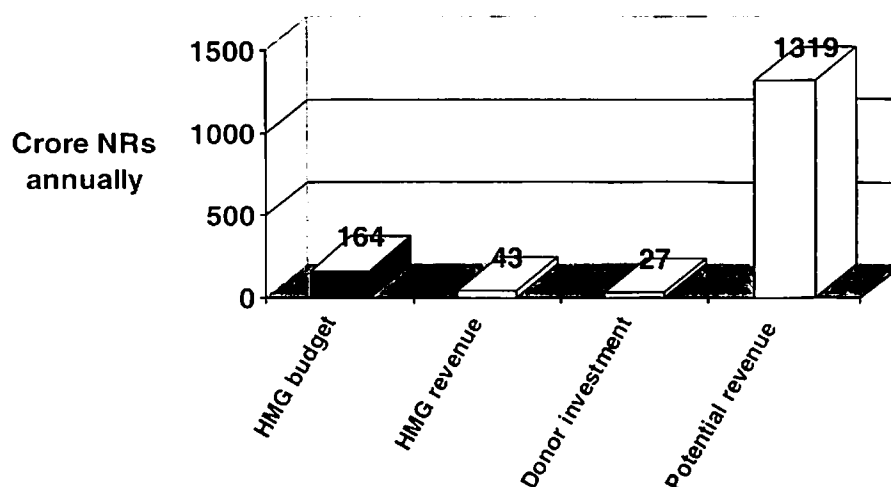


Figure 1. Monetary volumes of the annual HMG-forestry sector budget and revenue, donor investment, and potential sustainable timber revenue from Terai production forests (based on Sigdel, 2003).

Figure 1 gives a graphic representation of some indicative figures in the forestry sector, derived from Sigdel, 2003 (who analysed figures for 1997-2003), DoF, 2003 and Table 1. For the government, the forestry sector costs NRs 164 crore (regular plus development budget), while revenues are around NRs 43 crore (2002-2003 data). The annual contribution to the GDP by timber production in the Terai could value up to NRs 13 arab (1319 crore), around 15 % of the national budget. In 1997-2003 donors invested around NRs 27 crore annually through the national budgeting system. Probably donors a few times that amount through direct funding, mostly in the Community Forestry programme and Wildlife

Conservation. Earlier efforts to support productive management in the Terai failed (Gyawali and Koponen, 2004); since a few years new efforts to utilise Terai forests are underway.

The forestry sector financial system in brief

The present investment system in the forestry sector

For an understanding of the present financial system of the forestry sector, we should concentrate on investment cycles directly linked to investments for sustainable forest-based economic development.

Figure 2 (derived from Rijn, 2002) schematically shows the dominant financial cycles in the forestry sector. Major investment cycles include a national forest management cycle and a community forest investment cycle:

- For government-managed forests, the Ministry of Finance (MoF) allocates funds through the Department of Forests (DoF); mainly for protection and collection of dead and fallen trees. 90% of the revenues are submitted to the central treasury; 10 % to the District Development Committee (DDC), with little expenditure on forestry activities.
- Revenues from Community Forests go to the Forest User Committee which decides on investments in forest management and other expenditures. Since 2002, a legal battle is going on between MFSC and Community Forest User Group (CFUG) associations about a 10-40% taxation on products sold outside the CFUG; revenues are to be submitted to the DFO; i.e., to the central treasury.

There are a few problems with the present financial system. Firstly, decisions on investment levels in government managed forests are taken by the Ministry of Finance, with little feed-back about investment-revenue ratios. For example, in Bara in 2002-2003, the Ministry of Finance scrapped a budget of 50 lakh for the harvesting of dead and fallen trees, missing an opportunity to generate

revenue of NRs 3 crore over the same Fiscal Year. Secondly, CFUGs produce benefits and revenues, as managed by the user committee. In rural Nepal reality, local elite easily dominates re-investment decision making, and is not held sufficiently accountable for long-term productivity and objectives such as poverty reduction and gender equity. Third, local bodies lack formal rights over both government-managed and community forests that represent a major resource in their area. In fact, the Forestry Sector has set up a complete parallel governance structure. For example, Forest User Groups (due to their access to resources) often finance local development activities, which are in fact functions of local government bodies. However, CFUGs structurally exclude non-group members.

Different taxation and marketing mechanisms for timber of different origin

At this moment, the forestry sector lacks a coherent taxation system. The taxation of timber from national forest, community forest, collaborative forest, and others, is inconsistent. A quick analysis of the taxation on timber harvested from different management modalities is shown in Table 2. In all cases the sum of the stumpage value (royalty) plus handling costs make the minimum sale price. At auctioning, the price may get higher, resulting in margins. An exception is the internal sale of timber within Community Forest User Groups (CFUGs) with internal price fixing.

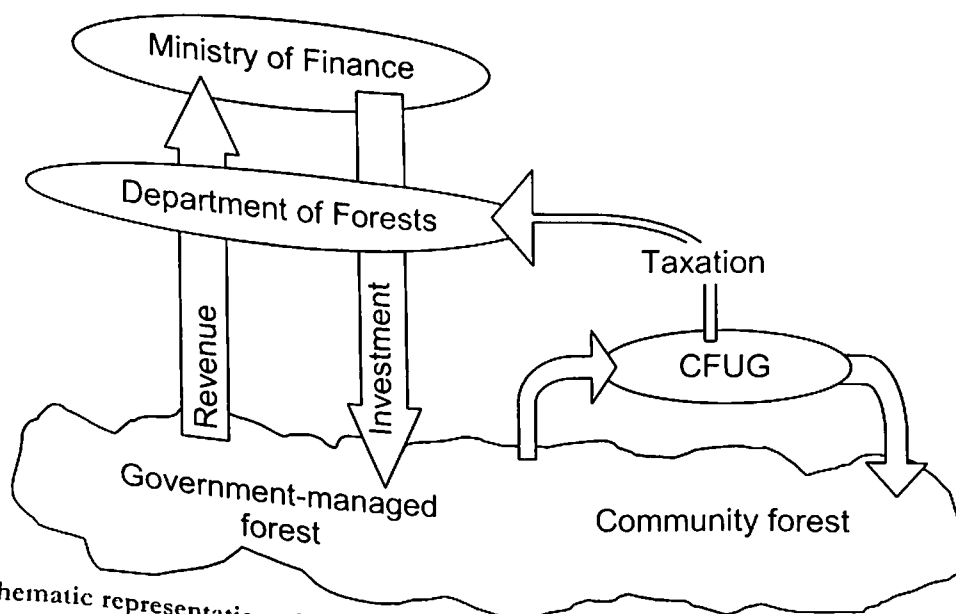


Figure 2. Schematic representation of the present financial investment cycles in the forestry sector. For government-managed forests, the Ministry of Finance allocates funds through the Department of Forests with most revenues flowing to the central treasury. For community forests, user groups invest and reap the benefits; taxation mostly goes to the central treasury.

Table 2. Timber lots originating from different forest management modalities have vastly different tax bases, resulting in an irregular timber price formation.

Forest modality	Handling institution and sales procedure	Taxation
Government-managed forest	DFO harvesting and auctioning	10% of sales value minus handling costs goes to the DDC.
Government-managed forest	TCN harvesting and auctioning	Handling costs plus margins go to the TCN; the royalty to the DFO; who pays 10% to the DDC and 90% to the central treasury
Government-managed forest	District Forest Products Supply Board (DFPSB) that fixes the price for sales to the public	Handling costs plus margins go to the DFPSB; the royalty to the DFO (only 10% in case of disaster relief); who pays 10% to the DDC and 90% to the central treasury
Community forestry (internal sale)	Forest User Group (sale as per internally defined procedure)	No taxation imposed
Community Forestry (external sale)	Forest User Group (sale as per internally defined procedure; minimum price is royalty + handling costs)	Taxation 40% of sale price minus handling costs (for sal and khair); the DFO pays 10% to the DDC and 90% to the central treasury
Collaborative Forest Management	Collaborative Management Sub-Committee	Handling costs + (royalty + profit) of which 25 % of sales price to various district stakeholders, 75 % to national government
Driftwood	DFO harvesting and auctioning	Of sales price minus handling costs, 50 % goes to the DDC and 50 % to the central treasury

The table shows that the price build-up of timber varies between different management modalities, not only in level of taxation, but also in principle of taxation (royalty is an absolute taxation; 40 % is a relative taxation). The result is a blurred discussion on forest management modalities to be applied, where tax levels rather than institutional arrangements are brought up as major arguments (see for example Forest Action, 2003), hampering proper development of Terai forestry modalities (Bampton, pers. comm.). The responsibility for marketing timber from government-managed forests lays with the DoF and the Timber Corporation of Nepal; which are accountable to MFSC, with little transparency, and a consequent mistrust from the general public (Mitchell *et al.*, 2001). Besides, most timber comes on the market through CFUGs or illegally, with a non-transparent price formation (e.g., Baral, 2001, Chetty *et al.*, in prep. Gyawali, 2004). It is therefore no surprise that the timber market shows considerable inconsistency, and the price one pays depends on relations rather than the market decides.

The need for a sector-wide financial system that fosters trust

We can conclude that the present revenue and investment system is not fostering confidence among major stakeholders in the sector. The institutions responsible for handling of forest resources (CFUGs, DoF) lack transparency, particularly in areas where

forests represent vast economic resources, both in government managed and in community forestry. Groups that manage forests and generate revenues are willing to pay tax if it would be re-invested in forestry, or if it would be spent on development activities by local bodies. It is thus time to design a system that fosters trust; between central and local government, elite and non-elite, men and women, CFUG-members and non-members, and resource-rich and resource-poor areas; as to increase efficiency of forestry sector governance.

Decentralising the financial system for better forestry governance

A financial system linked to local government bodies

The presented figures show that there is a need for a taxation and reinvestment system that supports economic development and sustainable forest management; both for socio-economic and for macro-economic purposes. Some characteristics of the system would be:

- The forestry taxation system should allow for monitoring of marketing by credible institutions such as local governments or treasury offices with a legal enforcement mandate.
- Tax payers should have reasonable control over taxation money expenditures.
- Local government bodies take care of re-distribution over areas and sectors, while the

national government takes care of re-distribution of revenues over regions.

- Productive activities should be directly paid from the revenues of the particular forest.
- Wider, forestry-related activities (e.g., in renewable energy programmes) should be paid from forest revenues.
- Marketed timber from either forestry modality should be taxed similarly.
- Decision-making bodies should apply tools such as equity and gender budgeting to ensure forest sector accountability to national policy commitments.

representatives, local bodies and civil society take part in planning and monitoring the forestry programme (Schoubroeck and Karna, 2003, Bampton, 2003). Village, District and Regional FCCs, or other groups such as Community or Collaborative Forest Management-groups, can play a key role in taxation and allocation of re-investments. Figure 3 conceptualises a financial system that address the concerns raised in previous Section. A central element is the idea of local forestry funds such as the District Forestry Development Fund, at the disposal of the District Forestry Co-ordination Committee (DFCC) (e.g., Sah, 2002, Rijn, 2002).

Decentralising the financial system fosters local responsibility

Over the last decade, the political and legislative environment is fostering local involvement in development activities, particularly by involving locally elected bodies (Ministry of Law and justice, 1999). The forestry sector is experimenting with Forestry Co-ordination Committees (FCCs) at local and district level, in which Line Ministry

A few opportunities of a devolved financial system that come to mind are:

- Local Government Bodies can monitor financial management of Community and Collaborative Forest Management, fostering transparency and regularity.
- Revenues from participatory forestry models (community and leasehold forestry, collaborative forest management, bufferzone and park management) will be allocated to local Forestry

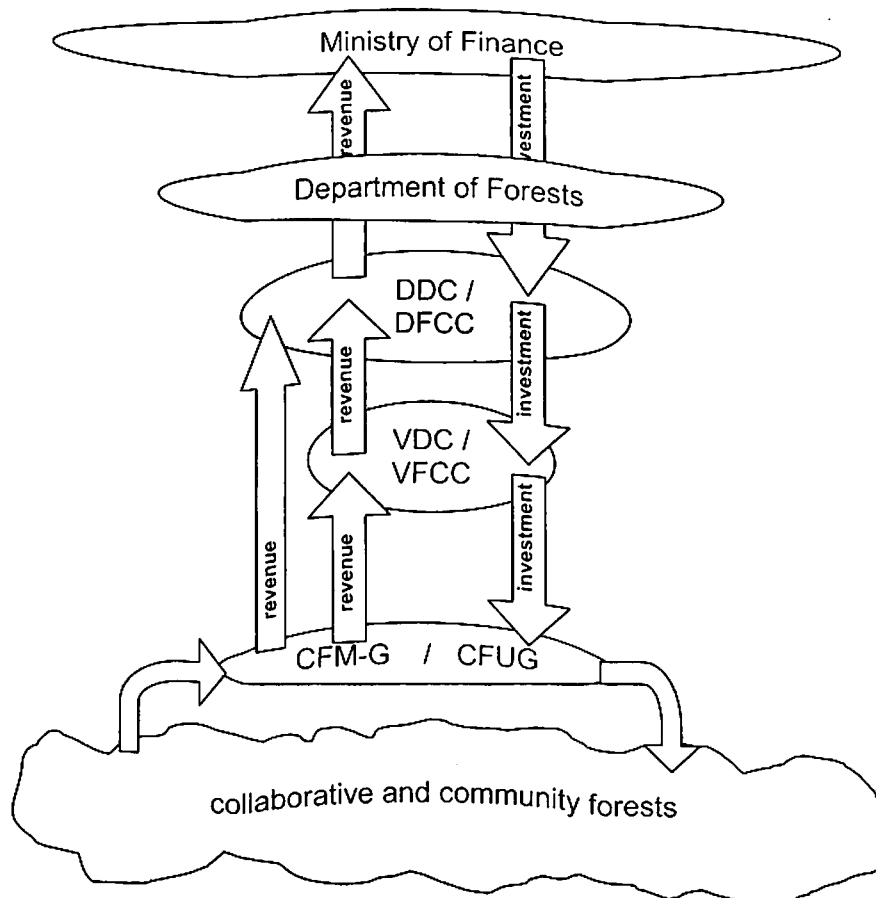


Figure 3. Sketch of a financial system with taxation and planning links to village and district government bodies. The system allows revenues to be locally invested in forestry activities; with taxing links to higher governance levels for higher-level services and re-distribution of resources.

Development Funds for the implementation of forestry sector plans, and to development in general; as per locally defined sharing quotas.

- Local forestry development funds allow for locally planned and managed forestry programmes through FCCs.
- In productive areas (such as in the Terai), part of the forest revenues will replace national financing of development activities, and part of the revenue will go to the central treasury for national development.
- Donors can support local institution building by targeted capacity building and funding of activities through local management mechanisms; to be phased over to local funding.

For example, in a particular hill district, the 40% taxation of Community Forestry will be submitted in the District Forestry Development Fund; the DFCCs then choose to support the DFO and NGOs to spread of community forestry all over the district, or utilise the resources for a gender and equity programme. Or, the CFM-Group submits its revenues to the District Forestry Development Fund,

who disburses funds for a Private Forestry Programme in distant Village Development Committees (VDCs) through the Village Forestry Development Fund. Through such mechanisms, the forestry sector can institutionalise social equity and reduce its dependence on foreign financing.

Local Forestry Co-ordination Committees monitor and plan forestry activities

Prerequisite for a successful taxation and re-investment system is a transparent collection of the revenues and expenditure planning. For the formation of decentralised forestry programme planning, MFSC and local bodies are establishing FCCs at various levels. They typically consist of representation of the local bodies, the line departments, and of civil society and private sector⁴. These committees will monitor forest revenue generation and distribution, and develop local forestry sector development plans. FCCs might be linked to a particular patch of forest (e.g., in community forestry and in collaborative forest management), or might be linked to a particular local government body (e.g., in case of DFCCs and VFCCs

Table 3. Major Forestry Co-ordination Committees, their constituency and forestry development fund.

Forestry Co-ordination Committee (FCC)	Closest general government body (forestry structure may be inconsistent with existing delineation)	Constituency	Forestry Development Fund (FDF) and planning
Forestry Sector Co-ordination Committee	HMG / MFSC	National population	Central treasury / Donor funds not consolidated; to implement the Master Plan for the forestry sector and five-year plans
Regional Forestry Co-ordination Committee	Regional Administrative Offices / Regional Directorate of Forests	Regional population	Red Book / Donor funds not consolidated
District Forestry Co-ordination Committee	District Development Committee	District population	District Forestry Sector Development fund; to implement the District Forestry Sector Plan
Collaborative Forest Management Committee	Ilaka, or a group of VDCs	Collaborative Forest Management Group	Collaborative Forestry Development fund; to implement the CFM-scheme
Village Forestry Co-ordination Committee (not yet operational)	Village Development Committee	VDC population	Village Forestry Development fund
Bufferzone Committee	Ilaka, group of VDCs or wards	Bufferzone population	Bufferzone fund; to implement the Bufferzone Scheme
Community Forest Users Committee	tole, ward or part of VDC	Community Forestry User Group	Forest User Group Fund; to implement the Operational Plan

⁴ An exception is community forest user groups that consist of forest users with no formal representation of local government or line ministry.

linked to DDCs and VDCs). Table 3 presents a list of such committees. A financial framework that allows the various FCCs to retain authority over part of the local revenues will increase their capability in managing local forest resources.

Changing institutional roles

The financial system of the forestry sector is to underpin a more general forestry governance system (FACD, 2004). Table 4 present a rough task division in the forestry sector, where line ministries, local bodies and NGOs will take up particular tasks. The exact way in which different stakeholders will link their implementation capacity (proceeding of sales, forest management, support for income generation,

gender and equity functions) is yet to be developed. At present, the DFO is the main implementer of planned forestry activities. Once local forestry development funds get established, the FCCs develop programme support units for administration of the Forestry Development Funds. Such units are already being experimented with in some sector support programmes.

Discussion

The financial reform strategy is an essential element of larger forestry sector institutional reform at national, district and local level. At the national level, decentralisation policy is proposed through the Local Self-Governance Act (Ministry of Law, 1999) with

Table 4. Present and possible future role of various institutions related to the forestry sector.

Institution	Present role in forestry sector	Possible future role in forestry sector
Ministry of Finance	<ul style="list-style-type: none"> allocation of funds for forestry activities through central government channel 	<ul style="list-style-type: none"> providing financial framework taxation and redistribution of revenues over sectors and regions
MFSC / DoF	<ul style="list-style-type: none"> planning of forestry investments implementing forestry programmes 	<ul style="list-style-type: none"> providing forestry policy framework, including forestry governance structure central co-ordination tasks of forestry sector linking to international developments, treaties, etc.
District Development Committee	<ul style="list-style-type: none"> - 	<ul style="list-style-type: none"> providing general policy framework investment forestry revenues in general development pay tax to central treasury
District Forestry Co-ordination Committee	<ul style="list-style-type: none"> - 	<ul style="list-style-type: none"> planning forestry programme m&e forestry programme
District Treasury Office	<ul style="list-style-type: none"> channelling of funds 	<ul style="list-style-type: none"> audit service to forestry development fund
District Forest Office / other line agencies (soil, parks, women& social welfare, etc.)	<ul style="list-style-type: none"> implement development programmes 	<ul style="list-style-type: none"> provide legal framework law enforcement co-ordinate with national Ministries
District Support Unit	<ul style="list-style-type: none"> - 	<ul style="list-style-type: none"> co-ordinate with all implementing agencies manage district forestry development fund contracting service providers for jobs in planning support DFCC-functions (m&e, planning, etc.)
NGOs & civil society	<ul style="list-style-type: none"> advocacy 'on the street' 	<ul style="list-style-type: none"> advocacy in (C,R,D,V) FCCs implementing specific programmes (training, awareness, social mobilisation, gender & equity) prepare operational plans
Private Sector	<ul style="list-style-type: none"> contracting operational activities 	<ul style="list-style-type: none"> contracting operational activities
Village Development Committee	<ul style="list-style-type: none"> - 	<ul style="list-style-type: none"> utilise forest taxation for development activities pay tax to DDC for general community development and DFCC-planned support to forestry activities
Village Forestry Co-ordination Committee	<ul style="list-style-type: none"> - 	<ul style="list-style-type: none"> planning forestry programme for local needs, including poverty reduction and gender balance m&e CF and CFM, including financial monitoring
Forest user Groups (CF, CFM)	<ul style="list-style-type: none"> manage forest invest revenues in general development 	<ul style="list-style-type: none"> manage forests pay tax to VDC for general community development and VFCC-planned support to forestry activities

vast consequences for district and local forestry programming. At the sector level, MFSC is developing an institutional reform agenda. Major moves include the introduction of taxation of forest produce, the development of linkages between local government, civil society and line agencies for planning and monitoring (MFSC, in prep.a); develop implementation linkages between line agencies and civil society (MFSC, in prep. b; NARMSAP NGO-study taskforce, 2003); and development of collaborative approaches for forest management (MFSC, 2003). At the heart of the financial reform strategy are the Forestry Development Funds financing Forestry sector plans and sustaining the new institutional set-up. This will lead to more pronounced addressing of local needs and a wide feeling of ownership over the forestry programme.

This article argues that financial and institutional reform is the sensible thing to do. That in itself does not mean it will indeed happen. Links between existing (centralised, or donor-funded) systems to possible (locally managed, locally funded) systems are yet to be developed. One can imagine that first central and donor funding supports locally planned programmes, with a phasing over strategy to locally managed funds. The approach will need experimentation. The process for reform is complicated and can only succeed if relevant actors such as forest users, local bodies and relevant Ministries support, push and co-ordinate. Informal discussion with officials of the Ministry of Finance and the Ministry of Local Development suggest that they regard MFSC as the best positioned to co-ordinate the reform process. MFSC thus could initiate an inter-Ministry financial reform task force that hires an experienced service provider for wide consultation, drafting of legislation, piloting with help of donor-supported programmes, for final legislation and nation-wide introduction.

We argue that the forestry sector is in dear need of a governance system with wide public involvement and financial underpinning. After all, every day the nation is loosing around NRs 4 crore in missed revenues and reduced timber stock. Improved sector governance will create room for local people to save forest and unblock its potential as a vast contributor to national development objectives. By developing an inclusive institutional framework, MFSC has a unique chance to show that it takes its responsibility serving the nation and the people. The task ahead is complicated but rewarding.

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