

Nepal

Critical Development Constraints

DFID Department for
International
Development





Country Diagnostics Studies

Nepal: Critical Development Constraints



© 2009 Asian Development Bank (ADB), Department for International Development (DFID), and International Labour Organization (ILO)
All rights reserved. Published 2009.

ISBN 978-971-561-803-8
Publication Stock No. RPT090743

Cataloguing-In-Publication Data

ADB, DFID, and ILO.

Nepal: critical development constraints.

Mandaluyong City, Philippines: Asian Development Bank, 2009.

1. Economic development. 2. Nepal. I. Asian Development Bank. II. Department for International Development. III. International Labour Organization.

The views expressed in this publication do not necessarily reflect the views of ADB or its Board of Governors or the governments they represent, DFID, or ILO.

ADB, DFID, and ILO do not guarantee the accuracy of data included in this publication and accept no responsibility for any consequence of their use.

In this report, “\$” refers to US dollars unless otherwise specified.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel: +63 2 632 4444
Fax: +63 2 636 2444
www.adb.org/economics

Department for International Development
1 Palace Street
London SW1E 5HE, United Kingdom
Tel: 44 845 300 4100
www.dfid.gov.uk/

International Labour Organization
4 route des Morillons
CH-1211 Genève 22
Geneva, Switzerland
Tel: +41 22 799 6111
Fax: +41 22 798 8685
www.ilo.org

Foreword

Almost three years into the home-grown peace process, the crucial agenda before Nepal is to ensure sustainable peace. This is just not possible by only finding political solutions to many problems that Nepal is facing. It is necessary for us to accelerate development, achieve higher and inclusive economic growth. Nepal's development lost momentum during decade-long conflict. Since Fiscal Year 2007/08, the economy is showing signs of improvement, but there are many impediments to faster growth and equitable distribution. The conflict is not over yet, as many groups spread in different parts of the country are staking claims for their rightful place in politics and economy.

Without faster development and perceptible change in the lives of ordinary people, we cannot possibly overcome this post-conflict turbulence. We need to move tactfully, clearly identifying the obstacles, implementing reforms that minimize the obstacles, and at the same time using a development strategy that can work even amidst turbulence and obstacles.

The present report does part of what is outlined in the above paragraph. It identifies critical development constraints and recommends a series of measures that can minimize them. Therefore, the government welcomes this report. The diagnostic framework used in the study is an attempt to establish priorities among many candidate policies and institutional reforms aimed at sustained and inclusive growth. The analyses and the informed recommendations geared to fostering growth and overcome poverty, inequality, and other unwanted economic and social outcomes are of immense value to the government.

Nepal, as the report notes, has implemented a number of important policy reforms during the past three decades. Today, Nepal has a thriving financial sector with a vibrant stock market, and a growing tourism sector. It is actively pursuing a policy of converting itself from an electricity deficient nation to a key source of electricity to its fast growing neighbors in the north and the south. In the area of social development, Nepal adopted the Millennium Development Goals and has made some impressive progress in reducing the poverty levels despite low levels of economic growth.

The government, however, is aware that poverty, exclusion, under-employment, and income disparities are persistent reminders of the difficulties that some of our countrymen are still experiencing. The report is, thus, very timely and will be a source of valuable inputs in formulating the country's next development strategy.

The report provides insights that can enrich cooperation between the government of Nepal and development partners, especially the Asian Development Bank (ADB), Department for International Development (DFID), and International Labor Organization (ILO). In particular, we are highly appreciative of the consultative process that the study adopted to ensure that views of all the key stakeholders were taken into account in the diagnosis and formulation of the policy recommendations. The findings and recommendations of the report can form part of the basis for joint work with the development partners toward a common objective of enhancing inclusive and sustainable growth in Nepal. The high priority given, for example, to fiscal management is bound to improve the conduct of official development assistance. The government gratefully acknowledges ADB, DFID, and ILO for the timely conduct of the study.



Rameshore P. Khanal

Secretary

Ministry of Finance

Preface

Nepal's performance on the economic development front since the turn of the century has lagged behind that of the other South Asian economies. In terms of per capita gross domestic product (GDP), Nepal is now where Sri Lanka was in 1960, Pakistan was in 1970, and India and Bhutan were in 1980. This lackluster economic performance has occurred despite some very important reforms during the 1990s and 2000s. Although the poverty incidence declined from 42% in 1995/96 to about 31% in 2003/2004, it remains high and may climb further if the global recession reduces remittance flows. Another emerging concern is the sharp rise in inequality from 1995/96 to 2003/04.

Although GDP registered an impressive 5.6% growth in 2007/08 compared with 3.0% in 2006/07, the surge was largely due to timely rains leading to a good harvest of the main agricultural crops and to a rise in tourism arrivals—not due to major improvements in economic fundamentals. This raises the question of how Nepal can improve its pace of growth and poverty reduction. Thus the report attempts to identify the most critical constraints that the country faces—constraints that, when removed, can yield the highest welfare gains. The report also attempts to answer how the constraints can be converted into opportunities for long-term growth and how the benefits of economic growth can be translated into faster poverty reduction.

Nepal: Critical Development Constraints presents a diagnosis of Nepal's economy. The diagnosis was led by the Asian Development Bank (ADB) and jointly undertaken with the United Kingdom's Department for International Development (DFID) and the International Labour Organization (ILO). The work at ADB was led by Muhammad Ehsan Khan; Juzhong Zhuang, assistant chief economist, Economic Analysis and Operations Support Division, Economics and Research Department, provided the oversight and overall direction. DFID's work on the study was coordinated by Matthew Greenslade, and ILO's was coordinated by Shengjie Li and Duncan Campbell. The report was prepared by Muhammad Ehsan Khan, Yoko Niimi, and Ma. Rowena M. Cham with contributions from Peter Owen and Duncan Campbell. The report benefited from background papers prepared by a team of experts comprising Mahesh Acharya, Dadhi Adhikari, Devendra Chapgain, Madan Kumar Dahal, Rana Hasan, Niny Khor, Simon Lucas, Mick Moore, Posh Raj Pandey, Rabi Jung Pandey, Sabina Panth, Bishwamber Pyakuryal, Jasmin Rajbhandary, Surendra Rajbhandary, Michel Samson, Shiva Sharma, Bandita Sijapati, Para Suriyaarachchi, and Liz Alden Wiley. Navin Dahal, Lucia Hanmer, Stefan Kossoff, Nick Leader, Andrew Masters, Bishnu Pant, Paolo Spantigati, Raju Tuladhar and Tony Venables provided constructive comments and support in finalizing the report. The report was edited by Jill Gale de Villa; design, layout, and typesetting was by Mike Cortes.

The study followed a consultative process where first the framework and approach and then the study findings were discussed with key stakeholders, including the government of Nepal, academic and research institutions, civil society, development partners, and the private sector. Feedback received during these consultations greatly assisted the report's preparation, and we believe that the report will provide valuable inputs to the formulation of development policies and reform programs aimed at inclusive growth and sustainable development in Nepal.

We are grateful for the support provided by the government of Nepal. In particular, we would like to thank Secretary Rameshore P. Khanal, Ministry of Finance, the government focal point, for his keen interest in the study and guidance in completing this work. We are also grateful for the support and feedback from Dr. Pitambar Sharma and Dr. Guna Nidhi Sharma, former Vice Chairmen, National Planning Commission (NPC); Secretary Janak Raj Joshi, NPC; Secretary Purna P. Kadariya, Ministry of Physical Planning and Works; and Joint Secretary Bimal Wagley, Ministry of Finance. Finally, we also thank the Federation of Nepalese Chambers of Commerce and Industry, Confederation of Nepalese Industries, Nepal Chamber of Commerce, and other representatives of the private sector for their continued support and interest in the study. We look forward to continued and productive dialogue with the government in pursuing an agenda of inclusive growth and sustained development in Nepal.



Barry J. Hitchcock
Country Director
Nepal Resident Mission
Asian Development Bank
(ADB)



Sarah Sanyahumbi
Head
Nepal Office
UK Government's Department
for International Development
(DFID)



Shengjie Li
Country Director
Nepal Office
International Labour
Organization (ILO)

Contents

1.	Introduction	1
1.1	Objectives	1
1.2	Methodology	1
1.3	Organization of the Study	3
2.	Development Performance and Policy	5
2.1	Political Context of Economic Growth	5
2.2	Synopsis of Economic Growth	6
2.3	Accounting for Sources of Growth	8
2.4	Recent Trends in Poverty and Inequality	12
2.5	Evolution of Nepal's Development Policy	14
3.	Critical Constraints to Growth	18
3.1	Cost of Finance	20
3.2	Social Returns to Investments	28
3.3	Appropriability of Returns to Investments	43
4.	Critical Constraints to Inclusiveness	62
4.1	The Inclusiveness of Economic Growth	62
4.2	Constraints to Inclusive Growth	68
4.3	Root Causes of the Constraints	93
5.	Governance, Political Economy, and the Institutional Context	98
5.1	Key Features of the Current Governance Context	98
5.2	Governance, Political Economy, and Institutional Underpinnings of the Constraints	101
5.3	Implications for Development Partners	105
6.	Conclusions and Policy Recommendations	107
6.1	Key Constraints to Accelerating Economic Growth	107
6.2	Policy Recommendations	108
6.3	The Way Forward	117
6.4	Conclusion	117

Abbreviations

ANFTU	—	All Nepal Federation of Trade Unions
CAR	—	capital adequacy ratio
CPIA	—	country policy and institutional assessment
FSI	—	failed states index
FYP	—	five year plan
GDP	—	gross domestic product
IMF	—	International Monetary Fund
LSGA	—	Local Self-Government Act
MTIP	—	medium-term investment plan
NDHS	—	Nepal Demographic and Health Survey
NEA	—	National Electricity Authority
NGO	—	nongovernment organization
NLSS	—	Nepal Living Standards Survey
NPL	—	nonperforming loan
O&M	—	operation and maintenance
PAF	—	Poverty Alleviation Fund
PETS	—	Public Expenditure Tracking System
PPA	—	power purchase agreement
PRGF	—	poverty reduction growth facility
SPI	—	social protection index

Measures

GWh	—	gigawatt-hour
ha	—	hectare
km	—	kilometer
MW	—	megawatt
t	—	ton (metric)

Chapter 1

Introduction

1.1. Objectives

Nepal's performance in terms of economic development has lagged behind that of the other South Asian economies despite the important reforms made during the 1990s. In per capita terms, the growth was even less favorable: Nepal's per capita gross domestic product (GDP) has been the lowest in the region since 1990. Despite the lackluster growth performance, poverty incidence declined from about 42% in 1995/96 to 31% in 2003/04. While this is a welcome development, the level of poverty remains high. In addition, an emerging concern is the rise in inequality over the same period—from 0.34 to 0.41 in terms of the Gini coefficient. Given that inequality is thought to be one of the most significant drivers of the recent conflict, it is important that a new growth strategy opens up economic opportunities for hitherto excluded groups.

The latest national plan, the Three Year Interim Plan (2007/08–2009/10), spells out the government's commitments for addressing the many challenges it still faces, particularly against the backdrop of its fragile law-and-order situation, following the end of the 11-year armed conflict in April 2006. The plan focuses on enhancing reconstruction and rehabilitation, improving governance, and pursuing a more inclusive development process, and aims to achieve 5.5% GDP growth per annum and to reduce poverty incidence by 7 percentage points to 24% by 2010 (NPC various years).

This report has two interrelated objectives. The first is to identify critical constraints to long-run economic growth and equitable development in Nepal. The second is to spell out policy options that stand a good chance of overcoming the constraints identified to broad-based growth and to achieving the government's development targets.

1.2. Methodology

The study uses a diagnostic approach, and broadly follows growth diagnostics developed by Hausmann, Rodrik, and Velasco (2005). The growth diagnostics approach provides a consistent framework for identifying the most critical or binding constraints to growth and for discerning the priorities and sequence of policies required to ignite and sustain growth. The growth diagnostics approach differs from the laundry list approach, as implied by the Washington Consensus, and recognizes that the economic and political environment differs a great deal among developing countries: there is no “one-size-fits-all” solution to development problems and, therefore, the ordering of policy priorities contingent on country-specific circumstances is critically important. Further, countries at an early stage of development may not have adequate capacity to implement a wide array of policy reforms at the same time. With the diagnostic approach, reforms can start with easing a few critical areas that most constrain growth. Therefore, the approach offers a practical tool for

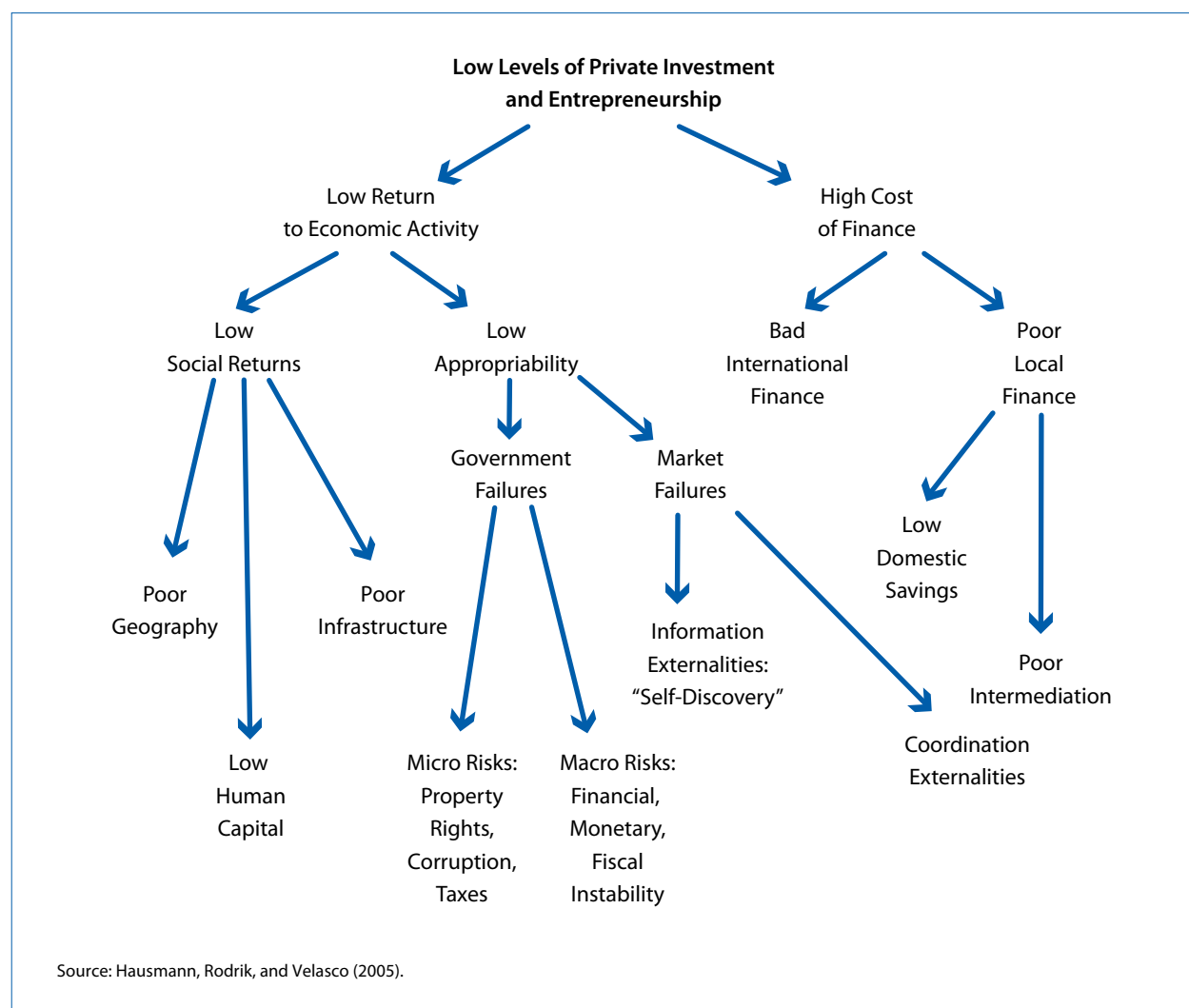
policy makers and development planners to use in formulating country-specific growth strategies. The application of growth diagnostics is one of the efforts in the search for new approaches to growth strategy after the Washington Consensus was questioned in recent years.

The growth diagnostics approach starts with a set of proximate determinants of growth, investigates which of these post the greatest impediments or are the most critical constraints to higher growth, and figures out specific distortions behind the impediments. The inquiry's point of departure is a standard endogenous growth model in which growth depends on the social return to accumulation, private appropriability of this social return, and the cost of financing. Each of these three

broad determinants of growth is in turn a function of many other factors, which can be presented in a problem tree (Figure 1.1).

The problem tree provides a framework for diagnosing critical constraints to growth. The diagnosis starts by asking what keeps the level of private investment and entrepreneurship low. Is it low social return to investment, inadequate private appropriability of the social return, or high cost of financing? If it is low social return, is that due to insufficient levels of complementary factors of production—in particular, human capital, technical know-how, and/or infrastructure? If the impediment is poor private appropriability, is it due to macro vulnerability, high taxation, poor property rights and contract enforcement, labor–capital conflicts,

Figure 1.1. Growth Diagnostics Framework



information and learning externalities, and/or coordination failures? If high cost of finance is the problem, is it due to low domestic savings, poor intermediation in the domestic financial markets, or poor integration with external financial markets?

At each node of the problem tree, the diagnosis looks for signals that may help determine which constraints are most binding. The two types of diagnostic signals that one can look for are price signals and nonprice signals. Examples of price signals are returns to education, interest rates, and cost of transport. For example, if education is undersupplied, returns to skills/education will be high and unemployment of skilled people will be low; if investment is constrained by savings, interest rates will be high and growth will respond to changes in available savings (for example, inflows of foreign resources); and if poor transport link is a serious constraint, bottlenecks will occur and the cost of private transport will be high.

The use of nonprice signals is based on the idea that when a constraint binds, activities may be designed to get around it. For example, high taxation may lead to “high informality” (e.g., under-reporting of income, resulting in lower tax revenues); poor legal institutions may result in high demand for informal mechanisms of conflict resolution and contract enforcement; and poor financial intermediation may lead to internalization of finance through business groups. Cross-country and cross-period benchmarking and results of business surveys are useful means to gauge whether particular diagnostic evidence signals a binding constraint for the country concerned.

Although the growth diagnostics approach was developed to identify the binding constraints to growth and associated policy priorities, the approach can also be applied to other areas of policy analysis, such as identifying critical constraints to inclusiveness of growth (Figure 1.2). Despite Nepal’s poverty reduction between 1995–1996 and 2003–2004, the evidence suggests that the benefits of economic growth were not shared equally across the segments of society. Limited inclusiveness can be caused by the lack of economic opportunities due

to poor growth, by unequal access to opportunities, and/or by the absence of effective and adequate social safety nets. While the absence of productive employment opportunities is one of the key factors that hinder households from improving their livelihoods, unequal access to opportunities can also constrain the inclusiveness of growth.

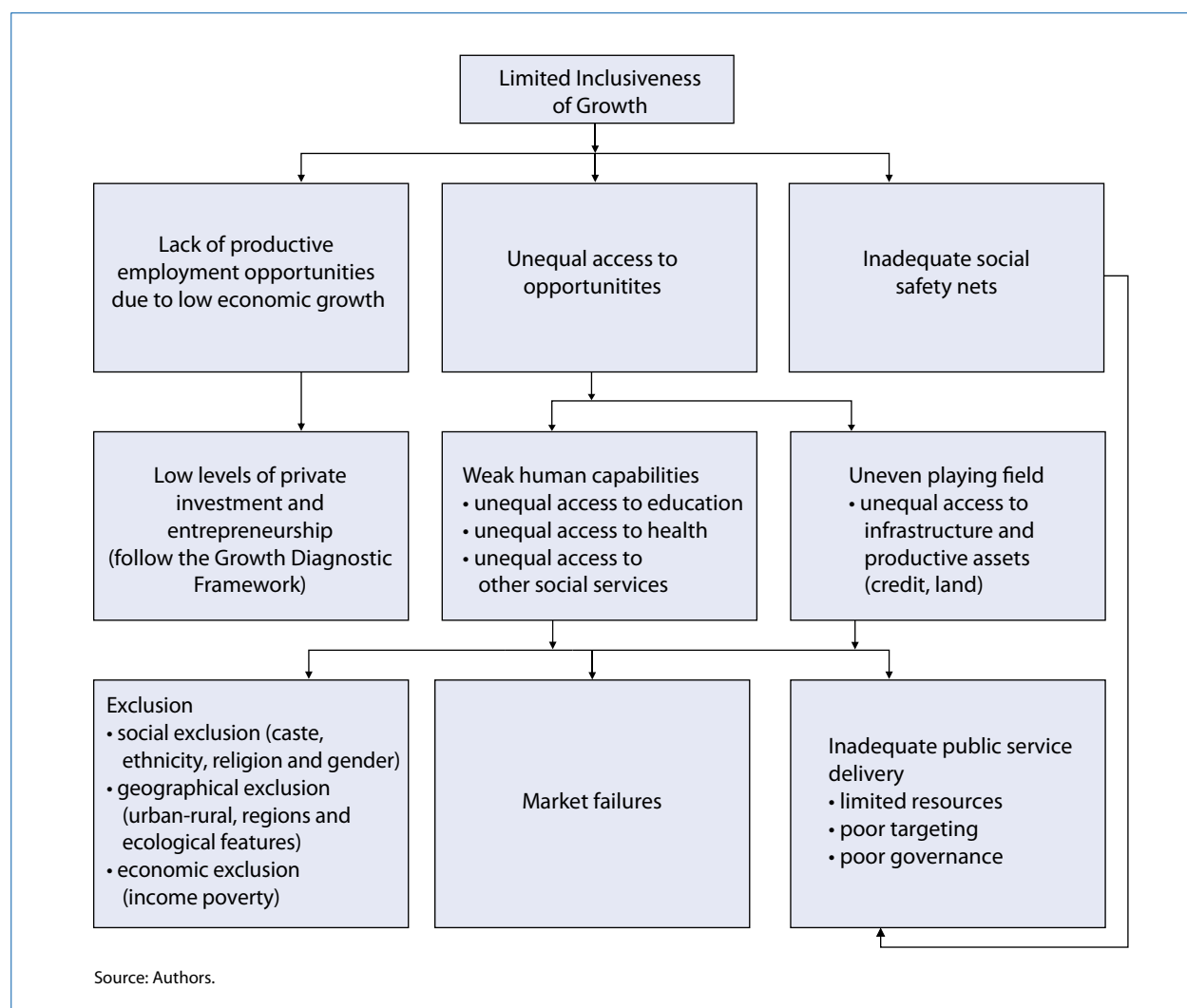
Inequitable access to economic opportunities can be attributable to weak human capabilities and/or an uneven playing field, both of which can prevent individuals from participating in and contributing to the growth process on an equal basis regardless of their individual circumstances. Each of these can, in turn, be due to a number of factors, such as exclusion, market failures, and/or government failures to deliver adequate public services. In Nepal, exclusion has multiple dimensions—social, geographic, and economic—and is a cross-cutting issue that needs to be addressed in order to attain the development objectives.

Diagnostic frameworks can identify key factors that are constraining economic growth and its inclusiveness, which can then help policy makers formulate effective measures to overcome the constraints.

1.3. Organization of the Study

The rest of the report is organized as follows. Chapter 2 provides an overview of Nepal’s development performance and the evolution of its development policies during the last several decades. The chapter describes the episodes of growth, discusses key growth drivers, and examines progress in poverty reduction. Chapter 3 elaborates on growth diagnostics, focusing on the three broad determinants of growth that could act as constraints: social return to investment, private appropriability, and cost of finance. Chapter 4 looks at critical constraints to broadening the inclusiveness of growth. Chapter 5 examines the governance and political underpinnings of the constraints to growth and its inclusiveness. Chapter 6 summarizes the findings and discusses policy implications.

Figure 1.2. Diagnostics Framework for Inclusiveness



Chapter 2

Development Performance And Policy

Nepal's economic growth during the last 5 decades has not been very impressive when compared with that of other South Asian countries. The growth has been even more modest when considered in per capita terms. Nevertheless, the country has made some impressive achievements in terms of reducing poverty. The proportion of the population living below the poverty line declined by 10 percentage points, from 41% in 1995/96 to 31% in 2003/04 largely on account of strong remittance flows. Despite this, the poverty incidence remains high and the level of income inequality continues to be one of the highest in Asia. Nepal's performance on most other welfare indicators also lags behind that of other Asian countries. This section discusses Nepal's development performance in the past several decades and the evolution of government development policies that had implications for economic growth and poverty reduction efforts.

2.1. Political Context of Economic Growth

Since the 1960s, Nepal has gone through a number of transformations on the political front. With the promulgation of a new constitution in 1962, the country shifted from a system of government headed by a hereditary prime ministership to a partyless

council (*panchayat*) system¹ in 1981, when an amendment to the constitution allowed for the first direct elections. In response to a people's movement, the partyless panchayat system was abolished and was replaced by a multiparty democratic system of government in 1990. Between 1991 and 2006, Nepal continued to experience political instability resulting in frequent changes in the political leadership.

In 1996, the Maoists launched a campaign for a one-party communist republic. Civil unrest and violence escalated on a nationwide scale. The murder of the royal family in June 2001 and the clash between the Maoists and government troops after the failure of initial peace negotiations in November 2001 resulted in the first declaration of a state of emergency rule. In 2005, when the political unrest continued and the peace talks reached a deadlock, the King abolished the government, announced a state of emergency, and assumed absolute power. In reaction, the main political parties took to the streets with a consensus to overthrow the King's autocratic rule. In April 2006, 19 days of street protests forced the King to step down and relinquish power. Parliament was restored and a prime minister was appointed to assume the position of the head of state. During

¹ The council (*panchayat*) system comprised a tiered structure of government by which the King exercised absolute power through the national, district, and village level panchayats. Under the system, the elections to the National Panchayat (the National Parliament) were on an indirect basis where the village- and district-level panchayat members voted to elect the National Panchayat members.

Table 2.1. Annual Average Growth Rate of Real Gross Domestic Product (%)

Country	1961–1970	1971–1980	1981–1990	1991–2000	2001–2006	2007
Bangladesh	—	1.5	3.7	5.0	5.7	6.5
Bhutan	—	—	9.3	5.6	8.1	19.1
India	4.1	3.2	5.5	6.0	7.8	9.0
Nepal	2.5	2.4	4.3	4.9	2.9	5.6*
Pakistan	7.4	5.2	6.1	3.8	6.0	6.4
Sri Lanka	4.6	4.8	4.0	5.3	5.8	6.8

— = no data available.

Note: Nepal figure in 2007 is for 2007/08.

Source: Nepal 2007/08 data from MOF (various years). All other data from World Bank (various years).

this time, the Maoists and the government agreed on the Comprehensive Peace Accord to put an end to the decade-long conflict/civil war.

In 2007, the Maoists joined the government after the passage of the first amendment to the Interim Constitution. The Constituent Assembly elections, held in April 2008, gave an overwhelming victory to the Maoists and transformed Nepal from a monarchy to a parliamentary republic.

Instability resulting from the frequent changes in government and the conflict had a profound impact on the country's development, as they shifted resources and the government focus away from the development needs. In addition, the conflict/civil war also delayed implementation and completion of some of the more difficult reforms, and hence weakened economic growth.

2.2. Synopsis of Economic Growth

As shown in Table 2.1, Nepal had three distinct phases of growth in gross domestic product (GDP): a phase of slow growth during 1961–1980, a phase of high growth during 1981–2000, and again a phase of slow growth in 2001–2006. Although GDP registered an impressive 5.6% growth in 2007/08, the surge was largely due to timely rains leading to a good harvest of the main agricultural crops and to a rise in tourist arrivals and may not be due to major improvements in economic fundamentals.

During 1961–1980, the economy could be characterized as small, closed, and centrally planned with few incentives for outside investors.

During that period, development was focused mainly on improving transport and communication infrastructure, and developing the agriculture and industrial sectors. However, the development plans of the period were rarely fully funded and hence key targets were not achieved. As a result, the economy largely remained agrarian with outputs, employment, and social relations dominated by agriculture and agricultural production. Industry and services did not grow and the agriculture sector was not modernized. In addition, protectionist policies constrained growth in trade to less than 5% per annum. External shocks such as high oil prices resulting from the oil crisis of the 1970s weakened the growth and fuelled inflation. During this period, annual GDP growth averaged only about 2.3%. The policies prior to the 1980s were not only ineffective in accelerating growth, but also created long-term problems for the economy.

By the early 1980s, development expenditures had risen and less than 17% of them were being financed by revenue surpluses²; the rest were being financed by borrowing from the banking sector. Excessive public sector borrowing had effectively crowded out private investment and the majority of expansion in the domestic banking sector was on account of government borrowing. To solve this problem, the country initiated a series of reforms to transform itself into a market-oriented economy and implemented several major reforms in the mid to late 1980s under an economic stabilization program. The reforms included (1) devaluing the currency, (2) deregulating the financial sector, (3) liberalizing trade, (4) reducing the budget

² Revenue surplus is defined as total revenue minus regular expenditures.

deficit by curtailing public expenditures, and (5) removing various subsidies. In terms of public sector investment, focus was placed mainly on agriculture and social services. While transport and communication infrastructure remained an important area of focus, resources earmarked for them were significantly reduced. As a result, trade, restaurant and hotel, and manufacturing industries grew, which, with the improved performance in agriculture, led to a 4.3 % GDP growth during 1981–1990. Although Nepal's GDP growth rate was lower than that of India and Pakistan, it was higher than growth in Bangladesh and Sri Lanka. Nepal's growth rate could have been higher but for external shocks such as the severing of trade and transit treaties with India in 1989.

In the 1990s, despite political instability, the country continued on the path of liberalizing the economy and implemented a number of key reforms. Some of the major initiatives included (1) deregulation of the trade, industry, finance, and foreign exchange regimes; (2) streamlining of price controls and subsidies; (3) privatization of key public enterprises; (4) massive reductions in trade-related tariffs; (5) new industrial policy (1992), and (6) improved opportunities and access for foreign investment (1992). In addition, the country undertook a number of initiatives to improve the investment climate, including

- introducing a basic legal mechanism for the corporate sector and enacting the Cooperative Act of 1991;
- enacting the Hydropower Development Policy and the Electricity Act (1992) and Electricity Regulations (1993) to reduce the monopoly of the Nepal Electric Authority;
- developing the financial sector through the Development Bank Act (1995) and Financial Intermediary Societies Act (1998); and
- improving access to microfinance by establishing the Rural Self-Reliance Fund (1990), regional rural development banks (1992), and the Rural Microfinance Development Center (1998).

As a result of these initiatives and policies that helped develop the nonagricultural sector, annual average GDP growth was about 5% despite political instability and the lackluster performance in agriculture. Nepal's GDP growth rate during this

period compared well with that of other countries in the region.

In the 2000s, the country stayed on the course of economic reforms and implemented a number of key initiatives such as (1) reforming the income tax and excise tax laws (2002) and establishing the Large Taxpayer Office (2005); (2) improving the autonomy, governance, and accountability of the central bank through the Nepal Rastra Bank Act (2002); (3) continuing reforms in the financial sector, including a directive on credit information and blacklisting of defaulters (2002), the Public Debt Act, and the Foreign Exchange Regulation Act (2003); establishing the Debt Recovery Tribunal (2003); and passing the New Bank and Financial Institutions Ordinance (2004); (4) privatizing several state-owned enterprises; and (5) joining the World Trade Organization and enacting the new Customs Act (2004). Despite the reforms, the growth rates of the 1980s and 1990s could not be sustained. The conflict that started in 1996 in the northwestern region escalated to a national scale. Political fragility increased. As a result, the annual average GDP growth rate fell to about 2.9% during 2001–2006 with the economy contracting in 2002. While preliminary data for 2007 suggested that the declining trend will continue, the economy was able to register a much higher growth rate in 2007/08 as agriculture and tourism grew significantly. However, erratic growth remains a cause for concern because Nepal went from being one of the better performing economies in the region during 1991–2000 to one of the weakest during 2001–2006.

High population growth of 2.25% per annum on average during 1960–2007 and slow GDP growth meant that per capita income for Nepal, which was the lowest in South Asia in 1960, remains the lowest in the region (Table 2.2). Nepal's per capita GDP had risen to only about \$243 by 2007: an increase of about 81% over the 1960 levels. In comparison, during the same period per capita GDP in India had risen by about 250% and in Pakistan by about 237%. If per capita GDP were to grow at an average annual rate of 1.92%—the actual growth rate achieved between 1990 and 2007—Nepal would take 36 years to double its per capita GDP and about 31 years to increase it to Bangladesh's

Table 2.2. Per Capita Gross Domestic Product in 2000 dollars

Country	1960	1970	1980	1990	2000	2006	2007
Bangladesh	235	270	230	261	338	419	439
Bhutan	—	—	258	504	801	1,086	1,277
India	181	214	229	318	453	634	686
Maldives	—	—	—	—	2,287	3,251	3,668
Nepal	134	142	140	176	225	241	243
Pakistan	188	285	330	465	536	635	660
Sri Lanka	269	338	442	577	844	1,070	1,144

— = no data available.

Source: Data from World Bank (various years).

level in 2007. However, if per capita GDP grew at the more modest level of 1.15%—the average growth rate of 2000–2007—Nepal would take 61 years to double its per capita GDP, or 52 years to achieve Bangladesh's level in 2007.

2.3. Accounting for Sources of Growth

2.3.1. Growth By Production Sector

The structural transformation of the Nepalese economy has been slow for the past 40 years (Figure 2.1 and Table 2.3). The economy has traditionally been agrarian in nature, with its share in GDP ranging from 60% to 70% between the 1960s and

early 1980s. Only during the mid 1980s did the share of agriculture in GDP start to decline on account of liberalization and various structural reforms. As a result, agriculture's share shrank, from 51% in 1985 to about 40% in 2000, and to 33% in 2007.

In comparison, industry had a mixed performance. Benefiting from liberalization policies and widening of export opportunities, the sector expanded in the 1980s and 1990s and its share grew from about 12% of GDP in 1980 to 16% in 1990 and to 22% in 2000. However, it then shrank to 16.3% in 2007 due to the conflict/civil war, power shortages, and labor-related issues. Moreover, Nepal's industry sector is the least developed in South Asia.

In contrast to agriculture and industry, services have shown steady growth since the mid 1980s and rose to nearly half of GDP in 2007 from about one third in 1985. The wholesale and retail trade subsector is the largest subsector of services, followed by transport and communication, real estate, renting and business activities, and education. Services' share of GDP in Nepal is still smaller than the sector's share in Bangladesh, India, Pakistan, and Sri Lanka (Figure 2.2).

While the share of services in GDP grew and those of agriculture and industry declined, the growth rates were erratic, especially of agriculture. Services, which have been growing steadily over years, overtook agriculture in terms of growth rate and contribution to GDP growth by the 1990s. Meanwhile, industry grew in the latter half of the 1970s to the first half of the 1980s, then began to decline and its contribution to growth has since continued to decrease.

Figure 2.1. Sector Shares in GDP, 1965–2007

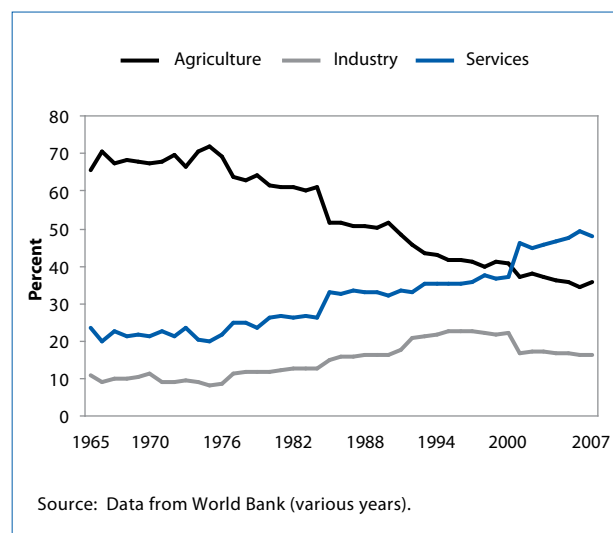


Table 2.3. Annual Average Real GDP Growth and the Contribution of Major Production Sectors to GDP Growth (%)

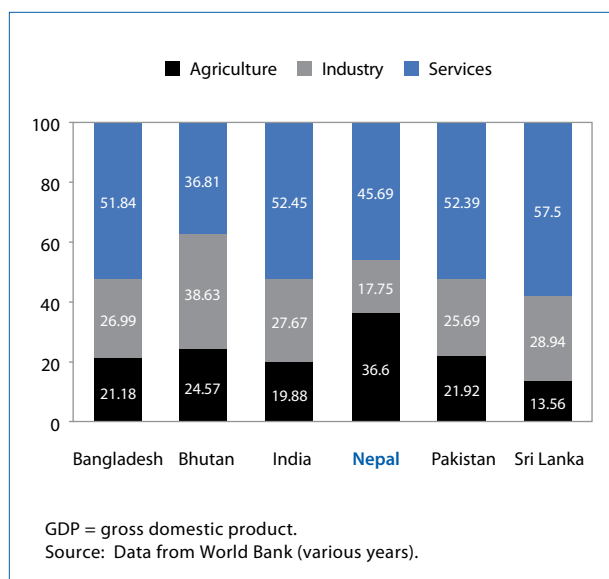
Period	GDP Growth Rate	Agriculture		Industry		Services	
		Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth
1976–1980	1.98	–1.09	–0.56	10.27	0.75	4.44	1.79
1981–1985	4.65	5.19	2.51	10.63	1.04	2.69	1.10
1986–1990	4.52	4.12	1.92	6.17	0.79	4.51	1.81
1991–1995	5.07	1.54	0.65	9.33	1.34	7.43	3.09
1996–2000	4.91	3.35	1.29	6.47	1.06	5.68	2.56
2001–2006	3.38	3.57	1.34	2.59	0.43	3.55	1.61
2007/08	5.60	5.67	2.00	1.81	0.30	6.90	3.30

GDP = gross domestic product.

Note: GDP is at constant prices.

Source: World Bank (various years).

Figure 2.2. Average Shares of Major Production Sectors in GDP (%) 2001–2007



As just discussed, the economy did not follow the expected course of development wherein agriculture gives way to industry. Agriculture's gross value added was fluctuating, as evidenced by its growth rate and contribution to GDP growth. From a negative growth in the latter half of the 1970s, the sector was able to grow at 4–5% during the next decade. However, agriculture was unable to sustain this rate in the 1990s, when the growth averaged 1.5% during 1991–1995 and 3.4% during 1996–2000. The growth rate continued to fluctuate throughout the 2000s. For example, in 2006/07 agriculture grew by 1.0% and in 2007/08 it grew by 5.7%.

Industry on the other hand performed relatively well during the 1976–1980 and 1981–1985 periods, with annual average growth rates exceeding 10%. Its growth rate, however, slipped to 6.2% during the second half of the 1980s, partly due to the loss of protection as the economy opened up, but was then able to recover during the first half of the 1990s. The sector's erratic growth again manifested during the latter half of the 1990s and slipped to its lowest average during 2001–2006. The lowest point was during 2001/02, when the manufacturing subsector's contribution to GDP dipped to a negative 0.5% (Table 2.4).

Services, meanwhile, have been contributing steadily, with its growth rate averaging 2.6–7.4% over the various periods. Services became the main contributor to growth starting in the 1990s and has been the largest sector in terms of share of GDP growth since 2001.

Within the services sector, the growth has mainly been led by wholesale and retail trade, transport, storage and communications, financial intermediation and real estate, renting, and business activities. While the performance of other subsectors has fluctuated, financial intermediation has been growing in real terms since 2003/04 and has been consistently contributing to GDP growth.

2.3.2. Growth By Expenditure Component

On the demand side, private consumption has dominated Nepal's GDP, as in other countries in South Asia. The share of private consumption in

Table 2.4. Sectoral Contribution to GDP Growth (percentage points)

Sector and Subsector	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Agriculture, Fishery, and Forestry	1.1	1.2	1.8	1.3	0.7	0.4	2.0
Agriculture and Forestry	1.1	1.2	1.7	1.3	0.6	0.3	2.0
Fishing	0.0	0.0	0.1	0.0	0.1	0.0	0.0
Industry	0.1	0.5	0.2	0.5	0.7	0.7	0.3
Mining and Quarrying	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Manufacturing	-0.5	0.0	0.2	0.2	0.2	0.2	0.0
Electricity, Gas, and Water	0.2	0.4	0.1	0.1	0.1	0.3	0.1
Construction	0.4	0.1	0.0	0.2	0.5	0.2	0.2
Services	-0.8	1.7	3.1	1.2	2.9	1.9	3.3
Wholesale and Retail Trade	-1.9	0.3	1.5	-0.9	0.5	-0.6	0.8
Hotels and Restaurants	-0.4	0.0	0.2	-0.1	0.1	0.1	0.1
Transport, Storage, and Communications	0.6	0.4	0.6	0.2	0.6	0.4	0.6
Financial Intermediation	0.1	0.0	0.2	0.7	0.8	0.5	0.6
Real Estate, Renting, and Business Activities	-0.4	-0.3	-0.2	0.7	0.5	0.9	0.4
Public Administration and Defence	0.5	0.2	0.0	0.1	0.1	0.0	0.1
Education	0.9	0.7	0.3	0.5	0.2	0.4	0.3
Health and Social Work	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Other Community, Social, and Personal Service Activities	-0.3	0.1	0.4	-0.1	0.1	0.3	0.3
GDP Growth Rate (%)	0.5	3.4	5.1	3.0	4.4	3.0	5.6

GDP = gross domestic product.

Note: Estimated using GDP in basic prices instead of market prices.

Source: Based on MOF (various years).

GDP averaged 80–83% during the 1970s and 1980s, but declined slightly to over 77% in the 1990s and 2001–2006 (Table 2.5). An encouraging trend has been the consistently rising share of investments, which, as a result of liberalization and reforms, has risen from about 13% in the 1970s and 19% in the 1980s to 23% in the 1990s, to nearly 27% in 2001–2006, and to 29% in 2007. The government's share of GDP has increased only slightly, from nearly 8%

in the 1970s to about 10% in 2001–2006, but dipped to 9.5% in 2007. On the other hand, the unfavorable trade balance has meant that the net exports' share in GDP has declining consistently, from -4.2% in 1970s to about -14.1% in 2001–2006 and to -18.5% in 2007.

The main contributors to GDP growth have been consumption followed by investments (Table

Table 2.5. Shares of Expenditure Components in GDP (%)

Period	Consumption		Government		Investment		Net Exports
	Growth Rate	Share of GDP	Growth Rate	Share of GDP	Growth Rate	Share of GDP	Share of GDP
1971–1980	1.33	83.31	0.46	7.79	15.78	13.05	–4.16
1981–1990	4.99	80.61	7.89	9.01	5.30	19.41	–9.03
1991–2000	4.03	77.78	5.65	8.85	8.55	23.50	–10.13
2001–2006	3.40	77.38	5.07	10.07	6.67	26.61	–14.07
2007/08	2.21	83.20	4.48	9.50	2.52	28.80	–18.50

GDP = gross domestic product.

Note: For 2007/08, GDP growth rate is based on the producer prices, which do not account for tax and subsidies on the products.

Source: UNSD (various years).

2.6). As calculated from Table 2.6, the contribution of consumption to GDP growth ranged from 83% in the 1980s to 63% in the 1990s and 94% in 2001–2006. However, the contribution declined significantly in 2007, to about 43%. Investment's contribution to GDP growth increased from about 20% in the 1980s to 35% in the 1990s and 62% in 2001–2006. In 2007, industry was the most dominant, with a contribution of 130% to GDP growth. The government's contribution to GDP growth during these periods ranged from 10% to 17%. Net exports' contribution to GDP growth has been negative, ranging from –15% in the 1980s to –7% in the 1990s and –73% in 2001–2006. In 2007, the deterioration in net exports continued and reduced the GDP growth level.

In Nepal, consumption's share in GDP, at about 81% in 2001–2006, was higher than that of other South Asian economies (Figure 2.3), and Nepal's

share of net exports in GDP was the lowest in the region. The GDP shares of government expenditures and investment were comparable with those of most other countries in the region.

2.3.3. Growth By Development Region

The disparity between development regions' shares in GDP is high. Data suggest that the Central Development Region accounted for about 42% of GDP in 2001, whereas the Mid-Western and Far-Western development regions together accounted for only about 18% of GDP (Figure 2.4). Similarly, the Eastern and Western development regions accounted for only about 21% and 19% of GDP, respectively. Production in most sectors is concentrated in the Central Development Region—the exceptions are agriculture, fisheries, and forestry; trade, hotels, and restaurants; and finance and real estate.

Table 2.6. Contribution to GDP Growth by Expenditure Component

Period	Consumption		Government		Investment		Net Exports
	Growth Rate (%)	Contribution to GDP Growth (percentage points)	Growth Rate (%)	Contribution to GDP Growth (percentage points)	Growth Rate (%)	Contribution to GDP Growth (percentage points)	Contribution to GDP Growth (percentage points)
1971–1980	1.33	1.06	0.46	0.01	15.78	1.51	–0.46
1981–1990	4.99	3.98	7.89	0.61	5.30	0.94	–0.74
1991–2000	4.03	3.14	5.65	0.47	8.55	1.76	–0.36
2001–2006	3.40	2.62	5.07	0.48	6.67	1.73	–2.04
2007/2008	2.21	2.00	4.48	0.40	2.52	6.10	–3.80

GDP = gross domestic product.

Note: For 2007/08, GDP growth rate is based on the producer prices, which do not account for tax and subsidies on the products.

Source: UNSD (various years).

Figure 2.3. Average Shares of Expenditure Components in GDP, 2001–2006 (%)

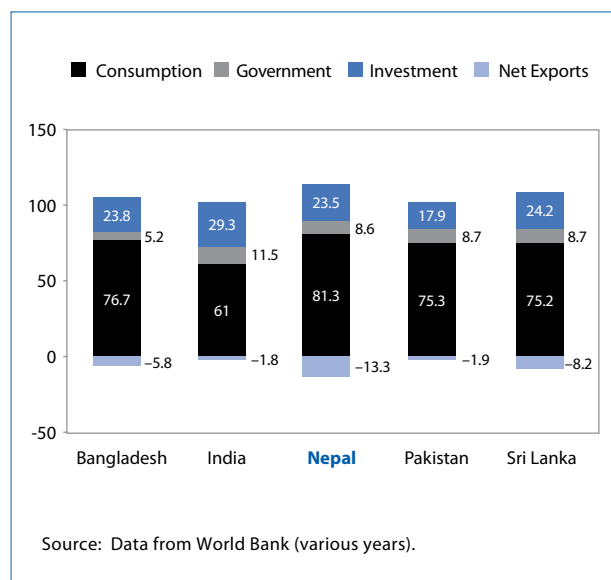
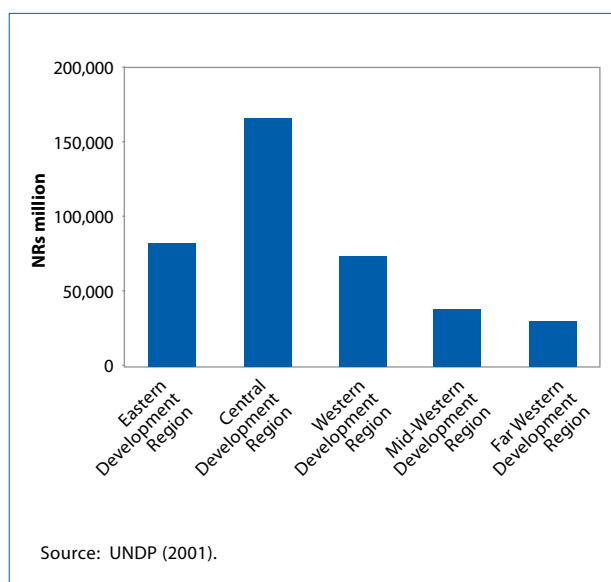


Figure 2.4. Regional Share in Sectoral Value Added, 2001



2.3.4. Growth By Factors of Production

In decomposing real GDP growth by the factors of production (labor; capital and residual or total factor productivity, which captures technological progress; efficiency gains due to policy and institutional reforms; etc.), the Asian Productivity Organization (APO 2004) estimated that the annual average

growth of total factor productivity adjusted for business fluctuations in Nepal during 1980–2000 was less than half that of India (Table 2.7). When adjusted for fluctuations in the business cycles, it was even lower. Moreover, the total factor productivity growth declined from 1.24% in the mid 1980s and 2.27% in the first part of the 1990s to 0.14% in the last half of the 1990s.

2.4. Recent Trends in Poverty and Inequality

2.4.1. Poverty

Despite its lackluster growth in recent years, Nepal has progressed well on the poverty reduction front. The latest data available from living standards surveys indicate that the incidence of poverty, based on the national poverty level, declined from about 41.7% in 1995/96 to about 30.9% in 2003/04, or by over 10 percentage points (Figure 2.5). During the same period, the incidence of poverty based on the \$1-per-day poverty line showed a similar decline, from about 34.4% to 24.7% (Figure 2.6). Although Nepal's poverty incidence remains high, it is lower than India's (35.1% in 2004) and that of Bangladesh (36.3% in 2005). Studies suggest that key factors for the fall in poverty despite the very low growth in per capita GDP include (1) overseas remittances, (2) increased rates of rural-to-urban migration, and (3) increased entrepreneurial activities in agriculture. Although these trends were partly driven by the lack of opportunity in local economies and by conflict/civil war, recent studies suggest that improved access and connectivity through investment in rural roads was a key factor³—the proportion of paved roads increased from about 37.5% in 2000 to 56.9% in 2004.

The incidence of poverty declined between 1995 and 2003 across all development regions (Figure 2.7, p. 14). Although the decline was highest in the Mid-Western Region and lowest in the Central Region, the Mid-Western Region continued to have the highest poverty incidence. In terms of ecological belt, the

³ The Enterprise Survey findings also indicate that improved infrastructure has had a major impact on poverty reduction in recent years (ILO, ADB, and FNCCI 2008).

Table 2.7. Annual Average Growth of Total Factor Productivity in Selected Asian Countries (%)

Period	India		Nepal	
	Growth Rate	Growth Rate Adjusted for Business Fluctuations	Growth rate	Growth Rate Adjusted for Business Fluctuations
1980–1984	0.58	0.57	0.57	1.34
1985–1989	2.63	2.64	1.24	1.47
1990–1994	2.01	2.02	2.27	0.14
1995–1999	2.90	2.90	0.14	0.64
1980–2000	2.08	2.08	1.11	0.91

Source: APO (2004).

Figure 2.5. Poverty Incidence in Selected Countries Based on the National Poverty Lines (%)

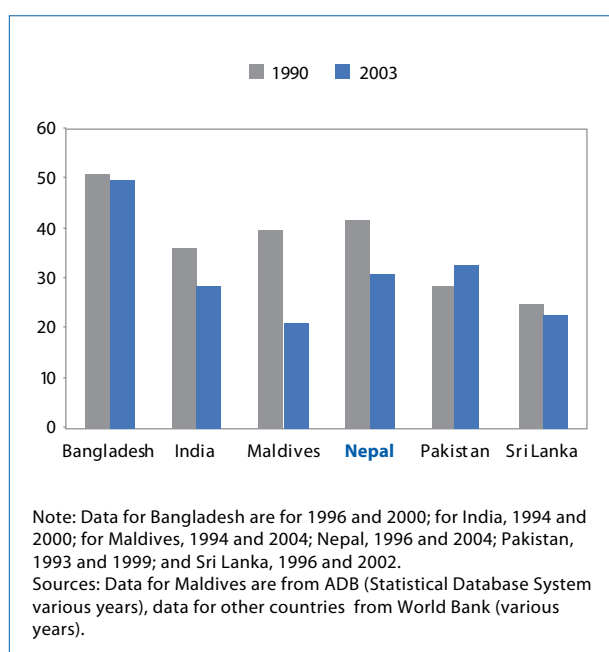
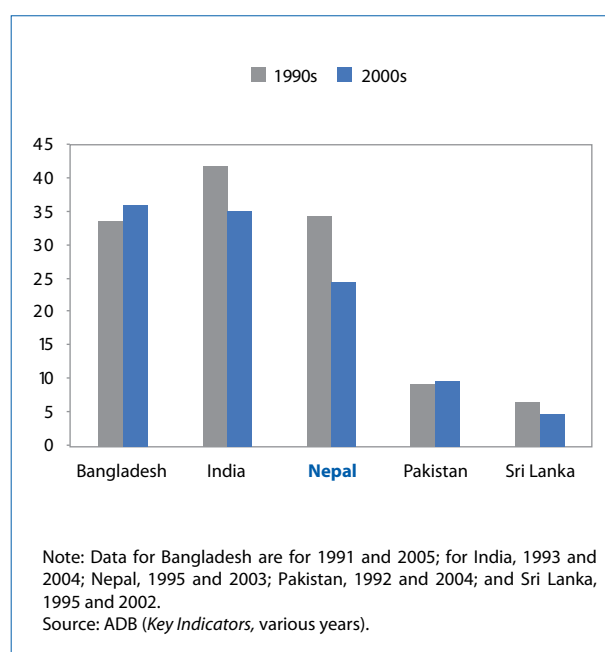


Figure 2.6. Poverty Incidence in Selected Countries Based on the \$1-a-Day Poverty Line (%)



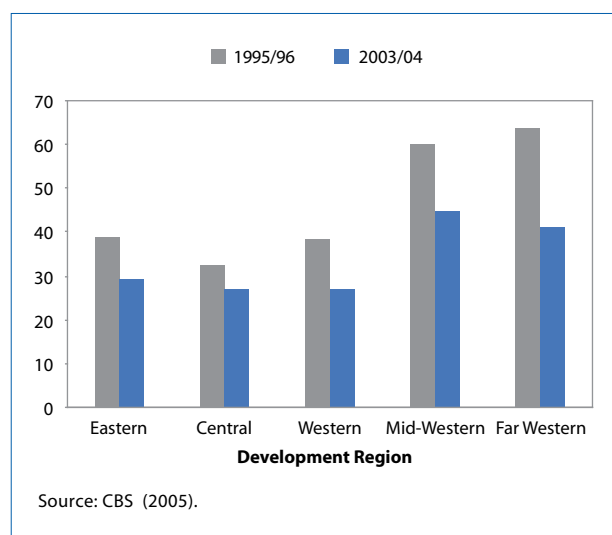
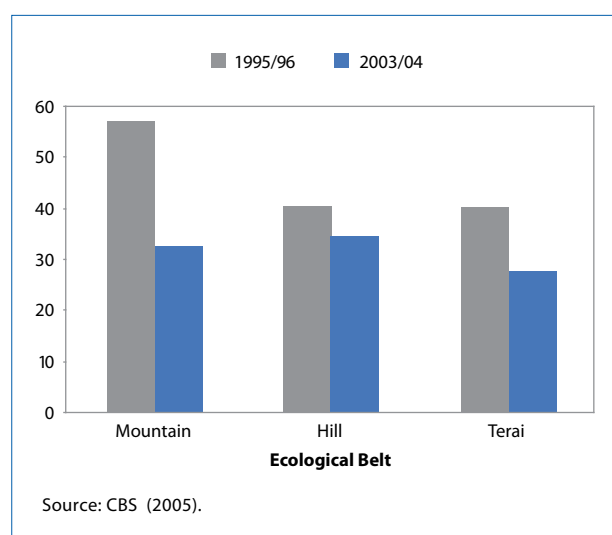
greatest decline in poverty incidence occurred in the mountain belt, where it dropped from about 57.0% to 32.6% (Figure 2.8). In the hill area, the poverty incidence declined from 40.7% to 34.5% and in the terai, from 40.3% to 27.6%. Overall, declines between 1995 and 2003 were largest in the poorest ecological belt.

2.4.2. Inequality

Although the incidence of poverty declined between 1995/96 and 2003/04, inequalities rose over the same period. Table 2.8 (p.15) shows that the income-related Gini coefficient for Nepal is the highest in South Asia. It rose from 0.38 in 1995/96 to 0.47 in

2003/04, at an annual rate of 2.85%. The official estimates suggest slightly lower values for the Gini coefficient, but also confirm the rising inequality in the country (Three Year Interim Plan, NPC various years). Other measures of income inequality, such as inter-quintile ratios, paint a similar picture. Comparing the incomes of the quintiles with the highest income share and those with the lowest indicate that the richest quintile of the population had incomes nearly 10 times those of the lowest quintile in 2003/04.

A key factor behind income inequality has reportedly been the household head's education level. Decomposition analysis using Theil's Index

Figure 2.7. Poverty Incidence by Development Region (%)**Figure 2.8. Poverty Incidence by Ecological Belt (%)**

shows that as much as 26% of the income inequalities in 2003/04 can be explained by differences in education levels. In 1995/96, differences in income levels attributable to education level were about 17%. The trend suggests that income disparities related to employment or to labor market development are rising (Table 2.9).

Another major reason for inequalities in Nepal has been social exclusion, which was primarily driven by institutions and processes that uphold or exacerbate income and capacity poverty based

on gender, ethnicity, and caste.⁴ Gender-based exclusion in Nepal is pervasive and deep-rooted, with discrimination against women reducing their survival, health, and educational opportunities; ownership of assets; mobility; and overall status.

The impact of exclusion is evident from the fact that poverty incidence is higher among ethnic minorities such as the Limbus, Magars, Mushahars, Tamangs, and Tharus, and in the lower castes. Similar disparities in human development indicators are evident between minorities and non-minorities, and lower- and upper-caste groups (ADB 2002). Furthermore, evidence indicates that inequalities may be rising. Inequality as decomposed by ethnicity shows that between-caste inequality worsened from 1995/96 to 2003/04 (Table 2.10).

While the rate of poverty reduction has been significant, some studies suggest that the reduction could have been greater but for the rising inequalities. A recent World Bank study suggests that the same level of GDP growth could have reduced poverty by as much as 13 percentage points if the income inequalities had not worsened (Table 2.11).

In other measures of welfare, the *Human Development Report 2007/2008* notes that Nepal has the lowest Human Development Index in South Asia and ranks 142nd out of 177 countries (Table 2.12, p. 16), underscoring the major challenges Nepal faces in providing basic services (UNDP 2009).

2.5. Evolution of Nepal's Development Policy

Nepal began its move toward an open, market-oriented economy in the mid-1980s with the adoption of policies involving greater liberalization of the domestic economy and trade. Interest rates were partially deregulated and barriers to entry for joint-venture banks were lowered. Relations with the People's Republic of China were also strengthened during these years. A trail of reforms followed in the 1990s and early 2000s, particularly to improve

⁴ World Bank et al. (2006) reports the Gini coefficient at 0.34 for 1995 and at 0.41 for 2003.

Table 2.8. Inequality in Selected South Asian Countries

Country	Period	Gini Coefficients			Top 20%/Bottom 20 %		
		Initial Year	Final Year	Annualized Growth Rate (%)	Initial Year	Final Year	Annualized Growth Rate (%)
Bangladesh	1991–2005	0.28	0.34	1.34	4.06	5.03	1.53
India	1993–2004	0.33	0.36	0.88	4.85	5.52	1.18
Nepal	1995–2003	0.38	0.47	2.85	6.19	9.47	5.31
Pakistan	1992–2004	0.30	0.31	0.24	4.22	4.46	0.46
Sri Lanka	1995–2002	0.34	0.40	2.24	5.34	6.83	3.52

Source: ADB (Statistical Database System, various years).

Table 2.9. Inequality Decomposition by Level of Education of Household Head

	1995/96	2003/04
Theil's Index: Total	21.8	33.7
<i>Of which</i>		
within education level	18.0	25.0
(as a share of total)	82.7%	74.1%
between education levels	3.8	8.7
(as a share of total)	17.3%	25.9%

Source: World Bank et al. (2006).

Table 2.10. Inequality Decomposition by Ethnicity and Caste

	1995/96	2003/04
Theil's Index: Total	21.8	33.7
<i>Of which</i>		
within ethnicity and caste	19.7	29.2
(as a share of total)	90.3%	86.7%
between ethnicity and caste	2.0	4.5
(as a share of total)	9.7%	13.3%

Source: World Bank et al. (2006).

Table 2.11. Growth and Redistribution Decomposition of Poverty Changes in Nepal from 1995/96 to 2003/04

Area	Poverty Incidence (%)		Change in Incidence of Poverty (percentage points)		
	1995/96	2003/04	Actual Change	Growth	Redistribution
Nepal	41.76	30.85	-10.92	-24.13	13.22
Urban	21.55	9.55	-12.00	-11.90	-0.10
Rural	43.27	34.62	-8.65	-17.25	8.57

Source: World Bank et al. (2006).

the financial sector, improve access to microcredit, and strengthen government institutions. These reforms included the Co-operative Act of 1991, the Development Bank Act of 1995, the Financial Intermediary Societies Act of 1998, establishment of the Rural Self-Reliance Fund in 1990, establishment of Grameen-like regional rural development banks in 1992, and establishment of the Rural Microfinance Development Center in 1998.

In addition, several laws were passed in the early 1990s to improve the capabilities of institutions in the power sector, such as the Hydropower Development Policy and Electricity Act of 1992. In the mid-1990s, Nepal was hit by political instability, double-digit inflation and ballooning external debt, and a current account deficit. To address the fiscal deficit, several tax reforms were passed, including introducing a value-added tax in 1997 to cover a

Table 2.12. Human Development Index, 1975–2005

Rank in 2005	Country	1975	1980	1985	1990	1995	2000	2005
99	Sri Lanka	0.619	0.656	0.683	0.702	0.721	0.731	0.743
100	Maldives	—	—	—	—	—	—	0.741
128	India	0.419	0.45	0.487	0.521	0.551	0.578	0.619
133	Bhutan	—	—	—	—	—	—	0.579
136	Pakistan	0.367	0.394	0.427	0.467	0.497	0.516	0.551
140	Bangladesh	0.347	0.365	0.392	0.422	0.453	0.511	0.547
142	Nepal	0.301	0.338	0.380	0.427	0.469	0.502	0.534

— = no data available.

Source: UNSD (various years).

wide range of businesses. This was followed by the new income tax and new excise tax laws, and establishment of the Large Taxpayer Office in the early to mid 2000s. Revenue generation generally shifted from customs duties to the value-added tax and other sources. Several laws were also passed to improve the banking sector, particularly the credit culture. Some of the salient laws include the Nepal Rastra Bank Act, the new Directive on Credit Information and Blacklisting in 2002, and the new Bank and Financial Institutions Ordinance in 2004.

Other key reforms accomplished include privatization of state enterprises, greater flexibility of the currency, and a trade policy that has increasingly abandoned import substitution in favor of export promotion (ADB 2002). These reforms helped pave the way toward Nepal's membership to the World Trade Organization in 2004.

Another major institutional reform has been adopting a planning approach to development. This began in Nepal in 1956 with the formulation of the First Five Year Plan (FYP), 1957–1961. Nepal's FYPs generally set the government's overall goal and specific targets for the medium term. While the plans have different priorities, they usually have common objectives—to increase output and employment; develop infrastructure; attain economic stability; promote industry, commerce, and international trade; establish administrative and public service institutions to support economic development; and introduce labor-intensive production techniques to alleviate underemployment. The social goals of the plans were to improve health and education as well as to encourage equitable income distribution.

Ten FYPs have been implemented and the Three Year Interim Plan (2007/08–2009/10) is currently being carried out (NPC various years). The first four FYPs emphasized the development of infrastructure, especially roads and electricity. Under the Fifth and Sixth FYPs, emphasis shifted toward agriculture and industry. Poverty reduction has been explicitly stated as a development objective since the Sixth FYP (1980–1985). Poverty alleviation was a major objective of the Eighth FYP (1993–1997), the first national plan formulated after restoration of multiparty democracy in 1991. The Ninth FYP (1998–2002) adopted poverty alleviation as its sole objective. And the Tenth FYP was generally based on the Poverty Reduction Strategy Paper (NPC various years). Box 2.1 summarizes the thrusts in the FYPs since 1986.

While poverty reduction has always been an overriding concern in development planning in Nepal, only since the Sixth FYP (1981–1985) has it been explicitly stated it as a development objective. The Ninth FYP (1998–2002) adopted poverty alleviation as its sole objective and intended to reduce poverty through (1) sustained and broad-based growth, (2) development of rural infrastructure and high priority social sectors, and (3) specific programs targeting the poor. The FYPs recognize accountability, democratic systems, and market-oriented economic structures that avow social and ecological responsibility as key factors in sustaining growth. A comprehensive poverty reduction strategy was developed and fully integrated into the Tenth FYP (2003–2007).

Box 2.1. Nepal's Development Plans, 1985 to Present

Seventh Five Year Plan, 1986–1990. During the Seventh Five Year Plan (FYP) period (1986–1990), the Government formulated its Program for the Fulfillment of Basic Needs, the first separate plan for reducing poverty. This ambitious long-term program envisaged eliminating poverty in Nepal during a 15-year period. It targeted increasing productivity of all sectors, expanding opportunity for productive employment, and fulfilling the minimum basic needs of the people. However, the FYP was later abandoned during the period of political upheaval. The Seventh FYP proposed expenditures of NRs29 billion. It encouraged private sector participation in the economy (less than NRs22 billion) and local government participation (NRs2 billion).

Because of the political upheavals in mid-1990, the new government postponed formulating the next plan. The July 1990 budget speech of the minister of finance, however, implied that, for the interim, the goals of the seventh FYP were to be continued. During this period, foreign aid was expected to play a major role in development; thus, approximately NRs11.8 billion, or 44.4% of the total budget of NRs26.6 billion, was expected to be derived from foreign loans or grants.

Eighth Five Year Plan, 1993–1997. Poverty alleviation was a major objective of the Eighth FYP, the first national plan formulated after restoration of multiparty democracy in 1991.

Ninth Five Year Plan, 1998–2002. The Ninth FYP adopted poverty alleviation as its sole objective and, unlike previous plans, established long-term goals for improving development indicators in all sectors based on the potential of each for reducing poverty. One of the goals of the Ninth FYP was to lower the poverty incidence from 42% to 32% by the end of the plan period in 2002, with a long-term goal of reducing this to 10% within the coming 2 decades. In addition to these targets, the FYP identified several other variables relating to “human poverty” (literacy, infant mortality, maternal mortality, and average life expectancy at birth) as opposed to “income poverty,” and set target levels for each of them. The Ninth FYP intended to reduce poverty through (1) sustained and broad-based growth, (2) development of rural infrastructure and social priority sectors, and (3) specific programs targeting the poor. In addition to integrating the “moderately poor” into the mainstream and providing targeted assistance to extremely poor households, the Ninth FYP included components to benefit the poor, the two most important being maintaining macroeconomic stability and restructuring government finances to increase the flow of resources to the social sectors.

Tenth Five Year Plan, 2002–2007. The Tenth FYP set a target to reduce the poverty level to 30%. A 10% improvement in Nepal's human development index ranking is expected due to the improved social indicators. In the context of development goals, 6.2% economic growth was targeted. The strategy of the Tenth FYP was to implement self-employment creating, income earning, and social protection programs that directly benefit economically, geographically, and socially disadvantaged groups and castes, disabled and helpless people, and people living below poverty line. The Ninth FYP focused on (1) high, sustainable, and broad-based economic growth; (2) social sector and infrastructure development; (3) targeted programs; and (4) good governance.

Three Year Interim Plan, 2007/08–2009/10. The Interim Plan's main goal is to lay the foundation for economic and social transformation to build a prosperous, modern, and just Nepal by supporting the establishment of peace and reducing unemployment, poverty, and inequality in the country. The plan's strategy includes (1) giving special emphasis to relief, reconstruction, and reintegration; (2) achieving employment-oriented, pro-poor, and broad-based economic growth; (3) promoting good governance and effective service delivery; (4) increasing investment in physical infrastructure; (5) emphasizing social development; and (6) adopting an inclusive development process and carrying out targeted programs.

Source: NPC (various years).

Chapter 3

Critical Constraints to Growth

Historically, Nepal's investment rate has ranged between 20% and 25% of gross domestic product (GDP), comparable with that of other South Asian countries (Figure 3.1). In 2007, Nepal's investment rate was about 25%, which was lower than rates for Bhutan and India, similar to that of Bangladesh, and higher than that of Pakistan. Despite an investment rate comparable to rates of other South Asian countries, Nepal's GDP growth rate remained low until 2007 (Figure 3.2). One reason for low GDP growth rates despite respectable investment rates is the

recent low growth in investments (Figure 3.3). In other words, investment levels may be historically high but incremental investments to spur growth are scarce.

Another reason for the divergence between the high investment rate and GDP growth rate could be estimation errors and statistical discrepancies. While Nepal's Central Bureau of Statistics estimates the "fixed investment or gross fixed capital formation" component of the investments using a materials-and-inputs approach backed by surveys, "changes in stocks or inventories" are

Figure 3.1. Total Investment Rate in South Asian Countries (% of GDP)

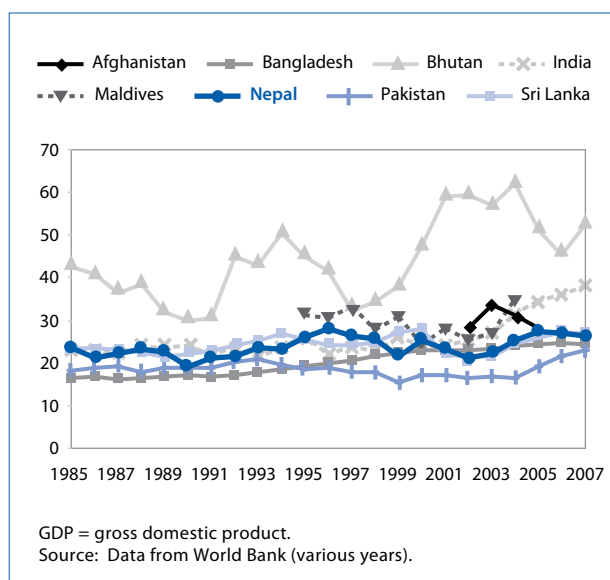


Figure 3.2. Nepal's GDP Growth and Investment Rate (%)

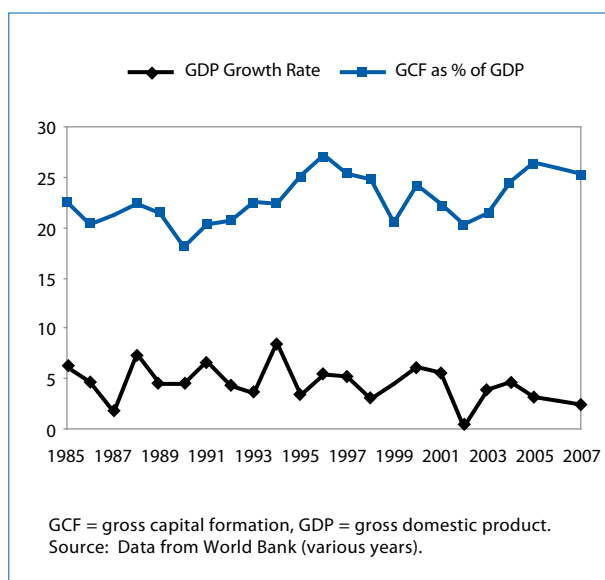
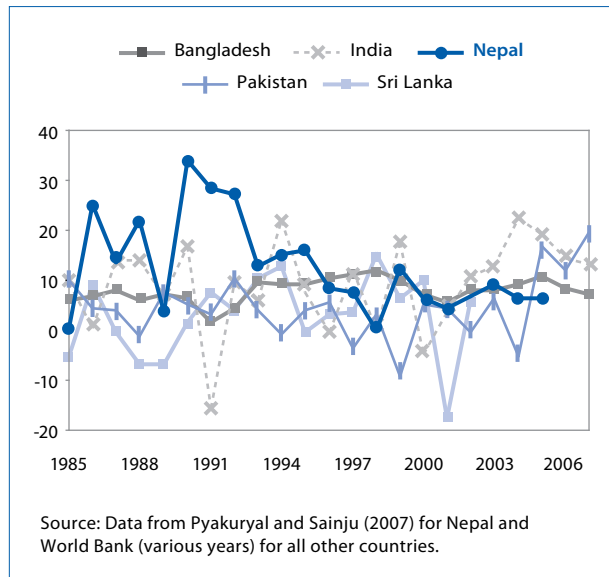
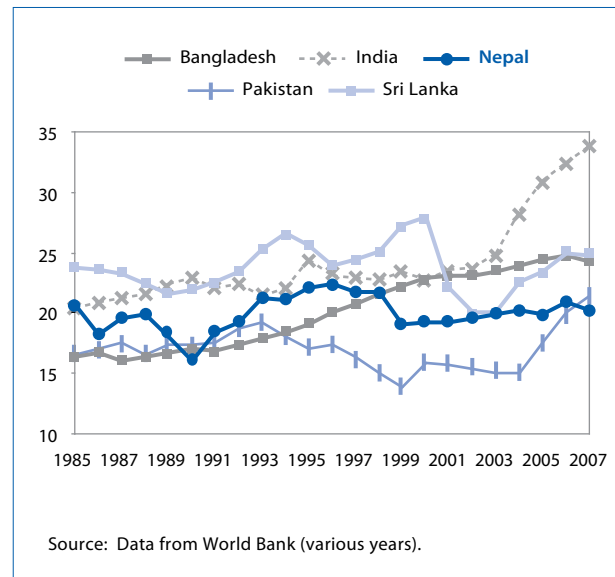


Figure 3.3. Growth Rate of Total Investments in Selected South Asian Countries (%)

estimated as a residual to balance the income and expenditure account, which opens up the possibility of noninvestment data and anomalies being counted as investments. Experience from countries that attempt to isolate or quantify such discrepancies suggests that they can be substantial.⁵ In Nepal, one reason for such discrepancies or estimation errors may be the difficulties in accurately estimating the remittance flows into the country. A comparison of changes in stocks with other major South Asian economies lends some support for the view that changes in stocks may have been overestimated. During 2005–2007, changes in stocks in Nepal were 5.0–6.5% which was significantly higher than the 1.5–1.6% for Pakistan, 2.5–2.8% for Sri Lanka, and 3.5–4.3% for India during the same period. In view of this, it may also be useful to compare trends in fixed investment or gross fixed capital formation rates. While Nepal's total investment or gross capital formation is comparable with that of other countries, Nepal's fixed investment rate in 2007 was one of the lowest in South Asia (Figure 3.4).

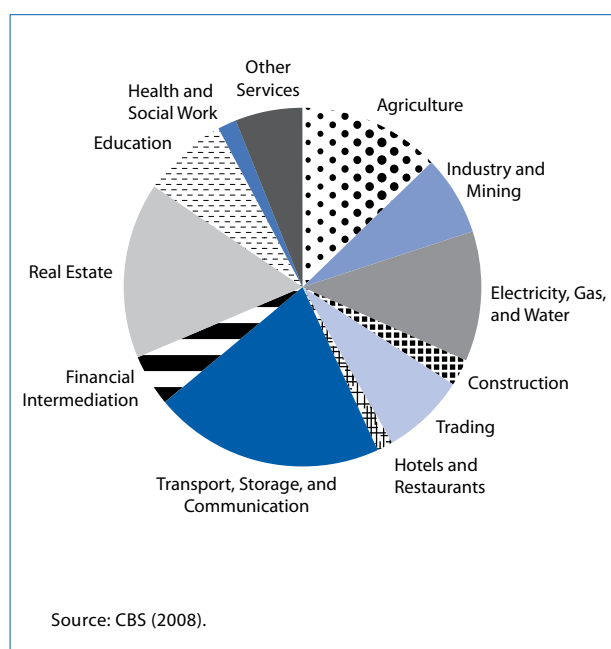
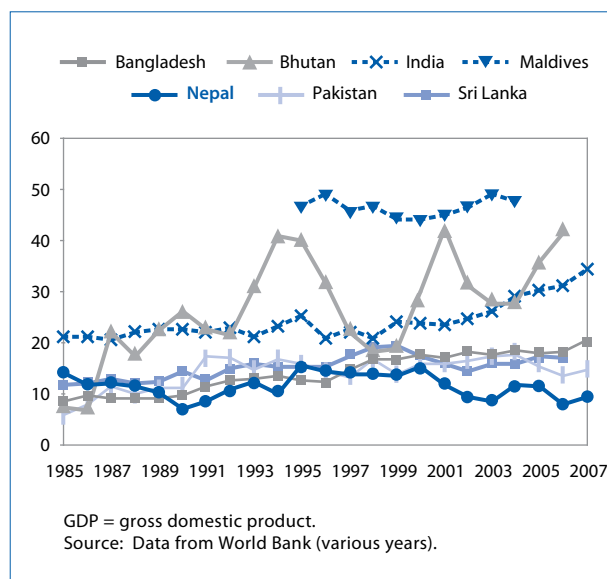
Another reason for divergence between the investment rate and GDP growth rate may be that the returns to private investments are low.

Figure 3.4. Fixed Investment Rate in Selected South Asian Countries (% of GDP)

Khatriwada and Sharma (2002) noted that services accounted for about 60% of investments in 2000, while agriculture and industry accounted for about 20%. More recent data suggest that agriculture's share in investments may have fallen further. While the time series data with a breakdown of private sector investment are not available, data for 2006/07 suggest that the share of private investment in agriculture is less than 13% (Figure 3.5), and is low in activities involving infrastructure development, especially in hydropower. Private investment is instead conspicuously high in real estate, rent, and business activities, which may not have as high a multiplier effect as infrastructure, agriculture, and industry. Private sector investment in industry is also relatively low.

This raises several questions as to why economic growth and private investment are constrained. Is it due to low social return to investment, low private appropriability, high cost of financing, or a combination of the three? This chapter will look at some of the empirical evidence, and will attempt to ascertain the constraints to economic growth and private investment.

⁵ For example, the statistical discrepancy for Philippines was estimated at about 6.3% of GDP in 2006 and 5.2% of GDP in 2007 (NSCB 2008).

Figure 3.5. Private Sector Investment in 2006/07**Figure 3.6. Gross Domestic Savings in Selected South Asian Countries 1985–2007 (% of GDP)**

3.1. Cost of Finance

A low level of domestic savings could push the real interest rate up, inefficient financial intermediation could make access to finance difficult, and together they could lead to a high cost of funds in domestic financial markets. For a small economy such as Nepal's, with little or no access to the international capital market, remittances from overseas workers are an important source of finance.

Aggregate domestic savings is low but may not constrain growth as remittance flows are financing the shortfall. A low level of domestic savings can constrain an economy's ability to grow, especially when the economy has limited access to international sources of finance. In particular, low domestic savings can push the real interest rates up and increase the cost of financing investments. Historically, Nepal's gross domestic savings rate has been quite modest. However, the savings rate has fallen farther since 2000, contrary to trends in other countries in the region, where domestic savings rates have been rising steadily. In 2006, Nepal's domestic savings rate fell below 8% of GDP, which is the lowest rate since 1990, when it was about 7% of GDP (Figure 3.6). The domestic savings rate has since shown some improvement,

but at 9.4% of GDP is still lower than the levels that prevailed in the late 1990s or even in 2004 and 2005. One reason for the low domestic savings may be low income levels that require households to spend a high share of their incomes to meet basic consumption needs, leaving less room to save. A comparison of Nepal's domestic savings rate with rates of other Asian countries when they were at a similar level of per capita GDP lends some to support this hypothesis (Table 3.1). While the People's Republic of China, India, and Viet Nam had higher domestic savings rates than Nepal, other countries had comparable rates.

A comparison of the gross domestic savings rate with the investment rate (gross domestic capital formation) suggests that a large gap between the two has persisted since 1985 (Figure 3.7). In 2007, the investment rate was about 28% of GDP or about 17 percentage points higher than the domestic savings rate. This suggests that the low savings rate impeded Nepal's investment and economic growth. However, the domestic savings rate does not capture the significant levels of remittance inflows from abroad, which ranged from \$1.2 billion (equivalent to 14.8% of GDP) to \$1.7 billion (equivalent to 17.0% of GDP) between 2005 and 2007 (Figure 3.8). A more appropriate measure of assessing the adequacy of

Table 3.1. Gross Domestic Savings in Selected Asian Countries at Comparable Per Capita GDP

Country	Year of Comparison	Per Capita GDP in 2000 \$	Domestic Savings Rate (% of GDP)
Bangladesh	1970	270	7.15
Bhutan	1980	258	5.75
Cambodia	1998	245	-1.31
China, People's Republic of	1985	290	34.40
India	1980	229	15.41
Nepal	2007	242	9.35
Pakistan	1970	285	8.89
Sri Lanka	1960	269	—
Viet Nam	1992	251	13.55

— = data not available, GDP = gross domestic product.

Source: Data from World Bank (various years).

Figure 3.7. Comparison of Savings and Investments 1985–2007 (% of GDP)

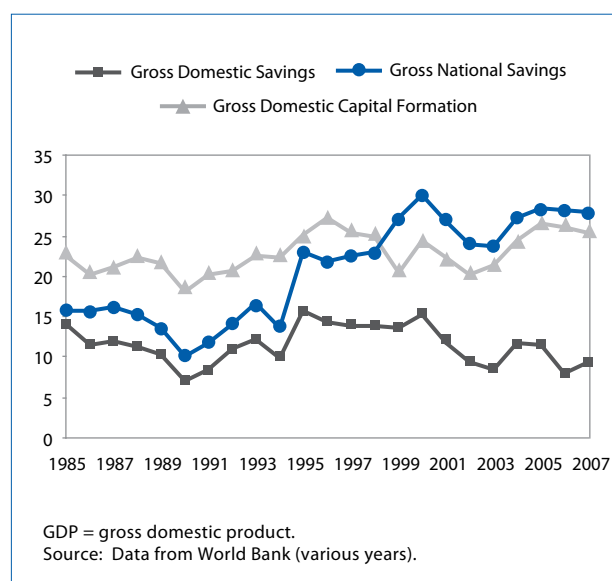
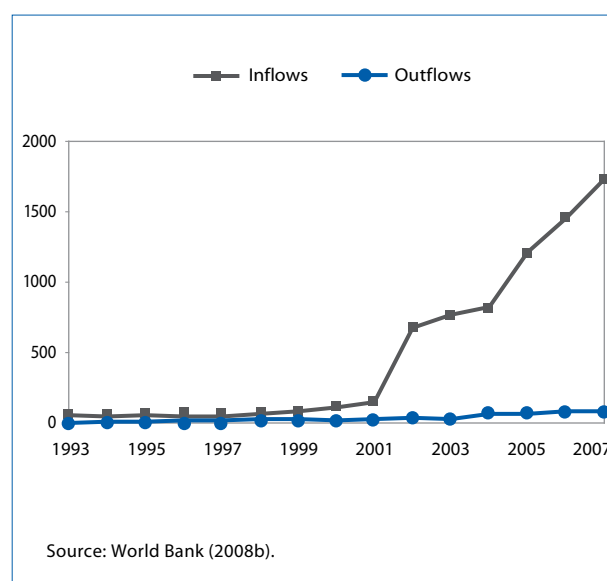


Figure 3.8. Remittance Inflows and Outflows (\$ million)



savings in Nepal may be the gross national savings rate, which takes remittance inflows into account. A comparison of the gross national savings rate and gross domestic capital formation shows that the gross national savings rate has been higher than gross domestic capital formation since 1998. During 2005–2007, the gross national savings amounted to about 28% of GDP, which was nearly 3 percentage points higher than domestic investment rates during the same period. In other words, the gap between gross domestic investments and gross domestic savings is being financed by the remittances from abroad.

On the external payments position, Nepal has had substantial trade deficits that increased from about 12% of GDP in 1990 to about 24% in 1997, fell to about 14% of GDP in the early 2000s, and then rose above 16% of GDP in 2006 and 2007. Despite the substantial trade deficits, the country has been able to post current account surpluses since 2002 due to the remittance inflows (Figure 3.9). Although the current account surplus declined significantly in 2007, mainly due to the surge in oil prices, the surplus is expected to recover with a drop in oil prices. Net resource transfers in terms of the current account surplus in the last 6 years have helped Nepal reduce its external debt as a percentage of gross national

income from about 49.5% in 2002 to 37.8% in 2006 (Figure 3.10).

The evidence and discussions just cited suggest that modest levels of domestic savings may have been compensated for by significant levels of remittance inflows, which propped up the national savings to levels above the domestic investment rates. While national savings can comfortably meet the current domestic investments needs, low levels of domestic

savings may become a constraint to investment if remittance inflow levels are significantly affected by the downturn in the global economy or if the investment levels experience a sharp upsurge.

The efficiency of domestic financial intermediation could be improved but may not constitute a critical constraint to growth. Inefficiencies in financial intermediation can affect investors' costs of finance. As of January 2008, Nepal's financial system comprised the Nepal Rastra Bank (the central bank); 23 commercial banks; 58 development banks; 79 finance companies; 12 microcredit development banks; and cooperative financial institutions, non-government organizations, insurance companies, and postal saving offices. In addition, the financial sector included the Nepal Stock Exchange, Employee's Provident Fund, and Citizen Investment Trust. Capital markets and nonbank financial institutions have shown impressive growth in recent years. Market capitalization of the Nepal Stock Exchange rose from about 7% of GDP in 1999 to 15% in July 2006 and to about 40% of GDP in December 2008. Despite a large diversity of institutions, the financial system has been dominated by banking, which accounted for about 86% of the financial sector assets in 2005 (Figure 3.11). More recent data suggest that total banking sector assets had risen from 62% of GDP in 2000 to 81% in July 2007

Figure 3.9. Current Account and Trade Balance 1990–2007 (% of GDP)

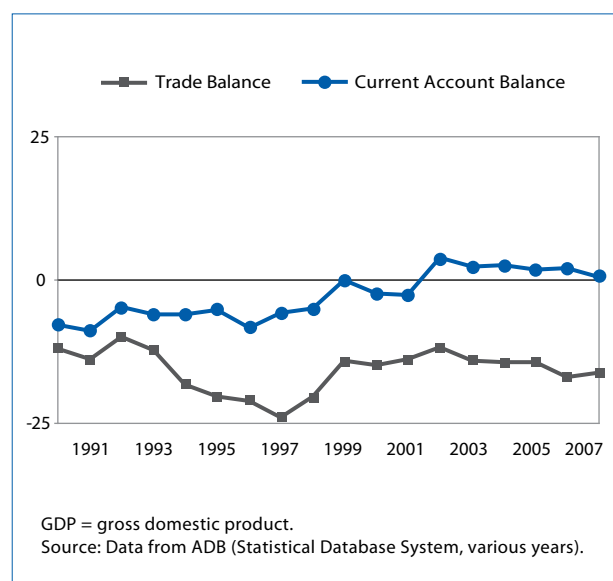


Figure 3.10. Comparison of External Indebtedness 1990–2007 (% of GNI)

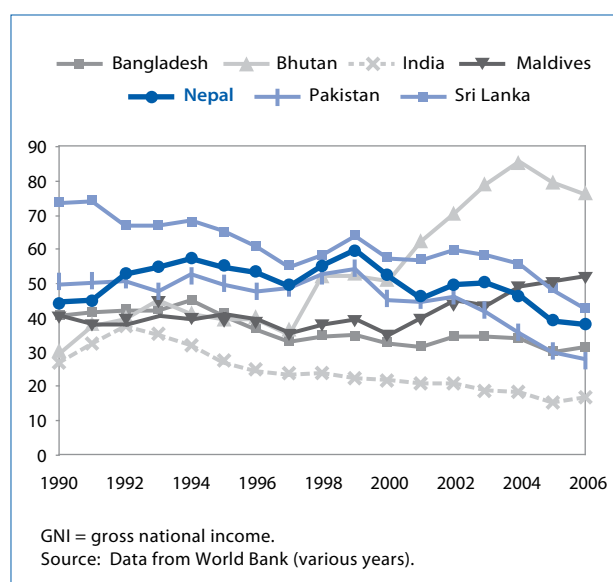
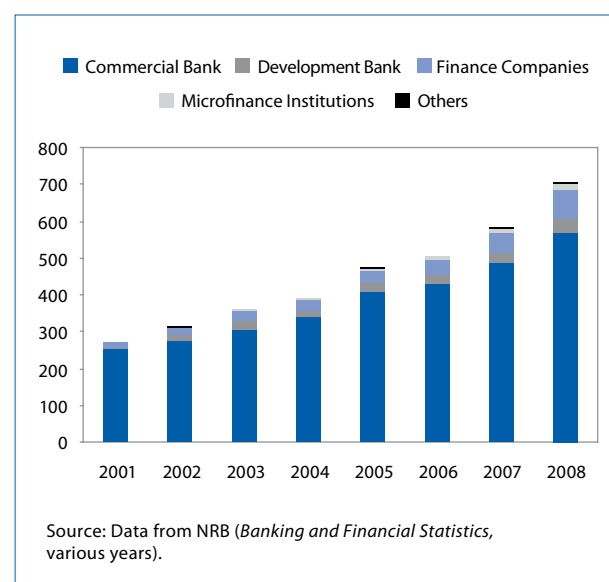


Figure 3.11. Financial Sector Assets (NRs billion)



(Ferrari, Jaffrin, and Shrestha 2007). With banking dominating the financial sector, inefficiencies in the banking system can affect investors' ability to finance their investments.

The spread between the lending and deposit rates is one indicator of a banking system's efficiency. An efficient banking sector will have lower interest rate spreads than an inefficient one. A comparison with other South Asian countries suggests that the spread between lending and deposit rates in Nepal has been among the lowest in the region (Figure 3.12). Thus, the efficiency of Nepal's banking sector in financial intermediation compares favorably with that in other South Asian countries and may not be a critical constraint to growth. At the same time, the recent level of spreads is nearly double that in 2001, which suggests some deterioration in efficiencies since 2001. A comparison with more developed economies in East Asia shows that Nepal's spreads are 2–3 percentage points higher; thus, there may be considerable scope to improve the system's efficiency and reduce costs of intermediation (Figure 3.13).

Although growth in real domestic credit has stagnated somewhat during recent years, it does not seem to be constrained by lack of liquidity in the banking system. Since Nepal's

Figure 3.12. Spreads between Lending and Deposit Rates in Selected South Asian Countries (in percentage points)

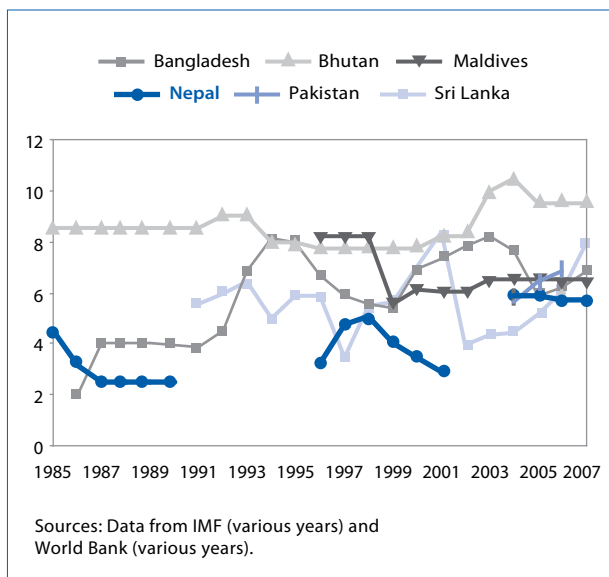
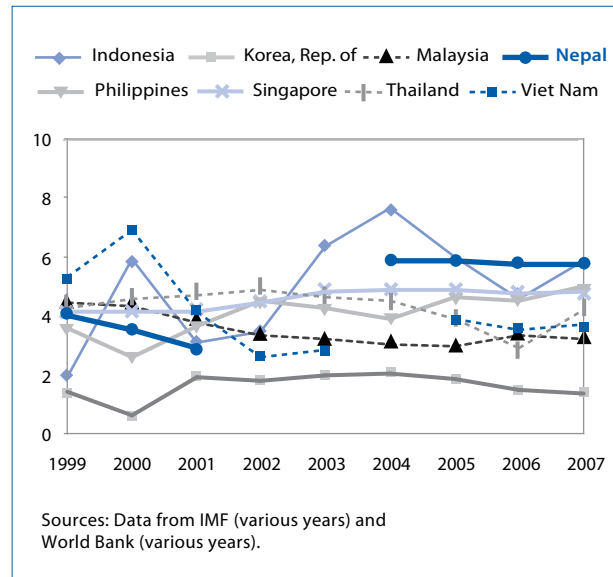
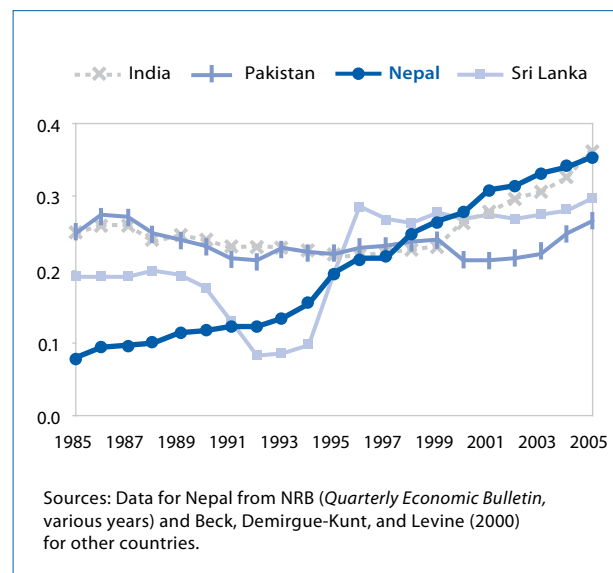


Figure 3.13. Lending and Deposit Rate Spreads in Nepal and Selected Asian Countries (in percentage points)



economy opened up in the mid-1980s, the country has undertaken substantial reforms in the financial sector, which led to more than a threefold increase in the credit-to-GDP ratio since 1985. Among major South Asian economies, Nepal's credit-to-GDP ratio is lower only than that of India (Figure 3.14). However, when compared with Southeast Asian economies, Nepal's credit-to-GDP ratio is lower

Figure 3.14. Ratios of Domestic Credit to GDP in Selected South Asian Countries

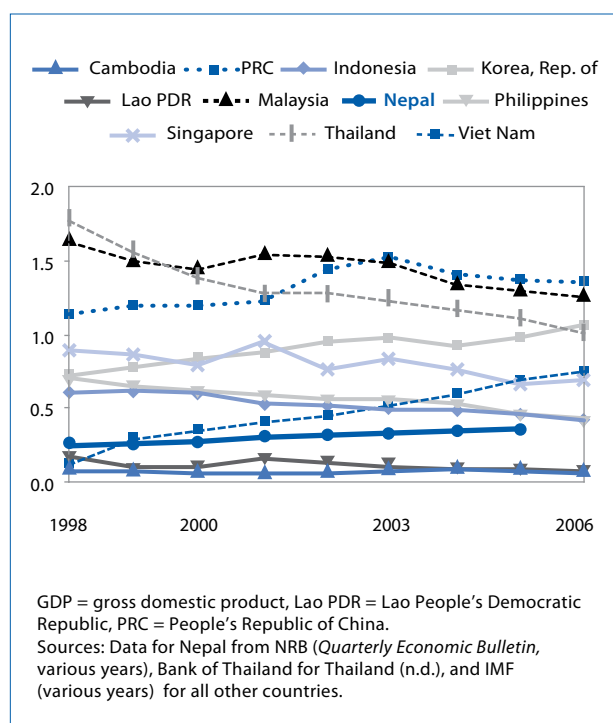


than that of all countries except Cambodia and the Lao People's Democratic Republic, which suggests substantial room for improvement (Figure 3.15). Moreover, the credit-to-GDP ratio seems to have stagnated since 2000, when the conflict peaked. Given that GDP (the denominator) grew more slowly between 2000 and 2006 than in the 1990s, the stagnation in credit levels is more pronounced as not only did the ratio fail to improve, but the volume of credit did not increase.

A slowdown in the credit levels is also obvious from trends in the level of deposits with banks. The credit-to-deposit ratio, after peaking at 71.5% in 1997, declined to a low of 59.9% in 2004, but recovered to 68.7% in 2007 (Figure 3.16). Over the same period, investments by the banks rose from about 12.0% in 1996 to 26.9% in 2007, mainly due to their increased participation in capital markets. Moreover, a recent report notes that the banks also expanded their investment in government securities from 9.0% of total assets in 1996 to about 12.0% in 2005 (Ferrari, Jaffrin, and Shrestha 2007).

Financial intermediation levels—the degree to which the banking subsector is putting its deposits

Figure 3.15. Ratios of Domestic Credit to GDP in Selected Asian Countries



back into the economy—could decline if banks have options for investment that are more attractive than lending. The evidence suggests that despite banks' substantial investments in government securities and participation in capital markets, the banks are holding reserves in excess of the Nepal Rastra Bank's mandatory requirements (Figure 3.17). In July 2008, the actual reserves reported by the commercial banks were about 45% higher

Figure 3.16. Bank Lending-to-Deposit and Bank Investment-to-Deposit Ratios (%)

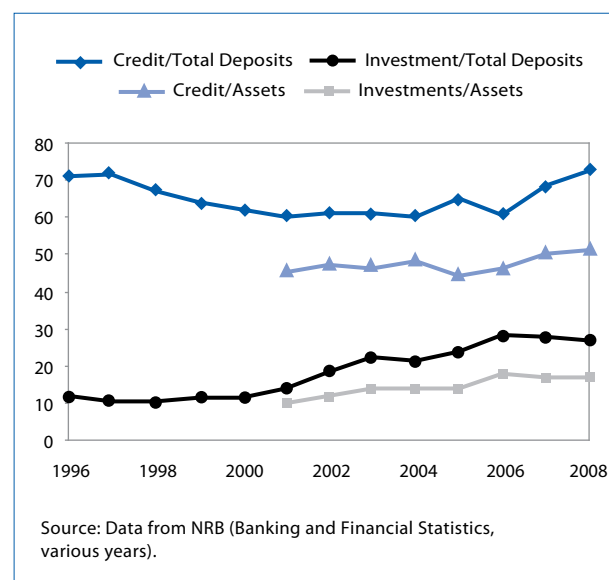
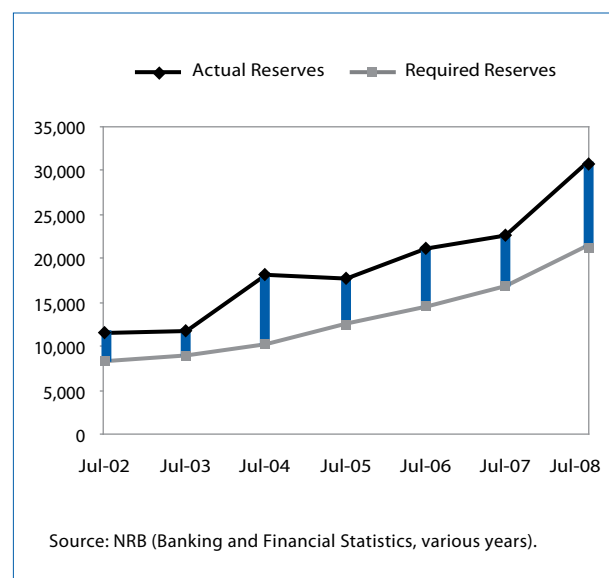


Figure 3.17. Available and Required Reserve Assets of the Banking Subsector, in NRs million

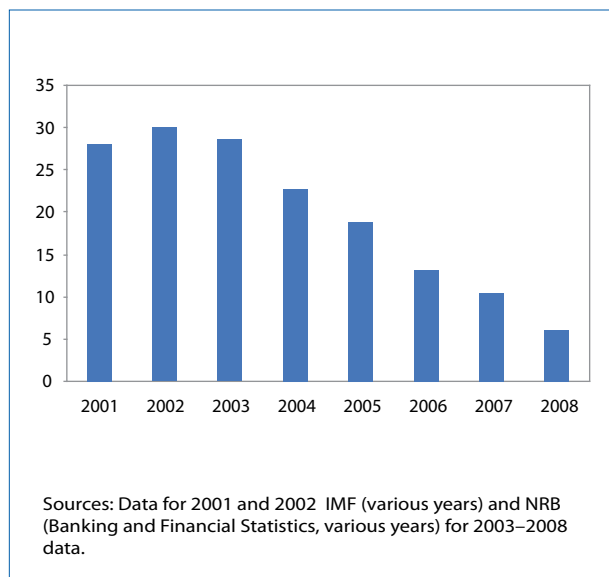


than the reserve requirement. Excess liquidity with commercial banks suggests that the declining levels of financial intermediation may be due to factors other than liquidity constraints.

Banks may curtail their lending levels if they consider that lending is overly risky. However, the ratio of nonperforming loans (NPLs) to total loans declined by about 80% between 2001 and 2008, to a little over 6% (Figure 3.18). This declining trend indicates that the health of banks' loan portfolios has been improving and lending may not be as risky an endeavor as it may have been in the past.

Borrowing cost is low, and hence is unlikely to critically constrain investment and growth. Historically, lending rates have been high in Nepal, but they have declined quite significantly as a result of reforms in the financial sector. A comparison of borrowing costs in South Asian countries suggests that Nepal's lending rates are currently among the region's lowest (Figure 3.19). Given the openness of Nepal's economy to India, it is interesting that Nepal's treasury bill rates are almost 3 percentage points lower than Indian treasury bill rates, even though the inflation rates are not far apart (Figure 3.20). It is also interesting to note that the real interest rates in Nepal are negative, which is partly on account of the increased inflation and large deposits with financial institutions.

Figure 3.18. Nonperforming Loans as Percentage of Total Loans (%)



A comparison of the rate at which industry has been borrowing from banks and the per capita GDP growth rate suggests little or no correlation between the two (Figure 3.21). In other words, a reduction in lending rates has had little effect on growth. This suggests that other factors, such as the conflict/civil war, poor infrastructure, and presence of a large informal sector with little access to financial markets, may have been more critical than the borrowing costs.

Figure 3.19. Lending Rates in South Asian Countries (%)

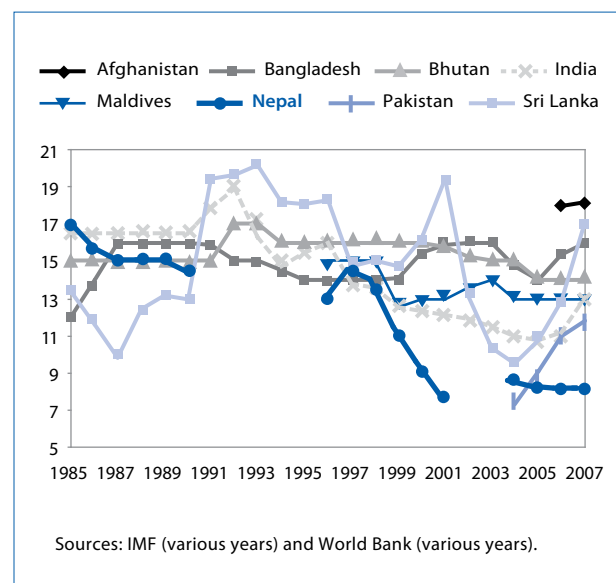


Figure 3.20. Trends in Lending Rates (%)

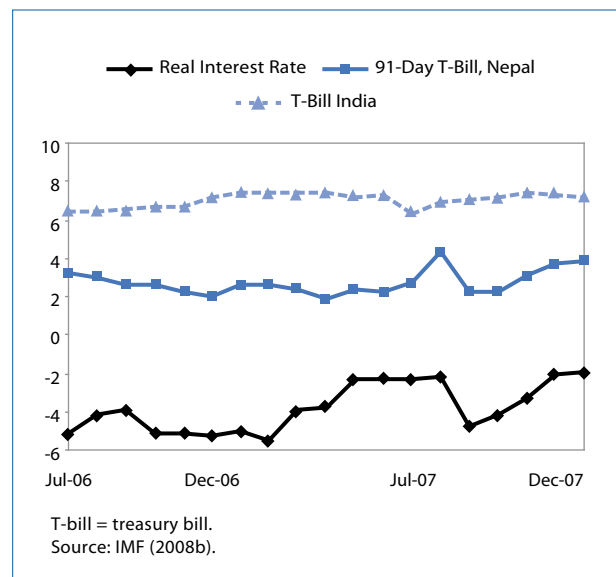
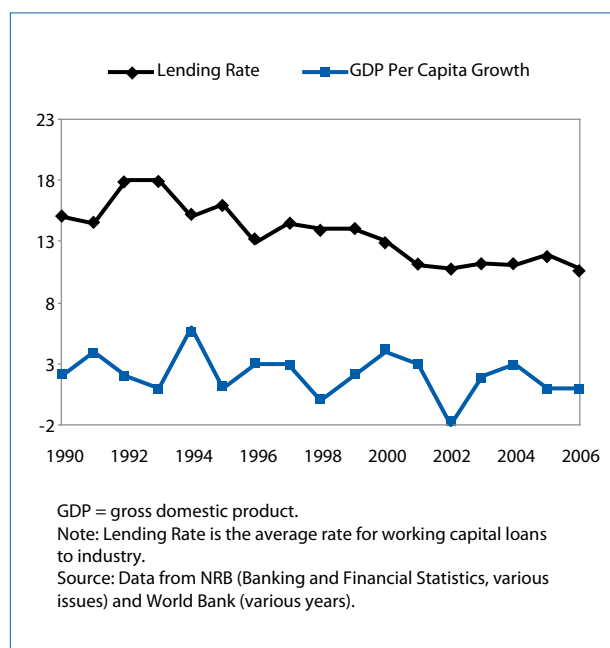


Figure 3.21. GDP Per Capita Growth Rates and Lending Rates (%)



Although the banking sector is relatively healthy, close monitoring is needed to ensure that risks and vulnerabilities remain well under control. The banking sector has made a major turnaround since 2000. NPLs have declined by about 80% and key financial soundness indicators, including the capital adequacy ratio (CAR),⁶ asset quality, and profitability, have improved steadily. Yet despite the improvements in these and other indicators, there is concern that recent rapid expansion in the financial sector may have led to increased risks. The International Monetary Fund (IMF) recently noted that banks' exposure to real estate and stock markets may be substantial, although due to limitations in the loan classification system, the size of the exposure is not clearly known (IMF 2008a). The IMF reports that nearly 60% of all bank loans are secured by real estate, which leaves the banks vulnerable to any crisis in the real estate markets. Moreover, about 3.0% of the banks' loan portfolios is collateralized against stocks, which, though small, still exposes the banks to stock market fluctuations. The IMF's stress

⁶ The CAR was increased from 10% to 11% in January 2008. Currently, two large public banks, the Agriculture Development Bank, and three private commercial banks are below the CAR. Two more private commercial banks have been given additional time to meet the increased CAR levels.

tests to ascertain the banking sector's vulnerabilities to various risks indicate the following:

- A 25% equiproportional increase in NPLs at all banks reduces the aggregate CAR by 1.2 percentage points. However, the decline in CAR for the large public banks would be 1.8 percentage points because of their higher NPL ratios. In this scenario, the capital of an additional private commercial bank would fall below the minimum CAR.
- The largest negative shock could arise from a default by the banks' single largest borrowers. In this case, nearly all banks would cease to meet their minimum CAR, and a significant number of them would be insolvent if their largest 3–5 borrowers defaulted.
- Banks' liquidity positions are not able to withstand standard shocks to deposits (e.g., if 15% of demand deposits are withdrawn in a day) under standard assumptions for market discounts on liquid assets.
- The sensitivity tests confirm that the banks' balance sheets are relatively resilient to the direct effects of an exchange rate shock (vis-à-vis the United States dollar) due to stringent open-position limits and the peg to the Indian rupee. Likewise, the impact of interest shocks would be limited. The impact of a 1.5 percentage point increase in interest rates on the CAR of all banks is only –0.3 percentage points (–1.2 percentage points for public banks) due to an increase's modest effect on the net interest income of private banks given their profile of interest-sensitive assets/liabilities.

Keeping in view the foregoing, the banks could be vulnerable to asset quality and liquidity shocks and it would be prudent to closely monitor these aspects as well as the banking subsector's exposure to real estate and stock markets to ensure timely response, if required.

Access to international financial markets is limited, but may not constitute a critical constraint. Investors in Nepal have little or no access to international financial markets; however, this may not constitute a major constraint despite low levels of domestic savings. Large remittance inflows have supplemented the domestic savings in meeting the country's investment requirements and,

as a result, Nepal has had surplus savings. Moreover, borrowing costs from the domestic banking system are low and the banking system has excess liquidity that could finance current trends in investment.

Although access to and cost of finance do not critically constrain private investment and economic growth, microenterprises and farming find access to formal financial services difficult. The foregoing discussions tend to suggest that, while domestic savings rates are rather low, they are consistent with savings rates in other Asian economies when their development levels were similar to that of Nepal now. Low levels of savings are currently not a critical constraint to private sector investment, as the total national savings, including the remittance flows, exceed the country's current level of investment. This view is also supported by banking indicators, which suggest that there is excess liquidity in the system. Findings of investment climate surveys, including ILO, ADB, and FNCCI (2008) and IFC (2007) also support this view, as very few formal businesses consider access to finance or its cost a major constraint.

However, feedback from informal subsectors, including microenterprises and farmers, suggests they have limited access to finance. Ferrari, Jaffrin, and Shrestha (2007) note that, in 2003/04, as much as 93% of borrowing by households and microenterprises came from informal sources, including family, friends, and moneylenders. Of the 64% that borrowed from family and friends, nearly two thirds had to pay interest on the loans. Households that borrowed from moneylenders had to pay interest rates higher than market rates. The report also notes that the poorer households were charged on average about 10 percentage points more by informal sources than the better-off households. Only 7% of the respondents were able to access financing through formal sources, which was less than half of the respondents who reportedly sought financing from formal sources. The report considered long processing time and cumbersome bank requirements, including the requirement for physical collateral, as some of the key reasons that a low proportion of households and enterprises accessed loans from formal sources.

Another factor behind high dependence on informal sources is difficulty in physical access to banks. The number of bank branches peaked at 511 in 1999 and declined to 413 by 2005, increasing the number of inhabitants per branch from about 36,100 in 1999 to about 60,000 in 2005 (Figure 3.22). The decline in the number of bank branches resulted primarily from branch closures by two state-owned commercial banks due to conflict/civil war and the process of rationalization. The trend has since reversed and the number of branches has increased. However, compared with other South Asian and Southeast Asian countries, Nepal still has the highest number of inhabitants per bank branch. While in 2007 Nepal had 48,700 inhabitants per branch, other South Asian countries had at least 65% fewer (Figure 3.23). The number of branches increased again, to 574 by January 2008, reducing the number of inhabitants per branch. This has in part been due to the opening of new private banks and new private bank branches, which are largely concentrated in the Kathmandu Valley and other urban areas, and has not had much effect on the rural population's access to banking services.

Due to its lack of easy access to bank branches, a low proportion of Nepal's population has bank accounts. Only 4% of Nepalis had bank accounts in 2007, which is half of the figure in India and less

Figure 3.22. Bank Branches and Inhabitants per Bank Branch

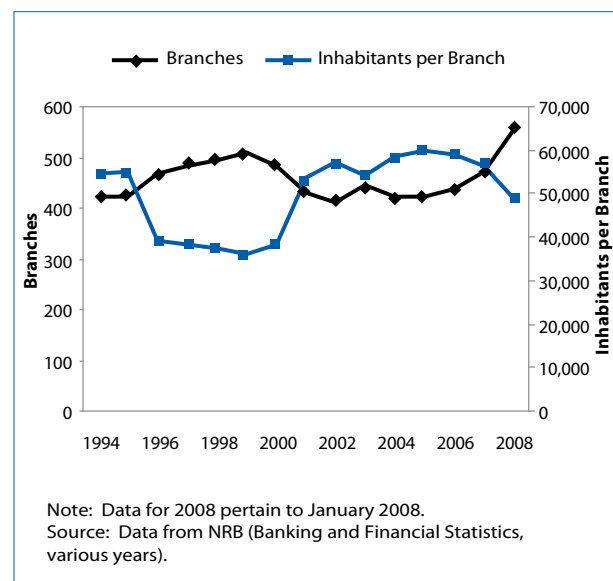
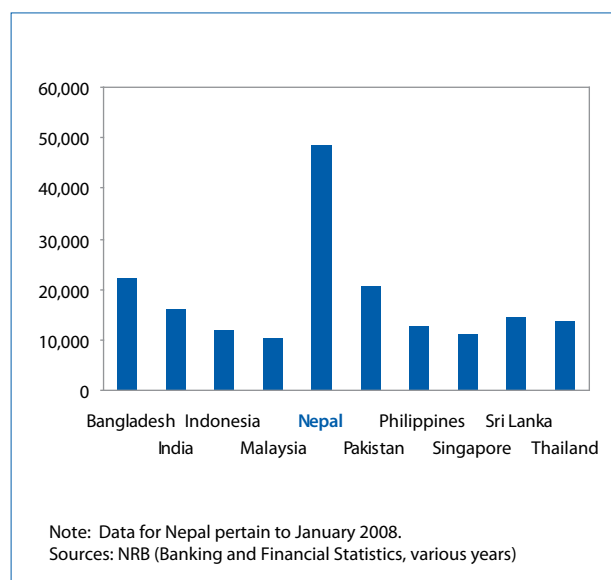


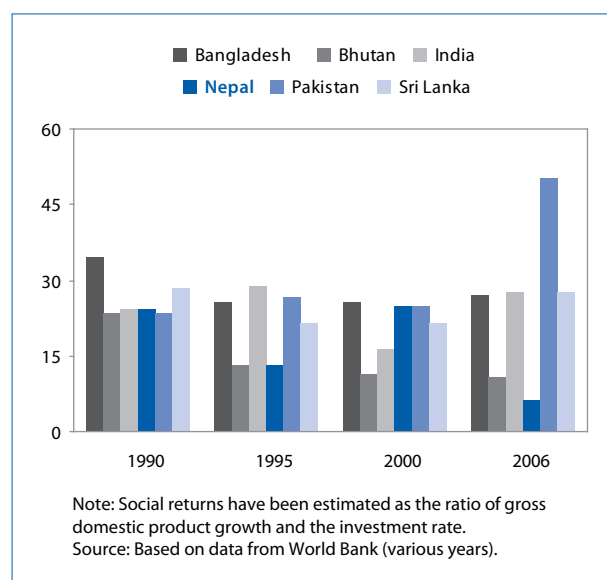
Figure 3.23. Inhabitants per Bank Branch in Selected Asian Countries, 2007

than one fourth of that in Pakistan (Akhtar 2007 and Ferrari, Jaffrin, and Shrestha 2007).

3.2. Social Returns to Investments

Low economic growth can also be due to low returns to economic activity, which in turn can result from low social returns to investment or low private appropriability of returns. Social returns or returns to society can be affected by the level of investments in human capital, infrastructure, and other public goods that complement private investments. Inadequate investment in these complementary factors can lead to low social returns by lowering the productivity of factors of production and increasing the cost of doing business, which in turn can lower the returns to investment.

Nepal's social returns, at 6.2%, were the lowest in South Asia in 2006 (Figure 3.24). Bhutan was the next lowest, with social returns of about 10.6%. All other major economies in South Asia recorded returns above 25%. Nepal's social returns are currently lower than the levels achieved in earlier periods. In 2000, social returns for Nepal were estimated at 25%, similar to the levels for 1990 but nearly twice those for 1995. As previously discussed, the recent low levels of social returns could be due to inadequacies in human capital or infrastructure.

Figure 3.24. Social Returns in Selected South Asian Countries (%)

3.2.1. Human Capital

Unemployment rates are low but underemployment rates are high. In the absence of regular labor force surveys, it is difficult to assess the true extent of employment and unemployment levels at any given point in time. Various studies have tried to get around this by using data from other surveys such as the Population Census of 2001 and the Nepal Living Standards Survey of 2003/04. Estimates based on that survey suggest that the unemployment rate was about 4.1% among the male members of the labor force and about 3.8% among the female members (Chapter 4, Table 4.5). Unemployment rates were substantially higher in urban areas for both male and female workers than in rural areas. The unemployment rate for male workers in the urban areas was 7.0% versus 3.6% in the rural areas. The disparity between unemployment of female workers was even greater, at 13.5% in urban and 2.5% in rural areas. Given the slow economic growth since 2003/04 and closure of many small and medium enterprises in recent years, unemployment levels may now be even higher. For Nepal, a more significant statistic is a very high level of underemployment. In Chapter 4, Table 4.5 suggests that, in 2003, about 15.4% of male and 25.7% of female workers were underemployed. The significant levels of urban un- and underemployment suggest that, overall, the economy

has not been able to fully utilize the available human capital.

In terms of quality of human capital, educated workers may not be in short supply and the unemployment rate for the better educated workforce is significantly higher than that for illiterate or less educated workers. The Nepal Living Standards Survey 2003/04 found the unemployment rate among workers with 11 grades of education or more was about 9.4%, or more than three times that for illiterate workers (Figure 3.25).

Moreover, recent evidence suggests that Nepal's enterprise structure does not depend on a highly educated workforce. Findings of a recent survey of formal sector enterprises (ILO, ADB, and FNCCI 2008) suggest that only about 11% of the enterprises reported a workforce with more than 12 years of schooling while 57% of enterprises had a workforce with 7–12 years of schooling and 28% had workers with less than 7 years of schooling (Figure 3.26). These results are in line with findings of Ravallion (2001), who noted the labor force's average schooling was 3.9 years and that 62% of the workers had no schooling at all.

Returns to education are generally not disproportionately higher for better educated or skilled workers in most sectors, which suggests that skills are not short-supplied in

most sectors. If an educated workforce were indeed a constraint to growth, demand for labor would have been high and, as a result, returns to the educated labor force would have been disproportionately higher. Parajuli (1999) estimated that both social and private returns to education were highest for primary education (Figure 3.27)—more recent estimates of returns to education in Nepal are not available. The returns on primary education were nearly double those on secondary education, and 38–72% higher than those on tertiary education.

Figure 3.26. Educational Attainment of the Workforce in 2008 (%)

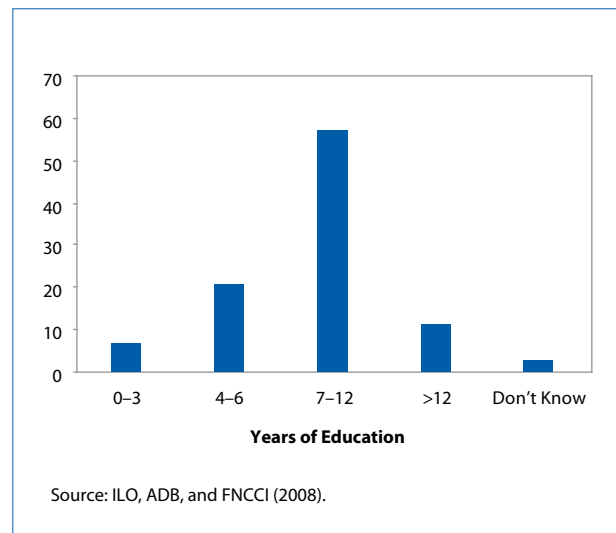


Figure 3.25. Unemployment Rate by Educational Attainment in 2003/04 (%)

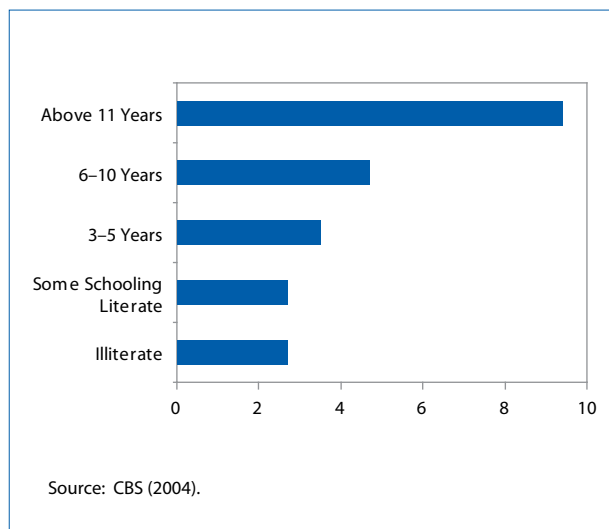
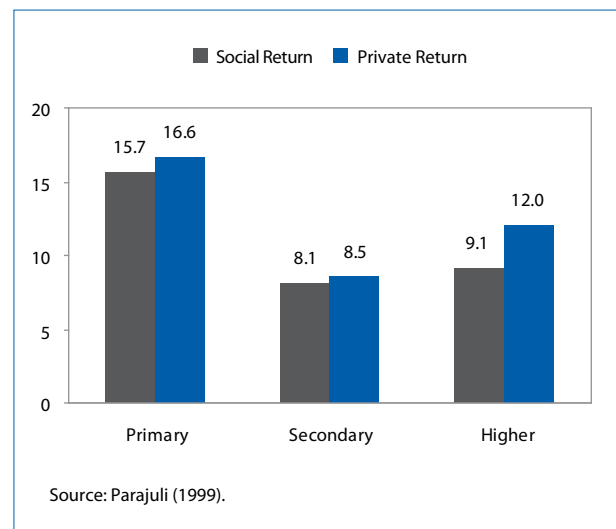


Figure 3.27. Social and Private Returns to Education Level in 1999 (%)



unskilled workers across sectors provides mixed evidence as to whether the skilled workers are in high demand (Table 3.2). The IMF (2007) noted that wages had risen in agriculture, industry, and construction between 1998/99 and 2003/04, but the level of increase was not consistent across the sectors or the regions. In agriculture, wages in the Kathmandu Valley did not rise in real terms, but wages in the Birgunj area rose substantially to equal levels in Kathmandu. This could be due to substantial improvements in rural and district-level infrastructure in the early 2000s, which improved market access and profitability of agricultural production in surrounding areas. On the other hand, wages in industry did rise, but the wage increase for unskilled workers was much greater than that for skilled workers, substantially narrowing the difference between them. Wages in construction have risen across the regions and skill categories during recent years; however, wage differentials between skilled, semi-skilled, and non-skilled workers remained unchanged except in the Kathmandu Valley. Relatively higher wage differentials for the skilled and semi-skilled construction workers suggest that the construction boom, especially in the Kathmandu Valley, may have created a high demand for skilled construction workers.

Out-migration of skilled workers may not be a critical constraint to growth at this point, but may constrain an economic transformation. In recent years, more workers are seeking employment opportunities abroad, with the number nearly doubling between 2003 and 2006 (Figure 3.28). However, the vast majority of them are unskilled or semi-skilled—the Nepal Institute of Development Studies (2004) found that 70% of Nepali workers abroad were unskilled and 27% were semi-skilled. Bhattarai (2007) surveyed the Nepali workers in New Delhi and concluded that about 32% of them had completed only primary education and 34% had completed lower secondary education. Thus, out-migration may not be leading to a skill drain that constrains private investment and economic growth. Moreover, the open border with India provides Nepali investors with access to a large pool of skilled workers from India—as many as 15% of the technical workers employed in manufacturing are of Indian origin (MOICS 2004).

A more alarming statistic for the longer term may be the increasing number of students who are going abroad and may choose to remain away (Figure 3.29). More than 21,000 students went abroad in 2008, a 12-fold increase over the 2003 levels. The loss of these students, arguably the brightest among

Table 3.2. Nominal Monthly Wages in Major Sectors (NRs)

Sector	Skill/Location	1998/99	2001/02	2003/04
Agriculture	Kathmandu	3,000	3,000	3,400
	Birgunj	1,500	2,550	3,500
	Biratnagar	1,500	1,500	2,400
Industry	Skilled	1,960	2,276	2,620
	Unskilled	1,800	2,116	2,560
Construction	Skilled			
	Kathmandu	5,700	6,300	9,500
	Birgunj	3,900	4,500	5,625
	Biratnagar	4,470	4,800	5,700
	Semi-skilled			
	Kathmandu	4,950	5,550	7,250
	Biratnagar	3,870	4,200	4,900
	Unskilled			
	Kathmandu	3,000	3,450	4,250
	Biratnagar	2,370	2,400	2,900

Notes: Figures for Industry refer to minimum monthly wage, including allowances, which are the same in Kathmandu, Birgunj, and Biratnagar; Construction refers to carpenters and masons.
Source: IMF (2006).

Figure 3.28. Workers Going Abroad to Countries Other than India

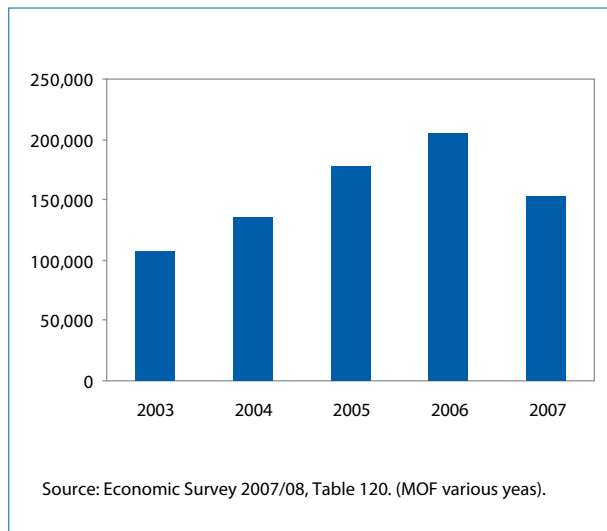
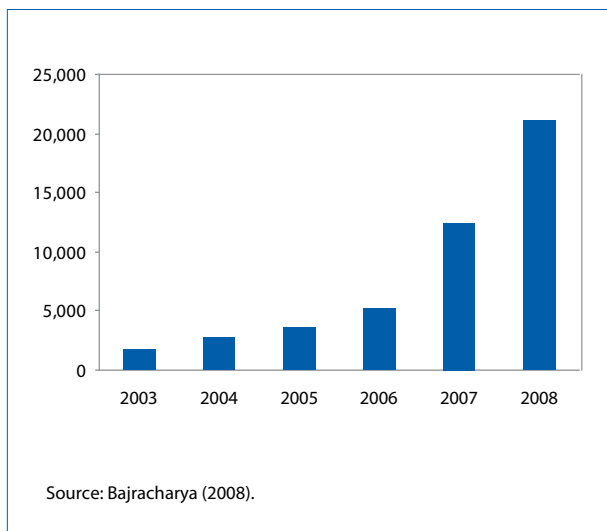


Figure 3.29. Students Going Abroad



the bright, may constitute a brain drain that could affect the country's ability to transform into a more sophisticated economy in the long run.

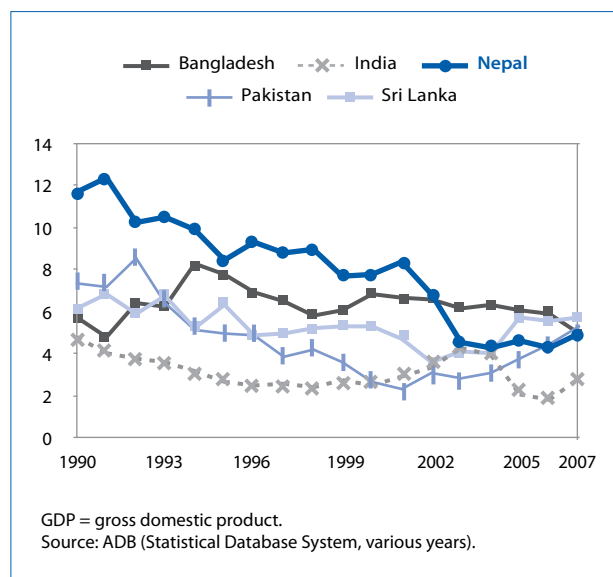
Investor feedback suggests that shortage of skilled human capital may not be a critical constraint to growth. Studies and surveys aimed at gathering investor feedback suggest that investors do not consider scarcity of skilled human capital a major constraint to investment and growth. Biggs et al. (2000) reports that only 7% of the surveyed firms considered labor skill levels as a major problem. These results were confirmed by the

Mini-Diagnostic of the Investment Climate, which did not find scarcity of skilled workers among major constraints identified by the firms (IFC 2007). The Enterprise Survey reported that labor and employer or industrial relations and strikes were a much larger constraint than scarcity of quality labor (ILO, ADB, and FNCCI 2008). In terms of quality of human capital, the survey respondents complained more about workers' low motivation and commitment than about their skill levels.

3.2.2. Infrastructure

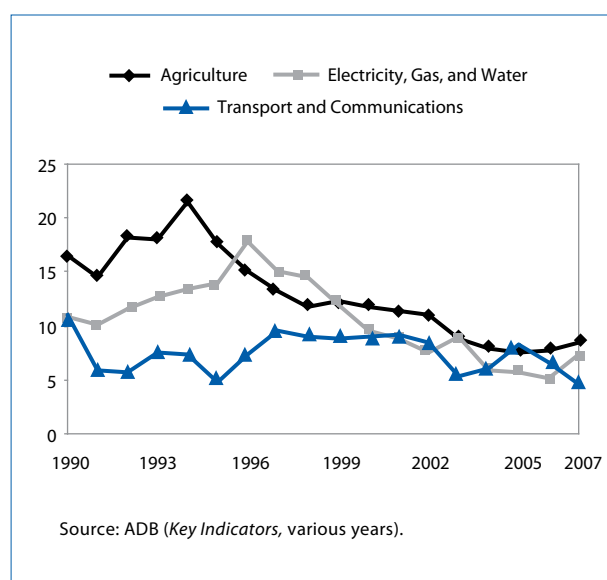
Limited and low quality infrastructure constrains investment and growth. While Nepal's development expenditures as a percentage of GDP are similar to those in other South Asian countries, the expenditures have not been sufficient because the funding is small in absolute terms and the needs are larger than those in most other South Asian countries. Moreover, development expenditures as a percentage of GDP declined by two thirds between 1990 and 2007 (Figure 3.30). While expenditure levels have been declining, investment requirements have risen rapidly due to delayed investment and damage to infrastructure during the conflict/civil war. The Asian Development Bank (2006d) estimated that \$129.6 million worth of physical infrastructure was damaged during the conflict/civil war period.

Figure 3.30. Government Development Expenditures (% of GDP)



With lowered development expenditures, expenditures on economic services have also been declining (Figure 3.31). As a share of GDP, expenditures on economic services contracted by 47.5% between 1990 and 2007. Within overall expenditures, the key infrastructure subsectors—such as agriculture (irrigation); electricity, gas, and water; and transport and communication—have been receiving less funding. In absolute terms, expenditures on economic services increased slightly between 1990 and 2007, but the increase was negligible compared with needs. In agriculture, spending in real terms stagnated during the period, but declined by 48% as a share of total government expenditure. Expenditures on electricity, gas, and water contracted by 32% in real terms and declined by 58% as a share of total development expenditure. Only transport and communications had an increase in funding in real terms, from NRs4.68 billion in 1990 to NRs6.19 billion in 2007. Expenditure on infrastructure declined despite the fact that studies suggested that countries in the region need to scale up investments in infrastructure. Fay and Yepes (2003) estimated that South Asian countries needed an annual investment in key infrastructure subsectors of at least \$35 billion, or about 6–7% of their GDP, to meet the demand related to their growth prospects.

Figure 3.31
Expenditure on Selected Sectors,
(% of government expenditures)



Private sector investment in infrastructure has also been low. Private investment is concentrated in sectors with a potential for high returns, such as power, telecommunications, and some transport infrastructure. Between 1990 and 2003, Nepal's private foreign investment as a percentage of GDP only grew by 0.3% in aggregate (Jones 2006). The very small increase in private sector financing was not sufficient to offset the impact of a decline in public infrastructure spending in the last 17 years.

The declining levels of capital and recurrent expenditures have greatly affected key infrastructure in Nepal. Comparative infrastructure indicators show that Nepal's infrastructure availability has been the lowest in South Asia (Table 3.3).

Low levels of investment also had an impact on the overall quality of infrastructure (Figure 3.32). The Global Competitiveness Report 2008–2009 ranked Nepal among the lowest South Asian countries in overall infrastructure quality (Porter and Schwab 2008). Of 134 countries, Nepal ranked 130 compared with Pakistan, 62; India, 90; Sri Lanka, 101; and Bangladesh, 121. Among the infrastructure categories, Nepal ranked lowest in electricity and road transport.

Investor feedback suggests that a lack of affordable and reliable electricity supply and insufficient transport network constrain growth. Of about 120 enterprises responding to the 2008 Enterprise Survey, 82% identified availability of electricity as a constraint and 61% considered it a major or very serious constraint (ILO, ADB, and FNCCI 2008). Similarly, 82% of the firms identified availability of transport as a constraint and 37% considered it to be a major or very serious constraint.

The inability to attract domestic and foreign private investment constrained economic growth in the last 15 years. Empirical tests by the present study found that, among the infrastructure variables, electricity was the most significant ingredient needed to bring about an increase in per capita income. Although the road variable was found to be less significant than the electricity variable, the result supports earlier findings that infrastructure development plays a major role in economic growth

Table 3.3. Comparative Infrastructure Indicators

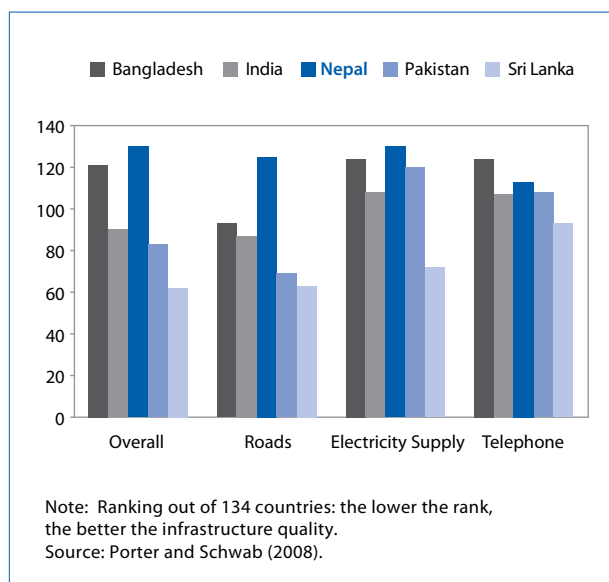
Indicator	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Electricity Consumption Per Capita (kWh)	136 (2005)	480 (2007)	70 (2007)	456 (2007)	378 (2007)
Road Density (km/km ² of land)	1,838 (2003)	1,138 (2002)	121 (2004)	335 (2004)	1,505 (2003)
Paved Roads (% of Total)	9.5 (2003)	47.4 (2002)	56.9 (2004)	64.7 (2004)	81.0 (2003)
Telephone Lines—Fixed and Mobile (per thousand people)	224 (2007)	243 (2007)	64 (2007)	516 (2007)	538 (2007)
Internet Users (per thousand people)	3.6 (2007)	71.4 (2007)	15.0 (2007)	109.7 (2007)	38.6 (2007)
Irrigated land (% of total arable land)	56 (2002)	35 (2002)	36 (2002)	83 (2002)	68 (2002)
GDP per unit of energy use (constant 2005 PPP \$)	6.8 (2005)	4.5 (2005)	2.8 (2005)	4.5 (2005)	7.2 (2005)

GDP = gross domestic product, km = kilometer, km² = square kilometer, kWh = kilowatt-hour, PPP = purchasing power parity.

Note: Year indicated in the parenthesis.

Sources: Data from World Bank (various years) and ADB (*Key Indicators*, various years).

Figure 3.32. Infrastructure Quality Ranking in Selected South Asian Countries

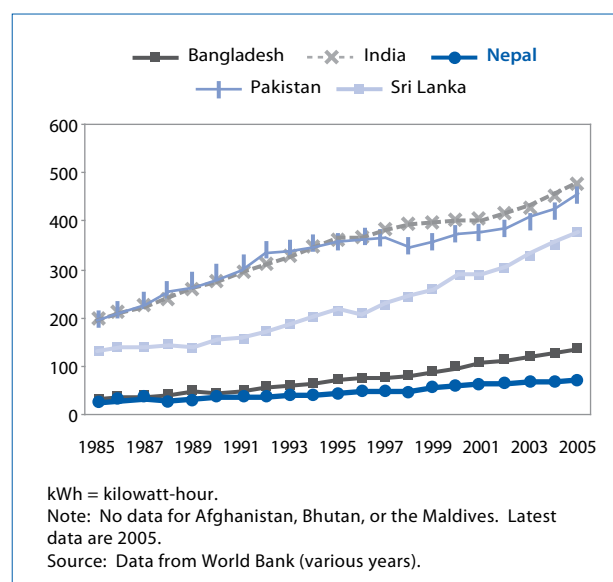
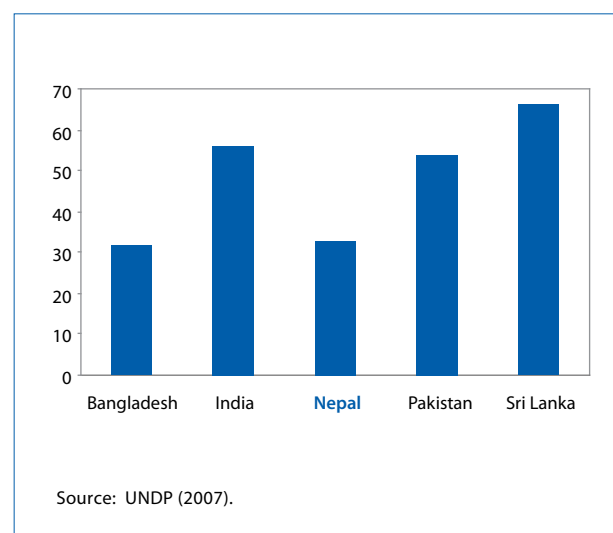


and that availability of infrastructure such as electricity and transport facilities is a prerequisite for economic development. Moreover, the inadequacy and unequal distribution of infrastructure facilities in Nepal resulted in its lower-than-expected performance.

Given the economy's dependence on agriculture, both in terms of contribution to GDP and to employment generation, constraints on agricultural production and investment in agriculture are critical

to continued growth in the sector and the economy. In a field survey conducted under the Agriculture Sector Performance Review in 2001, 51% of the farmers cited lack of reliable irrigation as a major constraint to increasing production. In comparison, only 11% of farmers considered improved seeds and fertilizer to be a major constraint, and only 9% of them deemed the lack of extension services a major constraint (ADB 2004).

Electricity supplies are inadequate, unreliable, and expensive. Any increase in economic activity increases requirements for electricity. Over the years, Nepal's average and peak load requirements have been increasing. However, Nepal's per capita power consumption is the lowest in the region—in 2005, per capita consumption levels for Nepal were only 14% of those in India and 51% of those in Bangladesh (Figure 3.33). The low consumption is due to the low coverage and low availability of power to those with access to it. The electrification coverage in 2005, at 33% of the population, although similar to that of Bangladesh, is the lowest in the region (Figure 3.34), and is about 60% that of India and Pakistan and about half that of Sri Lanka (ADB 2003). The 33% electrification coverage translates to about 18.1 million people without access to electricity (UNDP 2007). A majority of the unserved people are in rural areas and remote districts.

Figure 3.33. Per Capita Energy Consumption in Selected South Asian Countries (kWh)**Figure 3.34. Electrification Rate in Selected South Asian Countries, 2005 (%)**

The population with access to electricity does not have sufficient supply to meet its requirements. Average consumption levels per consumer amounted to about 1,782 kilowatt-hours in 2006, which is about 46% of the consumption levels in India and Pakistan and about 61% of that in Bangladesh (Table 3.4). The low level of consumption is mainly due to the seasonal variation in power generation, with power outages of up to 42 hours per week (Box 3.1).

Nepal's power tariff is the most expensive in the region. A 2004 Ministry of Industry, Commerce and Supplies study noted that the consumers in Nepal were paying \$0.093 per kilowatt-hour, which was about 115% higher than tariffs in India and Bangladesh, 43% higher than tariffs in Pakistan, and 18% higher than those in Sri Lanka (Figure 3.35). High tariffs point to inefficiencies in the power sector in Nepal, as a country mainly relying on hydropower should have low generation costs.

Shortfalls in electricity supplies occur even though Nepal could meet its own consumption requirements and export to its energy deficient-neighbors, including the People's Republic of China, India, and Pakistan. Studies indicate that Nepal has a potential of about 80,000 megawatts (MW) of hydropower of which about 42,000 MW are technically and economically viable, but only a capacity of 564 MW has been developed (Figure 3.36). Other domestic sources of electricity include thermal and solar power stations that have a capacity of 155 MW. The growth has been slow with only 63 MW of generation capacity added to the system between 2005 and 2007. However, this may improve as about 18 power projects are under construction; upon completion they will provide an additional 177 MW of generation capacity.

Table 3.4. Electricity Consumption in Selected South Asian Countries

Country	Total Consumption (billion kWh)	Consumption Per Connection (kWh)
Bangladesh	21.37	2,354.82
India	517.21	3,872.17
Nepal	2.28	1,781.78
Pakistan	68.40	3,843.55
Sri Lanka	6.88	1,893.18

kWh = kilowatt-hour.

Sources: For consumption, International Energy Agency (2006); for number of connections, Bangladesh Power Development Board (2006), Central Electricity Authority (2005), Ceylon Electricity Board (2005), NEA (various years), and WAPDA (2008).

Box 3.1. Power Cuts Darken the Development Prospects

Jhapa, in the easternmost part of Nepal and home to about 688,000 people, is one of most developed districts in the country. It has one of Nepal's highest literacy rates and was ranked 3rd in terms of development in 2001. It is a major center of production for rice and tea. Jhapa's transport infrastructure is among the country's best, with an airport and a network of feeder roads that links almost all towns and villages to the East-West Highway and markets in rest of the country as well as in India.

Jhapa's rich endowment of natural resources and good infrastructure combined with its ideal location to serve markets in the Indian states of Bihar and West Bengal have led to development of a strong industrial base with about 90 large and 2,500 small and medium-size industries. Large industries include cement factories and tea processing plants, while the medium-size industries include Dhaka textile, garments, and iron grill factories. The Federation of Nepalese Chamber of Commerce and Industries estimates that these industries employ more than 13,000 workers and another 40,000 people depend indirectly on the industries for their livelihoods.

However, the power crunch in the winter of 2008/09 drastically affected this thriving district economy. In January 2009, power outages were forecast at 4 hours a day in January 2009 but lasted up to 12–16 hours a day. As a result, substantial losses were reported in production levels, with three cement factories reporting drops of up to 60%. Consequently, some industrial units downsized as much as 50% of their labor force. Some industrial units that had backup power generators reported a substantial increase in their production costs. One of the largest garment and apparel manufacturers reported a six-fold increase in its energy-related costs. Similarly, leading tea producers reported additional costs of up to NRs10 for every kilogram of tea produced. These additional costs did not include the production lost due to farmers' inability to adequately irrigate the tea plantations.

Losses in Jhapa were typical of conditions throughout the country. During the same period, Kathmandu had power outages of up to 16 hours a day while other important industrial estates, such as Birjung and Hetauda, reported outages of up to 12 hours a day. Some western districts fared better, with outages of less than 6 hours a day due to local generation and imports from India.

Sources: Baral (2009a and b) and Shahi (2009).

Figure 3.35. Comparative Electricity Tariffs in South Asia (\$/kWh, 2000)

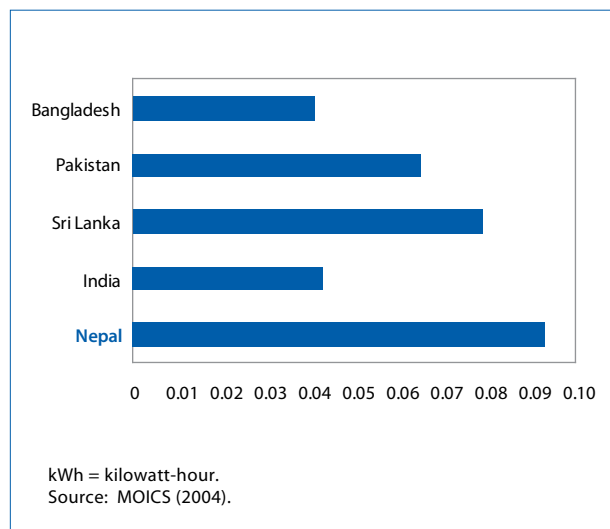
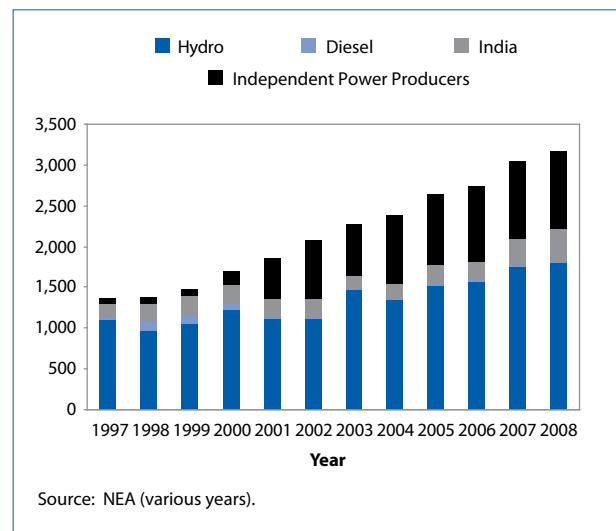


Figure 3.36. Power Availability by Source (GWh)



In addition, capacity utilization of the hydropower plants is low. In 2007/08, 3.55 gigawatt-hours (GWh) of power were generated, which was about 66% of the maximum possible 5.37 GWh (Figure 3.36).⁷ The low utilization rate was mainly because hydropower plants operated at about 49% capacity during the year due to their “run-of-the-river” nature. Without substantial water storage capacities, these plants operate at very low capacities during winter and when the water flows in the rivers are low. A continued focus on exploiting hydropower potential without providing accompanying water storage infrastructure will perpetuate high seasonality in power generation and the need for power load shedding.

To exploit the country’s abundant hydropower potential and raise consumer consumption to levels prevailing in neighboring countries, Nepal has to substantially increase its investment in the power subsector. As previously noted, Nepal’s electrification rate is 60% of India’s and its per consumer consumption is 45% of India’s. To increase its electrification rate to levels prevailing in India without improving system efficiencies or consumption levels, Nepal would need to expand its generation capacities by about 106%, which would require an investment of about \$1.5 billion in 2007 prices in generation infrastructure alone.⁸ The investment required to raise both the electrification rate and consumption levels to match those in India is estimated at \$5.1 billion in 2007 prices.

Additional investment will also be required to upgrade the grid. The investment required in transmission infrastructure, from power plants to the grids and from the grids to the consumers, is substantial. In 2008/09, the government substantially increased its budget and allocated NRs12.69 billion (\$163 million) for hydropower. This amounts to over 5% of the budget, but still falls well short of the investment required in generation and transmission infrastructure. Nepal needs

to mobilize private sector investment in power, especially foreign direct investment. However, this will not be easy as foreign inflows have been historically very low, with aggregate inflows of only about \$12 million during 2000–2007.

The transport network is inadequate, unreliable, and expensive. Nepal’s road network remains less developed than that of other countries in the region. Its road density, in kilometers per 1,000 people, is the region’s lowest (Table 3.5) at 0.6 kilometers (km) of road per 1,000 people compared with 6.5 in Bhutan, 4.7 in Sri Lanka, 3.0 in India, 1.9 in Bangladesh, and 1.7 in Pakistan. In road density per square kilometer of land area, Nepal fares better only than Afghanistan and Bhutan and substantially lags behind Bangladesh, India, Pakistan, and Sri Lanka. Because of Nepal’s difficult topography, it has a pressing need for a higher road density. About 90% of Nepal’s roads are concentrated in the lowland-terai and hill areas. Some villages in the remote areas are up to 13 days’ walk from the nearest road (World Bank et al. 2006). In 2007, nearly 57% of the rural population did not have year-round ready access to roads, compared with only 15% in Pakistan, 35% in Sri Lanka, and 39% in India.

Road network expansion at an average rate of 5% during the last decade has been respectable, but largely entailed district and rural roads. As of 2007, only 38% of Nepal’s 17,282 km of roads were blacktopped (Figures 3.37 and 3.38), about 25% were gravel, and the rest were only usable in fair weather. At the district and village level, the quality of the road network is poorer. In 2004/05, 80% of the district or village roads were still earthen and operable only during the dry season (World Bank 2007d).

In addition, the unreliability of the transport network due to a lack of sufficient alternate routes affects the timely movement of people and cargo and delivery of services. The East-West Highway is the main thoroughfare linking Nepal’s eastern and western borders. The link roads from the main entry points and major dry ports, such as Bhairawa, Biratnagar, and Birgani/Raxaul, connect to the East-West Highway for onward movement to major population centers outside terai areas. Disruptions in traffic on that highway or roads linking it to ports

⁷ The maximum power generation potential was estimated using an operational period of 356 days per year at 100% installed capacity.

⁸ Investment requirements were estimated at \$2.53 million/MW based on the Middle Marsyangi Hydroelectric Project, which was costed at \$181.7 million and was to have an installed capacity of 72 MW in 2000/01 (2004 Annual Report, NEA various years). Costs were inflated to 2007 levels using the MUV–G5 Index (World Bank 2009b).

Table 3.5. Comparison of Road Density and Access to All-Weather Roads in Selected South Asian Countries, 2007

Country	Road Density in Terms of (as of 2007)		Access to All-Season Roads (% of rural population)
	Land (road km/ 1,000 km ²)	Population (road km/ 1,000 people)	
Afghanistan	53	1.1	
Bangladesh	2,079	1.9	39
Bhutan	93	6.5	47
India	2,226	3.0	61
Nepal	121	0.6	43
Pakistan	335	1.7	85
Sri Lanka	1,422	4.7	65

km = kilometer, km² = square kilometer.

Source: World Bank (2007c).

Figure 3.37. Length of Road by Classification, 1989–2007

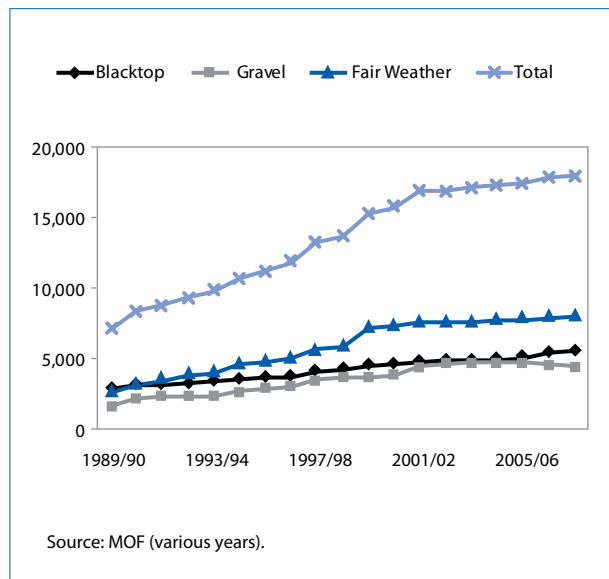
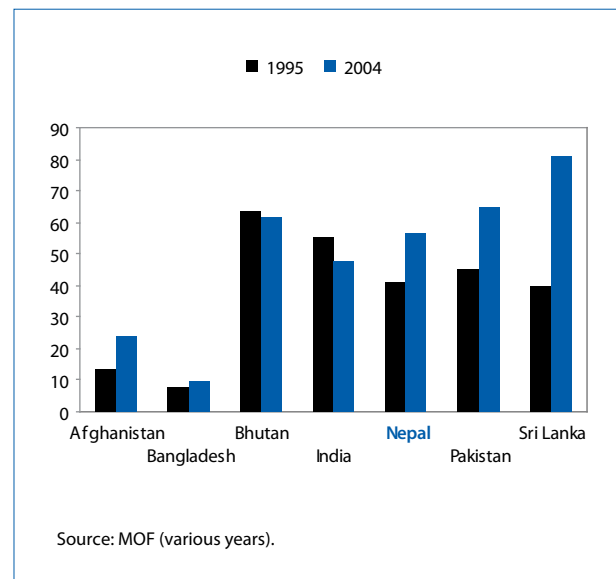


Figure 3.38. Paved Roads in Selected South Asian Countries as Percent of Total Roads, 1990–2004



and population centers can lead to losses in trade and severe shortages of essential commodities. Disruptions on the highway or south of it are common, typically due to transport strikes rooted in politics or protests over traffic-related accidents. In the north, landslides are also a common cause for disruption on the roads linking the highway to population centers, such as Kathmandu and Pokhara. In the recent past, disruptions have been frequent and have incurred significant losses to the national and local economies (Box 3.2 and Figure 3.39, p. 39).

In addition, the surge in global fuel prices and Nepal Oil Corporation's precarious financial condition led to fuel supply being unreliable in 2007 and 2008. Supplies of petrol, diesel, and kerosene were rationed and consumers, both domestic and commercial, had to queue up for hours to purchase fuel. Fuel shortages greatly affected the levels and flow of passengers and cargo traffic. Of respondents to the 2008 Enterprise Survey, 57% considered the availability of petroleum a very serious or major constraint to investment (ILO, ADB, and FNCCI 2008). However, increased domestic fuel prices, a supplier's credit agreement between the Indian and Nepalese governments in September 2008,

Box 3.2. Highways—Closed for Business

Highways in the eastern terai districts were obstructed 165 times between 1 January 2007 and 31 July 2007. According to the Eastern Region Traffic Office in Itahari, highways in the five eastern districts—Jhapa, Morang, Saptari, Siraha, and Sunsari—were closed for 488 hours during this period.

The East-West Highway, an important lifeline for the Nepalese economy, passes through these districts. The highway is the country's main link with markets in Bangladesh, Bhutan, and India. According to the Itahari Eastern Regional Traffic Office, roads in the area used to be packed with traffic and were difficult to manage at peak morning and evening hours. However, according to the Nepal Day and Night Transport Association, the movement of vehicles on the highways has dropped steeply due to blockades and strikes, with only about 50 buses operating daily, down from 150.

Common causes for the transport strikes include political protests and protests over fatalities resulting from traffic accidents. In August 2008, in Koshi, Mechi, and Sagarmatha zones, a strike over protests and demands for compensation for the family of a bus driver murdered by robbers lasted 8 days and led to fuel and food shortages in the affected districts. Fuel shortages were so severe that even ambulance services had to be discontinued during this period. Several vehicles violating the strike, including an ambulance, were damaged or burned. Hundreds of passengers and over 200 trucks were stranded for days waiting for the highway to open. By the fourth day of the strike, grocers in Guthitaar alone had lost about 50 tons of vegetables that rotted during transport.

Between mid July and mid August 2008, transport strikes along the East-West Highway and other highways severely affected the flow of traffic (Figure 3.39). In addition, landslides in hilly and mountain regions disrupted the traffic several times. Thus, alternate routes are essential to keep transport flowing when there are disruptions in one part of the country or on one road.

Source: Sources: Bhandari (2007), Kantipur Online (2008, accessed July-August 2008), and *The Himalayan Times* (2008, accessed July-August 2008).

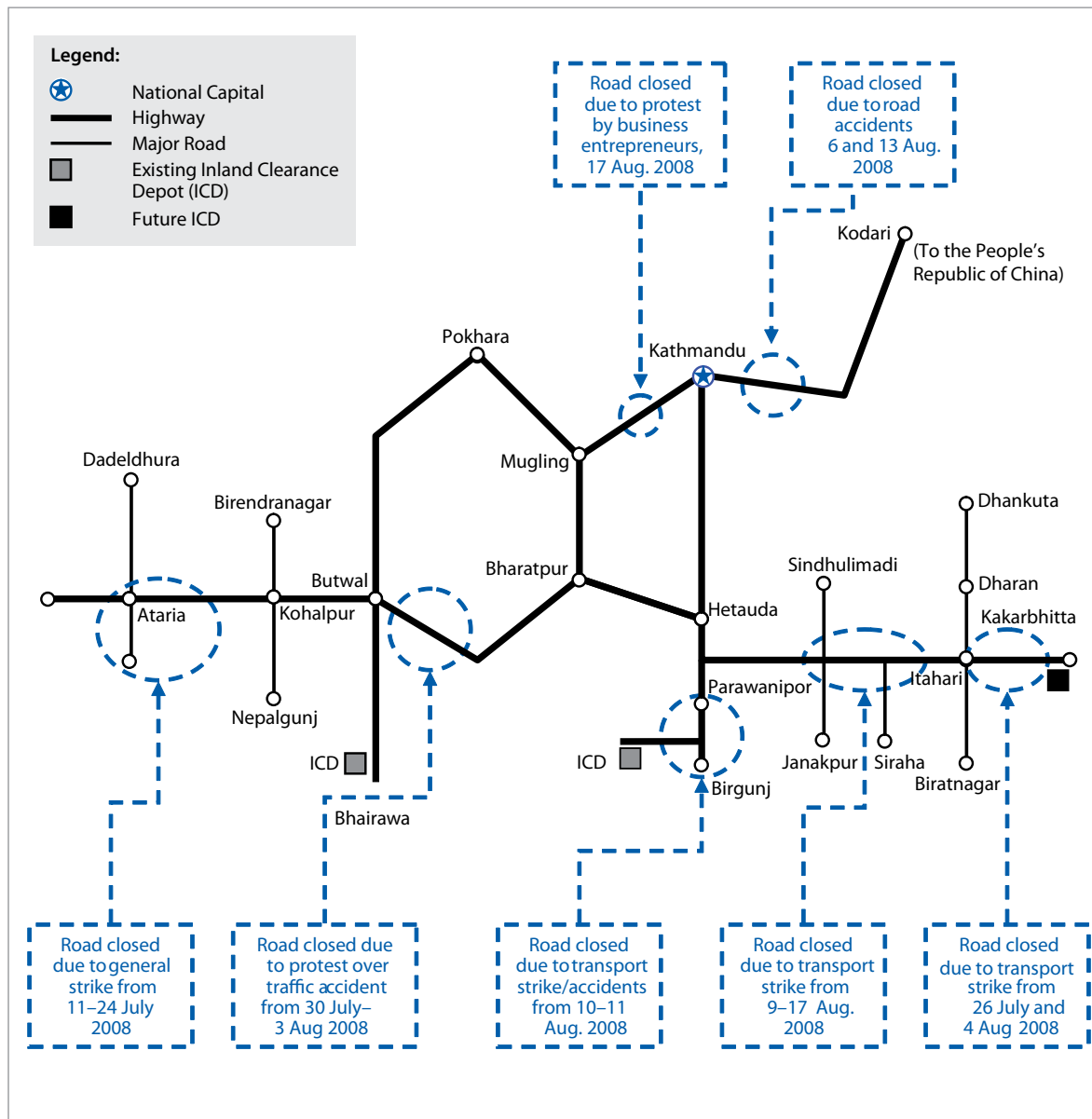
and declines in global fuel prices have improved the availability of fuel and it may no longer be a critical constraint.

Poor quality road infrastructure and lack of sufficient alternate routes have made transport costly in Nepal. According to the Doing Business Report for Nepal, the cost of exporting and importing a container is much higher than in Bangladesh, India, and Pakistan (World Bank 2008a). In 2008, the cost to export a container from Nepal was estimated at \$1,764, most of which was due to transport. In comparison, costs to export a container were estimated at \$970, \$945, and \$611 from Bangladesh, India, and Pakistan, respectively. Similarly, the cost to import a container was estimated at \$1,900 for Nepal, compared with \$1,375, \$960, and \$680 for Bangladesh, India, and Pakistan, respectively.

In part, the high transport costs are because Nepal is landlocked. However, costs are also high because the supply of trucks is limited and the cost of obtaining service is high due to a syndicate system or collusive practices. The syndicate system prohibits firms from choosing their own trucking operator and increases cost by 25–30% (Biggs et al. 2000). The government of Nepal has recently taken steps toward abolishing the syndicate system, but the 2008 Enterprise Survey suggests that it persists (ILO, ADB, and FNCCI 2008).

An underlying reason for inadequacies in transport infrastructure is insufficient funding for maintaining and rehabilitating the network and for constructing new infrastructure. The World Bank (2007c) estimates that maintenance of 1 km of blacktopped road costs an average of \$10,521 which

Figure 3.39. Disruptions of Traffic, 11 July to 17 August 2008



Sources: Kantipur Online 2008, and *The Himalayan Times* (2008), both accessed July–August 2008.

implies annual funding requirements of \$57.9 million to maintain the 5,500 km of blacktopped road (Table 3.6). Costs for rehabilitating roads in poor condition are estimated at nearly 5 times higher, or \$49,235/km, which suggests even higher annual maintenance requirements. The country has 4,449 km of gravel roads that, at \$39,241/km, would cost about \$174.6 million to upgrade to blacktop.

In 2006/07, at least 11 of Nepal's 75 districts were not connected to the road network and additional investment will be required to link these (*Three Year Interim Plan*, NPC various years).

Compared with investment needed for the road transport network, total expenditure levels (including nondevelopment expenditures) in

Table 3.6. Improvement and Maintenance Costs of Roads

Cost Head	Average Financial Cost (\$/km)
Rehabilitation	49,235
Upgrading	39,241
Maintenance	10,521

km = kilometer.

Note: A sample of 1,073 km of roads was evaluated using the Highway Development and Management Model Version 2.0 (HDM-4).

Source: World Bank (2007d).

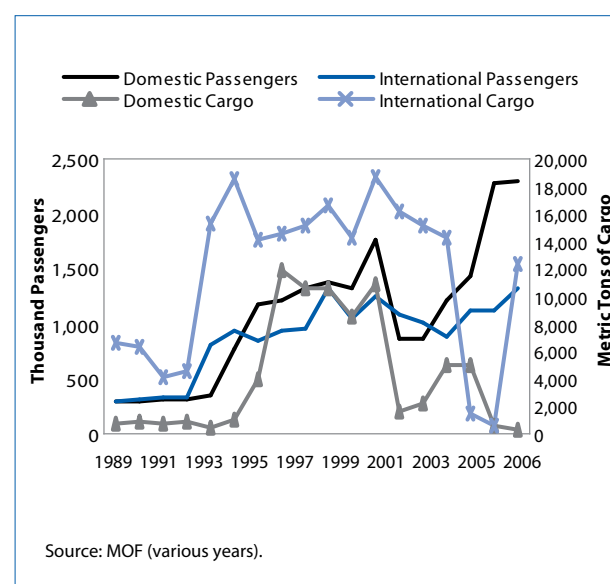
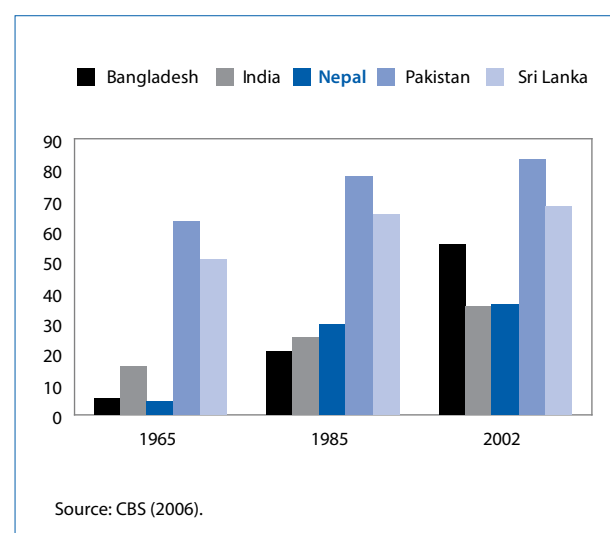
2006/07 were far short at \$104 million. Nepal needs to invest at least 2.5% of its GDP in expanding and maintaining its road assets in order to achieve and sustain a growth rate of 6% in GDP (World Bank 2007d). In 2006/07, 2.5% of GDP amounted to about \$273 million, which was more than 2.5 times the actual expenditure levels during the year.

Air transport is thriving with significant private sector participation and may not be a constraint to investment or growth. Air transport is a major mode of moving people and goods in hill and mountain areas and to other countries. Nepal has 51 airports, including 1 international airport in Kathmandu, 3 regional hubs (Bhairahawa, Biratnagar, and Nepalgunj), and 43 domestic airports. Four additional airports are being constructed. The government of Nepal has adopted a policy of encouraging private airlines to operate and the Civil Aviation Authority of Nepal has issued Airline Operations Certificates to 43 airline companies, of which 19 are operating. Passenger traffic, both domestic and international, has been rising, indicating that the subsector is thriving despite high fuel prices (Figure 3.40). However, air cargo traffic has been fluctuating, suggesting fluctuations in comparative advantage vis-à-vis land transport. Over the years, the volume of domestic air cargo has declined, possibly due to improvements in the road network.

Irrigation infrastructure is inadequate and poorly maintained. Due to the erratic rainfall pattern, irrigation is essential for increasing and maintaining agricultural production levels in Nepal. The yields of Nepal's major crops are much lower than their potential. For example, rice yields in 2007/08 were 2.8 tons (t) per hectare (ha) compared with the maximum average yield of about

6 t/ha in Asia (ADB 2008d). Similarly, the yields for wheat were 2.2 t/ha compared with the maximum average yields in Asia of 4.3 t/ha (ADB 2008d). Nepal has irrigated about 1.19 million ha, or 36% of its arable and 52% of its irrigable land, which is one of the lowest in South Asia (Figure 3.41).

Due to the low crop yields, production levels and agriculture sector GDP have been erratic. After declining since 2003/04, the sector's growth rate shot up from a low of 1.0% in 2006/07 to 5.6% in

Figure 3.40. Volume of Air Services**Figure 3.41. Irrigated Land as Percentage of Arable Land in Selected South Asian Countries (%)**

2007/08 (Figure 3.42). The sharp reversal was mainly attributed to timely and adequate rainfall.

Fluctuations in the growth rate can be traced to fluctuations in yields of major crops such as rice, wheat, and sugarcane that depend heavily on water. Figure 3.43 shows that rice and wheat yields have varied over the years, with rice yields declining sharply in 1997/98, 2000/01, and 2005/06. Wheat yield are less variable because wheat requires 325–450 millimeters of water versus 1,200–1,600 millimeters for rice (Ministry of Food, Agriculture and Livestock 1997).

An analysis of the correlation between rainfall pattern and yields for major crops between 1993 and 2004 also indicates the country's high dependence on rainfall (Table 3.7). The correlation between average annual rainfall and rice productivity was highest among the major crops, due to rice's intensive need for water. The correlation indicates that the fluctuation in yields can be reduced by further developing the irrigation system. These findings support earlier studies that attribute erratic agricultural productivity to lack of irrigation and heavy dependence on rainfall (Thapa and Rosegrant 1995).

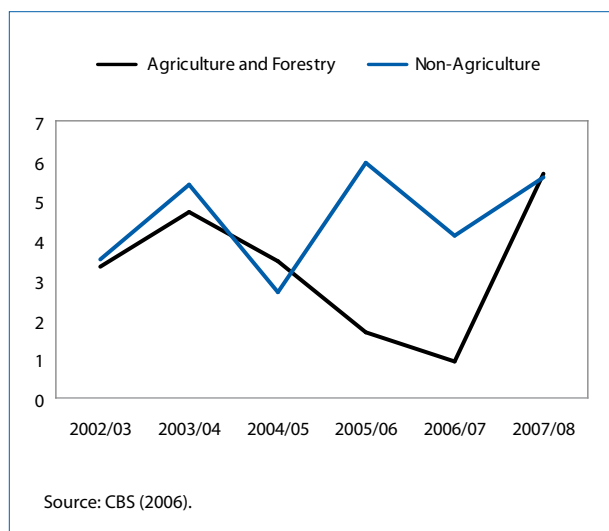
The rate of expanding irrigation has slowed in the last 5–6 years (Figure 3.44). Between 2003 and 2006, the total new area brought under irrigation

amounted to roughly 50,000 ha, which is equivalent to the new area brought under irrigation in 1999 alone. Although the irrigated area increased in 2007 by about 27,000 ha, expansion remains slow and at this rate it will require 40 years to irrigate the remaining 1.11 million ha of irrigable land. The cost to irrigate the remaining irrigable land is estimated at \$3.3 billion⁹ at current prices, or roughly one third of Nepal's GDP in 2007/08.

In addition, the irrigation infrastructure is poorly maintained and inefficient. Data are not available for all irrigated land, but irrigation schemes serving 0.3 million ha or 48% of the 0.62 million ha managed by farmer's associations, urgently require rehabilitation (ADB 2004). As the cost of rehabilitating irrigation averages \$1,000–1,200/ha,¹⁰ the farmer-managed irrigation schemes alone urgently require \$300 million to \$360 million. In addition, annual operation and maintenance costs for surface irrigated schemes amount to about \$30 million.¹¹

Communication infrastructure has been growing consistently and may not be a constraint to growth. While Nepal has lower fixed and mobile line densities than most of its neighbors, the subsector has been growing rapidly during the last 10–12 years (Figures 3.45 and 3.46). Growth has largely been led by private investment, which amounted to \$97 million during 2000–2005. Nepal Telecom Authority has licensed about 165 enterprises to provide telecommunication services in the country, including 2 basic telephone services, 2 cellular mobile services, 32 internet services (including e-mail), 7 VSAT¹² network services, 1

Figure 3.42. Growth Rate in Gross Value Added of Agriculture and Non-Agriculture Sectors (%)



⁹ Based on an average cost of \$3,000/ha. The average cost of irrigation development is \$2,900–3,700/ha for large schemes and \$850–4,300/ha for small hill schemes (Pannikar 2008).

¹⁰ The estimate includes cost of civil works, community organization, consulting services, and project management. The average cost is based on the Asian Development Bank-financed Community Managed Irrigated Agriculture Sector Project, which aims to rehabilitate farmer-managed irrigation schemes covering 34,000 ha at a cost of \$38.6 million.

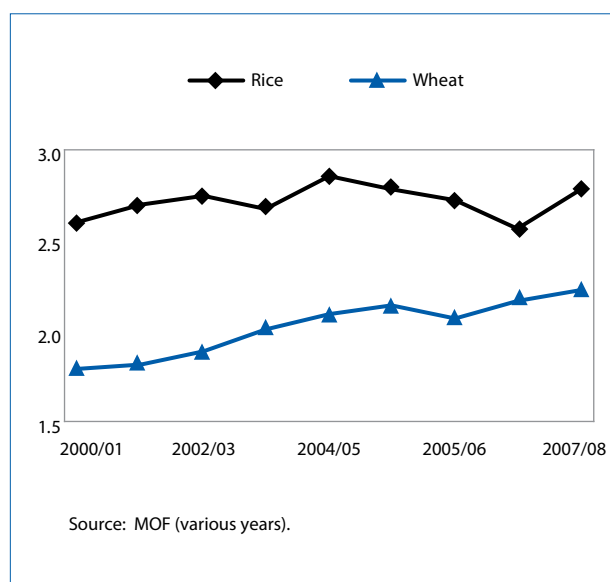
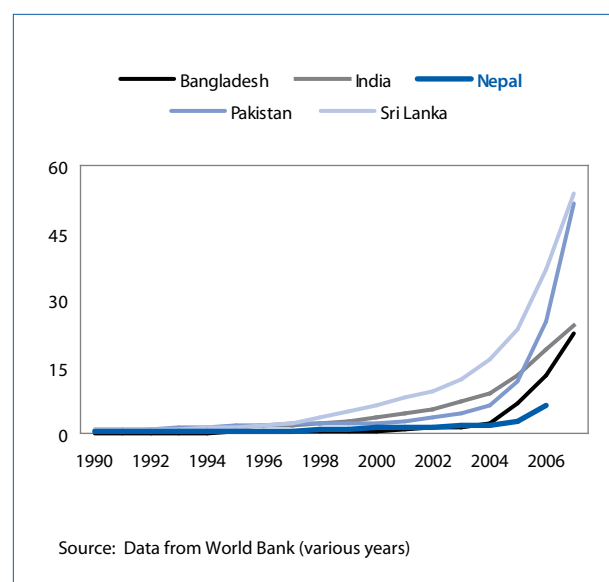
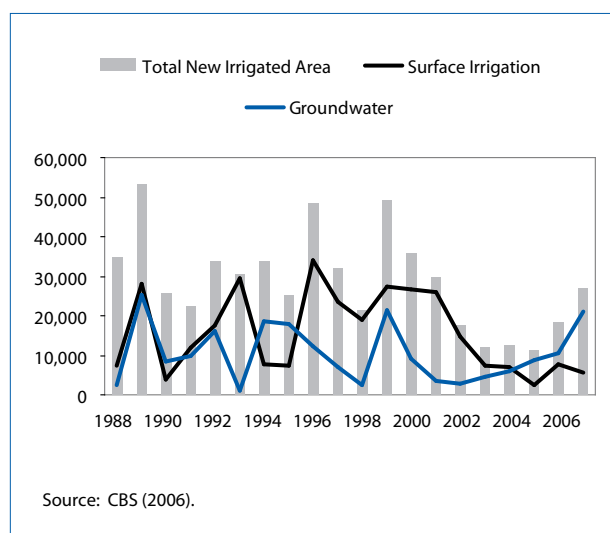
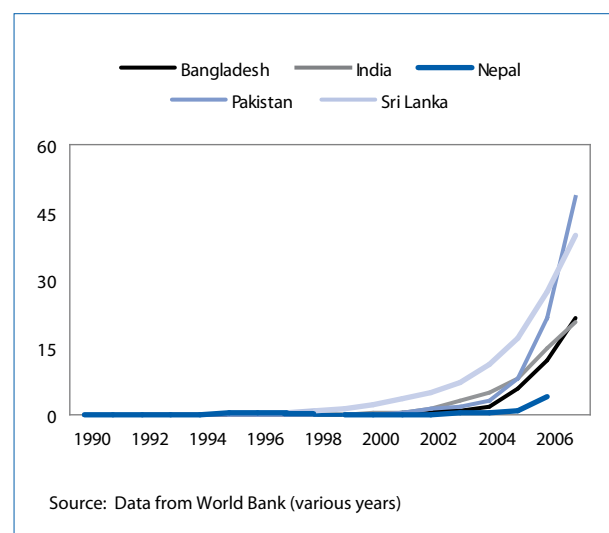
¹¹ The average cost of operation and maintenance (O&M) is about \$42/ha for small schemes and \$8–14/ha for large schemes. At an average cost of \$42/ha, the O&M requirements for farmer-managed irrigation schemes covering 0.62 million ha amount to \$26.0 million per year. At an average cost of \$12/ha, the annual O&M requirements for the government-managed irrigation schemes covering 0.27 million ha amount to \$3.2 million (Pannikar 2008).

¹² VSAT—very small aperture terminal.

Table 3.7. Water Requirements and Correlation Between Average Annual Rainfall and Yields for Major Crops

Crop	Water Requirements (in mm)	Correlation
Rice	1,200–1600	0.49
Wheat	325–450	0.30
Barley	250–325	0.45
Potato	400–900	0.22
Sugarcane	1,600–1,800	0.37

Sources: CBS (2006) for rainfall data, MOF (various years) for crop yields, and Ministry of Food Agriculture and Livestock, Pakistan (1997).

Figure 3.43. Food Crops Yield (tons/hectare)**Figure 3.45. Fixed Line Subscriptions (per 100 people)****Figure 3.44. Expansion in Irrigated Areas by Source (hectares)****Figure 3.46. Mobile Line Subscriptions (per 100 people)**

rural telecom service, 1 local data network service, and 6 limited mobility services. By mid-March of 2008, 3,212 village development committees had access to telephone services, almost 3.6 million telephones had been distributed by the telephone service providers, and there were almost 300,000 internet users (MOF various years).

The improvements in telecommunications infrastructure are also evident from investor feedback. Biggs et al. (2000) found that about 17% of firms identified lack of proper telephone connectivity as a problem while 8% identified it as a severe problem. However, more recent studies and surveys do not suggest that enterprises consider telecommunication as a constraint.

3.3. Appropriability of Returns to Investments

Private parties will invest only when they expect to gain adequately as a result. Anything that weakens the returns discourages investment and, ultimately, slows growth. Risks to such appropriability can emanate from government or market failures. Government failures increase macro or micro risks. The macro risks may include fiscal and financial crises; the micro risks may be bad governance such as political instability, corruption, and weak rule of law; overly burdensome taxation; and poor industrial relations. Market failures affecting appropriability normally reflect information and learning externalities and coordination failures.

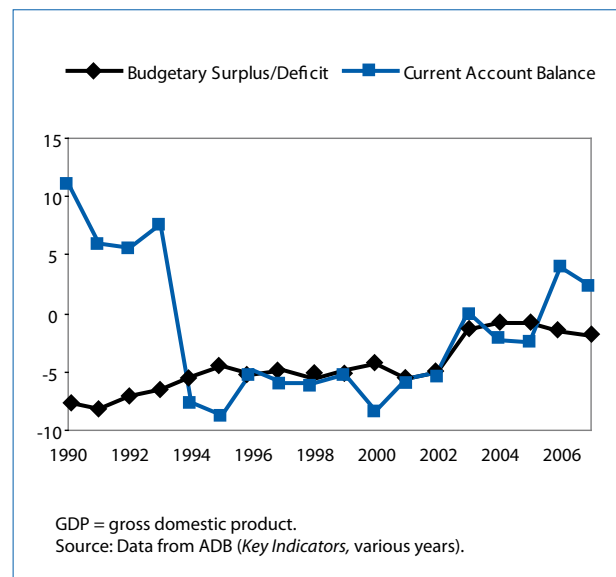
3.3.1. Macroeconomic Risks

Macroeconomic management has been good, with low levels of deficits, public debt, and single digit inflation, and may not be a critical constraint to investment or growth. Despite conflict/civil war and political instability, Nepal has maintained sound macroeconomic management. Nepal was the beneficiary of an IMF poverty reduction and growth facility (PRGF) between 2003 and 2008. Among other things, the PRGF focused on ensuring sound macroeconomic management. At completion of the PRGF in 2008, the IMF concluded that the PRGF was broadly successful in

achieving its macroeconomic targets, noting that macroeconomic stability, the overarching aim, was preserved even during the conflict/civil war and in difficult political circumstances. The IMF further noted that most numerical targets set under the PRGF were achieved, in some cases with significant margins (IMF 2008a).

As discussed in earlier sections, Nepal has had a positive current account balance despite a negative trade balance during recent years. Nepal was able to bring its fiscal deficit down from about 5.5% of GDP in 2001 to 2.0% by 2007 (Figure 3.47) due to an improved tax effort and privatization of public enterprises. During this period, revenues increased by 74% in nominal and 27% in real terms, and total tax revenues increased by 80% in nominal and 32% in real terms. Although revenues have been rising, both total revenues and tax effort as a percentage of GDP remain low compared with those in other South Asian countries (Figures 3.48 and 3.49). In 2007, Nepal's total revenues were about 11.7% of GDP; they were 16.1%, 15.8%, 14.0%, and 12.0% in Bangladesh, Sri Lanka, Pakistan, and India, respectively. Similarly, the tax effort amounted to 9.7% of GDP in 2007, while it was 23.8%, 14.6%, and 10.7% for Maldives, Sri Lanka, and India, respectively. Comparatively lower levels of revenues and tax effort suggest that there may be room to

Figure 3.47. Fiscal and Current Account Position (% of GDP)



raise revenues and boost investment in public infrastructure and services without overly burdening investors. Increased revenues are especially required to meet the vast public sector expenditure needed for providing infrastructure and other services.

Nepal has effectively kept its inflation at low levels compared with those in other South Asian

countries (Figure 3.50). Growth in the consumer price index stayed below 5% during 2000–2004 before rising to 6–8% during 2005–2007. Despite inflationary pressures from surges in food, fuel, and construction material prices, the country was able to keep inflation to single digit levels (Figure 3.51). Ginting (2007) found that inflation in India passes into Nepal after about 7 months and inflation

Figure 3.48. Central Government Revenues in South Asian Countries (% of GDP)

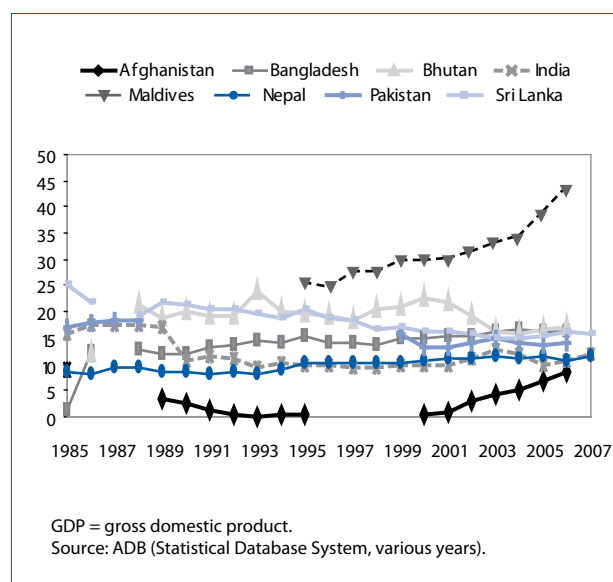


Figure 3.50. Inflation Levels in South Asian Countries (%)

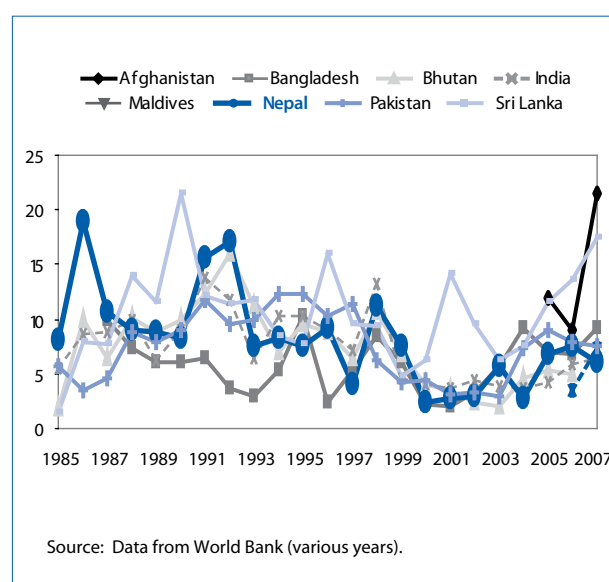


Figure 3.49. Tax Effort in South Asian Countries (% of GDP)

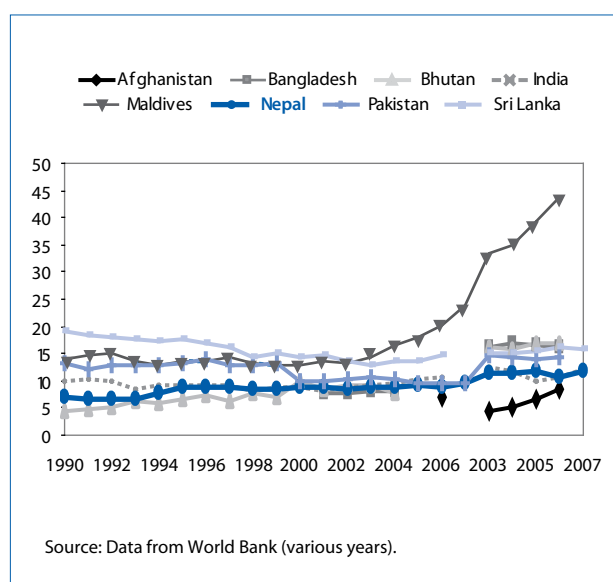
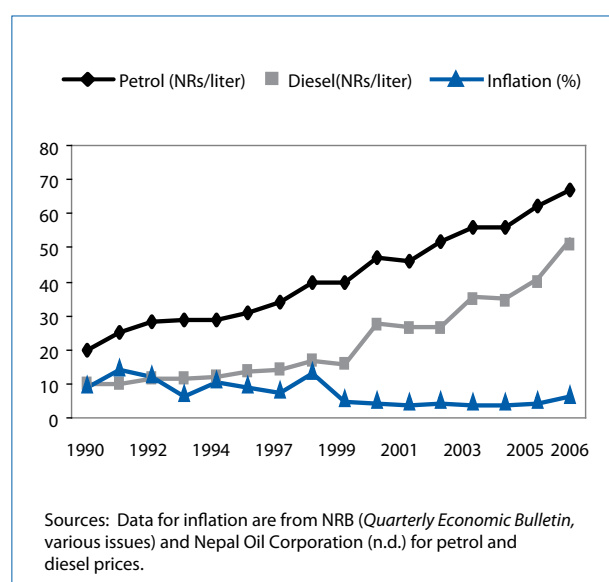


Figure 3.51. Inflation and Oil Price



levels in the two countries converge in the long run (Figure 3.52), possibly due partly to the open border between the two countries and the Nepalese rupee peg with the Indian rupee. Because inflation in India recently escalated to about 13.0%, Nepal may also experience higher inflation in the near future.

Transfers from the government to public enterprises rose sharply in 2007/08, which may constrain public expenditures in infrastructure and key services if the trend is not reversed. In 2008, about 36 enterprises were wholly or partly owned by the government; among them were 7 industrial units, 13 businesses, 3 public utility companies, and several financial institutions. The government's capital share in these enterprises totaled about NRs75.8 billion although the net worth of its share was estimated at only about NRs39.0 billion at the end of 2006/07. In 2006/07, these enterprises earned profits of about NRs7.96 billion, with 22 of them yielding profits and 14 running losses. The overall net flow from the enterprises to the government was about NRs2.6 billion, with Nepal Telecom and the Agriculture Development Bank contributing the major portion. However, the Nepal Oil Corporation alone lost about NRs3.67 billion, and this rose further in 2007/08. Due to losses by the Nepal Oil Corporation and other enterprises, the net flow of funds from the enterprises to the government reversed in 2007/08,

and the government transferred about NRs5.1 billion to the enterprises (Figure 3.53). The reversal was primarily because of the Nepal Oil Corporation's inability to pass on to consumers the full effect of high oil prices. While flows are anticipated to improve with reductions in fuel-related subsidies and a decline in global oil prices, the enterprises should be carefully reevaluated and the government may want to consider disinvesting in the loss-making ones, which otherwise will continue to draw funds that could be used for infrastructure and public goods (MOF various years).

3.3.2. Microeconomic Risks

The level of governance has deteriorated in most aspects, and is a critical constraint to investment and growth in the country. As indicated in Table 3.8, in 1996, Nepal ranked above the South Asian average in 4 of the 6 governance-related indicators that the World Bank monitors (World Bank n.d.). However, its rank has since slipped in all indicators except regulatory quality. The most drastic decline was in "political stability" where the percentile rank dropped from 26.9 in 1996 to 2.9 in 2007. During the same period, Nepal declined in "voice and accountability" from 46.4 to 22.6, in "government effectiveness" from 36.0 to 21.8, in "rule of law" from 51.4 to 31.0, and in "control of corruption" from 44.2 to 30.4.

Figure 3.52. Inflation in India and Nepal

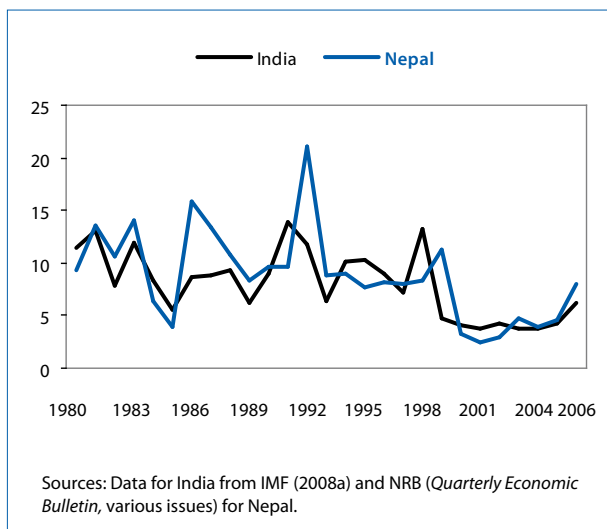


Figure 3.53. Net Transfer of Funds from Government to Public Enterprises (NRs million)

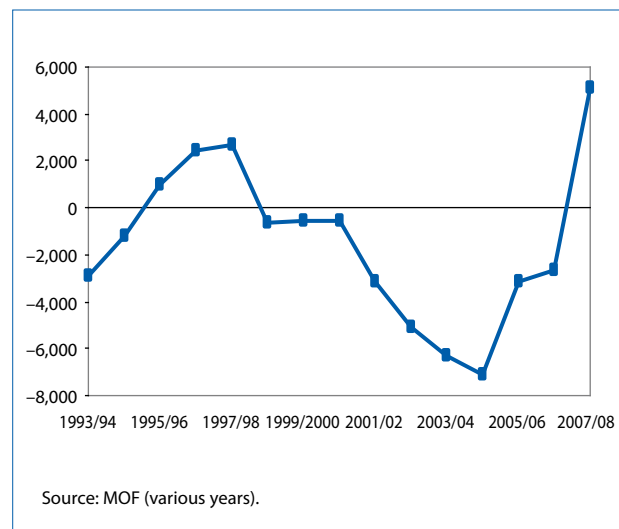


Table 3.8. Governance Indicators for Nepal, Percentile Rank (0–100)

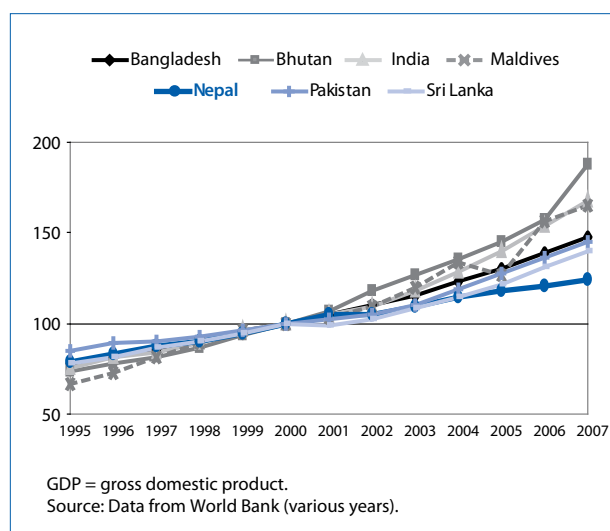
Indicator	1996	1998	2000	2003	2004	2005	2006	2007	Regional Average	
									1996	2007
Voice and Accountability	46.4	42.3	43.3	25.5	18.3	13.9	15.4	22.6	29.5	28.0
Political Stability	26.9	23.6	14.4	5.3	2.9	1.4	2.9	2.9	25.3	19.3
Government Effectiveness	36.0	36.0	40.8	34.1	22.3	15.2	21.8	21.8	45.4	36.5
Regulatory Quality	22.9	31.7	28.3	33.2	31.2	25.9	26.3	26.7	43.3	31.9
Rule of Law	51.4	52.9	44.8	37.1	32.4	23.8	33.3	31.0	33.9	38.3
Control of Corruption	44.2	42.7	40.3	51.0	33.0	28.2	29.6	30.4	35.2	33.9

Note: A higher value indicates a higher rank.

Source: Data from World Bank (n.d.).

Although the conflict/civil war is over, political instability remains a threat to appropriability and is a critical constraint to investment and growth. The conflict/civil war and political instability in the 2000s have been major setbacks to Nepal's GDP growth, which dropped to about 3.1% between 2001 and 2007 from 4.9% in the 1990s. In contrast, other South Asian countries solidified and improved their GDP growth rates over the same period, ranging from 4.9% for Bangladesh to 9.5% for Bhutan. The slow down in the economic growth led to a widening GDP gap between Nepal and its South Asian neighbors. Figure 3.54 compares growth in GDP of selected South Asian countries by normalizing their GDP at levels that prevailed in 2000 when the conflict/civil war and political instability had started to peak.

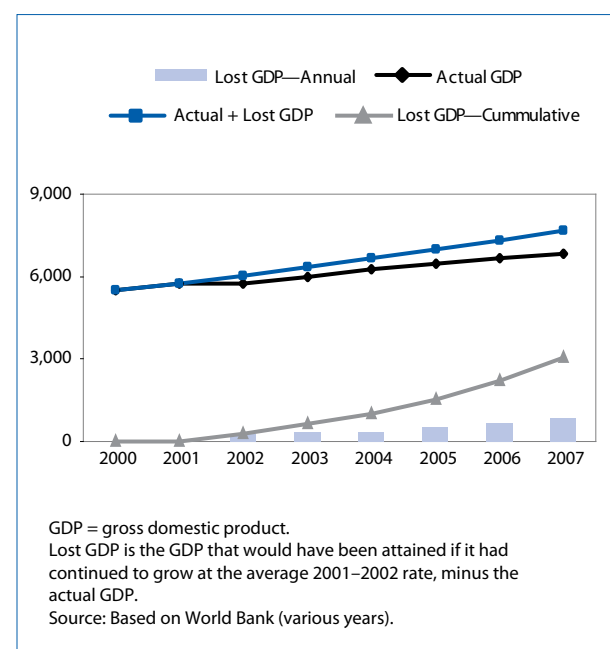
Figure 3.54. GDP in Selected South Asian Countries (normalized at 2000=100)



Nepal's GDP growth between 2001 and 2007 was lower than that of Sri Lanka by about 16 percentage points, about 21 percentage points behind Pakistan, about 24 points behind Bangladesh, about 41 points behind Maldives, 43 points behind India, and over 64 points behind Bhutan.

The cost of the conflict/civil war in terms of lost GDP growth has been significant. If GDP had continued to grow at the rate that it had attained in 1991–2000, the aggregate loss between 2001 and 2007 would amount to about \$3.0 billion in 2000 terms (Figure 3.55). Pyakuryal and Uprety (2005) estimated the cost of conflict to the economy at a similarly high level. An Asian Development Bank

Figure 3.55. Cost of Conflict in Terms of Lost GDP (in 2000 \$, million)



study estimated a loss of NRs10 billion to NRs15 billion (\$135 million to \$205 million) for the 3-week strike in April 2006 alone (ADB 2006c). Other estimates cited by Pyakuryal and Uperty noted that, in the first 9 years of the conflict/civil war, over 5,100 establishments were partly or fully destroyed and infrastructure worth \$129.6 million was badly damaged.

The conflict/civil war and political instability also led to deterioration in other key economic indicators. A comparison of domestic savings, total national savings, and investment rates normalized at the 2000 level suggests that all three indicators experienced a significant negative downturn (Figure 3.56). Most affected among them was the domestic savings rate, which by 2006 had dropped to about 52% of the 2000 levels. The sharp decline in the domestic savings rate suggests that the population in general lost confidence in the economy and the country's ability to weather the uncertain conditions. There are also indications that wealthy people used the open access to India and shifted their savings to banks in neighboring Indian states. Although total national saving rates also deteriorated over this period, the decline was primarily due to the lower domestic savings rate, which was largely overcome by the surge in remittance flows from overseas workers in the post 2003 period. After declining between 2001 and 2003, investment rates

have risen above the 2000 levels, but the increase remains modest and may partly be attributable to data quality issues discussed in earlier sections.

Another key area that was negatively affected by the conflict/civil war and economic instability was foreign direct investment (FDI) inflow (Figure 3.57). Prior to the escalation of the conflict/civil war, FDI was rising and had nearly tripled between 1995 and 1997. However, FDI started to decline thereafter, with several years of no or negative flows. The aggregate FDI flow between 2000 and 2007 amounted to only about \$12 million, or roughly half the FDI inflows of \$23 million in 1997 alone.

Among the notable projects and initiatives delayed by the direct and indirect affects of conflict/civil war and political instability was the development of hydropower, with private sector investment not reaching significant levels despite the government's policy of actively seeking private investment. An example is the Middle Marsyangdi hydropower project, which was delayed by about 4 years due to conflict/civil war, security, and other issues. Because the construction was delayed, construction costs more than doubled and the economy went without about 400 GWh per year of much-needed power that could have cut power shortages by about one quarter (Shahi 2008).

Figure 3.56. Trends in Selected Economic Indicators (normalized at 2000=100)

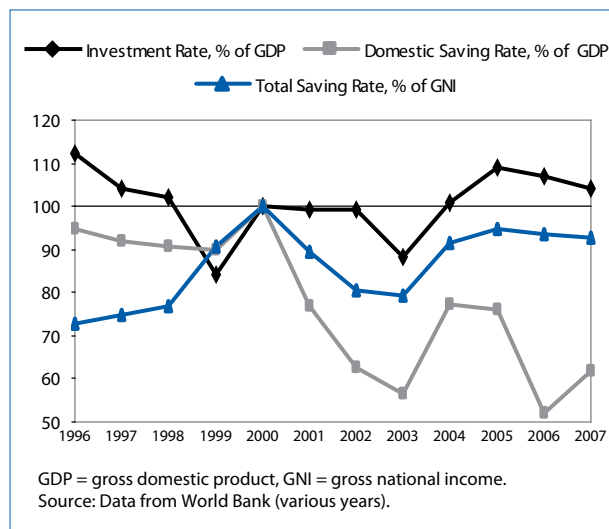


Figure 3.57. Foreign Direct Investment, 1995–2007 (\$ million)

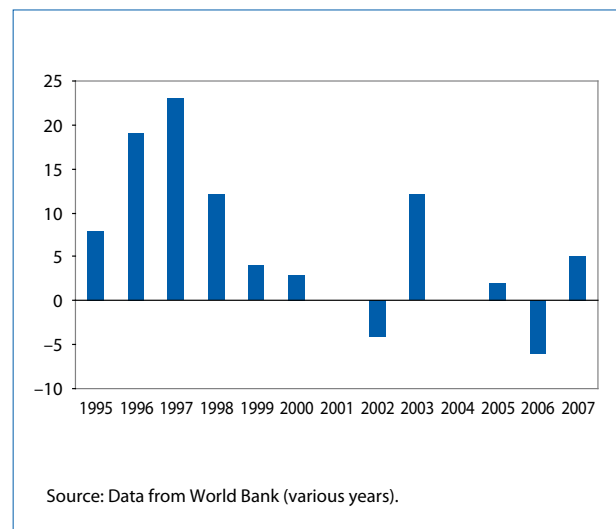
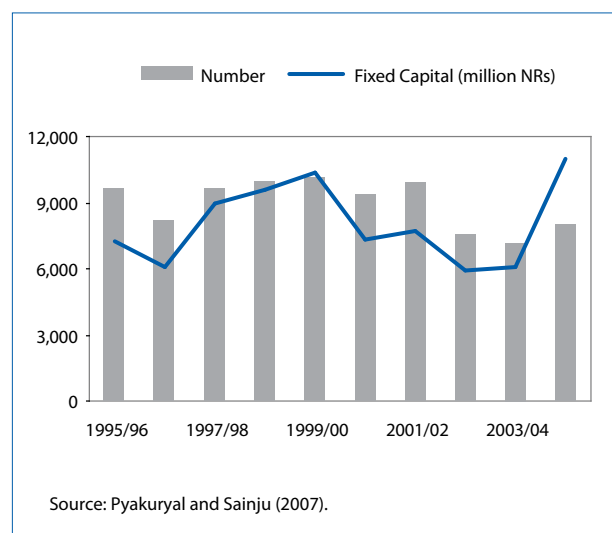


Figure 3.58. Small and Medium Size Cottage Industry, 1995/96–2004/05

Conflict/civil war and political instability also negatively impacted domestic industry. Pyakuryal and Sainju (2007) note a decline in the number of small and medium sized cottage industries and fixed capital investments in them between 1995/96 and 2003/04 (Figure 3.58). The number of registered small and medium size cottage industries, after peaking at 10,127 in 1999/2000, had declined to 7,133 by 2003/04. During the same period, fixed capital in them, after peaking at NRs10,340 million, declined to NRs6,110 million. While the decline in fixed capital amounted to about 41% in nominal terms, it was about 50% in real terms. Pyakuryal and Sainju considered the conflict/civil war to be the primary cause for this downturn and argued that the impact was grossly underrecorded, as the data do not include a large number of enterprises that remain unregistered.

Another cost of conflict/civil war was the diversion of public sector spending from development activities to defense- and law-and-order-related activities. A review of central government accounts suggests that expenditures on defense and general public services rose from 2.4% of GDP in 1995 to 4.0% in 2005. In contrast, public sector expenditures on economic services, including agriculture and major infrastructure, declined from 6.5% of GDP in 1995 to 3.8% in 2005. Pyakuryal and Uprety (2005) note that the cost of deploying security forces to tackle a strike alone amounted

to about \$100,000 a day in 2004/05—sufficient to construct and upgrade several kilometers of road or finance annual development funds for 6–7 villages. With the end of the conflict/civil war, expenditures on defense and general public services declined slightly to about 3.8% of GDP, and expenditures for economic services improved slightly, from 3.8% of GDP to 3.9% (Figure 3.59). However, the improved expenditure levels are far below those required for meeting the country's key infrastructure needs.

Although the conflict/civil war has ended, the progress in regaining political stability is slow. Nepal's percentile rank in the Worldwide Governance Indicators was 2.9 in 2007, unchanged from 2006 levels and only slightly improved from its rank of 1.4 in 2005 (World Bank n.d.). Compared with other countries in the region, Nepal ranked higher than Afghanistan and Pakistan in 2007 (Figure 3.60). Nepal's low rank for political stability highlights that, although the conflict may be over, political instability continues to haunt the country. An indication of persisting political instability is the continued occurrence of strikes. Between November 2007 and January 2009, Nepal experienced 274 strikes or road blocks, of which 40% were in the hill and mountain regions, 39% in the east and central terai, and 22% in the west terai (Figure 3.61).

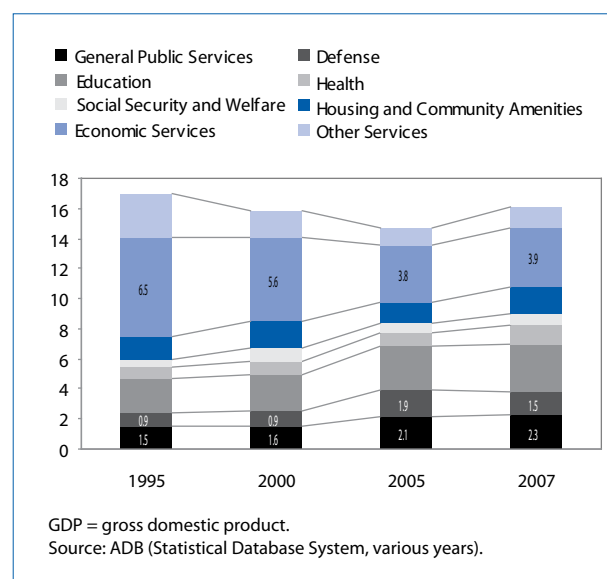
Figure 3.59. Central Government Expenditure by Function (% of GDP)

Figure 3.60. Political Stability in South Asian Countries (percentile ranks)

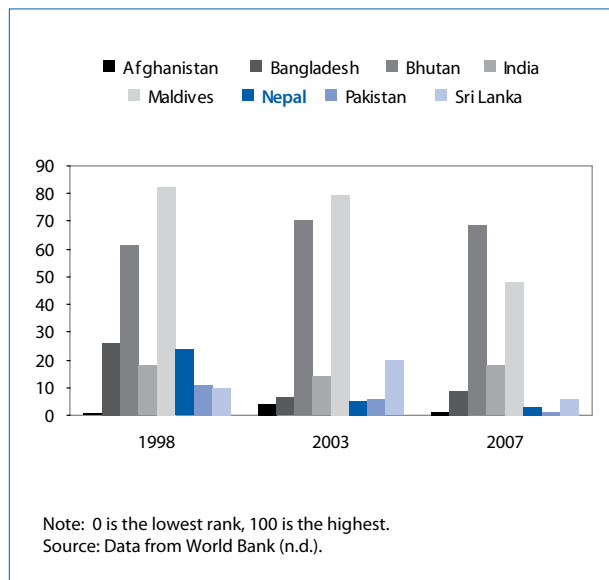
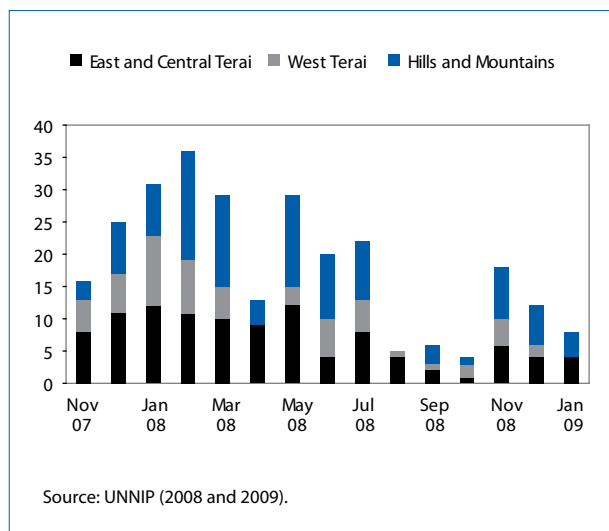


Figure 3.61. Reported Strikes and Blockades in 2008



Investor feedback confirms that political instability continues to be a major constraint. *The Global Competitiveness Report 2008–2009* notes that investors cited government instability as the most problematic factor for doing business (Porter and Schwab 2008). The 2008 Enterprise Survey also found that firms ranked political instability as the biggest constraint to growth and investment, with 72% of respondents considering it as a very serious or major constraint; in addition, 26% of the firms considered social unrest as a very serious or major constraint (ILO, ADB, and FNCCI 2008). With

slow recovery in political stability and the frequent strikes, investors will find difficulty regaining the confidence to invest at levels required for growth that is at par with neighboring countries.

Control of corruption seems to have weakened and is a constraint to investment and growth in the economy. The literature suggests that corruption in Nepal is prevalent and affects the access of individuals and businesses to justice (the judiciary and the police), access to public services and infrastructure, access to public finances, payment of taxes and duties, acquisition and registering of land, and management and exploitation of natural resources. There are frequent allegations of corruption by government officials in the distribution of permits and approvals, the procurement of goods and services, and the award of contracts. In addition to the direct impact on investors, corruption also impacts the quality, cost, and timely implementation of key infrastructure in the country. The 2008 *Global Corruption Report* cites several high profile examples of corruption-related incidents (Transparency International 2008).

Studies and governance indicators show that the control of corruption has weakened since 1996. As shown in Table 3.8, Nepal's percentile rank, at 44.2 in 1996, was better than the average of 35.2 for South Asia, but it declined to 30.4 in 2007 against the South Asian average of 33.9. The 2007 Global Integrity Report ranks Nepal as "weak" in "anti-corruption and rule of law" (Global Integrity 2007). The report considers a weak anticorruption law as the main bottleneck and rates the Commission for Investigation of Abuse of Authority and the National Vigilance Center under the Ministry of Home Affairs, the national level agencies responsible for control of corruption, as "moderate" in control of corruption.

In terms of investor feedback, findings of studies and surveys suggest that investors consider corruption as a major constraint to investment. The *Global Competitiveness Report 2008–2009* identifies corruption as the third most cited constraint to doing business (Porter and Schwab 2008). This is in line with the 2008 Enterprise Survey, which found that 44% of responding firms

considered corruption to be a very serious or major constraint (ILO, ADB, and FNCCI 2008).

Although the rule of law remains weak, investors do not report it as a critical constraint to investment and growth in the economy. Prior to the conflict/civil war, Nepal ranked very high in “rule of law.” In 1996, its percentile rank in the Worldwide Governance Indicators was 51.4, substantially higher than the South Asian average of 33.9 (Table 3.8). However, Nepal’s rank slipped to 31.0 in 2007, while the South Asian average had improved to 38.3. Nepal’s rank has improved since 2005, when it was 23.8, but the number of security-related incidents remains high. Figure 3.62 presents the incidence of violent crime reported during the 14-month period, November

2007 through December 2008. Of the violent crimes, 70% were reported in the terai districts—Saptari and Siraha districts had the highest crime rate and Banke, Bara, Kaksi, Mohottari, Morang, Rautahat, Shanusa, and Sunsari also had high crime rates. Most of these districts are key stops on the East-West Highway and have very high rates of transport-related strikes.

Despite the high crime rate and deterioration in the rule of law since 1996, investors do not seem to consider it problematic for doing business. The *Global Competitiveness Report 2008–2009* ranked crime and theft 11th among the constraints businesses faced.

Nepal’s tax rates are one of the lowest in the region, and while paying taxes is cumbersome, it may not be a critical constraint to investment or growth. Nepal’s personal income tax, corporate income tax, and value-added tax rates are among the lowest in the region (Table 3.9). Similarly, tax as a percentage of business profits is low versus all but Maldives, which is considered a “best practice” country (Table 3.10). On the other hand, the effort involved in paying taxes is high. On average, an investor is expected to pay taxes about 33 times a year, which is more often than in all countries except India, Pakistan, and Sri Lanka. In addition, an average business spends 408 hours preparing, filing, and receiving a refund, which is only less than that in Pakistan.

Despite the cumbersomeness tax-related processes, investors did not consider tax rates or regulation as the most problematic factor in doing

Figure 3.62. Reported Security Incidents

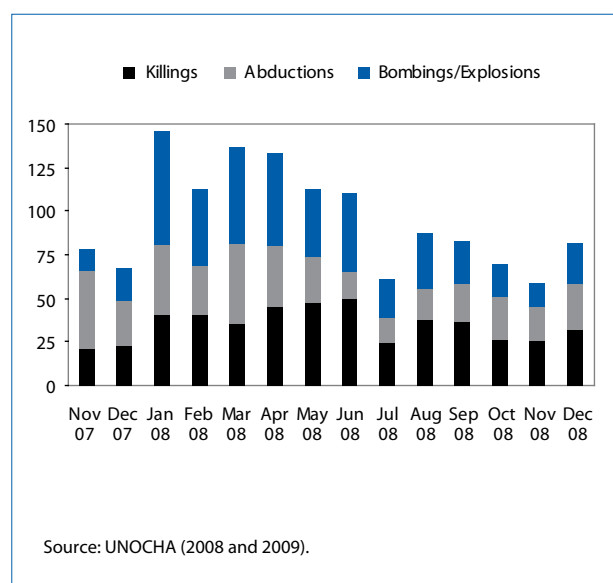


Table 3.9. Tax Rates in South Asia (%)

Country	Personal Income Tax Rate	Corporate Income Tax Rate	Value-Added Tax Rate
Afghanistan	10–20	20	2–5
Bangladesh	10–20	35–40	15
Bhutan	—	30	—
India	10–30	33.7	12.5
Maldives	—	—	—
Nepal	15–25	25	13
Pakistan	10–35	39	15
Sri Lanka	10–25	35	15

— data not available.

Sources: Data from World Bank (2008a); AsiaTradeHub.com (n.d.); Ministry of Finance, Afghanistan; and OnlyAtNepal.com (n.d.).

Table 3.10. Paying Taxes in South Asian Countries

Country	Number of Payments (per year)	Time Spent (hours per year)	Total Tax Rate (% of profit)	Overall Rank
Afghanistan	6	275	35.5	38
Bangladesh	17	400	39.5	81
Bhutan	19	274	39.8	68
India	60	271	70.6	165
Maldives	1	0	9.1	1
Nepal	33	408	32.5	92
Pakistan	47	560	40.7	146
Sri Lanka	62	256	63.7	158

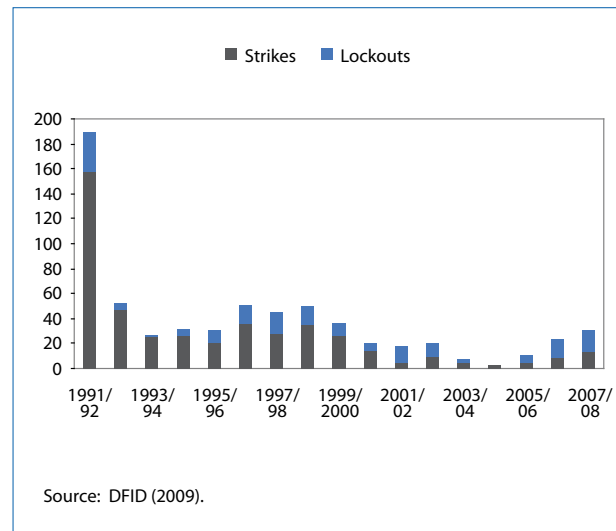
Note: Total Tax Rate includes corporate income tax; social contributions and labor taxes paid by employers; property and property transfer taxes; dividend, capital gains, and financial transactions taxes; and waste collection, vehicle, road, and other taxes.

Source: World Bank (2008a).

business. The *Global Competitiveness Report 2008–2009* found that only 4.4% of investors cited tax administration as a constraint, while only 2.0% considered the tax rates to be a major constraint to growth and inclusiveness (Porter and Schwab 2008). The 2008 Enterprise Survey had similar findings, with respondents ranking the tax burden in 9th place out of 16 constraints (ILO, ADB, and FNCCI 2008). The low rank of taxes as a constraint may be because businesses have found ways of avoiding taxes; thus, the tax issue may be a constraint only for new investors, both domestic and foreign. In addition to constraining new investment, cumbersome procedures for assessing and paying taxes may be a disincentive for paying taxes and may create an opportunity for rent seeking.

The poor industrial relations climate and labor market rigidities are critical constraints to investment and growth. Despite the historic peace accord of late 2006, abolition of the monarchy, and formation of a democratically elected coalition government, the industrial relations climate remains poor and labor-related strikes and lockouts remain frequent. Indeed, labor strikes and lockouts have been rising since lows in 2004/05 (Figure 3.63). The rising incidence of strikes, blockades, and lockouts has mainly been due to the re-emergence of the All Nepal Federation of Trade Unions (ANFTU) in 2006. In Nepal, the blockades are often termed *bandhs* and are frequently accompanied by implicit or explicit threats of violence to those who ignore the disruptive action. In the past, many of the *bandhs* were organized by trade unions

Figure 3.63. Labor Related Strikes and Lockouts, 1991–2007



and in particular by ANFTU. However, many of the *bandhs* in 2007 were not organized by the trade unions but by organizations associated with political parties, such as the Youth Communist League and Madheshi People's Rights Forum; student associations linked to political parties; and indigenous groups. Even the main employers' organizations in Nepal have organized *bandhs* in regional centers and conducted a mass protest in Kathmandu in an effort to force the government to act to prevent the extortion from and abduction of entrepreneurs.

The full economic impact of poor industrial relations is difficult to ascertain due to data limitations and the difficulty of isolating the impact of strikes and lockouts from other constraints such

as weak governance and inadequate power supply. However, production time lost due to poor industrial relations provides an indication of the scale of problem. In 2005/06, about 190,000 person-days of work were lost due to labor-related issues; this declined in 2007/08 to slightly less than 90,000 person-days (Figure 3.64). Given that the number of strikes and lockouts increased during 2005/06–2007/08, the decline in lost work hours may have resulted from manufacturing units reducing their operating time due to other constraints, such as worsening power shortages.

Figure 3.64. Person-Days Lost Due to Strikes and Lockouts

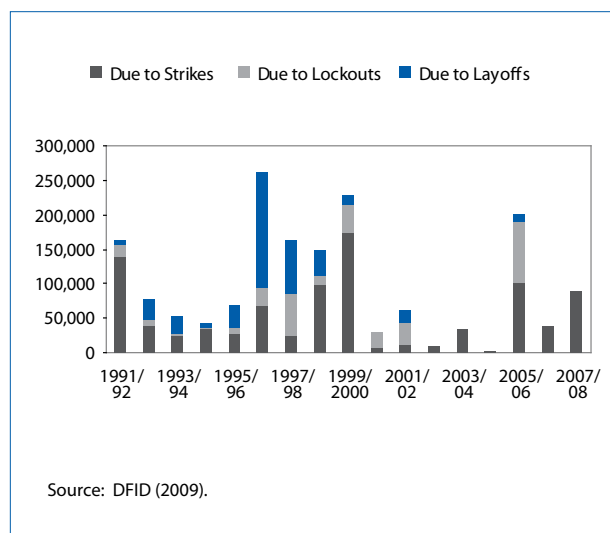
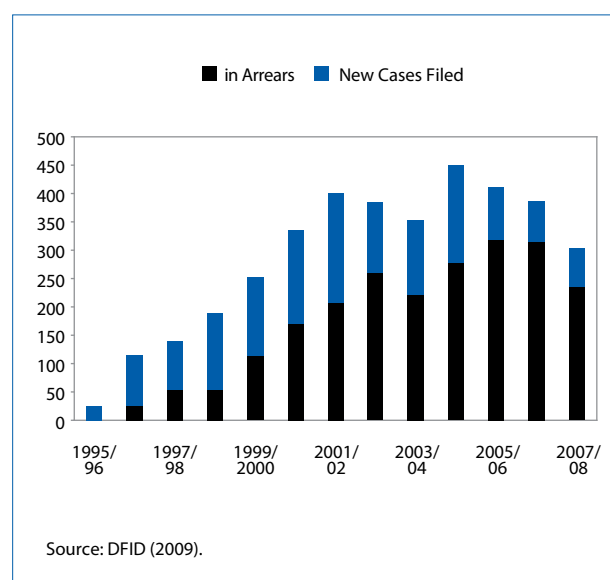


Figure 3.65. Number of Cases in Labor Court



Another indication of the poor industrial relations and the labor market rigidities is the number of cases in labor court, which increased from 1995/96, when the labor court was established, to the early 2000s (Figure 3.65). The trend turned down somewhat in the early 2000s with the expanded cadre of judges assigned to the labor court, but the number of cases remains rather large.

Poor industrial relations result from complex factors including institutional aspects and shortcomings in the labor law. Salient institutional factors include an underdeveloped tradition of collective bargaining, weak human resources and business management, and trade unionism structured along ideological and political lines. This results in issues or disputes that are more political than industrial in nature being brought to the workplace. Labor–management relations are further hampered by multiple unions in the workplace, with unions trying to outdo each other for gains and membership. Last but not least, rigidities in the labor market and the labor law underlying workings of the labor markets are a source of discontent and friction between employers and employees. Findings of the 2008 Enterprise Survey tend to confirm the binding nature of poor industrial relations on investment and economic growth (ILO, ADB, and FNCCI 2008). When asked about the top two constraints in doing business, enterprises ranked strikes as the most critical constraint after political instability. Shortcomings in the labor law and lack of motivation in the workforce were also identified as major constraints, ranking 4th and 6th, respectively.

Findings of the 2008 Enterprise Survey suggest a correlation between firm size and the identification of industrial relations as a problem. However, there was little or no correlation between trade union membership and firm size—nor, more interestingly, was a correlation found between union membership and the identification of industrial relations. Possibly, the smaller the firm, the less hierarchical the management structure, the more personal the labor–management relationship—i.e., “distance” is less. But these remain speculative points that require further investigation to verify.

Labor-related laws and regulations in Nepal are some of the most rigid in South Asia, with the 2008

Table 3.11. Labor-Related Regulations in South Asian Countries

Country	Difficulty of Hiring Index	Rigidity of Hours Index	Difficulty of Firing Index	Rigidity of Employment Index	Non-Wage Labor Cost (% of salary)	Firing Cost (weeks of wages)
Afghanistan	0	40	30	23	0	0
Bangladesh	44	20	40	35	0	104
Bhutan	0	0	20	7	1	10
India	0	20	70	30	17	56
Maldives	0	0	0	0	0	9
Nepal	67	20	70	52	10	90
Pakistan	78	20	30	43	11	90
Sri Lanka	0	20	60	27	15	169

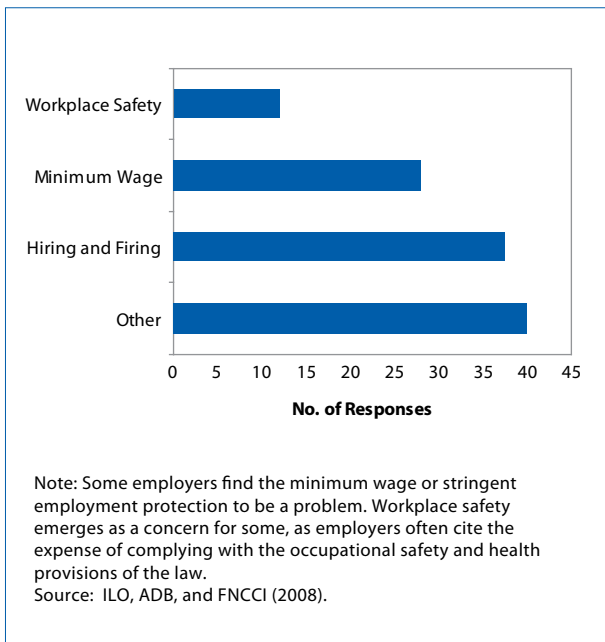
Note: Lower numbers indicate better labor regulation.

Source: World Bank (2008a).

Doing Business report ranking labor law in Nepal in 2008 as the most rigid in South Asia (World Bank 2009a). In rigidity of the employment index, Nepal scored 52—other South Asian countries ranged from 0 for Maldives to 43 for Pakistan (Table 3.11). The report's findings suggest that the law makes it difficult for employers to hire and fire employees, whereas in other countries in the region the rigidities in one aspect may be offset by those in the other. For example, while Indian labor law scores equally high in difficulties in firing, it poses no difficulties in hiring. Similarly, difficulties in hiring are

compensated for by relative ease in firing under the labor law in Pakistan. These findings are confirmed by the feedback from the 2008 Enterprise Survey, in which the respondents ranked difficulties in hiring and firing as the most problematic of aspects (Figure 3.66). Other aspects that the enterprises considered problematic related to the minimum wage and compliance with the occupational safety and health provisions in the law. The three labor-related variables (workplace safety, minimum wage, and hiring and firing) in the questionnaire all emerged as concerns to employers.

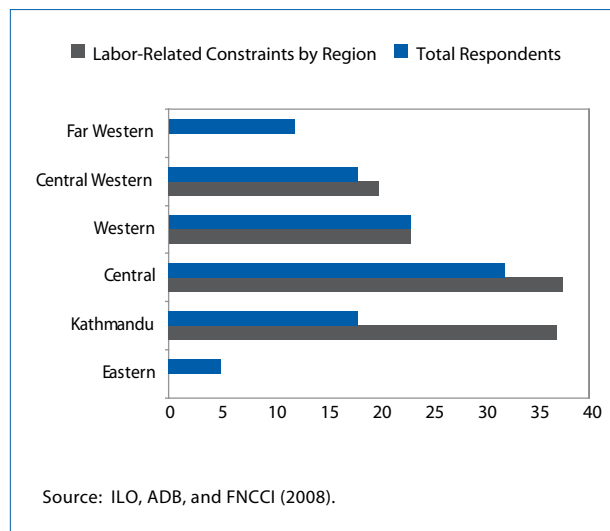
Figure 3.66. Enterprise Feedback on Weaknesses in the Labor Law



Firm size appears to matter, with larger firms reporting labor-related issues as greater concerns than did smaller firms. However, employers perceive issues of labor quality as related to problems with the labor law. For example, “employers are concerned about high levels of absenteeism, low levels of motivation, and low productivity. Most employers believe that this is related to shortcomings with the labor legislation, including sections 11 and 12 of the Labor Act, which deal with dismissal and retrenchment” (Kyloh 2008, 162–3).

Findings of the survey also suggest regional variations in the perceived labor-related concerns. For example, reports of labor-related concerns are disproportionately high in the Kathmandu Valley relative to all firms surveyed. Arguably, this could reflect two factors: (1) trade union density is higher in the Kathmandu Valley than elsewhere in the country, which may mean that disputes are also greater in number there; and (2) compliance with the labor law may be greater in the Kathmandu Valley

Figure 3.67. Regional Distribution of Firms Identifying Labor Law and Industrial Relations as Constraints (%)



than in more remote areas with weaker institutions for implementing the law (Figure 3.67).

3.3.3. Market Failure

The economy is dominated by services and agriculture, with industry accounting for less than 18% of GDP. Within the industry sector, the manufacturing subsector's share does not even amount to 10% of GDP. No doubt, constraints identified earlier, in particular political instability and weak governance, inadequate infrastructure, and poor industrial relations, have contributed to poor performance in the manufacturing subsector by lowering social returns to investment and/or private appropriability. However, as pointed out in recent literature, the presence of market failures in an economy may also lead to low private appropriability and low private sector investment. Hausman, Rodrik, and Velasco (2005) argue that such market failures include information and learning externalities and coordination failures.

An example of information externality is when the benefits of successfully introducing products and production processes that are well established elsewhere but new to a country may spill over to third parties without giving due remuneration to the original proponent, but in cases of failure only the original proponent bears the cost. The presence

of such information externality could lead to underinvestment in new products and production processes, yielding a low level of diversification and innovation. Similarly, an example of a learning externality is when the benefits from investing in developing the capacity of a workforce may spill over to third parties if the trained workers switch employers or migrate to other countries, acting as a disincentive to training a workforce. Reference to coordination failures recognizes that a firm's productivity depends not only on its own efforts and the general economic conditions, but also on how the upstream and downstream firms link and perform, and on the firm's access to infrastructure, regulations, and other public goods. Similar to information and learning externalities, coordination failures can deter investment. The presence of these market failures calls for nonmarket corrective actions.

The following broad symptoms suggest that such market failures are at work in Nepal.

Domestic manufacturing is low in technological quality and not growing. The

Figure 3.68. Composition of Domestic Manufacturing Value Addition (% of total)

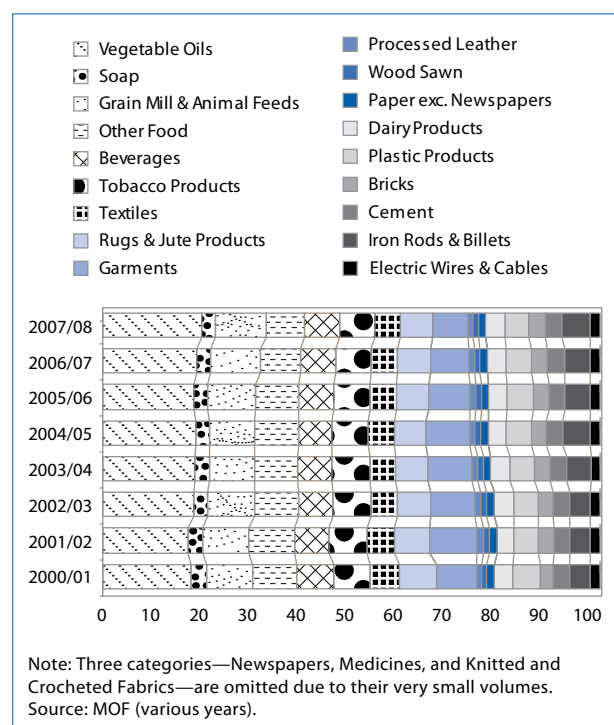
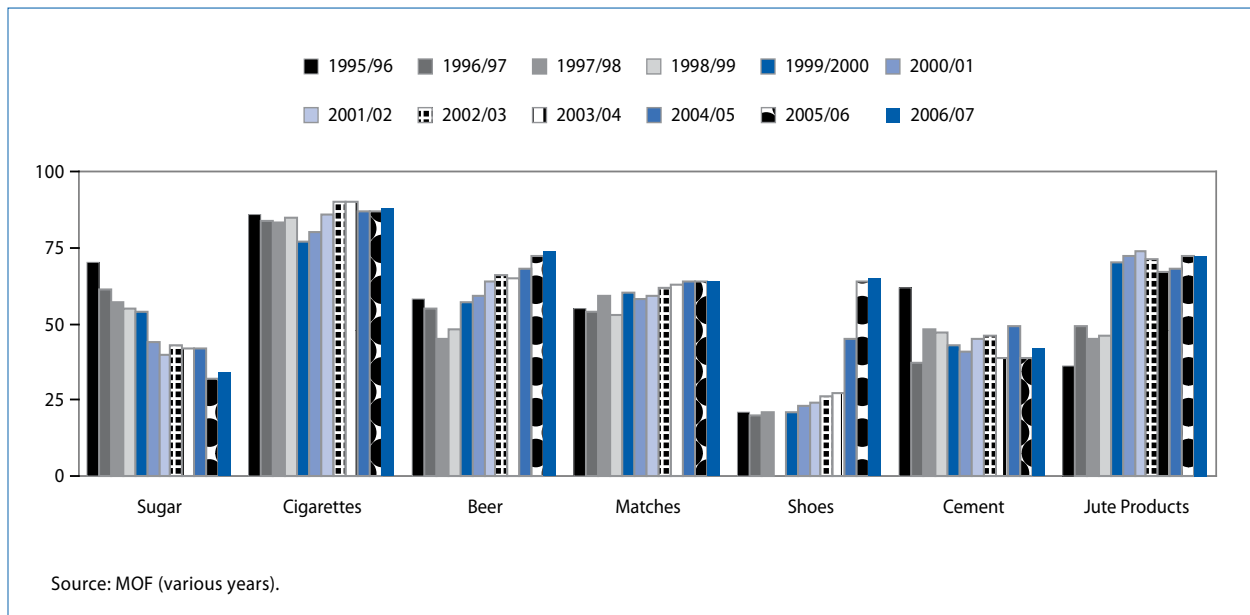


Figure 3.69. Capacity Utilization of Selected Manufacturing Units (%)



manufacturing subsector is small and has not been growing in value or sophistication (Figure 3.68). During 2000/01–2007/08, the overall value addition of manufacturing declined about 0.8 percentage points in real terms. In terms of individual products, export-oriented manufacturing, such as textiles, garments, rugs and jute products, paper, dairy products, and food products, shrank between 2000/01 and 2007/08. The largest expansion occurred in construction-related materials (iron rods and billets, bricks, and electric wires and cables), which is logical given the recent growth in construction. The only other products for which production expanded were milled grain and animal feed, processed leather, and sawn wood.

In addition, capacity utilization in most types of manufacturing is very low (Figure 3.69). Except for cigarette production, most units are operating below 75% of their capacity levels. Capacity utilization in sugar production has been declining constantly, from about 70% in 1995/96 to 34% by 2006/07. Exceptions include the cement, match, and jute industries, which have had relatively steady capacity utilization, and the two industries that have grown in recent years—production of beer and shoes, with beer production nearing utilization rates of 75%. In addition to the high levels of unutilized capacity in other manufacturing units, a large number of them

have closed in the last few years. Of the industrial estates' 524 manufacturing units, 76 units, or 15% of the total, were reported closed in 2005/06 (MOF various years).

Exports are low in volume and technological quality. As in the manufacturing subsector, the export base is small and the exports of goods and services accounted for only about 8.2% of GDP in 2007, down from a high of 12.8% in 2001 and 2002. Due to the slide, in 2007 Nepal had South Asia's lowest level of exports of goods and services as a percentage of GDP—exports from other countries in the region ranged from 12.1% of GDP in Pakistan to 23.9% in Sri Lanka. Not only have the exports shrunk in size, but the trends in terms of their evolution have not been clear (Figure 3.70). The share of exports of materials, after expanding for several years, began to shrink but started to increase again since 1999/2000. The shares of chemicals and drugs, and animal and vegetable oils and fats increased till about 1999/2000, but have since stagnated.

Manufactured exports in Nepal are comparable in structure of sophistication to those of other poor South Asian countries. The study analyzed Nepal's manufactured exports in terms of their technical sophistication using

**Figure 3.70. Composition of Exports
(% of total)**

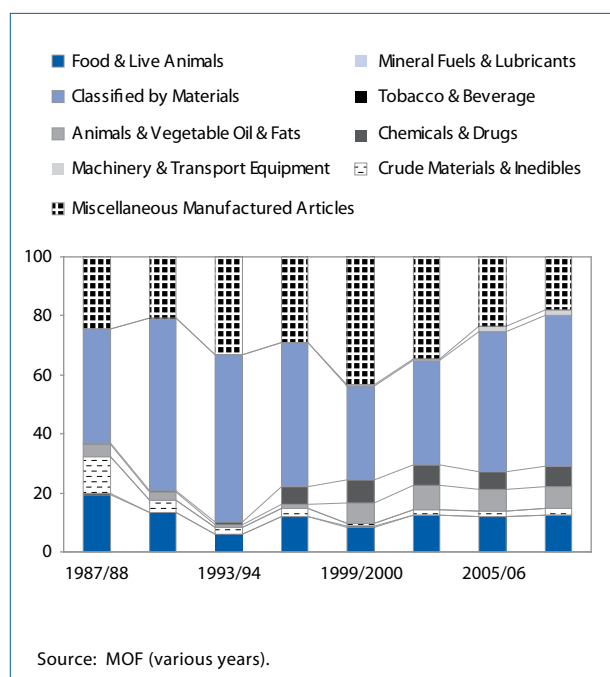
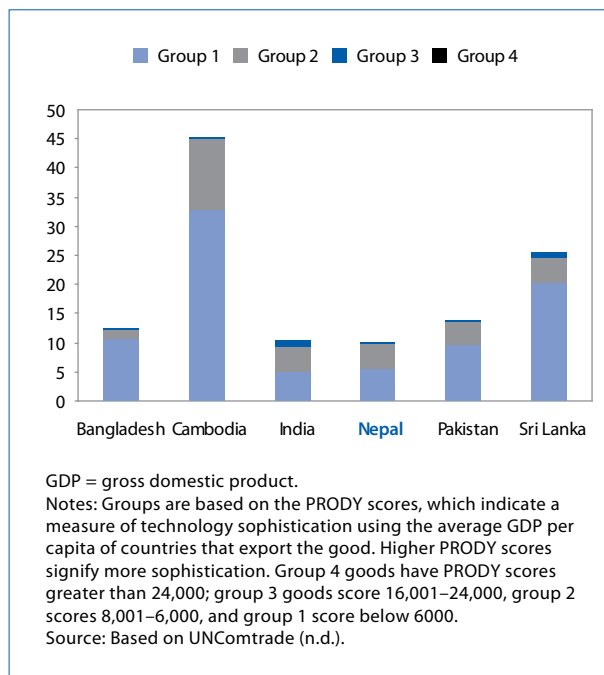


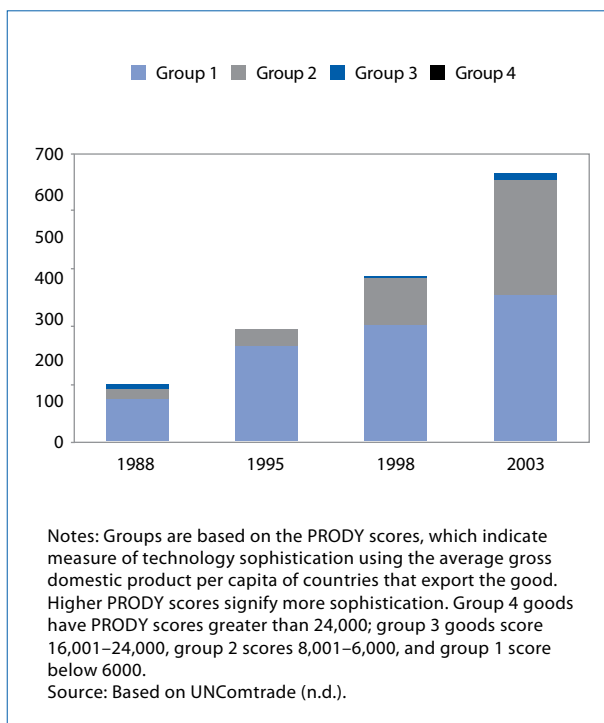
Figure 3.71. Groups of Exports of Selected Asian Countries, 2003 (% GDP)



2003 trade data, the latest year for which data are reported by UNComtrade. Manufactured exports were divided into four groups ranging from the lowest levels of technical sophistication to the highest using a commodity-specific index based on the methodology pioneered by Hausmann, Hwang, and Rodrik (2006).¹³ Results revealed that none of Nepal's exports in 2003 belonged to the most sophisticated group—group 4—and more than half of them belonged to the least sophisticated group—group 1 (Figure 3.71). Compared with selected Asian countries, Nepal fared better than Bangladesh and Cambodia, which had 87.2%, and 72.2%, respectively, of their goods in the lowest group.

When compared over time, trends in sophistication levels of manufactured exports are not clear. Analysis suggests that the sophistication of manufactured exports actually decreased between 1988 and 1998, then increased between 1998 and

**Figure 3.72. Evolution of Nepal's Exports
(\$ million in 2003 prices)**



¹³ The commodity-specific index called PRODY is a weighted average of the per capita GDPs of countries exporting a given product. It represents the income level associated with that product. The highest group, 4, comprises goods with PRODY greater than 24,000. Group 3 includes goods with PRODY of 16,001–24,000, group 2 includes those with PRODY of 8,001–6,000, and group 1 goods have PRODY less than 6,000.

2003. The average PRODY score declined from 8,611 in 1988 to 8,379 in 1995 and then increased to 10,519 in 2003. In terms of export products, about 8.7% of Nepal's exports belonged to group 3 in 1988, but the goods belonging to this category had disappeared altogether in 1995 and 1998 (Figure 3.72). In 2003, group 3 goods accounted for approximately 3% of all exports. Part of this is explained by a change in the underlying goods that Nepal produces. In 1988, the biggest exports from group 3 comprised only six types of goods including linseed oil and wood and resin-based chemical products. However, 15 years later, the list had expanded to 45 goods and included plastics, paper manufacturing, and veterinary medicines.

Nepal's policies and thrusts to overcome market failures may not have been strategically well-targeted. Through various five year plans, Nepal instituted a number of thrusts to overcome market failures and promote industrial development in the country, including measures aimed at improving the investment climate in general and promoting specific industries. For example, the Ninth Five Year Plan (1998–2002) targeted promotion of 10 industries including hydropower generation, industries based on tourism, energy-based industry, computer software, industry based on domestic nonmetal minerals, agro-based industry, commercial forestry, industry based on leather, financial services, and sericulture and floriculture (*Ninth Five Year Plan*, NPC various years). Similarly, the Tenth Five Year Plan (2003–2007) targeted garment, woolen carpet, pashmina, and handicraft industries, and local agro-forest-based products. In addition, the 2008/09 budget speech outlined revival of some sick or underperforming industries, including agricultural tools, textiles, sugar refining, jute milling, rubber tires, cement, herb processing, and electricity generation. The question is: Are the efforts required to develop these industries in line with the expected gains in increasing the volume of exports, furthering industrial development, and expanding employment?

The study employed the product space analysis pioneered by Hausmann and Klinger (2006) to ascertain the suitability of the thrusts aimed at overcoming the market failures (Box 3.3, p. 59). Findings of the analysis suggest the following:

- Industries targeted in the Ninth Five Year Plan (1998–2002) were predominantly low in strategic value or their potential to lead to development of more sophisticated industries (Figure 3.73). Moreover, a number of the industries required a highly skilled work force, which may have been lacking in Nepal. Thus, the effort required to develop most of these industries may have far exceeded the potential gains.
- Industries targeted in the Tenth Five Year Plan (2003–2007) comprised both export and nonexport products. In this case too, the focus was predominantly on products that were less likely to lead to development of more sophisticated industries (Figure 3.74). However, the level of effort (or “jump”) required to develop most of these industries was not as large as for the industries targeted under the Ninth Five Year Plan.
- Industries targeted by the 2008/09 budget speech included a mix of products with no clear trends in terms of their export potential or strategic value toward the development of

Figure 3.73. Analyzing Industries Targeted in the 9th Five Year Plan

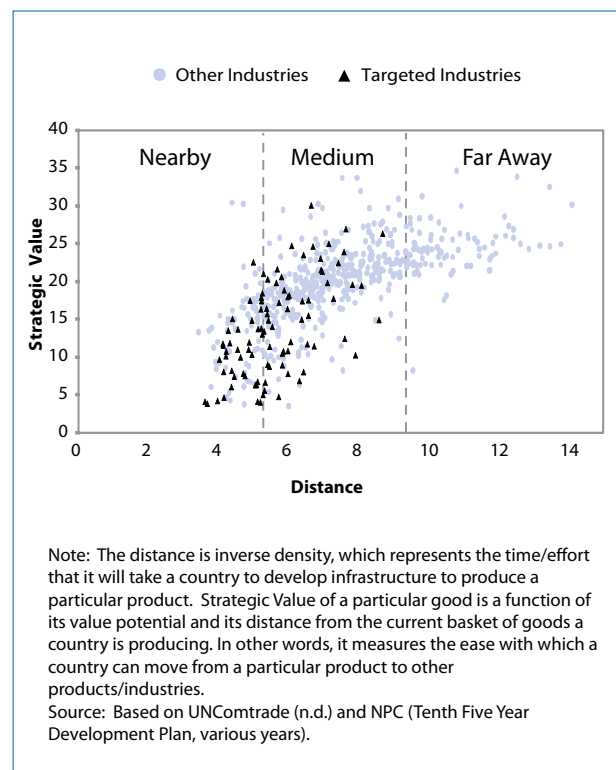


Figure 3.74. Analyzing Industries Targeted in the 10th Five Year Plan

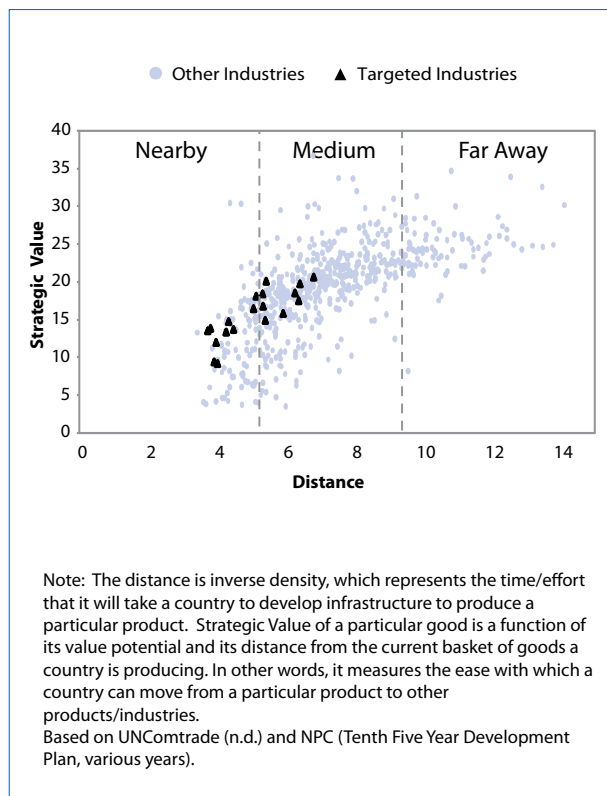
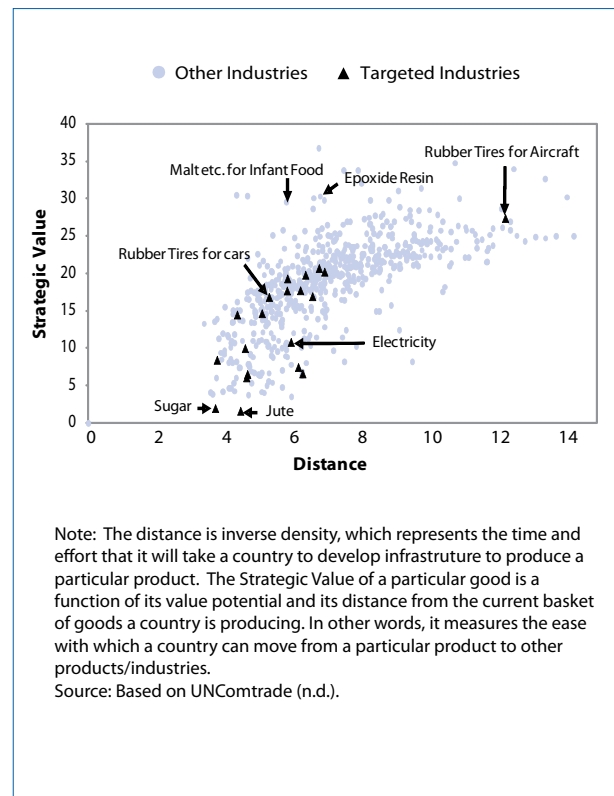


Figure 3.75. Analysis of Strategic Value of Industries Targeted in 2008/09 Budget



more sophisticated industries. For example, jute and sugar had little strategic potential while industries producing rubber tires for aircraft, epoxide resin, and infant food had higher potential for furthering Nepal's industrial development (Figure 3.75). Similarly, while jute had a very small potential export market (global trade amounted to \$58.6 million in 2003), footwear and furniture had a large potential export market (the market for footwear was \$48.25 billion and that for furniture parts,

\$38.3 billion). In terms of effort required to develop these industries, the range of products varied widely between the low and high ends of the spectrum. Overall, the strategic value of the targeted products was much lower than that of Nepal's existing exports and focus on such products would not have done much to further the development of Nepal's industry. Moreover, the potential export market for the targeted products was smaller than the average for products that Nepal already exported.

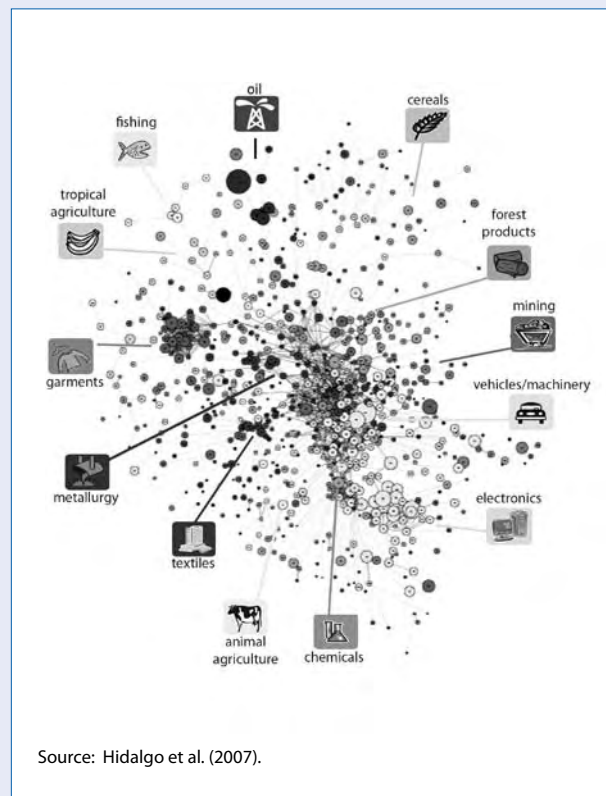
Box 3.3. Product Space Analysis of Nepal's Manufactured Exports

Product Space Analysis, pioneered by Hausmann and Klinger (2006), is a methodology to study structural transformation in an economy. Breaking away from the standard trade theory, the methodology considers that structural transformation is not a passive consequence of changes in comparative advantages due to factor accumulation and is not a smooth process that follows a continuum. They argue that structural transformation is made much more complicated by presence of market failures, and that decisions countries take could actively affect the pace and breadth of structural transformation. They further argue that market failures are less binding when moving to “nearby” products that require smaller adaptations of existing capacity than do “faraway” products. Hidalgo et al. (2007) further elaborate on this methodology by comparing the “product space” to a forest, with the trees being the products and monkeys being the firms. It is easier for the monkeys to jump to trees that are close by than to trees that are far away. They also argue that denser forest provides more opportunities for monkeys to jump. Building on this analogy, they argue that the monkeys’ current location, i.e., the trees that the monkeys are on today, determines where they will be tomorrow. In other words, the products a country produces today have a bearing on what products it will produce tomorrow. They argue that longer jumps are possible, but require more effort and time than shorter ones.

Hausmann and Klinger (2007) use disaggregated export data across a large sample of countries to estimate the probability that a country that is good at producing a product is also good at producing other products with higher levels of pairwise probability indicating that the two products are “near by.” Hidalgo et al. (2007) use the tools of network analysis to construct a visual image of the product space (Box Figure 1). Each node represents a product and its size indicates the product’s share of world trade. While the distance between the nodes is meaningless, the prominence of links with other nodes signifies that many products are “near by.” The figure indicates that the product space is highly heterogeneous, with products on the periphery with links to a few other products indicating the difficulty of moving from these to other products. Conversely, dense clusters in the middle indicate the ease with which firms in these clusters can move from one product to another.

Nepal’s export basket, when plotted on the product space, indicates that it lies rather “far

Box Figure 1. Product Space Tree



Box 3.3. continued

away” from the denser clusters (Box Figure 2). Except for garments and related products, most products are loosely scattered across the product space. The average distance of the nonexports from Nepal’s export basket is estimated at 6.8, compared with 2.0–2.5 for the People’s Republic of China and Malaysia. This indicates that Nepal will need to take longer jumps to move to more productive sections within the product space.

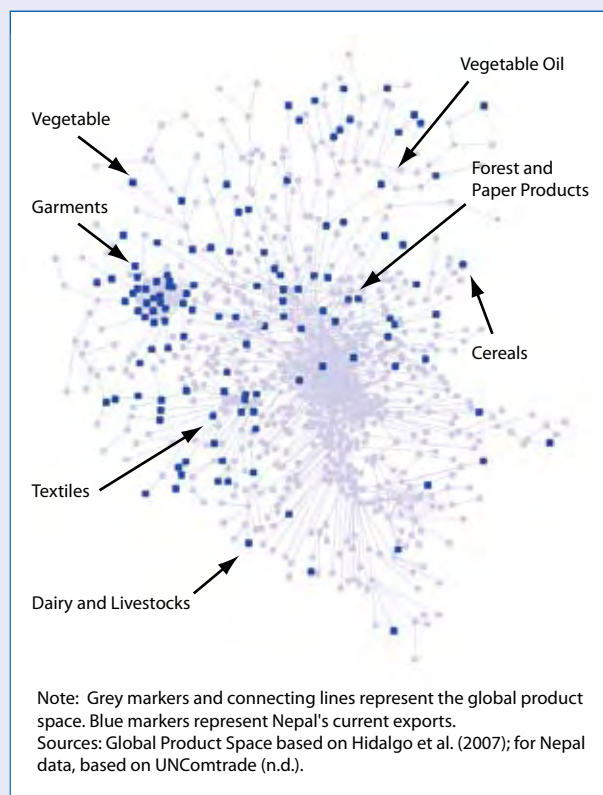
Two questions arise.

- What are the “nearby” products that Nepal may consider pursuing, which can help it move toward denser sections of the product space?
- Which of these products have high export potential and use a predominantly unskilled labor force?

To answer the questions, one may define the strategic value of each good as a function of both the potential value of the good and its distance from the basket of goods that Nepal is currently exporting. The top three strategic products are wood-based paneling; knitted/crocheted fabrics (elastic or rubberized); and bacon, ham, and other dried pork products. The Nearby Goods table lists a number of “nearby” products, without taking Nepal’s geography into account. The table is ordered from products of high strategic value (in terms of moving to denser sections of the product space) to those of low value, and lists the size of the global market for the product and typical share of unskilled labor in the workforce involved in its production. A few of the products, including the first three, may not be relevant given Nepal’s landlocked nature; nevertheless, Nepal did export some dried fish in 2003 and has exported 7 of the first 10 products in the list.

Sources: Authors, Hausmann and Klinger (2006 and 2007), and Hidalgo et al. (2007).

Box Figure 2. Nepal's Product Space



Box 3.3. continued**Nearby Goods**

Product Description	World Market in 2003 (\$ bn)	Unskilled Labor Quotient
Fish,Dried,Salted Or In Brine; Smoked Fish	2.95	53.60%
Crustaceans And Molluscs,Prepared Or Preserved	4.66	59.23%
Fish Fillets,Frozen	5.34	53.60%
Other Fresh,Chilled,Frozen Meat Or Edible Offals	0.65	60.02%
Pyrotechnic Articles: (Firework,Railway Fog Etc.)	0.49	48.43%
Potatoes	1.88	75.45%
Transformers,Electrical	9.74	20.16%
Candles,Matches,Pyrophoric Alloys Etc.	2.82	43.49%
Sinks,Wash Basins,Bidets,Water Closet Pans,Etc	2.58	79.31%
Fish,Fresh(Live/Dead)Or Chilled,Excl.Fillets	7.56	72.39%
Statuettes & Oth.Ornaments,& Articles Of Adornment	1.58	41.77%
Travel Goods,Handbags,Brief-Cases,Purses,Sheaths	17.79	36.06%
Vegetables,Frozen Or In Temporary Preservative	6.08	53.60%
Footwear	48.25	51.43%
Building & Monumental Stone,Worked,& Artic.Thereof	6.31	53.65%
Art.& Manuf.Of Carving Or Moulding Materials	0.52	38.02%
Fish,Frozen (Excludind Fillets)	9.61	53.60%
Art.Of Apparel & Clothing Accessories,Of Leather	8.46	42.38%
Other Materials Of Animal Origin, N.E.S	3.56	66.65%
Manufactured Goods,N.E.S.	3.17	39.20%
Portland Cement,Ciment Fondu,Slag Cement Etc.	4.72	79.31%
Clothing Accessories,Knitted Or Crochetem,N.E.S.	5.73	46.77%
Cotton Fabrics,Woven,Bleach.Merceriz.Dyed,Printed	22.11	59.49%
Oranges,Mandarins,Clementines And Other Citrus	4.23	75.45%
Corsets,Brassieres,Suspendres And The Like	5.91	43.60%
Fruit,Temporarily Preserved	1.61	53.60%

Note: Unskilled Labor Quotient = % of workers who have only primary school education.

Sources: Based on UNComtrade (n.d.) and National Sample Survey Organization (2006).

Chapter 4

Critical Constraints to Inclusiveness

Nepal made significant progress in poverty reduction from 1995/96 to 2003/04 despite political instability. However, the poverty incidence was still estimated to be as high as 31% in 2003/04. An important issue that Nepal faces is how to make growth more inclusive. Growth is said to be inclusive when it allows all members of society to participate in and contribute to the growth process on an equal basis regardless of their individual circumstances (Ali and Zhuang 2007). This is a particularly relevant question for Nepal, where exclusion remains an important hurdle to surmount in order to attain the country's development objectives (World Bank and DFID 2006). Indeed, inclusion is one of the four pillars of Nepal's Poverty Reduction Strategy Paper and Tenth Five Year Plan. This chapter examines whether Nepal's economic growth has been inclusive and attempts to identify constraints to the inclusiveness of growth.

4.1. The Inclusiveness of Economic Growth

The Nepal Living Standards Surveys (NLSSs) indicate that Nepal's incidence of poverty declined from about 42% in 1995/96 to 31% in 2003/04, a reduction of about 3.7% per year. Strong growth in real per capita expenditure during this period—an

average annual growth rate of 4.5%¹⁴—seems to have contributed to this significant poverty decline. Nevertheless, the elasticity of poverty reduction to growth for Nepal was relatively low by international standards (World Bank et al. 2006). While the cross-country elasticity of poverty reduction is estimated to be about -2 (Ravallion 2001), the elasticity for Nepal during this period was about -0.6 based on per capita expenditure data, implying that each percentage point growth of per capita expenditure resulted in a 0.6 percentage point reduction in the number of people below the poverty line (World Bank et al. 2006). In addition, inequality increased from 1995/96 to 2003/04, as noted in Chapter 2. A decomposition analysis shows that the same level of economic growth would have reduced poverty by 13 percentage points more if the inequality had not worsened (Table 2.10). These observations suggest limited inclusiveness in Nepal's recent economic growth.

One way of examining inclusiveness is to view the trends in poverty measures at a disaggregated level. Nepal is an ethnically diverse country with more than 59 main ethnic groups. The deeply embedded Hindu caste system adds complication to its social structure. Nepal is also diverse in terms of geography. The country is commonly divided into ecological belts—the mountain, hill, and terai

¹⁴ The growth rate of per capita expenditure based on the NLSS data was significantly higher than that of per capita gross domestic product (GDP) based on the national accounts. World Bank et al. (2006) discusses possible explanations for the discrepancy between the two data sources.

Table 4.1. Headcount Poverty Rates in Nepal (1995/96 and 2003/04, %)

	Poverty Headcount Rate			Proportion of Total Poor		
	1995/96	2003/04	Change	1995/96	2003/04	Change
Urban	21.6	9.6	–56	3.6	4.7	31
Rural	43.3	34.6	–20	96.4	95.3	–1
NLSS Regions						
Kathmandu	4.3	3.3	–23	0.3	0.6	100
Other Urban	31.6	13.0	–59	3.3	4.1	24
Rural Western Hill	55.0	37.4	–32	32.7	23.6	–28
Rural Eastern Hill	36.1	42.9	19	19.4	29.4	52
Rural Western Terai	46.1	38.1	–17	18.4	18.9	3
Rural Eastern Terai	37.2	24.9	–33	25.9	23.5	–9
Ethnicity/Caste						
Brahman-Chhetri	34.1	18.4	–46	26.7	15.7	–41
Terai Middle Caste	28.7	21.3	–26	2.9	1.9	–34
Dalit	57.8	45.5	–21	10.6	10.9	3
Newar	19.3	14.0	–28	2.5	3.4	36
Hill Janajati	48.7	44.0	–10	19.7	27.8	41
Terai Janajati	53.4	35.4	–34	10.4	9.2	–12
Muslim	43.7	41.3	–6	5.7	8.7	53
Other Minorities	46.1	31.3	–32	21.4	22.3	4
Nepal	41.8	30.8	–26	100.0	100.0	—

NLSS = Nepal Living Standards Survey.
Source: World Bank et al. (2006).

areas—and into five development regions—Eastern, Central, Western, Mid-Western, and Far-Western. Table 4.1 reports changes in poverty headcount rates for each of these dimensions.

The table clearly illustrates the variation in poverty incidence and reduction rates by geography as well as ethnicity/caste. For instance, the headcount poverty rate was more than halved in urban areas, but it declined only by 20% in rural areas. Hence, about 35% of the rural population was still below the poverty line in 2003/04. Poverty reduction was particularly significant in urban areas other than Kathmandu. In rural areas, the rural Eastern terai and rural Western hill areas experienced the greatest reduction rates—about 33% and 32%, respectively. However, poverty increased in the rural Eastern hills by 19% during this 8-year period. As a result, 43% of the rural Eastern hills population was in poverty in

2003/04, and the region contained the largest share of the country's poor: about 29%.

In terms of development regions and ecological belts, relatively poor areas (the Far-Western Region and mountain belt) experienced the greatest decline in poverty, as noted in Chapter 2 (Figures 2.7 and 2.8). However, in terms of the ethnicity/caste dimension, the Brahman-Chhetri,¹⁵ which are considered privileged groups in Nepal, benefited most from the economic growth. In contrast, the disadvantaged groups—Dalit, Hill Janajati, and Muslims—experienced the least poverty decline from 1995/96 to 2003/04. These variations unequivocally indicate the economic exclusion of some groups in Nepal. However, although the Brahman-Chhetri

¹⁵ The Brahman and Chhetri castes are referred to together in this report as Brahman-Chhetri, because they are treated as one group for purpose of analysis.

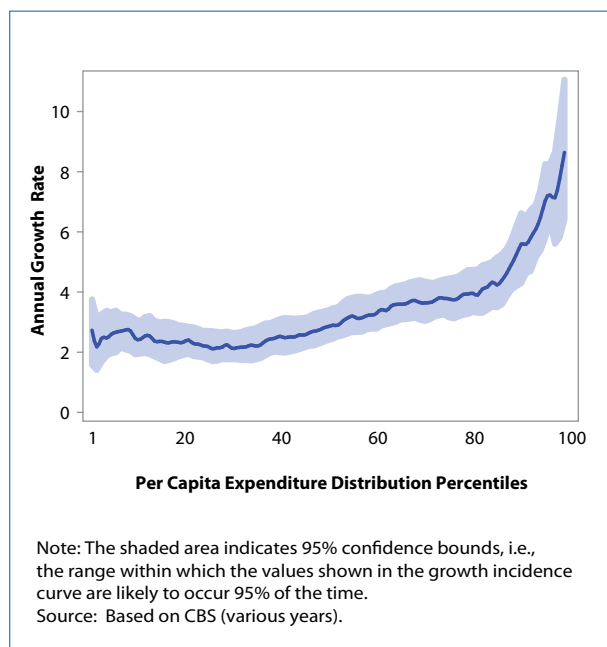
are considered privileged groups, about 18% of them were poor in 2003/04, when they comprised 26% of the total population and about 16% of the poor (Table 4.1). Thus, factors in addition to social exclusion keep certain households in poverty.

Figure 4.1 presents a growth incidence curve, which plots the annual growth rate for each percentile of the per capita expenditure distribution. Even though per capita expenditure increased for all percentiles from 1995/96 to 2003/04, the growth rate tended to be greater toward the higher end of the expenditure distribution. It is thus not surprising that the Gini coefficient rose from 34.2 to 41.4 during the same period (Table 4.2), which is also illustrated by Lorenz curves (Figure 4.2).

Table 4.2 reports the decomposition of inequality by geography and ethnicity/caste for 1995/96 and 2003/04. In all measures, the share of total inequality attributable to between-group inequality increased during this period for both geographic and ethnic/caste groups. In the case of geography, between-group inequality accounted for about 24% of total inequality at the low and middle range of the distribution (i.e., GE[0] and GE[1]), while it accounted for about 18% at the upper half of the distribution (i.e., GE[2]).¹⁶ For ethnicity/caste, although the share of total inequality attributable to between-group inequality is smaller than that for the geographical grouping, it also accounted for a larger share at the low and middle range of the distribution than at the upper range.

The results from the decomposition analysis suggest that geography and ethnicity/caste have been partly responsible for the limited inclusiveness of Nepal's recent economic growth. It is useful to determine the factors that helped certain groups of households escape from poverty between 1995/96 and 2003/04. This can provide guidance for identifying the constraints to inclusive growth. In Nepal, nationally representative household surveys

Figure 4.1. Per Capita Expenditure Growth Incidence Curve (1995/96 and 2003/04, %)



were conducted in 1995/96 (NLSS I) and 2003/04 (NLSS II), with a subsample of 962 panel households. By exploiting the panel component of the data, the determinants of poverty dynamics during this period may be examined.¹⁷ Table 4.3 illustrates the changes in poverty status of households from 1995/96 to 2003/04.

The matrix reports that 47.6% of households were non-poor in both years, 20.4% escaped from poverty during this period, 18.5% remained in poverty, and 13.6% fell into poverty. To identify the determinants of the observed poverty dynamics, a multinomial logit model was estimated based on the panel data from NLSS I and II. The multinomial logit model analyzes the probability of being in a particular state using several unordered alternatives. The poverty transition between 1995/96 and 2003/04 was examined in terms of (unordered) multiple choices, specifically

- (1) being poor in both periods (P→P),
- (2) being non-poor in 1995/96 and becoming poor in 2003/04 (NP→P),

¹⁶ GE(α) refers to generalized entropy indexes, which are commonly used as an inequality measurement. These inequality indexes differ in their sensitivity to income differences in different parts of the income distribution depending on the parameter used (i.e., α). Lower values of the parameter (0) make the index more sensitive to differences in the lower tail of the distribution, while the higher values (2) make it more sensitive to differences at the upper end. In this report $\alpha = 0, 1$, and 2 are considered.

¹⁷ As in most panel data sets, the panel data from NLSS I and II suffer from the attrition problem. However, Bhatta and Sharma (2006) demonstrate that the survey attrition bias does not pose a major issue for examining poverty dynamics.

Table 4.2. Decomposition of Expenditure Inequality by Geography and Ethnicity/Caste (1995/96 and 2003/04)

	GE (0)	GE (1)	GE (2)	Gini
Inequality Measures				
1995/96	19.0	21.8	32.7	34.2
2003/04	27.9	33.7	57.6	41.4
Between Group Inequality as % of Overall Inequality				
Geography				
1995/96	16.2	17.9	16.2	NA
2003/04	24.1	24.2	18.2	NA
Ethnicity/Caste				
1995/96	11.4	10.5	7.6	NA
2003/04	14.8	13.3	8.7	NA

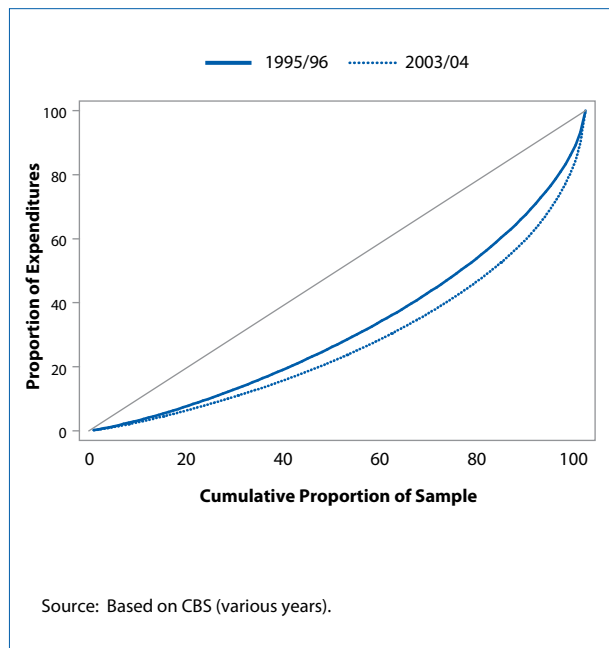
NA = not applicable.

Notes: For geography, the inequality is calculated based on the regions used in the National Living Standards Surveys.

"GE" refers to generalized entropy indexes, which are commonly used to measure inequality. The higher the value, the greater the inequality.

Source: Based on CBS (various years).

Figure 4.2. Lorenz Curves of Expenditure (1995/96 and 2003/04, %)



- (3) being poor in 1995/96 and becoming non-poor in 2003/04 ($P \rightarrow NP$), and
- (4) being non-poor in both years ($NP \rightarrow NP$).

The multinomial logit model is most easily interpreted as giving conditional probabilities. By setting Outcome 1 ($P \rightarrow P$) as the base category, the coefficients for Outcome 3 ($P \rightarrow NP$) inform us of

the probabilities of moving out of poverty relative to being poor in both years. The regression results are expressed in terms of relative risk ratios. A ratio less than one implies that the variable reduces the probability of the household escaping from poverty, while a ratio greater than one implies that the variable increases the probability of the household moving out of poverty. Table 4.4, on p. 66 reports the estimation results.

Model 1, the basic model, includes variables for the basic characteristics of the household and the household head as well as the geographic location of the household (column 1). Observations are as follows: If the household head was Dalit, Terai Janajati, or another ethnic minority, the household had less chance of escaping from poverty than if the head were Brahman-Chhetri. A higher share of children aged 0–6 years old also reduced the probability of moving out of poverty. On the other hand, residing in rural areas and in the Eastern Region (relative to living in urban areas or the Far-Western Region) helped households escape from poverty. This seems to contradict the results presented in Table 4.1, which show that the poverty reduction rate was higher among urban households than rural households. However, the contradiction may be explained by the fact that the majority of the poor reside in rural areas and thus a relatively greater number of households became non-poor

Table 4.3. Poverty Transition Matrix (1995/96 and 2003/04, %)

1995/96	2003/04			
		Poor	Non-Poor	Total
	Poor	18.45	20.38	38.83
	Non-Poor	13.59	47.58	61.17
	Total	32.04	67.96	100.00

Source: Based on CBS (various years).

Table 4.4. Relative Risk Ratios for Escaping from Poverty

	Model 1		Model 2		Model 3		Model 4		Model 5	
	Coef.	Robust S. E.	Coef.	Robust S. E.	Coef.	Robust S. E.	Coef.	Robust S. E.	Coef.	Robust S. E.
Household Head Characteristics										
Age	0.988	[0.010]	0.996	[0.011]	0.996	[0.011]	0.992	[0.011]	0.995	[0.012]
Female	1.968 *	[0.767]	2.288 **	[0.936]	2.577 **	[1.113]	3.043 ***	[1.315]	3.160 **	[1.538]
Ethnicity/Caste										
(Brahman-Chhetri)										
Terai Middle Caste	3.118	[2.573]	4.111 *	[3.391]	4.229 *	[3.527]	4.519 *	[3.569]	4.897 **	[3.833]
Dalit	0.321 ***	[0.133]	0.385 **	[0.167]	0.358 **	[0.164]	0.388 **	[0.180]	0.387 **	[0.178]
Newar	1.888	[2.205]	2.395	[2.835]	2.494	[2.944]	2.661	[3.054]	2.855	[3.289]
Hill Janajati	0.740	[0.298]	0.878	[0.375]	0.869	[0.374]	0.838	[0.364]	0.879	[0.382]
Terai Janajati	0.424 *	[0.205]	0.552	[0.273]	0.543	[0.275]	0.560	[0.299]	0.546	[0.293]
Muslim	2.309	[1.570]	2.619	[1.800]	2.441	[1.674]	2.699	[1.837]	2.857	[1.965]
Other Minorities	0.487 **	[0.180]	0.573	[0.222]	0.538	[0.215]	0.627	[0.254]	0.672	[0.272]
Education Level (years)										
(illiterate)										
4 or less			1.055	[0.398]	1.063	[0.407]	1.071	[0.404]	1.119	[0.422]
5-10			5.989 ***	[3.796]	6.046 ***	[3.821]	5.802 ***	[3.665]	6.164 ***	[3.909]
11+			5.043 **	[3.692]	4.711 **	[3.422]	3.559 *	[2.508]	3.882 *	[2.774]
Occupation										
(self-employed agriculture)										
self-employed/wage-skilled non-agri					1.674	[0.742]	2.211 *	[1.017]	2.178 *	[1.003]
wage agriculture					1.300	[0.456]	2.032 *	[0.795]	2.050 *	[0.794]
wage-unskilled non-agri					1.439	[0.680]	2.094	[1.097]	2.113	[1.127]
out of labor force/unemployed					1.732	[1.143]	2.260	[1.561]	2.460	[1.751]
Chronically Ill	0.814	[0.289]	0.809	[0.293]	0.801	[0.297]	0.878	[0.334]	0.879	[0.332]

Table 4.4 continued...

	Model 1		Model 2		Model 3		Model 4		Model 5	
	Coef.	Robust S. E.	Coef.	Robust S. E.	Coef.	Robust S. E.	Coef.	Robust S. E.	Coef.	Robust S. E.
Household Characteristics										
Household Size	1.135 ***	[0.051]	1.130 ***	[0.052]	1.143 ***	[0.054]	1.117 **	[0.061]	1.111 *	[0.061]
Share of Children Aged 0-6	0.062 ***	[0.045]	0.057 ***	[0.043]	0.048 ***	[0.037]	0.049 ***	[0.039]	0.052 ***	[0.041]
Access to Land										
Own Land							2.742 **	[1.211]	2.551 **	[1.134]
Size of Irrigated Land (ha)							1.896 **	[0.564]	1.936 **	[0.557]
Access to Finance										
Loans									1.258	[0.357]
Remittances (None)										
Received domestic remittances									2.207 *	[1.069]
Received international remittances									0.803	[0.331]
Remoteness										
Access to Paved Road	1.501	[0.687]	1.354	[0.612]	1.329	[0.598]	1.620	[0.764]	1.572	[0.745]
Geography										
Rural	3.855 **	[2.410]	4.180 **	[2.704]	4.839 **	[3.137]	3.977 **	[2.804]	3.866 *	[2.755]
Development Region										
Eastern	2.335 *	[1.057]	1.972	[0.945]	1.994	[0.974]	2.569 *	[1.325]	2.551 *	[1.333]
Central	1.288	[0.592]	1.159	[0.550]	1.182	[0.572]	1.489	[0.764]	1.445	[0.755]
Western	1.863	[0.853]	1.650	[0.790]	1.750	[0.852]	1.960	[0.984]	2.072	[1.061]
Mid-Western (Far-Western)	1.251	[0.560]	1.120	[0.529]	1.177	[0.562]	1.260	[0.622]	1.194	[0.604]
No. of observations		962		962		962		962		962
Pseudo R ²		0.126		0.159		0.169		0.181		0.189

***, **, and * = statistically significant at the 1%, 5%, and 10% levels, respectively; ha = hectare; SE = standard error.
Source: Based on CBS (various years).

in rural areas than in urban areas. Most of these results remained robust even when other variables were included in the model (see columns 2–5).

The results from the final model, Model 5, provide important observations. (1) Education was a key factor for escaping from poverty. In particular, having 5 or more years of schooling significantly increased the probability of becoming non-poor. (2) Being non-farm self-employed, a skilled wage worker in the non-agriculture sector, or a wage worker in the agriculture sector increased the household's chance of escaping from poverty more than did being self-employed in agriculture. This may be due, at least partly, to the steep increase in wages for such occupations between 1995/96 and 2003/04 as noted in section 4.2.2. (3) Access to land also was an important factor for moving out of poverty. The regression results suggest that both land ownership and greater access to irrigated land helped households escape from poverty. (4) The receipt of domestic remittances had a positive effect on the probability of becoming non-poor.

The empirical analysis of the determinants of poverty dynamics provided insights into the key factors affecting household welfare, which indicated the possible areas where constraints to inclusiveness of economic growth may be found.

4.2. Constraints to Inclusive Growth

Despite the impressive poverty reduction between 1995/96 and 2003/04, the evidence presented in the previous section indicates that the benefits of economic growth were not uniformly distributed through society. To enhance the ability to make economic growth inclusive, barriers to inclusive growth must be identified. Based on the conceptual framework outlined in Chapter 1, this section looks at whether inclusiveness has been constrained by

- (1) lack of productive employment opportunities,
- (2) unequal access to opportunities, and/or
- (3) inadequate social safety nets.

4.2.1. Lack of Productive Employment Opportunities

Limited productive employment opportunities constitute a critical constraint to inclusiveness, particularly in rural areas where the majority of the poor reside. The availability of productive employment opportunities is a key to a household's ability to improve its livelihood. In Nepal, the labor force participation rate is relatively high and unemployment low by international standards, possibly because the poor have no social safety nets and must accept whatever work they can find. Further, the labor market improved slightly between 1995/96 and 2003/04 (Table 4.5).

The unemployment rate among the youth (15–24 years old) remained high at 6% in 2003/04 and is higher than the national average (CBS 2004). Of concern is the increase in the underemployment rate for all groups during this period.¹⁸ Compared with selected South Asian countries, labor productivity or gross domestic product (GDP) per worker in Nepal is the lowest in the region (Figure 4.3). In 2006, per worker GDP was estimated at about \$614 in 2000 terms, which was about two thirds of labor productivity in Bangladesh, one third of levels in India and Pakistan, and one fourth of levels in Bhutan and Sri Lanka. In addition, Nepal's labor productivity has not been rising over time, with 2006 levels the same as levels in 2001.

In urban areas, the participation rates for women were particularly low, with both unemployment and underemployment rates significantly higher for women than for men. These observations reflect the dearth of productive employment opportunities partly due to the decade-long conflict/civil war that negatively affected industries and factories in the country.

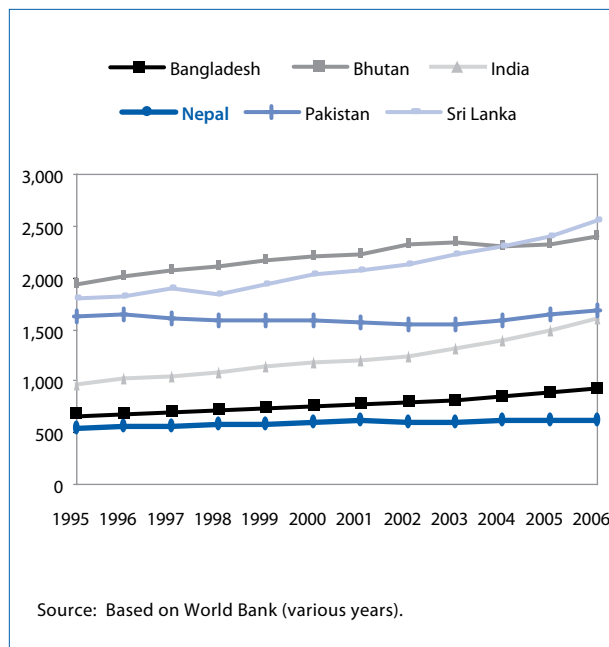
Employment opportunities in rural areas are particularly lacking due to sluggish growth in agriculture. In Nepal, the problem of underemployment, particularly in rural areas, can be explained, at least partly, by agriculture's sluggish

¹⁸ Underemployed is defined as working 20 or fewer hours per week (World Bank et al. 2006).

Table 4.5. Employment Trends (1995/96 and 2003/04, in %)

	Men		Women	
	1995/96	2003/04	1995/96	2003/04
Labor Force Participation Rate				
All	84.6	86.9	71.4	72.9
Urban	76.3	78.8	45.9	52.5
Rural	85.4	88.7	73.4	76.9
Poorest 40 Percent	87.2	89.7	74.2	77.7
Unemployment Rate				
All	5.4	4.1	3.8	3.8
Urban	9.5	7.0	17.4	13.5
Rural	5.1	3.6	3.2	2.5
Poorest 40 Percent	5.5	3.3	5.0	2.5
Underemployment Rate				
All	14.2	15.4	24.3	25.7
Urban	9.1	9.3	22.5	26.1
Rural	14.6	16.6	24.3	25.7
Poorest 40 Percent	13.3	16.3	22.6	24.1

Source: World Bank et al. (2006).

Figure 4.3. Labor Productivity in South Asia
(GDP in 2000 \$/Labor Force)

performance (see Chapter 3). Nevertheless, self-employment in agriculture, followed by agricultural wage employment, remains the country's most important source of household income (World Bank et al. 2006). Agriculture's performance is, therefore, a key to ensure inclusive growth.

In agriculture, land is the single most important productive asset. As discussed in detail in section 4.2.4, about 77% of Nepal's population owned land in 2003/04. Moreover, the size of landholdings varied significantly across regions, ethnicity/caste, and expenditure quintiles. Table 4.6 illustrates the importance of land size for agricultural performance. While land productivity is higher on small farms in terms of gross crop output and real profits per hectare, large farms perform considerably better in per worker terms because they use fewer workers per hectare. Small-scale farmers tend to be underemployed because of the greater number of people the land has to support.

Providing more productive employment opportunities, particularly to people who are engaged in subsistence or near-subsistence agriculture, the youth, people internally displaced by the conflict/civil war, and former People's Liberation Army members will be a challenge for Nepal in the coming years. Employment elasticity was estimated at 0.28 for enterprises in urban areas and 0.38 for those in rural areas. In other words, a 10% increase in gross revenues would increase the number of hired workers by 2.8% in urban and by 3.8% in rural areas. Hence, promoting productive employment through developing domestic entrepreneurship

Table 4.6. Land and Labor Productivity (2003/04)

	Small	Medium	Large	All
Average Gross Cultivated Area Per Hectare	0.95	2.45	5.90	1.81
Cropping Intensity (%)	80	181	178	180
Number of Workers Per Hectare	3.5	1.8	1.0	2.8
Gross Crop Output Per Hectare (NRs)	13,733	11,249	9,518	12,707
Real Profits Per Hectare (NRs)	10,707	8,495	7,427	9,841
Gross Crop Output Per Worker (NRs)	4,911	8,728	14,306	6,785
Real Profits Per Worker (NRs)	3,768	6,168	10,172	4,997

Source: World Bank et al. (2006).

by enhancing the access to local skills, capital, and technology may be a viable approach to inclusive growth.

High migration rates within and out of the country indicate lack of opportunities, particularly in rural areas. Given the limited employment opportunities in parts of the country, a relatively large percentage of workers seek employment elsewhere within Nepal. About 8% of adult men take jobs away from their usual place of residence (i.e., are “short-term migrants”) for their main economic activity.¹⁹ This figure rises to about 15% if all economic activity is included. The proportion of women who commute for work is negligible, however. For the commuters, non-agricultural unskilled wage employment provides the second largest source (about 27.6%) of primary economic activity whereas only about 7.2% of people who work in their usual place of residence take such jobs. Thus, commuting offers more opportunity than the local labor market for unskilled non-agricultural occupations. Although about half of the short-term migrants go to rural areas for work, they are increasingly drawn to urban areas (World Bank et al. 2006).

Both internal and international migration²⁰ increased significantly during the last decade. Although Nepal and India are the most common destinations for long-term migrants, recently, other

destinations include Malaysia and Qatar, Saudi Arabia, and other Middle Eastern countries, with Malaysia receiving the largest number of Nepali migrants beyond India.²¹ Table 4.7 shows that the rural Western hills and rural Eastern terai had the highest outflow rate of migrants—about 45% and 24%, respectively, of men aged 15 or over in 2003/04. A similar regional variation is observed for international migration alone. Further, these are the only two regions whose share in the country’s total poor population declined—by 28% and 9%, respectively—during 1995/96–2003/04 (Table 4.1). Lokshin, Bontch-Osmolovski, and Glinskaya (2007) indeed find that one fifth of the poverty reduction during this period can be attributed to work-related migration and remittances sent home. Migration thus offers a new source of employment opportunities for Nepali workers and a potential means to reduce poverty. However, opportunities for migration are not shared equally across the country and the populace—for example, the number of migrant women is still negligible (Table 4.7). The next subsection will specifically look at the issue of equality in accessing economic opportunities.

4.2.2. Unequal Access to Opportunities

Unequal access to agricultural inputs and opportunities to commercialize and diversify agricultural activities poses a constraint to inclusiveness. Unequal access to productive employment opportunities poses a constraint to poverty reduction and inclusive growth. As discussed in the previous subsection, the lack of

¹⁹ Working away from the usual place of residence implies working at a village development committee or municipality other than where the worker resides (World Bank et al. 2006).

²⁰ In the NLSS, “long-term migrants” are defined as remittance senders who would have lived in the household had they not migrated, i.e., spouses, children, grandchildren, parents, or sibling of remittance recipients (92% of all relations) (World Bank et al. 2006).

²¹ Department of Labour and Employment Promotion (2008) cited in MOF (various years).

**Table 4.7. Migrant Workers as a Proportion of the Population Aged 15 Years and Older
(1995/96 and 2003/04, %)**

	Men		Women		All	
	1995/96	2003/04	1995/96	2003/04	1995/96	2003/04
Total Migration						
Nepal	15.9	24.5	1.8	2.2	8.4	12.2
Kathmandu	10.6	7.4	1.9	1.2	6.4	4.2
Other Urban	9.6	19.5	2.8	3.9	6.1	11.4
Rural Western Hills	25.6	45.1	2.5	1.5	12.5	19.0
Rural Eastern Hills	9.3	19.8	1.6	2.9	5.3	10.6
Rural Western Terai	12.1	21.6	1.6	1.5	6.6	10.7
Rural Eastern Terai	17.5	24.1	1.4	2.1	9.3	12.1
International Migration						
Nepal	7.6	14.4	0.3	0.3	3.7	6.6
Kathmandu	1.8	2.5	0.5	0.5	1.1	1.5
Other Urban	2.4	9.1	0.4	0.6	1.3	4.7
Rural Western Hill	17.9	33.1	0.5	0.1	8.0	13.3
Rural Eastern Hill	1.7	6.7	0.0	0.2	0.8	3.2
Rural Western Terai	5.8	14.2	0.4	0.3	2.9	6.6
Rural Eastern Terai	6.9	14.5	0.3	0.4	3.6	6.8

Source: World Bank et al. (2006).

productive employment is partly caused by the poor performance of the agriculture sector. The three important determinants of agricultural performance are access to land and its size, access to inputs, and ability to commercialize and diversify agricultural activity. The data suggest that opportunities to improve agricultural productivity are unequally distributed. In Nepal, small landholdings and unequal access to irrigation pose a constraint to improving agricultural productivity for certain groups of the population, and will be discussed in more detail in section 4.2.4, on households' access to productive assets including land.

While access to inputs has improved, Figures 4.4 and 4.5 show a variation in access to inputs such as seeds and fertilizers across Nepal. Despite some improvement between 1995/96 and 2003/04, some households, particularly the Dalit and Hill Janajati, female-headed households, and lower expenditure quintiles, continue to have less access to improved seeds and fertilizers than do other households.

An important issue for Nepal's agriculture is the commercialization of agricultural activities.

**Figure 4.4. Use of Improved Seeds by Region, Ethnicity/Caste, Gender, and Expenditure Quintile
(1995/96 and 2003/04, %)**

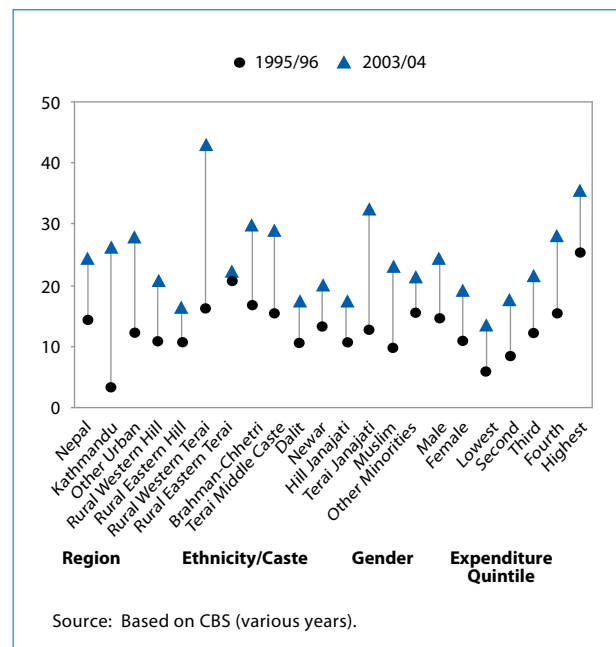


Figure 4.5. Use of Fertilizer by Region, Ethnicity/Caste, Gender, and Expenditure Quintile (1995/96 and 2003/04, %)

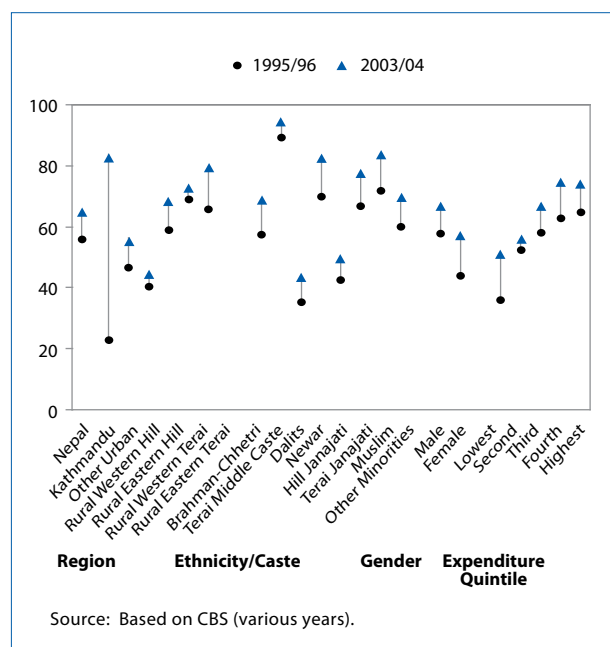
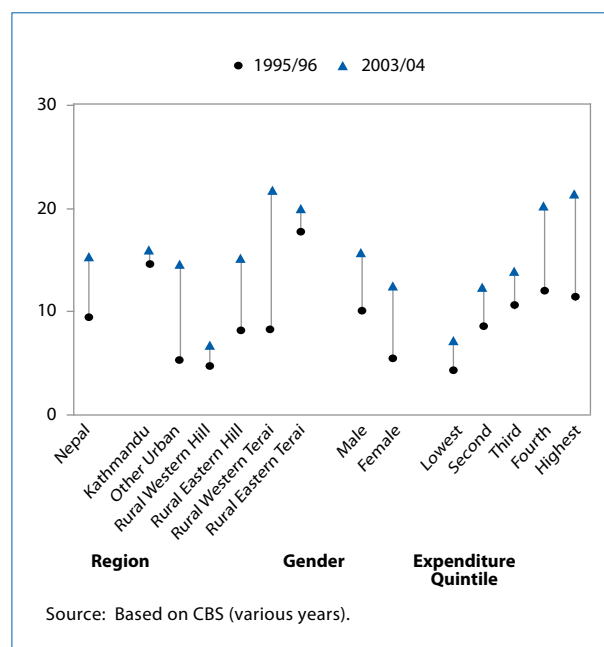


Figure 4.6. Share of Sales in Gross Output by Region, Gender, and Expenditure Quintile (1995/96 and 2003/04, %)



Although commercialization has increased in recent years, agriculture remains largely subsistence or semi-commercial in Nepal—only about 15% of gross output was sold in 2003/04 (Figure 4.6). Figure 4.6 also illustrates that ability to commercialize varies significantly among agricultural households. Households in the rural Western hills, the Dalit, and the lowest expenditure quintile households, in particular, face limited opportunities to sell their outputs. The rural Western hills was the area most affected by the recent conflict/civil war, and its households also have the least access to fertilizers (Figure 4.5), infrastructure such as roads (section 4.2.4, Figure 4.21), and irrigation (section 4.2.4, Table 4.21).

Diversification is also a challenge for Nepal's agriculture sector. Cereals continue to be the main agricultural product for many households. Brown and Kennedy (2005) argue that farmers have hesitated to produce primarily for the market due to the rudimentary infrastructure and high variability in prices. Their analysis also shows that the costs and benefits of developing markets have been unevenly distributed, with small landholders unable to capitalize on market opportunities and wealthier farmers engaging in input-intensive cash cropping.

The poor and other disadvantaged groups have fewer opportunities for non-agricultural employment. While self-employed agricultural activities still provide employment for many Nepali workers, there is a significant variation in occupations across the country (Table 4.8). Only about 9% of household heads in Kathmandu are engaged in agriculture (as self-employed and wage workers) while about 87% of people in the rural Eastern hills work in agriculture. Non-agricultural employment is primarily available in Kathmandu and other urban areas.

Dependence on agriculture also varies by ethnicity/caste and gender. The proportion of Dalit household heads who work in agriculture is lower than the national average, and, while the proportion of Muslim household heads who are self-employed in agriculture is lower than the national average, 25% of them work as wage earners in the agriculture sector. This may reflect their limited landownership vis-à-vis other ethnic/caste groups (see section 4.2.4, Table 4.21). Table 4.8 explicitly illustrates the greater dependence of female-headed households on agriculture, possibly due to the limited employment opportunities for women in the non-agriculture sector.

In per capita expenditure quintiles, about 68% of household heads in the lowest quintile are engaged in self-employed agricultural activities, whereas only about 49% of the highest quintile are so engaged. In addition, while agricultural wage employment provides an occupation for about 14% of household heads in the lowest quintile, less than 2% of the highest quintile are so employed. These

figures illustrate the greater dependence of poor households on agriculture for their livelihood. In contrast, a relatively large percentage of household heads in the highest quintile are engaged in non-agricultural self-employment and non-agricultural skilled employment compared with other quintile groups. This gap was even greater in 2003/04 than in 1995/96, reflecting the increasing rewards in

Table 4.8. Occupation Patterns of Household Heads (2003/04, %)

	Self-Employment				Wage-Employment		
	Agriculture	Manufacturing	Trade	Services	Agriculture	Skilled Non-agri.	Unskilled Non-agri.
NLSS Regions							
Kathmandu	8.6	10.5	15.4	8.4	0.4	22.7	34.1
Other Urban	32.1	10.7	12.0	8.8	1.8	8.0	26.7
Rural Western Hill	75.4	5.1	3.2	2.2	2.2	3.2	8.9
Rural Eastern Hill	83.6	3.2	1.9	1.4	3.0	1.3	5.6
Rural Western Terai	68.7	2.0	4.4	4.0	5.1	1.8	14.1
Rural Eastern Terai	61.1	3.5	4.4	2.8	17.9	1.2	9.0
Ethnicity/Caste							
Brahman-Chhetri	74.3	1.6	4.3	4.2	0.9	5.3	9.3
Terai Middle Caste	79.4	3.6	3.2	0.0	9.1	0.6	4.1
Dalit	51.0	16.8	1.2	2.5	7.2	0.0	21.4
Newar	44.7	8.9	14.3	5.1	2.2	10.4	14.3
Hill Janajati	78.4	3.6	2.6	1.2	2.8	1.2	10.3
Terai Janajati	70.4	1.2	4.3	4.7	8.9	2.2	8.4
Muslim	46.6	4.9	4.0	3.2	25.0	2.8	13.6
Other Minorities	51.3	4.7	6.8	4.2	15.6	3.2	14.2
Gender							
Male	60.9	5.1	5.2	3.9	7.2	3.9	13.8
Female	81.4	2.7	3.4	0.9	6.3	1.8	3.4
Per Capita Expenditure Quintile							
Lowest	68.3	4.2	1.1	1.6	14.0	0.4	10.3
Second	69.7	4.9	1.8	2.0	9.5	0.3	12.0
Third	69.0	3.9	4.6	2.2	6.7	2.1	11.5
Fourth	69.4	3.3	5.8	3.0	5.3	2.6	10.7
Highest	49.2	6.8	9.8	7.4	1.6	10.6	14.6
Nepal	64.6	4.6	4.9	3.4	7.0	3.5	11.9

Source: Based on CBS (various years).

these two sectors during this period (World Bank et al. 2006).

However, the agricultural labor market has tightened, resulting in an increase in agricultural wages between 1995/96 and 2003/04. This is the result of increased opportunities for temporary migration and easier commuting to urban centers, as well as the development of the rural non-farm sector, all of which may have lowered the agricultural labor supply in local labor markets (World Bank et al. 2006). Nevertheless, while agricultural and unskilled non-agricultural wages increased by about 25% and 20%, respectively, during 1995/96–2003/04, skilled professional wages increased by about 51% for people with 8–10 years of schooling and by about 250% for those with 11 or more years of schooling. Thus, despite the increase in agricultural wages, a significant increase in skill premia has widened wage differentials across occupations (Table 4.9). This may partly explain why the growth rate of per capita expenditure was greater toward the upper end of the expenditure distribution (Figure 4.1).

Opportunities to start and operate non-farm enterprises are limited for poor and disadvantaged groups. In Nepal, about 28% of households operated a non-farm enterprise in 2003/04, an increase from about 23% in 1995/96. However, the percentage of households with an enterprise as well as the change in the number of household enterprises during this period varied significantly between urban and rural areas and among income quintile groups. Figure 4.7 clearly illustrates that urban households are more likely to operate as an enterprise than are rural ones, and the percentage increase of households with an enterprise was greatest for the top quintile, but it declined during 1995/96–2003/04 among lower quintile groups in urban areas.

Among ethnic/caste groups, the Newar had the highest rate of operating a household enterprise, increasing by about 42% during 1995/96–2003/04. The Newar had the lowest poverty rate and the greatest increase in per capita expenditure during this period (Figure 4.1). The percentage of terai middle caste households that had an enterprise also increased significantly, while the percentage of Muslim households with an enterprise declined

sharply during 1995/96–2003/04. Figures 4.7 and 4.8 suggest that access to new business opportunities was not equal across households in Nepal. The main problems household enterprises faced seem to include a lack of demand and access to capital. The

Figure 4.7. Households with Enterprises, by Area and Income Quintile (1995/96 and 2003/04, %)

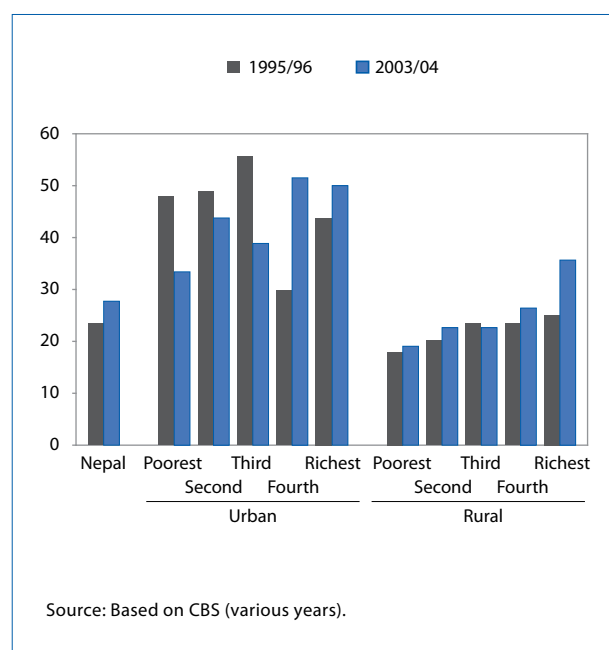


Figure 4.8. Households with Enterprises by Ethnicity/Caste (1995/96 and 2003/04, %)

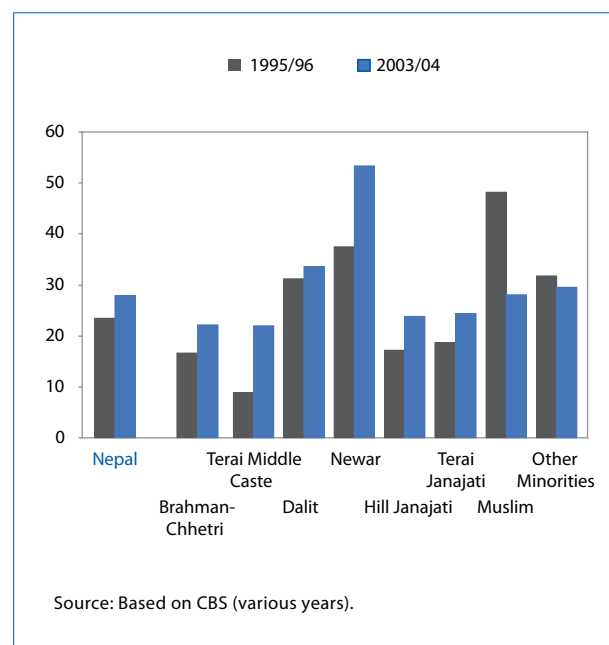


Table 4.9. Average Daily Wages (1995/96 and 2003/04, Real 1995/96 NRs)

	Agriculture			Unskilled Non-Agriculture			Skilled Non-Agriculture		
	1995/ 96	2003/ 04	Change (%)	1995/ 96	2003/ 04	Change (%)	1995/ 96	2003/ 04	Change (%)
Urban	42	58	38	98	92	-6	138	461	234
Rural	44	55	25	79	98	24	81	135	67
NLSS Region									
Kathmandu	—	—	—	103	83	-19	173	672	288
Other Urban	40	57	43	91	101	11	111	170	53
Rural Western Hill	49	54	10	75	91	21	72	111	54
Rural Eastern Hill	37	54	46	84	90	7	83	137	65
Rural Western Terai	50	63	26	81	94	16	97	126	30
Rural Eastern Terai	42	54	29	75	113	51	80	159	99
Education Level (years)									
Illiterate	43	52	21	73	83	14	—	—	—
Less than 5	53	61	15	82	99	21	—	—	—
5–7	44	65	48	94	99	5	—	—	—
8–10	45	63	40	86	108	26	75	113	51
11+	—	—	—	121	142	17	121	426	252
Gender									
Male	48	63	31	84	104	24	102	351	244
Female	39	47	21	59	54	-8	65	126	94
Nepal	44	55	25	81	97	20	94	295	214

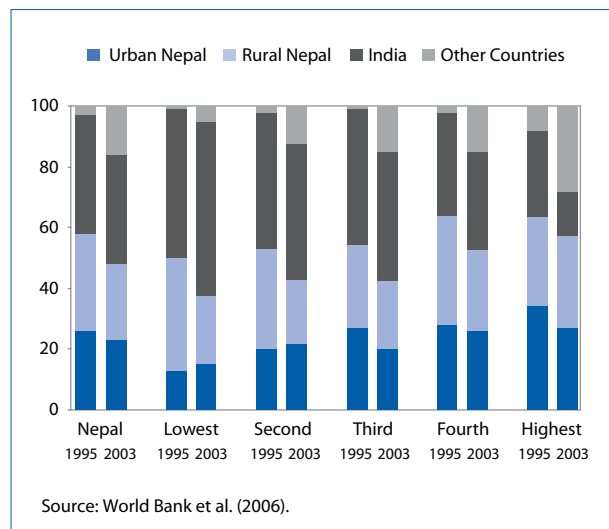
— = insufficient observations.

Source: World Bank et al. (2006).

issue of equality in accessing credit will be discussed in detail in section 4.2.4.

Poor and disadvantaged groups have less opportunities to migrate to countries other than India. Migration has become a growing source of income for Nepali households in recent years (as previously noted). Although a relatively large percentage of migrants still migrate internally and to India, the proportion of migrants going elsewhere increased steadily during 1995/96–2003/04 (Figure 4.9). The change is most apparent for the highest expenditure quintile households—28% of their migrants went abroad other than to India in 2003/04, up from 8% in 1995/96.

Figure 4.9. Destination of Migrants by Expenditure Quintile (1995/96 and 2003/04, %)



Similar trends can be observed in remittance flows during this period. Table 4.10 reports the share of households that received remittances in 1995/96 and 2003/04 by characteristics of the recipient households. The proportion of households that received remittances increased from about 23% in 1995/96 to about 32% in 2003/04. The most noticeable increase was observed in remittance inflows from abroad other than India—from about 1% of remittances in 1995/96 to 6% in 2003/04. The increase was greatest among the highest expenditure quintile, as in the case of migration (Figure 4.9). Certain groups of households, therefore, seem to have better opportunities to migrate abroad than other groups. However, India still provides an alternative place to earn income for households whose heads are illiterate, Dalit, or Muslim, who tend to fare worse in Nepal. This suggests that

relatively limited employment opportunities at home prompt these households search for jobs outside the country (Lokshin, Bontsch-Osmolovski, and Glinskaya 2007).

The amount of remittances received by a household varied significantly depending on the education level and ethnicity/caste of the household head (Table 4.11). While households with relatively less educated heads were more likely to receive remittances (Table 4.10), the amount received in per capita terms was greater for households with more educated heads. In terms of ethnicity/caste, Brahman-Chhetri and Hill Janajati tended to receive larger remittances than the average. Furthermore, households in the highest expenditure quintile received significantly larger remittances than did other expenditure groups.

Table 4.10. Households Receiving Remittances (1995/96 and 2003/04, %)

	Urban Nepal		Rural Nepal		India		Other Abroad		Any Remittances	
	1995/ 96	2003/ 04	1995/ 96	2003/ 04	1995/ 96	2003/ 04	1995/ 96	2003/ 04	1995/ 96	2003/ 04
Education Level of the Head										
Illiterate	7	8	8	9	12	16	0	6	25	37
Primary	5	8	6	8	7	9	1	6	19	28
Secondary	6	8	9	5	7	5	2	7	23	24
High Secondary	7	6	7	9	5	4	1	6	20	22
Ethnicity/Caste										
Brahman-Chhetri	6	9	8	10	11	14	0	5	24	36
Terai Middle Caste	3	5	10	10	11	16	0	5	24	34
Dalit	6	5	6	6	15	20	1	5	27	35
Newar	8	9	7	8	3	3	0	5	17	22
Hill Janajati	6	9	5	8	10	7	2	10	22	32
Terai Janajati	3	9	10	6	2	7	0	2	14	23
Muslim	7	7	8	6	13	16	1	7	26	33
Other Minorities	7	5	7	9	10	13	0	4	24	30
Per Capita Expenditure Quintile										
Lowest	3	5	7	6	10	17	0	2	18	29
Second	5	6	8	5	11	12	0	3	22	25
Third	7	7	6	8	12	14	0	6	23	33
Fourth	7	10	8	10	9	13	1	6	25	36
Highest	9	9	8	11	8	6	2	11	25	33
Nepal	6	8	7	8	10	12	1	6	23	32

Source: World Bank et al. (2006, Table 4.5a).

Table 4.11. Average Per Capita Remittances Received (1995/96 and 2003/04, real 1995/96 NRs)

	Urban Nepal		Rural Nepal		India		Other Abroad		Any Remittances	
	1995/ 96	2003/ 04	1995/ 96	2003/ 04	1995/ 96	2003/ 04	1995/ 96	2003/ 04	1995/ 96	2003/ 04
Education Level of the Head										
Illiterate	3,376	3,287	1,259	1,986	2,835	2,951	—	12,634	2,853	4,484
Primary	3,049	3,795	1,064	3,283	1,799	3,815	—	13,468	4,238	5,921
Secondary	—	2,614	—	—	—	—	—	22,098	5,636	8,715
High Secondary	5,675	4,229	2,834	4,936	—	5,287	—	23,970	4,319	10,323
Ethnicity/Caste										
Brahman-Chhetri	6,163	5,417	2,037	3,861	3,342	3,937	—	16,336	3,827	6,449
Terai Middle Caste	—	—	—	—	—	—	—	—	—	4,351
Dalit	—	—	—	—	2,070	2,238	—	—	1,780	4,683
Newar	3,286	2,695	—	4,669	—	—	—	—	3,789	5,750
Hill Janajati	2,482	2,150	1,220	2,072	3,183	5,673	—	16,157	6,852	7,588
Terai Janajati	—	—	—	—	—	—	—	—	1,138	2,577
Muslim	—	—	—	—	—	2,193	—	—	2,183	4,012
Other Minorities	2,356	2,971	763	1,963	1,616	2,350	—	16,327	1,758	4,311
Per Capita Expenditure Quintile										
Lowest	—	792	694	564	1,100	1,250	—	—	1,028	1,405
Second	1,454	1,399	431	1,779	1,710	2,411	—	—	1,390	2,910
Third	1,872	2,137	536	1,186	2,019	3,398	—	10,545	1,756	4,087
Fourth	3,270	3,335	1,385	2,271	2,508	3,633	—	10,695	2,766	4,637
Highest	6,508	6,439	2,900	5,467	5,570	8,198	32,624	23,288	7,749	13,373
Nepal	3,637	3,459	1,360	2,756	2,595	3,297	26,941	15,574	3,427	5,713

— = data not available.

Source: World Bank et al. (2006, Table 4.5b).

The observations made so far indicate unequal access to economic opportunities in Nepal as well as abroad. According to the conceptual framework described in Chapter 1, possible causes underlying unequal access to opportunities are weak human capabilities and an uneven playing field. The following subsections examine whether some groups of people face limited access to opportunities due to these factors.

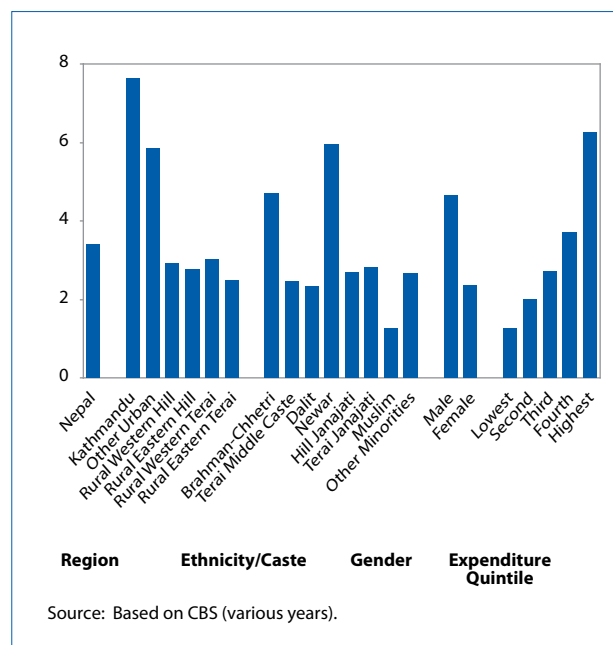
4.2.3. Weak Human Capabilities

A possible reason for the unequal access to opportunities is that certain groups of people have weaker human capabilities than others, partly due to unequal access to education; health; and/or other social services, including drinking water and sanitation.

School enrollment rates have significantly improved in recent years, but access to secondary education and vocational training is equitable and a critical constraint to inclusiveness. The empirical results presented earlier suggest that education played a key role in the movement out of poverty (Table 4.4) and that the 2% of the population with higher education earned very large premiums in 2003/04. As a result, per capita expenditure grew by an average 76% for highly educated people between 1995/96 and 2003/04, while it grew by about 42% for the population as a whole (World Bank et al. 2006).

Figure 4.10 clearly illustrates the great disparity in education level among the working-age population. People residing in Kathmandu or in other urban areas, Brahman-Chhetri and Newar,

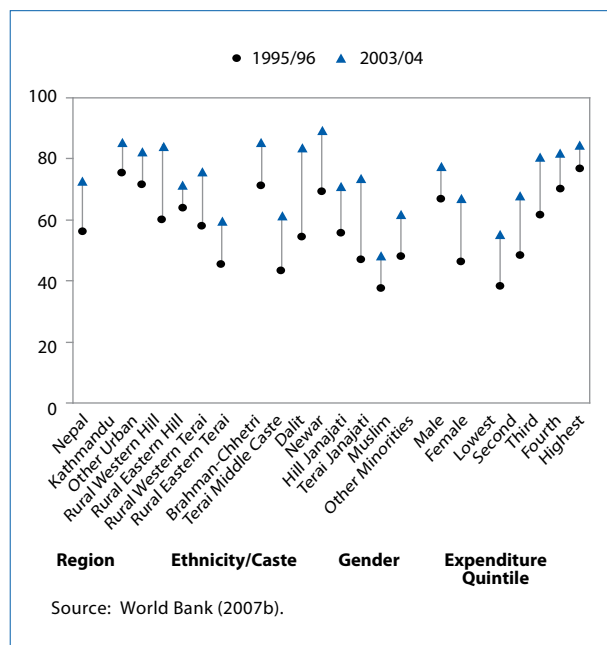
Figure 4.10. Years of Schooling by Region, Ethnicity/Caste, Gender, and Expenditure Quintile for People Aged 15 and Above (2003/04)



men, and the highest expenditure group tend to have more schooling. Individuals aged 15 or above in the highest expenditure quintile averaged 6.3 years of schooling, while those in the lowest quintile group had only 1.3 years. These differentials are at least partly responsible for unequal access to economic opportunities. To redress this issue, children, the future labor force, must have equal access to schooling.

Nepal made significant progress in primary school enrollment between 1995/96 and 2003/04, particularly for children in the rural Western hill and terai, Dalits, Terai Janajatis, girls, and lower expenditure groups (Figure 4.11). These pro-poor trends are the result of government policies, private sector expansion, and increases in household demand for education (World Bank 2007a). Other data sources—the Nepal Demographic and Health Surveys (NDHS) data (Macro 2007) and Flash I 2007–08 Report (Department of Education 2007)—also indicate improvements in primary

Figure 4.11. Primary School Net Enrollment Rates by Region, Ethnicity/Caste, Gender, and Expenditure Quintile (1995/06 and 2003/04, %)



and secondary school net attendance rates.²² Nevertheless, a disparity remains in primary school enrollment rates among population groups. For example, (1) the net primary school enrollment rate for the poorest quintile was 16.6 percentage points below the national average in 2003/04 (Figure 4.11); (2) girls' enrollment is still below boys'; and (3) Muslims had the lowest net enrollment rate in 1995/96 and the smallest increase in the rate during 1995/96–2003/04.

Improvements in secondary school enrollment were less impressive (Figures 4.12 and 4.13). The progress was particularly limited for upper secondary school enrollment rates. For lower secondary school, the greatest increase in enrollment rates during 1995/96–2003/04 was among children living in Kathmandu and children of the Brahman-Chhetri, Newar, and higher expenditure quintile groups (i.e., relatively advantaged segments of society). This widened the gap in accessing lower secondary education across the country.

²² Based on the 1996 and 2006 NDHS, the net attendance ratios increased from 69% to 87% for primary school, and from 22% to 47% for secondary school (Macro 2007). Data from the Flash I 2007–08 report (Department of Education 2007) indicate the net enrollment rate for primary education increased even further, to 89%, in 2007.

The factors underlying unequal access to education pertain to both the supply and demand sides. The supply side has several issues. First, while the share of public funding captured by the poorest

40% of households increased from about 20% in 1995/96 to about 36% in 2003/04, most of benefits in secondary and tertiary education still go to the richer households (Table 4.12). Second, private

Figure 4.12. Lower Secondary School Net Enrollment Rates by Region, Ethnicity/Caste, Gender, and Expenditure Quintile (1995/96 and 2003/04, %)

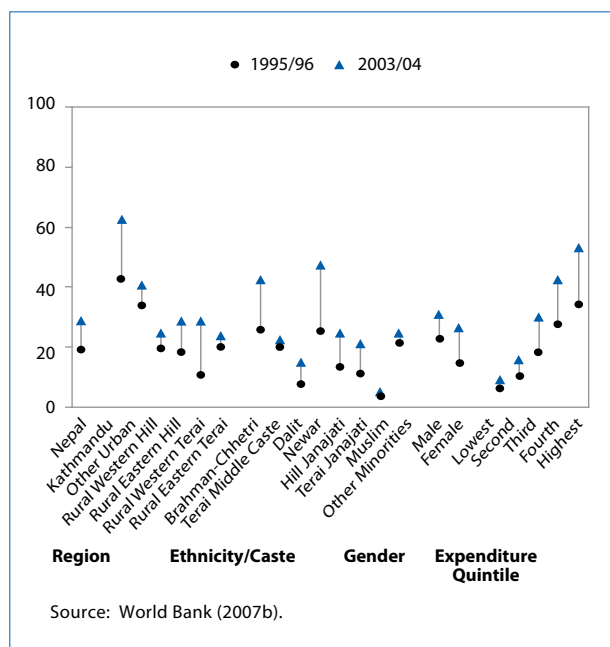


Figure 4.13. Upper Secondary School Net Enrollment Rates by Region, Ethnicity/Caste, Gender, and Expenditure Quintile (1995/96 and 2003/04, %)

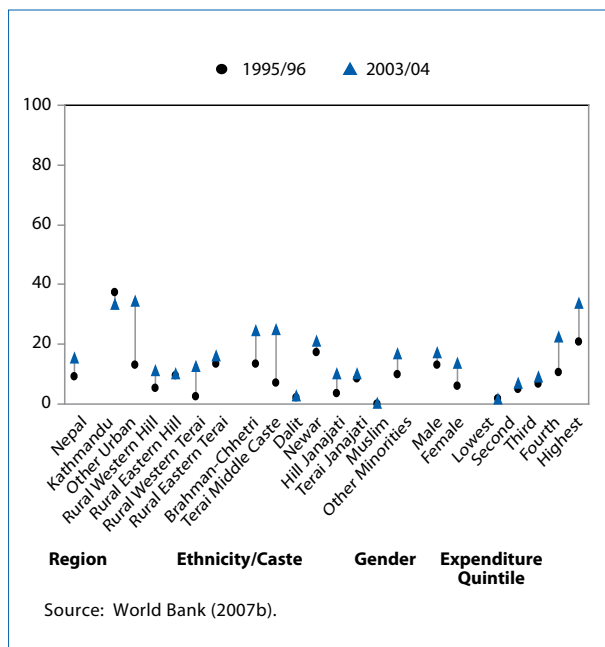


Table 4.12. Benefit Incidence of Public Expenditure on Education in Nepal (1995/96 and 2003/04, % of total spending)

Year Level	Per Capita Expenditure Quintile					Total
	Lowest	Second	Third	Fourth	Highest	
1995/96						
Primary	18	19	23	23	17	100
Secondary	6	10	17	26	41	100
Tertiary	0	4	0	11	86	100
All Levels	11	14	17	21	37	100
Per Capita Expenditure	8	12	16	21	44	100
2003/04						
Primary	22	26	23	20	8	100
Secondary	7	14	21	33	26	100
Tertiary	2	1	5	6	86	100
All Levels	16	20	21	22	21	100
Per Capita Expenditure	7	10	13	19	51	100

Source: World Bank et al. (2006).

schools tend to be located in urban areas or small towns, are patronized by children from the upper end of the expenditure distribution, and are thought to deliver better education than public schools. Thus, access to education, particularly at the secondary and tertiary levels, remains inequitable.

For the demand side, Table 4.13 summarizes the reasons given for children 6–15 years old not attending school. The main reason for not attending

school (cited by 23% of respondents) was the high cost of education. A relatively large share of children, about 16%, did not go to school because they had to help at home; 22% of children did not attend school because their parents did not want them to; and about 18% of children were unwilling to go to school. In contrast, the absence of and distance to school and a perception of education being not useful were not identified as main reasons for not going to school. Thus, barriers to children

Table 4.13. Reasons for Not Attending School (2003/04, %)

	School Not Present/ Too Far	Too Expensive	Had To Help at Home	Education Not Useful	Parents Did Not Want	Not Willing to Attend	Other Reasons
NLSS Region							
Kathmandu	0.00	27.21	10.82	0.00	14.24	41.39	6.33
Other Urban	0.00	38.20	6.48	1.84	21.19	10.43	21.86
Rural Western Hill	6.18	6.42	29.63	2.43	20.90	18.00	16.44
Rural Eastern Hill	14.63	13.44	23.11	0.00	18.19	14.68	15.95
Rural Western Terai	0.00	11.01	13.25	7.02	20.63	20.66	27.42
Rural Eastern Terai	3.14	33.06	10.14	0.28	24.22	18.43	10.72
Ethnicity/Caste							
Brahman-Chhetri	8.84	9.97	21.01	1.25	21.45	21.76	15.72
Terai Middle Caste	17.36	13.51	18.07	0.00	15.98	24.69	10.38
Dalit	8.84	12.42	16.99	0.00	21.49	15.45	24.80
Newar	6.11	13.10	23.90	0.00	25.84	18.77	12.28
Hill Janajati	14.02	13.18	26.33	0.00	15.69	13.47	17.31
Terai Janajati	0.00	9.19	17.71	0.00	29.33	17.16	26.60
Muslims	0.84	36.21	8.50	0.64	29.66	12.07	12.09
Other Minorities	3.80	30.63	11.48	1.05	20.68	20.43	11.94
Gender							
Male	6.91	26.29	8.11	0.31	18.71	21.52	18.17
Female	5.01	21.02	19.70	1.84	23.42	15.64	13.38
Per Capita Expenditure Quintile							
Lowest	7.64	22.85	13.04	1.15	20.60	21.43	13.30
Second	4.37	25.13	18.98	2.45	21.39	12.55	15.14
Third	3.73	22.03	18.94	0.00	16.66	16.47	22.18
Fourth	2.76	14.84	17.75	0.00	29.21	21.89	13.56
Highest	4.45	26.34	12.67	2.84	35.95	4.02	13.73
Nepal	5.64	22.78	15.83	1.33	21.85	17.60	14.97

NLSS = Nepal Living Standards Surveys.

Note: Based on individuals aged 6–15.

Source: Based on CBS (various years).

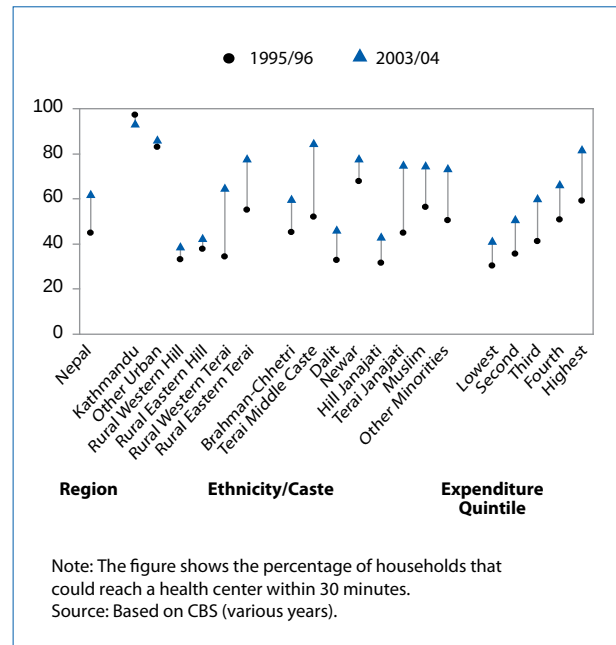
attending school are evident on both the supply and the demand sides.

Reasons for not attending school varied across groups. While the absence of school played a minor role in preventing children from attending school in the country as a whole, almost 15% of children not attending school in the rural Eastern hills had no school to attend. In Kathmandu, about 42% of children not going to school responded that they were unwilling to attend. This may be due to the relatively greater availability of jobs, particularly for older children, in Kathmandu. The high cost of education seemed to pose a constraint especially for Muslims and other minorities' children. And a substantially higher proportion of girls did not go to school because they had to help at home than boys.

Access to technical education and vocational training is also critical for ensuring equal access to economic opportunities. In Nepal, the Council for Technical Education and Vocational Training, established in 1989 under the Technical and Vocational Act of 1988, is responsible for managing a limited number of public technical schools across the country. There is an urgent need for cost-effective skill development schemes for the wider population, particularly for people who have little access to the existing technical education or vocational training opportunities (ADB 2006a).

While significant progress was generally made in access to health services and hence in health outcomes, continued efforts are needed, particularly in the provision of maternal health care, to promote equitable access to health services, but health may not be a critical constraint to inclusiveness at present. Another important determinant of human capabilities is health status. Despite the decade-long conflict/civil war, Nepal has made significant progress in health outcomes in recent years, including reduced infant and child mortality rates and increased life expectancy at birth by more than 5 years (World Bank 2007a). These improvements are a result of higher household incomes, the success of focused programs such as immunization and programs to control diarrhea and acute respiratory illnesses and tuberculosis, more health facilities and better road networks, improved

Figure 4.14. Access to Health Center by Region, Ethnicity/Caste, and Expenditure Quintile (1995/96 and 2003/04, %)



access to water and sanitation, increased education levels and health awareness, and declining fertility rates (World Bank et al. 2006).

During the last decade, the proportion of households that could access a health facility within 30 minutes increased from about 45% in 1995/96 to about 62% in 2003/04 (Figure 4.14). According to the 1995/96 and 2003/04 NLSS data, access to immunization, which plays a key role in reducing infant mortality, also improved during this period (Figure 4.15). The progress was particularly significant for groups with relatively low rates in 1995/96.²³

Significant progress was also observed in the proportion of women who received prenatal checkups, which rose from about 26% in 1995/96 to 57% 2003/04 (Figure 4.16). However, groups of women who had better access to prenatal checkups in 1995/96 had the greatest increase during 1995/96–2003/04. Disparity is also widening in access to medical assistance for birth deliveries (Figure 4.17).

²³ Similar trends can be observed from 1996, 2001, and 2006 NDHS data.

Figure 4.15. Percentage of Fully Immunized Children Aged 5 or Younger by Region, Ethnicity/Caste, Gender, and Expenditure Quintile (1995/96 and 2003/04, %)

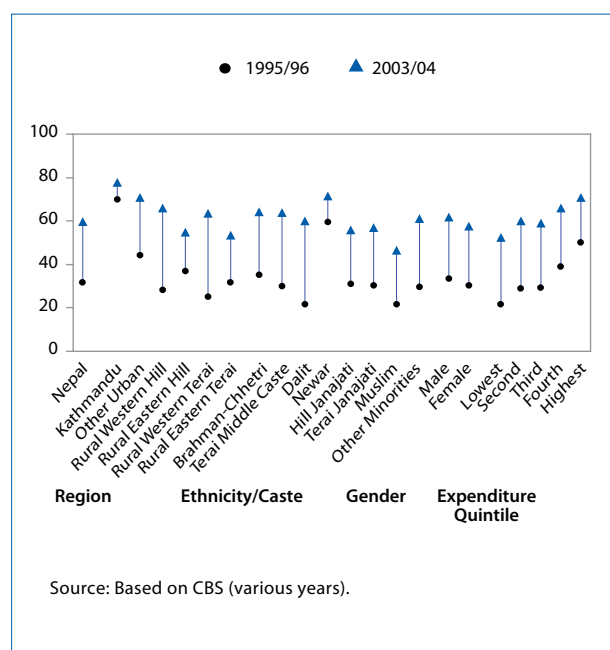


Figure 4.17. Percentage of Women Who Had Last Delivery Assisted by Medical Staff by Region, Ethnicity/Caste, and Expenditure Quintile (1995/96 and 2003/04, %)

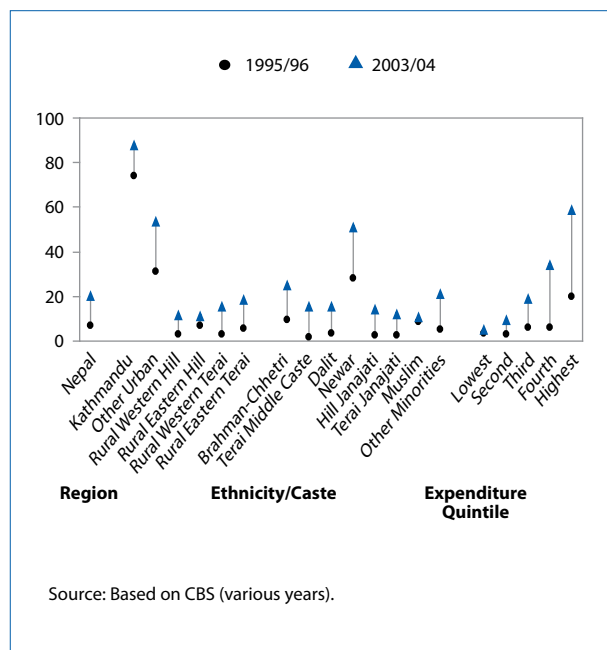
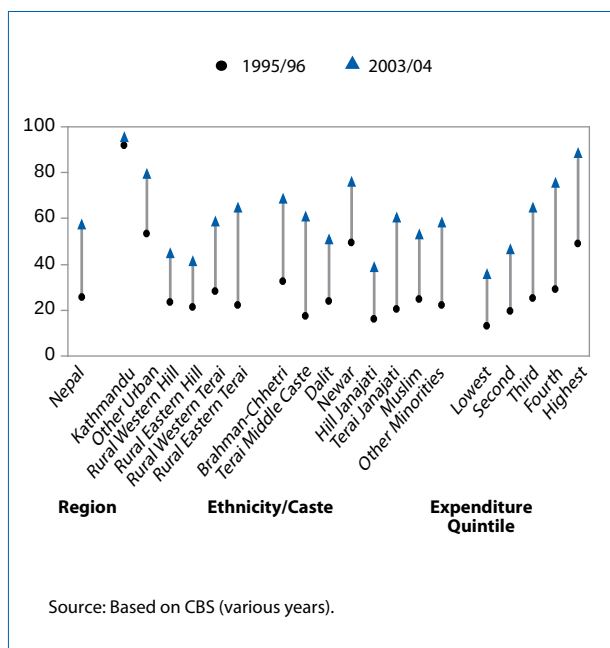


Figure 4.16. Percentage of Women Who had Prenatal Consultation by Region, Ethnicity/Caste, and Expenditure Quintile (1995/96 and 2003/04, %)



There is less variation in the proportion of people seeking medical consultation than in the case of prenatal checkups or assisted deliveries (Figure 4.18). However, the type of medical practitioners and facilities visited differ greatly among expenditure quintile groups (Table 4.14). While a larger share of consultations took place in private institutions in 2003/04, the share of consultations with doctors was greater for wealthier households.

The gap in access to certain types of health services among different segments of society has persisted; however, because health outcomes have improved in recent years, health may not constitute a critical constraint to inclusive growth at present.

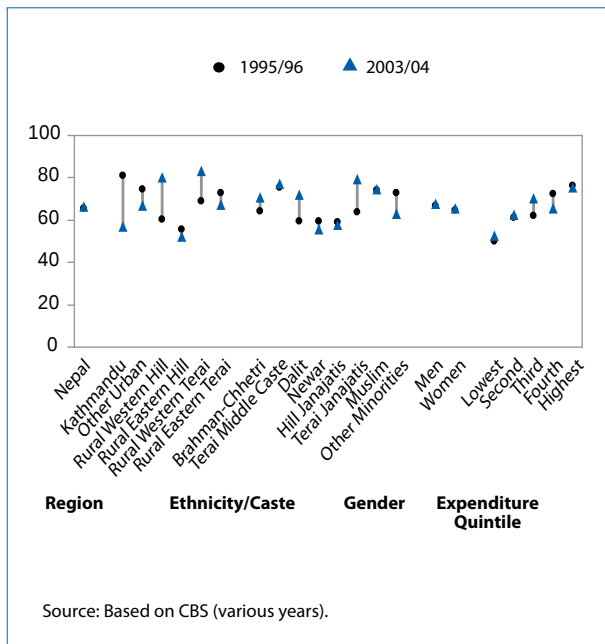
Access to safe drinking water and sanitation systems remains unequal, but may not constitute a critical constraint to inclusiveness. By improving people's health, access to safe drinking water and sanitation helps to enhance human capabilities. Households' access to water and sanitation improved somewhat during

Table 4.14. Distribution of Health Consultations by Practitioner (2003/04, %)

Group	Government			Private		
	Doctor	Paramedic	Others	Doctor	Paramedic	Other
Ethnicity/Caste						
Brahman-Chhetri	20.75	27.41	1.00	25.46	21.89	3.49
Terai Middle Caste	12.37	30.30	0.00	21.67	32.67	2.99
Dalits	13.48	35.03	2.12	19.05	26.50	3.81
Newar	18.91	18.98	2.56	27.26	26.39	5.90
Hill Janajati	16.54	34.28	0.82	17.74	22.41	8.21
Terai Janajati	13.05	21.30	0.00	13.20	49.71	2.73
Muslims	18.62	25.81	0.00	23.76	30.07	1.74
Other Minorities	16.60	20.85	0.64	22.09	32.42	7.41
Per Capita Expenditure Quintile						
Lowest	6.49	51.51	1.79	6.81	22.83	10.56
Second	11.61	34.33	0.25	10.75	37.03	6.04
Third	17.03	32.68	0.66	17.78	27.95	3.90
Fourth	17.95	21.41	0.83	21.64	33.60	4.57
Highest	25.24	10.42	1.06	38.16	21.54	3.58
Nepal	17.45	26.26	0.87	21.94	28.42	5.06

Source: Based on CBS (various years).

Figure 4.18. Percentage of People Seeking Medical Consultation by Region, Ethnicity/Caste, Gender, and Expenditure Quintile (1995/96 and 2003/04, %)



Source: Based on CBS (various years).

1995/96–2003/04.²⁴ About 44% of households had access to piped water in 2003/04, up from about 33% in 1995/96 (Figure 4.19). The proportion of households with access to a sanitary system also rose, from 9% to 12%, during the same period (Figure 4.20). However, the accessibility varied significantly across regions, ethnicity/caste, and per capita expenditure quintiles. For example, almost 90% of households in Kathmandu had access to piped water in 2003/04, but only 14% and 19% of households in the rural Western and Eastern terai did so. Similarly, while about 84% of Newar households had access to piped water, a limited number of terai middle caste, terai Janajati, and Muslim households had access. In contrast, Dalit households' access to piped water improved between 1995/96 and 2003/04. As expected, the higher expenditure quintile groups had the best access to piped water.

Accessibility to sanitary systems also varies. While almost all households in Kathmandu had access to sanitary facilities in 2003/04, less than 10% of rural households had such access

²⁴ Sanitary system refers to the liquid wastes connected to underground drains, open drains, or oak pits in the NLSS data.

Figure 4.19. Access to Piped Water by Region, Ethnicity/Caste, and Expenditure Quintile (1995/96 and 2003/04, %)

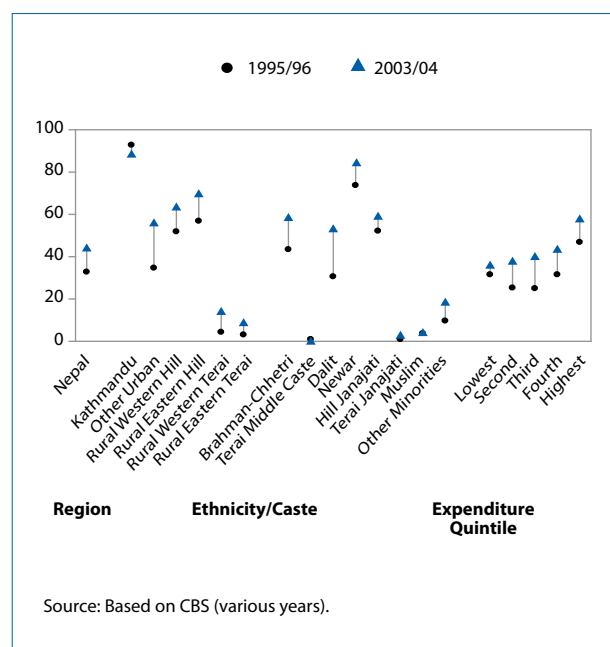
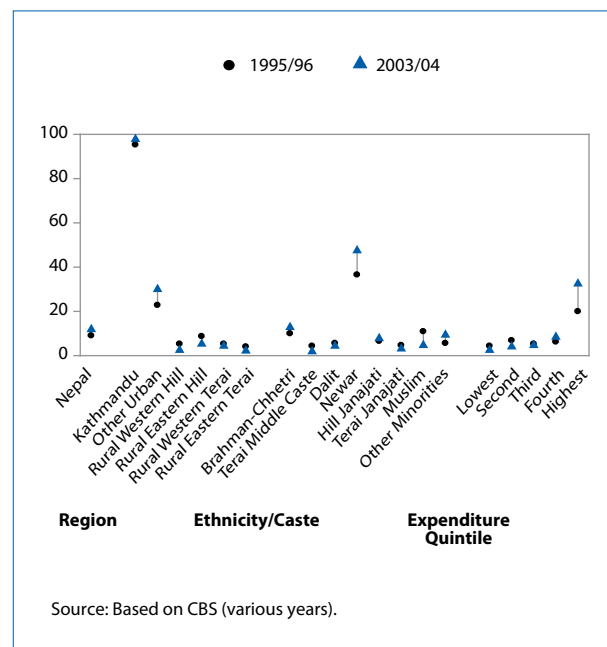


Figure 4.20. Access to Sanitary System by Region, Ethnicity/Caste, and Expenditure Quintile (1995/96 and 2003/04, %)



(Figure 4.20). In addition, the differences among expenditure quintiles and ethnic/caste groups were significant. In fact, much of the improvement in accessibility during 1995/96–2003/04 took place among households in the top expenditure quintile and the Newar ethnic group.

Access to safe drinking water and sanitation systems remains unequal and further efforts are needed to improve households' access in general. However, this may not constitute a critical constraint to inclusiveness given that health outcomes have improved recently. Thus, lack of access to safe drinking water and sanitation may not be a significant impediment to improving households' capabilities.

4.2.4. Uneven Playing Field

Unequal access to opportunities may also be caused by inequality in accessing infrastructure and productive assets such as credit and land. For growth to be inclusive, all segments of society must have an equal chance to enjoy opportunities arising from economic growth.

Great efforts have been made to improve the provision of roads, particularly in rural areas; however, relatively well-off households have benefited more than the poor from the improvement and much room remains for improving connectivity for all segments of society. In Nepal, access to roads is key to household welfare. Roads ease households' access to basic services such as education and health and can improve access to economic opportunities. Moreover, roads can allow migration for work, which may provide new employment opportunities or an additional source of income to smoothen household consumption and cope with risks.

Thus, Nepal has been improving its road network during the last few decades. District and rural roads (in comparison with highway, feeder roads, or urban roads) were expanded the most, with an annual growth rate of about 11% during 1995–2002 (World Bank et al. 2006). However, roads are not distributed uniformly across the country (Table 4.15). The Central Region enjoys the highest road density. The unequal provision of roads is most pronounced among the ecological

Table 4.15. Distribution of Roads

Area	Total Roads (km)	People per km of Road (no.)	Road Density (km/100 km ²)
Region			
Eastern	3,481	1,535	12
Central	6,665	1,205	25
Western	2,955	1,547	10
Mid-Western	2,215	1,360	5
Far-Western	1,518	1,444	8
Ecological Belt			
Mountain	742	2,275	1
Hill	7,590	1,351	12
Terai	8,504	1,318	25

km = kilometer, km² = square kilometer.

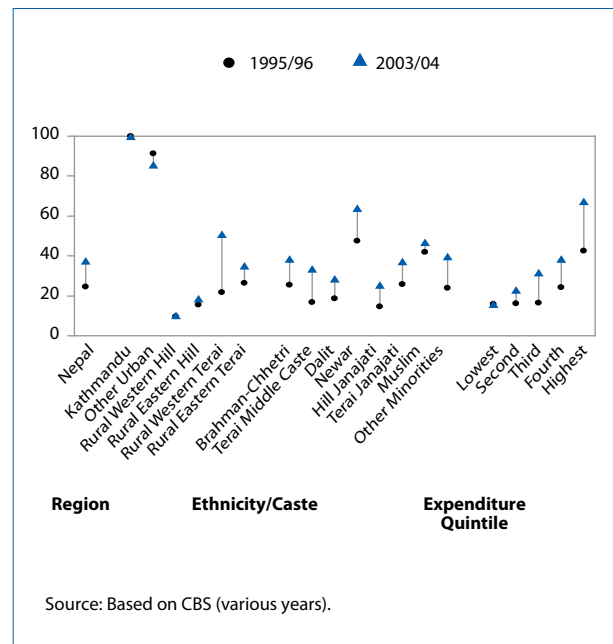
Source: Department of Roads (n.d.).

belts—mountain areas have limited road lengths, population coverage, and density.

The share of households that could access a paved road within 30 minutes increased from 24% to 37% during 1995/96–2003/04 (Figure 4.21). Given the already high level of accessibility in urban areas, much of the improvement took place in rural areas. The government exerted great efforts to improve infrastructure, including roads and other facilities, in underserved districts during 1995/96–2003/04. The road expansion resulted in relatively pro-poor improvements in overall accessibility (World Bank et al. 2006).

Nevertheless, connectivity still needs much improvement, especially in the mountainous and hilly areas. While the majority of households in urban areas could access a paved road within 30 minutes, in the rural Western and Eastern hills only 10% and 18% of households, respectively, had such access in 2003/04 (Figure 4.21). In terms of ethnicity/caste, the disadvantaged groups, particularly the Dalit and Hill Janajati, appear to have more limited access to roads than do other ethnic groups. Among expenditure groups, the highest quintile had the best access to roads; they also had the greatest improvement in accessibility during 1995/96–2003/04. Thus, despite efforts to extend the provision of roads in rural areas during 1995/96–2003/04, relatively well-off households benefited more from the improvement than did other households.

Figure 4.21. Access to Paved Road by Region, Ethnicity/Caste, and Expenditure Quintile (1995/96 and 2003/04, %)



Unequal access to markets constitutes a critical constraint to inclusiveness as it limits economic opportunities. While the majority of households in any region or expenditure quintile group could reach a primary school within 30 minutes, access to health centers and markets remains unequal despite the improvement during 1995/96–2003/04. Households in rural mountain and hill areas, the Dalit and Hill Janajati, and relatively

lower expenditure quintile households tend to have limited access (Figures 4.14 and 4.22 and Table 4.16). While the time taken to reach a primary school or health center does not vary significantly, the difference in access to paved roads or market centers is considerable.

Access to electricity is most limited in rural areas, which constitutes a critical constraint to inclusive growth. Access to electricity needs improvement. Despite the country's hydro-electric resources and some improved accessibility

during 1995/96–2003/04, about two thirds of the households did not have access to electricity in 2003/04. As Figure 4.23 clearly illustrates, access to electricity is more limited in rural than in urban areas—while almost all households in Kathmandu had access to electricity, only about 25% of those who reside in the rural Eastern hills had access in 2003/04. The disparity in accessibility is also visible among expenditure quintile groups. About 76% of households in the highest quintile group had access to electricity in 2003/04, whereas less than 10% of households

Figure 4.22. Access to Market by Region, Ethnicity/Caste, and Expenditure Quintile (1995/96 and 2003/04, %)

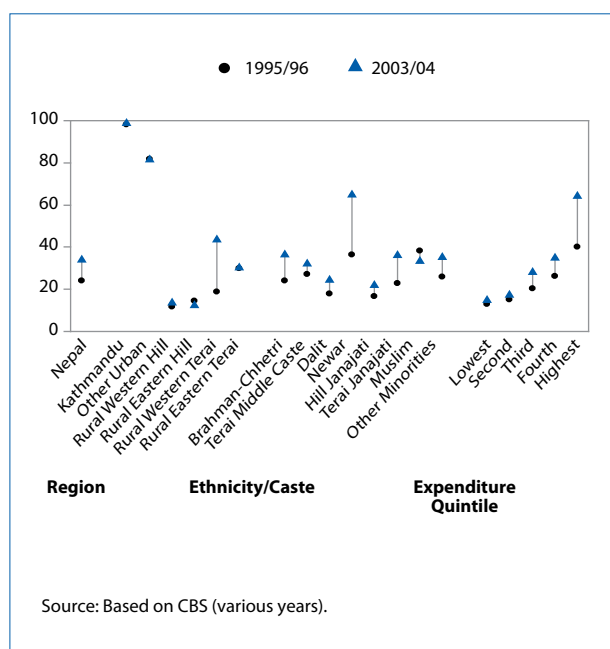


Figure 4.23. Access to Electricity by Region and Expenditure Quintile (1995/96 and 2003/04, %)

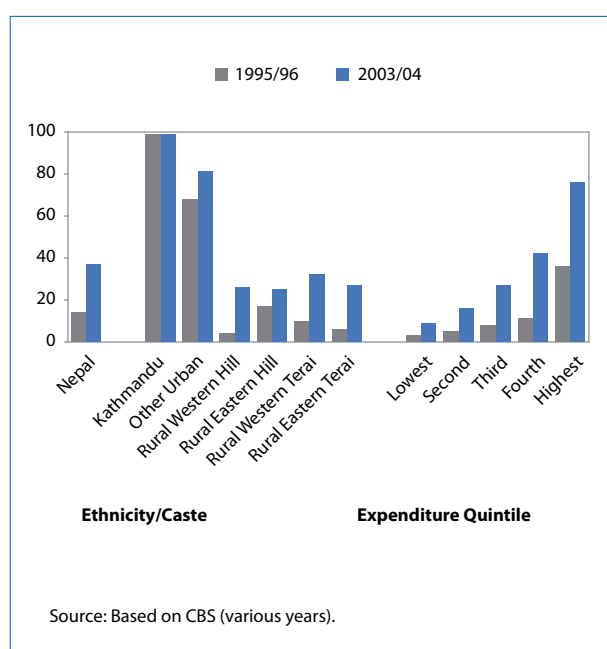


Table 4.16. Time to Access to Selected Facilities by Expenditure Quintile (2003/04, in mean hours)

Expenditure Quintile	School	Health Center	Paved Road	Market Center
Lowest	0.38	1.07	5.59	3.64
Second	0.30	0.88	5.50	2.72
Third	0.30	0.77	4.92	2.31
Fourth	0.29	0.69	4.23	2.02
Highest	0.18	0.45	1.71	1.05

Source: World Bank et al. (2006).

in the lowest quintile group had access in the same year.

Unequal access to formal financial services may be a critical constraint to equal access to economic opportunities, especially given the higher interest rates charged in the informal sector. Accessibility to financial services plays a key role in ensuring equal access to economic opportunities. Access to financial services enables poor households to smoothen consumption and manage risks. As Table 4.17 illustrates, about 47% of loans taken in 2003/04 were for household consumption, and the share of loans for household consumption was particularly large for the poorest expenditure quintile group—about 58%. This shows the importance of the poor being able to borrow money to cope with their consumption needs. The proportion of loans for business or farm use is generally low in Nepal, though it tends to be higher toward the upper end of the expenditure distribution.

An important question is whether the financial sector has been serving the needs of Nepalese people, including the poor. The country's financial sector has become deeper, the number of financial

intermediaries has increased, and types of intermediaries have broadened rapidly in the past few decades. Nevertheless, access to financial services remains limited and has actually been deteriorating in recent years (Ferrari, Jaffrin, and Shrestha 2007). Figure 4.24 illustrates changes in the distribution of

Figure 4.24. Source of All-Loans by Expenditure Quintile (1995/96 and 2003/04, %)

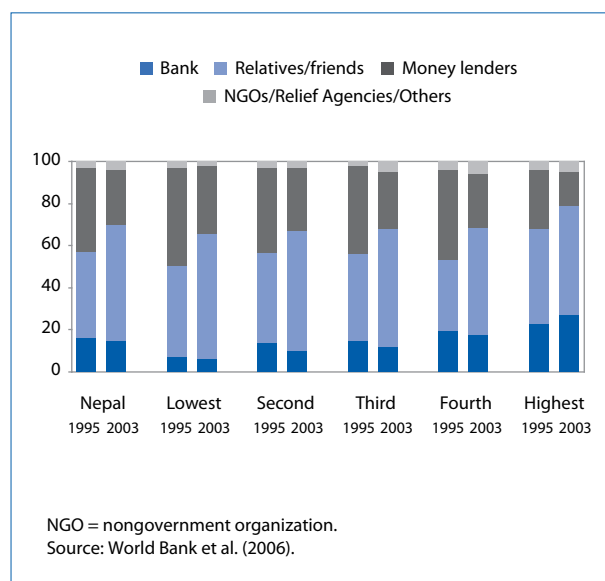


Table 4.17. Purpose of Loans by Regions and Expenditure Quintile (2003/04, %)

Table 1: Per Capita Expenditure by Region and Expenditure Quintile (2005/6-7, %)				
Region/ Quintile	Business/Farm Use	Personal Use		Total
		Household Consumption	Other Personal Use	
NLSS Region				
Kathmandu	34.6	29.9	35.6	100
Other Urban	37.4	35.2	27.4	100
Rural Western Hill	19.1	60.9	20.0	100
Rural Eastern Hill	25.4	45.0	29.6	100
Rural Western Terai	28.1	44.5	27.4	100
Rural Eastern Terai	21.4	43.1	35.5	100
Per Capita Expenditure Quintile				
Poorest	15.1	57.8	27.2	100
Second	21.7	51.8	26.6	100
Third	22.1	49.0	28.9	100
Fourth	27.8	41.1	31.1	100
Richest	33.0	34.8	32.2	100
Nepal	24.2	46.5	29.3	100

Source: CBS (various years).

loans by source per expenditure quintile for all loans in 1995/96 and 2003/04.

Despite the development of the financial sector, the percentage of loans from banks declined from 1995/96 to 2003/04, while that of loans from relatives and friends increased significantly for all expenditure quintiles. In 2003/04, about 55% of all loans came from relatives and friends. Underlying the trend is the lack of adequate savings institutions to provide alternate opportunities for investment and resource pooling in rural areas (World Bank et al. 2006). The figure also suggests that relatively well-off households take a high share of loans from the formal sector, partly because poor households are often unable to provide the required collateral. As interest rates are generally higher in the informal than in the formal sector (Table 4.18), the poor are more likely to face a greater burden when repaying the loans.

Ferrari, Jaffrin, and Shrestha (2007) point to three reasons for the limited access and use of formal financial services in Nepal. First, outreach by formal financial institutions declined, mainly because roughly one third of the branches of the two state-owned commercial banks closed, largely as a result of the conflict/civil war (World Bank et al. 2006). Since 1995, and particularly since 1999, the average number of inhabitants per branch rose from 36,100 to 60,000. It is, therefore, not surprising that the percentage of households that could access a commercial bank within 30 minutes declined from 12% in 1995/96 to 3% in 2003/04 in the rural Western hills, where the conflict/civil war started. Coverage by area is significantly skewed toward the

Central Region that includes Kathmandu (Table 4.19). While the average time to access a commercial bank was about 0.35 hours in urban areas in 2003/04, it was about 3.5 hours in rural areas in the same year (World Bank et al. 2006).

Second, borrowers, even among the highest expenditure quintile, tend to prefer informal lenders over formal lenders because of the rapid service delivery provided by the informal subsector. Banks require the same documents and information from small businesses as they do from large corporations. Because small businesses often do not have the in-house capacity to meet such requirements, they may need to hire outsiders, which adds cost and time for the businesses and the banks.

Finally, and importantly, government efforts to improve access to financial services have addressed the symptoms of limited access but not the root causes. For example, the government started requiring banks to direct a percentage of their loans to low-income households and small businesses. However, the government failed to take into account the fact that profitable lending to small businesses and low-income households requires a high degree of efficiency, and that the operation of microfinance with extensive outreach requires high levels of technical capacity. Consequently, the priority lending policy resulted in generating excess liquidity among microfinance institutions without significantly increasing their outreach. Further, Nepal's banking system has a very high rate of nonperforming loans (Ferrari, Jaffrin, and Shrestha 2007; World Bank et al. 2006).

Table 4.18. Interest Rates by Source (1995/96 and 2003/04, %)

Source	Rural			Urban		
	1995/96	2003/04	Change	1995/96	2003/04	Change
Formal						
Agricultural Banks	17	18	3	22	16	-25
Commercial Banks	17	16	-7	24	12	-51
Informal						
Relative or Friend	30	30	0	22	21	-3
Moneylender	37	31	-16	32	20	-38

Source: World Bank et al. (2006).

Table 4.19
Inhabitants per Bank Branch by Region (2005)

Region	No. of Inhabitants
Eastern	70,954
Central	49,617
Western	57,444
Mid Western	110,714
Far Western	100,654

Source: Ferrari, Jaffrin, and Shrestha (2007).

Foreign remittances are a missed opportunity for increasing access to formal financial services in Nepal. One of the challenges Nepal faces is to channel remittances into productive sectors of the economy. The bulk of foreign remittances is used for consumption (about 35%) and to repay loans (about 21%)—loans most likely incurred by workers to migrate abroad (Table 4.20). Only about 6% was saved in a financial institution. As expected, relatively well-off households and urban households tend to allocate a smaller share of remittances to consumption and repayment of loans, and a larger share to savings. Ferrari, Jaffrin, and Shrestha (2007) thus regard foreign remittances as a missed opportunity for increasing access to formal financial services in Nepal.

One of the main reasons for the unproductive use of remittances is that a large share of foreign remittances comes into Nepal through informal channels, most commonly through family and

friends. Since 2001, when money transfer operators were allowed to enter Nepal's remittance market, formal remittance payment services have increased and improved considerably (Ferrari, Jaffrin, and Shrestha 2007). Nevertheless, the use of formal channels for money transfers remains limited. Ferrari, Jaffrin, and Shrestha list three possible underlying factors. First, limited familiarity with the formal financial sector among migrants and their families is partly responsible for the widespread use of informal channels. Thus, the financial literacy of migrants and their families, particularly those from low-income and rural households, needs to be increased. Second, India is the largest source of migrant remittances and, given its proximity and ease of entry, migrants tend to move relatively frequently between India and Nepal, with little need to transfer money. Third, legal and regulatory constraints in the India–Nepal corridor hamper money transfer operations. Given that bringing remittances into the formal financial sector will offer considerable benefits for Nepal and its migrants, efforts should be made to formalize and facilitate remittance inflows to the country.

More than land ownership, the limited size and poor quality (in terms of access to irrigation in particular) of land are critical constraints to inclusiveness. Land is one of Nepal's main productive assets, as the majority of the poor are engaged in the agriculture sector

Table 4.20. Use of Remittances by Area and Expenditure Quintile (2006, %)

Area and Quintile	Savings	Educa- tion	Health	Consump- tion	Build Home	Invest in Agricul- ture	Live- stock	Repay Loan	Other	Total
Area										
Urban	19.5	26.3	8.5	22.0	9.3	2.5	0.0	2.5	9.3	100
Rural	4.7	14.5	7.6	37.0	7.3	0.8	1.3	23.1	3.9	100
Per Capita Expenditure Quintile										
Lowest	3.7	21.7	7.3	39.4	3.4	3.0	5.0	16.6	0.0	100
Second	0.0	6.0	10.4	46.7	6.2	0.0	0.0	26.4	4.3	100
Third	5.2	19.3	3.4	33.4	6.4	0.0	0.0	32.3	0.0	100
Fourth	19.0	18.2	1.4	23.3	12.0	0.0	0.0	15.1	11.1	100
Highest	12.4	19.0	15.3	20.6	13.5	2.1	0.0	5.6	11.4	100
Nepal	6.4	15.9	7.7	35.2	7.5	1.0	1.1	20.7	4.6	100

Source: Ferrari, Jaffrin, and Shrestha (2007).

for their livelihood. Equality in accessing land is thus important for enhancing the inclusiveness of economic growth. In Nepal, land ownership is also a broad indicator of socioeconomic status. Land titles are, for example, perceived to be required for obtaining a citizenship certificate or for accessing a number of productive services (World Bank et al. 2006).

About 77% of Nepali households owned land in 2003/04 (Table 4.21). Kathmandu residents, Newars, and people in the highest expenditure quintile had a relatively low share of land, perhaps because they tend to be less engaged in agricultural activities. However, an unequal distribution of land is evident in the size of landholdings. While average

landholdings declined by about 24% from 1.04 hectares in 1995/96 to 0.79 hectares in 2003/04, the reduction rate was highest among the poorest expenditure quintile group. As a result, in 2003/04, the average size of land owned by the poorest expenditure quintile was less than half that owned by the richest quintile. However, the relationship between land ownership and poverty is complex and poverty is not limited to marginal and small landholders (Deraniyagala 2005).

Lorenz curves for landholdings also confirm a relatively unequal distribution of land (Figure 4.25), although the land Gini dropped during this period. Also, inequality in landholdings is greater than that in expenditure (compare Tables 4.2 and 4.22) and

Table 4.21. Land Ownership and Access to Irrigation (1995/96 and 2003/04)

Group	Land Ownership (%)		Average Land Area (hectare)		Access to Irrigation (%)		Share of Irrigated Land (%)	
	1995/96	2003/04	1995/96	2003/04	1995/96	2003/04	1995/96	2003/04
NLSS Region								
Kathmandu	20.93	18.75	0.85	0.38	59.14	46.11	50.38	40.87
Other Urban	49.95	54.11	1.18	0.80	43.11	62.97	33.13	49.85
Rural Western Hill	94.51	93.51	0.91	0.65	56.80	58.51	24.84	26.15
Rural Eastern Hill	93.32	92.76	0.91	0.78	52.55	59.79	24.69	33.81
Rural Western Terai	89.02	87.44	1.29	0.92	52.59	68.35	43.72	61.29
Rural Eastern Terai	69.19	67.05	1.17	0.88	39.27	68.81	32.39	60.17
Ethnicity/Caste								
Brahman-Chhetri	90.61	86.30	1.11	0.84	62.31	74.36	33.34	47.44
Terai Middle Caste	84.73	86.22	1.21	1.20	31.55	60.66	22.07	45.82
Dalit	81.80	82.86	0.57	0.42	31.18	45.94	18.25	29.58
Newar	71.36	57.33	0.75	0.57	64.13	63.81	40.65	44.50
Hill Janajati	91.57	85.04	0.88	0.70	45.83	47.49	22.01	27.58
Terai Janajati	79.36	79.82	1.59	1.32	60.51	81.67	50.54	71.55
Muslim	60.99	60.40	1.30	0.80	33.33	65.49	22.73	57.10
Other Minorities	67.47	62.65	1.07	0.78	38.24	63.55	29.18	50.57
Per Capita Consumption Quintile								
Lowest	82.86	80.65	0.96	0.50	46.86	46.72	20.45	26.47
Second	83.77	79.61	0.92	0.69	46.97	55.46	27.94	35.67
Third	82.28	79.13	0.89	0.69	49.08	62.78	29.90	41.89
Fourth	83.43	82.63	1.13	0.87	50.85	74.95	31.73	54.55
Highest	78.96	64.80	1.22	1.12	56.46	70.38	36.68	54.81
Nepal	82.08	76.78	1.04	0.79	50.43	62.95	29.89	43.57

Note: Land area and share of irrigated land are the means of people who owned land.
Source: Based on CBS (various years).

Figure 4.25. Lorenz Curves for Land Holdings (1995/96 and 2003/04)

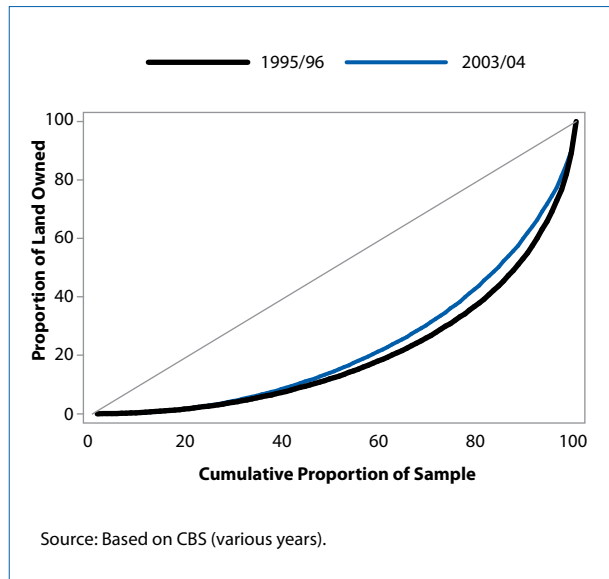
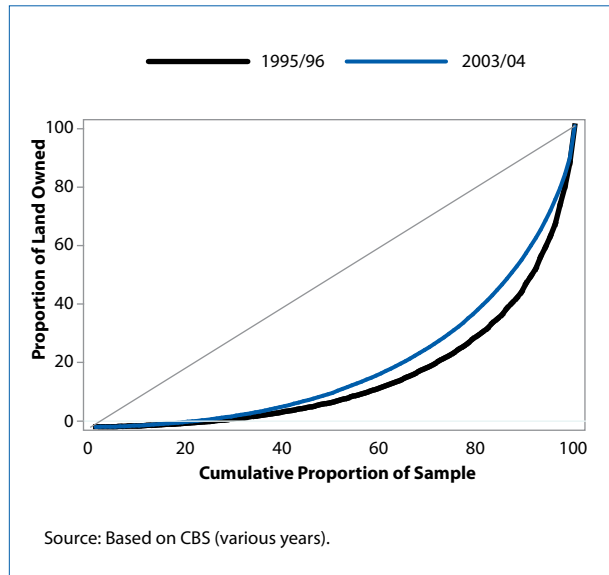


Figure 4.26. Lorenz Curves for Irrigated Land (1995/96 and 2003/04)



is even greater in irrigated land (compare Figures 4.25 and 4.26). While the share of households with access to irrigation increased significantly, from 50% in 1995/96 to 63% in 2003/04 (Table 4.21), the greatest increase was among the wealthier expenditure quintiles. The proportion of households with access to irrigated land actually remained the same for the poorest quintile. The share of irrigated land in the total land owned also increased for

Table 4.22. Decomposition of Land Inequality by Ethnicity/Caste and Geography (1995/96 and 2003/04, %)

	GE (0)	GE (1)	GE (2)	Gini
Land				
1995/96	70.1	67.5	142.7	58.4
2003/04	57.4	52.3	93.5	52.8
Irrigated Land				
1995/96	81.7	79.8	166.6	63.3
2003/04	63.4	62.7	120.9	57.1

Note: "GE" refers to generalized entropy indexes, which are commonly used to measure inequality. The higher the value, the greater the inequality.

Source: Based on CBS (various years).

all expenditure quintiles, but, again, households in the upper end of the expenditure distribution benefited most.

Given that rural poverty is increasingly concentrated among small-scale farmers and agricultural laborers (World Bank et al. 2006), it is important to improve access to land and to irrigation for small-scale farmers in order to ensure inclusive economic growth.

4.2.5. Inadequate Social Safety Nets

Inadequate social safety nets constitute a critical constraint in Nepal. Inadequate social safety nets can also constrain inclusive economic growth. The importance of social safety nets cannot be overemphasized in countries with deep-rooted traditional exclusion of certain segments of society. One way of examining the adequacy of Nepal's social safety nets is to compare the provision with that of other countries using an internationally comparable social protection index (SPI)—a summary indicator of the overall level of social protection activities in a country (ADB 2006e, 2008c). The SPI is derived from four components: (1) social protection expenditures, (2) social protection coverage, (3) social protection targeting, and (4) social protection impact on incomes of the poor.²⁵ Table 4.23 reports the overall SPI ranking and that of each of the four individual components of SPI for Nepal, Asia

²⁵ For the detailed methodology of the SPI construction, see ADB (2008c).

(average values for 31 countries in the Asia and Pacific region), and other South Asian countries.

Nepal has a relatively low SPI ranking—24th out of 31 countries overall. In South Asia, Nepal ranks higher than Bhutan and Pakistan but below other countries. Nepal also scores below the Asian average for all four SPI components in Table 4.23. Total expenditure on social protection was about 2.3% of GDP in 2002/03, or about \$5.5 per capita. These expenditures include the contributions from national and international nongovernment organizations (NGOs), which play an important role in social protection activities in Nepal. The relatively small share of social protection expenditure in GDP indicates the country's limited financial capabilities. Yet almost half of total social protection expenditure is for social insurance, which tends to be confined to the public and formal sectors and thus excludes the great majority of the population, particularly the poor. About 30% of social protection expenditure was for microcredit, while expenditure on social assistance, labor market programs, and child protection accounted for about 20% (ADB 2006e).

While the coverage of social safety nets varies across programs, the overall rate was only 18% of key target groups, such as the unemployed, elderly, poor, and disabled. The programs providing the highest coverage rates are those that have been developed in recent years as part of the government's major objective of poverty alleviation, and include

microfinance, food for work, and educational assistance (ADB 2006e). Nonetheless, only 35% of the poor are estimated to be receiving some form of social protection assistance. The majority of the beneficiaries among the poor were recipients of microcredit loans, without which, social protection assistance to the poor would be confined to a few people (ADB 2006e). The impact of social protection is likely to have been limited given that per capita social protection expenditure was only about 7% of the national poverty line per capita income.

Nepal's efforts at implementing social inclusion and targeted programs have increased in recent years in response to the recognition of the importance of inclusion in Nepal's Poverty Reduction Strategy Paper and Tenth Five Year Plan. To eliminate the prevailing regional, ethnicity/caste-based, and other inequalities, the current Three Year Interim Plan (2007/08–2009/10) focuses on inclusive and targeted programs to reduce the gap between the available opportunities and access (MOF various years). The two types of targeted programs are those aimed at (1) geographical areas, and (2) groups of people. The programs cover women, Dalits, indigenous peoples, Madheshis, communities in remote areas, the extremely poor, and small-scale farmers. The budget allocated for the targeted programs increased from NRs2,140 million in 2002/03 to NRs4,740 million in 2006/07. However, only about 77% of the allocated budget was actually spent (MOF various years). Although the share of

Table 4.23. Social Protection Index

Country	HDI Ranking	SPI Ranking	SPI	SP Expenditure (% of GDP)	SP Coverage (%)	Distribution Effect of SP (%) ^a	Impact of SP on Income (%) ^b
Nepal	30	24	0.19	2.3	18	35	7
Asia	NA	NA	0.36	4.0	35	57	23
Bangladesh	29	17	0.33	5.3	24	53	24
Bhutan	28	26	0.17	1.4	17	30	12
India	22	10	0.46	4.0	33	100	26
Maldives	12	21	0.28	1.5	22	74	8
Pakistan	27	30	0.07	1.6	7	8	3
Sri Lanka	11	9	0.47	5.7	41	85	26

NA = not applicable, HDI = human development index, SP = social protection, SPI = social protection index.

Notes: a. % of the poor receiving some social protection.

b. Per capita social protection expenditure as % of the national poverty line.

Source: ADB (2008c).

the targeted programs in the total budget allocation is gradually increasing (e.g., from 2.6% in 2002/03 to 3.1% in 2006/07), it is still inadequate given the severity of the problems the targeted population is experiencing (IMF 2007).

The Poverty Alleviation Fund (PAF) is one of the targeted programs. It was established under the Poverty Alleviation Fund Ordinance 2060 and is operating as an autonomous institution through the Poverty Alleviation Fund Act 2064. The PAF adopted a demand-led community-based approach to poverty alleviation with the full participation of poor communities in preparing, implementing, and managing the projects by forming and institutionalizing community organizations. The PAF's social inclusion strategy includes having (1) targeted beneficiaries—poor women, Dalit, and Janajati; (2) at least 50% of the community organizations be women's organizations; (3) at least 80% of the community organizations' members comprising targeted beneficiaries; and (4) the officers (chairperson, secretary, and treasurer) of the community organizations drawn from Dalit, Janajati, and women (IMF 2007). The PAF's major components include such activities as social mobilization, income generation, small-scale community infrastructure development, and capacity building. Local government organizations, private sector organizations, and NGOs partner with community organizations to provide necessary support. Since 2004/05, the PAF has implemented pilot programs in 6 districts (Darchula, Kapilvastu, Mugu, Pyuthan, Ramechhap, and Siraha). The PAF was expanded to 40 districts as of 2007/08, based on the success of the pilot program (IMF 2007, MOF various years).

During the Tenth Five Year Plan period, important progress was made in improving the Poverty Monitoring and Analysis System. For example, two important surveys, the NLSS and NDHS were completed. To streamline and strengthen district-level monitoring and evaluation, the task of institutionalizing the District Poverty Monitoring and Analysis System was also initiated during the Tenth Five Year Plan Period (MOF various years). Despite progress, there is a wide scope for improving the provision of social safety nets in

Nepal to ensure the inclusiveness of economic growth.

4.3. Root Causes of the Constraints

The previous section identified the following constraints to the inclusiveness of Nepal's economic growth:

- lack of productive employment opportunities, particularly in rural areas, partly due to the sluggish performance of the agriculture sector;
- unequal access to opportunities to improve agricultural productivity; to engage in non-agricultural activities; and to migrate abroad, especially to countries other than India—due mainly to unequal (1) access to education and skill development; (2) provision of infrastructure including roads, irrigation, and electricity; and (3) access to productive assets such as land and credit; and
- inadequate social safety nets.

Ascertaining the possible root causes of the constraints can help policy makers formulate effective measures to address them.

4.3.1. Exclusion

Exclusion—social, geographic, and economic—is one of the main root causes of all the critical constraints to inclusive growth. Nepal's geographic, ethnic, and linguistic diversity as well as the Hindu caste system contribute to exclusion. The three main dimensions of exclusion are social (caste, ethnicity, religion, and gender), geography, and economy (income poverty). To ensure equal access to opportunities and public services as well as an even playing field for all segments of society, exclusion needs to be properly addressed.

As illustrated in the previous section, traditionally excluded groups have attained improved access in areas such as primary school net enrollment rates (Figure 4.11) and child immunization (Figure 4.15). In addition, discrimination against disadvantaged groups, measured as lower returns to their human and physical assets, declined during 1995/96–2003/04. This implies that the observed increase in

inequality has been driven mostly by the increasing returns to assets and, to some degree, by faster accumulation of productive assets by advantaged ethnic/caste groups. World Bank et al. (2006) suggested that the past exclusion and discrimination is partly responsible for the lack of or limited human capital and productive assets among disadvantaged groups. Hence, improvements in their access to social services, infrastructure, and productive assets will be a key to enhanced inclusiveness.

In the case of public service delivery, a possible reason for unequal access to social services is the low representation of excluded groups among service providers. In education, for example, the percentage of female teachers has increased at all

levels in community schools (Figure 4.27) but the proportion of female teachers at secondary levels remains low. A more disappointing picture is that the percentage of teachers from excluded groups, such as Dalit and Janajati, is very low (Table 4.24). Even at the primary school level, the share of Dalit, Janajati, and disabled teachers is only about 20%.

The Technical Review of Education (cited in ADB 2006b) found a positive correlation between the presence of Dalit and Janajati teachers and the number of students enrolled from the corresponding groups. The same review records that most teachers in the schools surveyed belong to the high caste Brahmin-Chhetri groups. Also, the school management committees are largely dominated by male Brahmin-Chhetri (ADB 2006b). Similarly, most implementers of development programs and projects, whether of line agencies, local bodies, or NGOs, are Brahmin-Chhetri (Pradhan and Shrestha 2005).

Nepal's Constitution and the Civil Rights Act of 1955 prohibit discrimination on the grounds of "religion, race, sex, caste, tribe, ideological conviction or any of these." However, enforcement is lax and laws aimed at protecting people from discrimination have been weakly implemented. Poor implementation of the laws is, at least partly, attributable to deep-rooted values and discriminatory attitudes. Hence a key challenge is to change the mindset of people and formal and informal mechanisms that perpetuate discrimination (World Bank and DFID 2006).

Excluded groups currently lack fair representation in sociopolitical networks and decision-making institutions at all levels. Their greater representation is certainly needed at all levels of

Figure 4.27. Female Teachers in Community Schools (2004–2007, %)

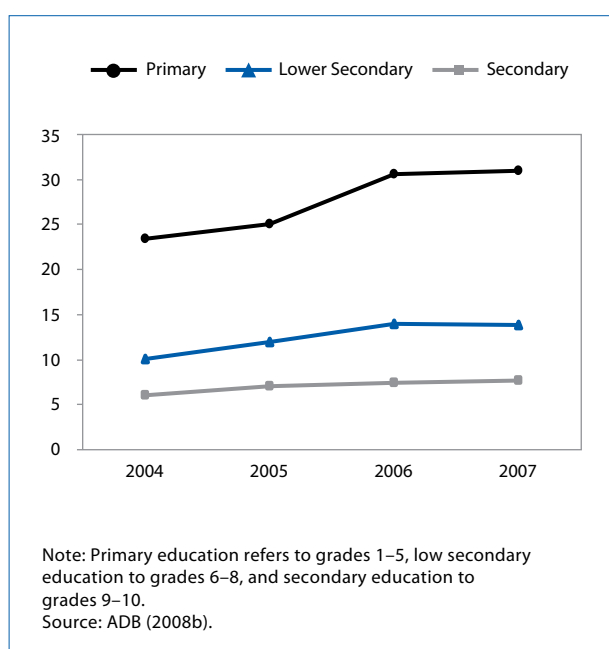


Table 4.24. Percentage of Dalit and Janajati Teachers by Type of Schools and Level (%)

Group	Primary			Low Secondary			Secondary		
	Female	Male	Total	Female	Male	Total	Female	Male	Total
Dalit	1.1	5.2	3.8	1.2	3.8	3.3	1.1	3.3	3.0
Janajati	13.9	15.8	15.1	14.0	10.5	11.2	12.7	9.0	9.4
Others	84.4	77.6	80.0	83.9	84.8	84.7	85.7	87.0	86.8
Disabled	0.6	1.3	1.1	0.9	0.9	0.9	0.5	0.8	0.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: ADB (2008b).

government (World Bank et al. 2006). More effort is required to mobilize excluded groups so that they can articulate their demands and be brought into the development mainstream. The long neglect of the agriculture sector by successive Nepali governments provides a useful example. Public services to agriculture are weak partly because poor agriculturalists do not constitute a distinct, self-conscious political interest group. Hence there is little incentive for the government to provide good services to agriculture. By comparison, in the adjacent states of North India, agriculture constitutes a powerful political interest group, which provides a constant performance incentive to the public sector providers of services to agriculture.

4.3.2. Inadequate Public Service Delivery

Inadequate delivery of public services is one of the root causes of weak human capabilities, the uneven playing field, and inadequate provision of social safety nets.

Factors underlying the government's failure to deliver adequate social services and facilities to rural communities and marginalized groups include (1) limited funding, (2) poor targeting, (3) poor governance, and (4) exclusion. Given that exclusion is a cross-cutting issue, it was discussed separately in the foregoing section.

Limited resources pose a challenge to the government in delivering adequate public services. Public expenditure on education has increased steadily, from about 1.8% of GDP in 1990/91 to 3.4% in 2006/07, or from about 8.8% of the national budget in 1990/91 to 17.3% in 2006/07 (Table 4.25). This is comparable to that in other

countries in the region—e.g., in 2005, it was 3.2% in Bangladesh, 2.7% in India, and 2.3% in Pakistan (UNESCO n.d. accessed 4 Sept. 2008). However, given Nepal's relatively low GDP, education expenditure per pupil is low when compared with its neighboring countries—for example, it is only about half that in India (World Bank et al. 2006).

The allocation of public expenditure to the health sector has also increased steadily, from about 2.8% of the total budget in 1990/91 to 5.5% in 2006/07 (Table 4.25). However, it is significantly lower than that for education and is only about 1.1% of GDP. Hence, Nepal's government expenditure on health is also very low in per capita terms—\$3, versus \$7 for India and \$14 for Sri Lanka in 2003 (WHO 2006).

To analyze the flow of budgets and the impact of education expenditures on the quality of service delivery, the government introduced the Public Expenditure Tracking System (PETS) in 2001/02. The PETS Survey showed that 80.4–82.5% of the total school budget was spent on teachers' salaries, leaving little room for physical development, academic activities, operating costs, and scholarships (ADB 2006a). This partly explains why public schools suffer from relatively poor learning environments, inadequate teaching facilities and materials, and weak performance of teachers, especially in remote areas (ADB 2008b). The results from the PETS survey suggest that the flow of school budgets can be improved in terms of the time taken to channel funds and eliminate leakages before the budgets actually reach the schools. Given that schools are receiving an increasing number of grants, a stronger expenditure tracking and monitoring system is needed to ensure the effective use of school budgets.

Table 4.25. Public Expenditure on Education and Health

Service	1990/91	1995/96	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Education									
% of GDP	1.8	2.5	2.7	3.0	2.9	2.9	3.1	3.2	3.4
% of Total Expenditure	8.8	12.9	13.9	16.4	15.7	16.0	16.7	17.3	17.3
Health									
% of GDP	2.81	3.68	4.41	4.82	4.35	4.44	4.57	5.23	5.54
% of Total Expenditure	0.57	0.72	0.85	0.90	0.79	0.79	0.85	0.95	1.10

Source: ADB (2008b).

In addition, the financial management capacity should be strengthened at all levels (ADB 2006a). These issues also apply to the public delivery of other services.

Poor targeting is also responsible for inadequate public service delivery, particularly for the provision of social safety nets. Targeted programs are one of the four strategic pillars of Nepal's Poverty Reduction Strategy. Poor targeting of such programs has been a critical issue, at least partly because the targeting criteria used fail to identify the most needy recipients. For example, in the Education For All (EFA) program, the current criteria for scholarships include "50% of girls" and "all Dalits." Because these criteria do not take into account the income level of the children's households, some girl or Dalit students from relatively well-off families receive scholarships (ADB 2006b). Moreover, lack of reliable data on eligible and actual recipients makes the monitoring and evaluation of the scholarship programs difficult for the government (ADB 2006a). Given the limited resources, it is essential to develop more effective measures to identify the most eligible beneficiaries of targeted programs and to establish a monitoring mechanism to ensure the efficient use of resources under targeted programs.

Inadequate delivery of public services is at least partly attributable to poor governance. The recent movement toward decentralization should help, but further efforts are needed to enhance the effectiveness of decentralization in addressing poor governance. Good governance is one of the four pillars of Nepal's Tenth Five Year Plan's Poverty Reduction Strategy. Good governance is sought through (1) controlling corruption and leakages, and implementing mechanisms that ensure accountability; and (2) pursuing the participation of local government bodies and communities in the development process and thus addressing the social exclusion aspects of poverty. As governance is a cross-cutting issue, the deterioration of governance discussed in Chapter 3 also applies to the constraints to inclusiveness.

The level of governance is a key determinant of adequacy of public service delivery. Problems due to poor governance include the recruitment of unqualified people through bribes and the absenteeism of teachers and health care professionals. Nepal is addressing the issue of poor governance through decentralization. While decentralization of service delivery is not a new concept in Nepal, the enactment of the Local Self-Governance Act (LSGA) 1999 was an important step in continuing the movement for decentralized systems of public service delivery.

The LSGA has empowered local bodies to deliver a range of social and economic services including infrastructure. The LSGA is a unified act that provides a legal as well as an institutional framework for local self-governance to both rural and urban bodies. For example, the LSGA makes the district development committee responsible for agriculture and livestock extension services in order to improve their delivery to farmers.

Subhealth posts are managed by the Sub-Health Post Implementation and Monitoring Committee. While decentralized health care provision is likely to increase the accountability of health care professionals, the flow of funds between levels of government has been erratic. In addition, the transfer of subhealth posts to local committees has not been accompanied with proper training or support during the transition to decentralization (World Bank et al. 2006). Unless these emerging issues are dealt with, decentralization could lead to a drop in the level of service quality.

In education, decentralization is the centerpiece of the school improvement strategy as defined in the Tenth Five Year Plan. Under the 7th Amendment to the Education Act in 2001, school management has been increasingly transferred to communities through the school management committees to enhance the accountability of school teachers and staff, and to improve equity of access and quality. The impact of the community school policy is yet to be examined as it was introduced only in 2002 and implementation intensified after 2006. The district

education offices under the Department of Education have the overall responsibility of monitoring and supervising all schools in their districts. However, because of inadequate travel and daily allowances, the supervisors have insufficient funding to visit schools. District education offices and school management committees need adequate resources to enhance their role in improving accountability.

4.3.3. Other Causes

Other causes of the unequal access to productive assets include difficult topography and market failures. In the case of access to credit, for example, the coverage of financial institutions is skewed toward the Central Region where Kathmandu is located (Table 4.19) and is especially limited in remote areas. The same applies to education and health services. The limited access to financial services also prevents remittances earned by local migrant workers from being channeled into the rural areas, which could be a source of local investment.

Chapter 5

Governance, Political Economy, and Institutional Context

This chapter supplements and builds on the diagnostics exercise by examining the immediate political and governance constraints on faster and more inclusive economic growth in Nepal.

5.1. Key Features of the Current Governance Context

Government capacities are weak and overstretched. Compared with other countries in South Asia, Nepal's government is small, centralized, and has relatively low capacity to reach beyond the Kathmandu Valley, which constrains delivery of public services to a majority of the population. Many positions in the government, especially in remote districts, remain vacant. Some districts have a parallel system that is run by political parties and other groups. Moreover, criminal groups, some with links to political parties, compete with one another to extract resources from the population, often resorting to violence.

Although the central civil service apparatus proved robust during the conflict/civil war and remained largely intact, it suffers from a weak management structure, with limited delegation below the ministerial level, poor supervision and accountability, the dominance of personal networks (operating in the main to serve narrow interests), and inappropriate skills. The ratio of managers and professionals to support staff is very low, the wage

structure is very compressed, and there are other problems of incentives.

The weak capacities also compound the government's ability to raise revenues, which has been leading to severe shortfalls in the capital budget. The composition of spending diverges widely from original budget estimates due to failures to implement planned capital spending and to large expenditures outside the budget. Public financial management has progressed somewhat, in confronting the problems and designing reform programs using the public expenditure and financial accountability approach, but large off-budget liabilities and a large bill for subsidies continue to pose risks. As a result, the government has not been able to make much headway delivering domestic development (e.g., in power and agriculture) despite having praiseworthy macroeconomic management.

Despite the weak and overstretched capacities, the government faces a daunting number of major tasks: to agree on a new constitution; to deliver adequately on a very challenging and contentious commitment to introduce federalism; to discipline and control the Young Communist League and other youth wings of political parties; to alleviate major trade union militancy; to keep a lid on the smoldering, fragmented, and volatile politics of the Madhesh and terai areas; to deal with at least one armed secessionist movement on the eastern border; to resolve the problems of competing security forces; to handle the politically "hot" issue of land reform;

to deal with a large legislative backlog; and, in the face of a major downturn in the global economy, to deliver sufficient material benefits to the poor of Nepal that the parties do not split or leave the government. These tasks are straining the political system (section 5.2).

The challenges posed by constitutional change and by the demand for delivery of faster development are placing severe strains on the limited government capacity.

The political system is vulnerable. Nepal's people are strongly attached to the principle of popular democratic rule. However, the levels of membership in or attachment to political parties are low, and direct political action—riots, strikes, and protests—remains the predominant way for interest groups to make demands on government. As a result, it is unclear how far the main political parties can (1) effectively represent and bargain on behalf of the wide variety of socioeconomic groups that have become politicized and mobilized, sometimes with arms, in the course of the conflict/civil war and the recent rise of militant Madheshi regionalism; or (2) agree sufficiently among themselves to maintain an authoritative, cohesive, and stable central executive power to deal with a range of urgent problems. The political mobilization for delivery of improved government services to support growth lacks effectiveness; for example, in agriculture the political emphasis is on land distribution rather than on modernization.

Integration of the Peoples Liberation Army into the Nepalese Army is still an outstanding issue, and can lead to destabilization if not addressed soon. The Nepalese Army was effectively responsible to the Royal Palace until the monarchy was abolished in April 2008. It has since been largely autonomous. The Maoists' Peoples Liberation Army appears to be still largely intact, although its personnel are divided between (1) the cantonments to which they are formally confined by the peace agreement, and (2) the Young Communist League. The questions of how to integrate elements of these two forces and demobilize others remain unresolved and contentious. The lack of progress means it is politically impossible for the government to bolster

its authority by using or threatening to use significant armed force—beyond that available through the police and related civilian agencies.

Private investors' confidence in the stability of government policies and support is low. As the earlier chapters note, the private sector is facing severe constraints and disincentives. Another key problem is with a variable that is not effectively captured in the formal governance scores—the extent to which potential private investors have confidence that the government will be both willing and able to support them and to protect them from those who might try to prey on their profits. In Nepal, the private sector has decreasing confidence in the capacity of the government to deliver support and protection.

The principal political problem for the private sector lies in the government's inability to effectively exercise authority, to solve the acute problems of political disorder, and to generate a sense of relative security and stability about future policies. Failure to make progress discourages new investment and encourages capital flight, and because most large-scale economic enterprise is in the terai, it is relatively easy to transfer capital and productive enterprise over the open border from Nepal into India.

That the present as well as previous governments were led by the two communist parties may not be a particular problem for the private sector, as so far both these parties' actions and policies toward the private sector have not been significantly different from those of the other political parties or recent governments. Indeed, their policies may be more positive given that they (1) are committed to the notion of ending corrupt, feudal, privileged links between politics and business; and (2) will collect their funds from business centrally rather than through prominent individual politicians. However, their political ideologies have introduced ambiguities and uncertainties. Certain youth wings and trade unions appear to be driven by an anti-business ideology, and the party leadership appears to have lost control of their actions. Deterioration in labor relations and greater politicization of employers is in part politically driven. Poor labor relations have intensified problems of low motivation and poor

discipline among employees. Such factors have contributed to the de-industrialization of the Nepal economy in recent years.

Identity politics are on the rise, especially in the terai region. The Madheshi are a large population group—about 30% of the total—living in a region that contains the bulk of Nepal's industrial and agricultural resources. They make strong claims to some degree of political and administrative self-government and a significant number of prominent Madheshi businesspeople might support and fund the Madheshi political movement. But there is so far little sign of the stable, credible, and relatively coherent political parties that will be needed if constructive political bargaining is to take place around Madheshi regionalist demands.

Partly because the movement is still very new, the Madheshi do not have coherent party organizations, but depend on webs of personal, caste, and ethnic networks and tend to be fragmented and internally competitive. To the extent that the political agenda has been defined by the Madheshi, to date it has been constructed mainly around issues of rights, citizenship, and power, and not around economic interests such as those of poor farmers.

Nepal's geography creates special incentives for disrupting road transport as an opposition political instrument. The Madheshi are very well located to deploy direct, informal economic and political pressure on any government in Kathmandu by blocking road transport, as happened in 2007. The near-open border with India and dense cross-border personal and commercial networks limit the damage of such action on the Madheshi themselves.

Clientelism and rent-seeking are key features of the political landscape, although there are signs of shifts to more agenda-centered politics. Clientelism and rent-seeking have long been key elements of the political landscape in Kathmandu and could now feature much more widely across Nepal. In previous elections, the major noncommunist parties had been able to win many rural electorates on the strength of the local power and influence of individuals. Rural political mobilization had by 2007 largely put an end to this elite dominance in rural electorates.

Nepal has caught up with most of the rest of South Asia: elections in rural constituencies are no longer mainly intra-elite contests; politicians will in future have to compete heavily for rural votes, through some combination of clientelist promises of targeted benefits to individuals, families, localities, etc., and, hopefully, programmatic campaigning around general policy issues such as improved agriculture services, support for disadvantaged communities, and land reform.

Regional political and economic relationships are critical for any development strategy for Nepal. The economics and politics of Nepal are inevitably greatly affected by events and policies in the two major countries between which it is landlocked—the People's Republic of China and India. In particular, the Nepalese economy is highly integrated into the Indian economy and almost entirely dependent on India for the transshipment of physical imports and exports from and to third countries. Large numbers of Nepalis work in India, and Indians comprise a significant fraction of the skilled labor force in Nepal. India and the People's Republic of China have substantial economic interests in the country with both competing for markets for products and services. Likewise both India and the People's Republic of China are potential markets—when Nepal develops excess hydropower generation capacity and starts to export electricity. In addition to the economic relations, close and cordial relations with both neighbors are important for political stability in the country.

A prolonged global crisis could deepen the political instability. As noted in previous chapters, Nepal was able to substantially reduce poverty levels despite slow economic growth. Continuing though slow growth has benefited from (1) the opportunities provided by the fast growth of the Indian economy; and (2) the relatively small effect that conflict/civil war had on one of the fastest growing economic activities: migration of unskilled or semi-skilled labor to India, Malaysia, and the Gulf. Industry has been in relative decline but services, which are generally less vulnerable to labor disputes, have expanded. However, these advantages are under threat. Due to the global financial crisis, remittance flows may decline significantly, with

potentially damaging economic and political consequences. And services probably do not have the scope to employ the increasing numbers of unskilled laborers. Large-scale unemployment could pose a risk to political stability.

5.2. Governance, Political Economy, and the Institutional Underpinnings of the Critical Constraints

Previous chapters present a diagnosis of the economy in detail and identify the critical constraints to growth and its inclusiveness. The diagnosis notes that the most immediate and urgent constraint is a cluster of interrelated governance factors that are directly political in nature: policy instability, corruption, crime and consequent insecurity, and extortion from private business. Additional critical constraints include poor governance and weak institutions. The constraints will not be overcome without improving and strengthening governance. The following paragraphs elaborate on the governance, political economy, and institutional underpinnings of the critical constraints.

5.2.1. Inadequate Infrastructure

The poor quality and limited extent of infrastructure are in part due to low and falling levels of public expenditures and limited private investment even where the potential returns are high. Unit costs are also high, and the efficiency of operation and maintenance is low. A key reason is insufficient political and administrative capacity for coordination, decision making, and implementation to do better.

Power. The potential beneficiaries from investments in power are numerous, and the scope for bargaining and negotiation among them is wide. Investment in power could end power cuts and additional hydropower could generate substantial incremental revenue for the government, providing resources for much-needed government services. However, development of Nepal's power potential requires (1) trust among key stakeholders that

long-term outcomes can be reasonably relied upon; and (2) authoritative mechanisms to enforce agreements, resolve differences, and discourage opportunistic behavior. Power outages of up to 16 hours per day have made it clear that something is seriously wrong.

Government responsibility for power is divided between the National Power Corporation; National Electricity Authority (NEA); and ministries responsible for water resources, forestry, and the environment. Coordination among them is poor, and there are long delays as issues go back and forth between them. An environmental assessment can, for example, impose a 5-year delay. The NEA Board is composed of politicians and their nominees. There are widespread concerns about their unwillingness to follow technical advice and the frequency of their interventions to pursue particular interests that are not aligned with sector development needs. A recently announced task force in the prime minister's office may improve matters when it gets started.

Electricity supplies depend heavily on hydropower, for which there is great untapped potential. The authorities have in recent years emphasized private sector involvement in development of hydropower generation. Many licenses have been issued, some as long as 10 or more years ago. Only a few have been implemented and many are said to be in unsuitable locations far from transmission lines and/or lacking road access. Some license holders have no intention of investing but hope to make a handsome profit by reselling the license. The critical step for the private sector is negotiating a power purchase agreement (PPA) with NEA. This can take many months or years. Potential new investors are concerned that an agreement reached now may be overturned by a federal government when the new constitution is in place. They are also fearful of extortion by local groups pursuing inflated claims for compensation (e.g., for forest land occupied by the project) or simply for "protection."

Several PPAs are currently in place for small-to-medium capacity and some have been operating for many years. PPA holders appear content that payments due under their PPAs are made when

they fall due and without default by NEA. Potential new investors, however, claim that the power purchase price currently offered for new investment is unattractive. NEA is said to buy 20% of its energy via past PPAs and at a cost that absorbs 40% of revenue, thus weakening the PPA holders' financial position. An obligation to take PPA power all year round may leave NEA with excess capacity during months of high rainfall.

Investing in capacity on a large scale or for export requires international financing and, in the latter case, export markets. The ample space in theory for mutually beneficial negotiation is in practice hamstrung by political complications on both sides. International financing is constrained by political uncertainty and NEA's financial weakness, as NEA lacks a credible cash flow adequate to pay for additional power generated or to service loans. Within Nepal there are concerns that the wrong kind of negotiations would create huge unproductive rents for contractors and clients, at the expense of uncompetitive power and high cost to the consumer. Progress is also constrained by the difficulty in negotiating with the seemingly divergent interests of India's federal and state governments and those of large (mostly Indian) contractors. Scope for power trading exists as India is in power deficit at times of the year when Nepal could be in surplus and possibly vice versa, but the skeptics argue that experience shows that India may not be interested in two-way power trading.

Eliminating power cuts in the dry season requires investing in additional water storage and/or thermal capacity. NEA is, however, financially weak and lacks resources for investment or to pay for additional privately generated power. Tariff increases are widely believed to be politically impossible—tariffs are already among the highest in South Asia. The current government can blame current shortages on past administrations but would take the blame for an increase while having no immediate improvement to offer, given the long lead times for new investment.

The returns in power generation and government revenue to overcoming these problems appear great enough to merit a very high priority for action on the economic growth agenda. Some of

the obstacles have been created by politicians, and mainly for other ends. Progress with the agenda will require good technical and presentation skills as well as strong political leadership.

Roads. Nepal's road density is the lowest in the region and transport costs are correspondingly high. A thin network of main highways links population centers and traffic often needs to follow indirect routes. A key problem affecting business and trade is the blocking of roads and delay by protestors pursuing economic and/or political ends and delayed customs and other administration due to limited capacity and to rent seeking. Reports of extortion from commercial traffic are common and could be constraining the export trade in, for example, cardamom. Rent seeking almost certainly constrains new investment as well as maintenance operations. The Department of Roads has, with development partner assistance, drawn up an ambitious, high-priority medium-term investment plan for expanding and improving the main road network during 2007–2016. Implementation is, however, constrained by limited capacity and inadequate finance.

The rural road network is limited and many centers are a day or more walk from the nearest road. Moreover, much of the network has been poorly constructed, in part due to the inappropriate use of bulldozers on unsuitable alignments and lack of proper technical design or supervision. Although local government capacity is very weak and staff often absent, funding agencies need to continue finding ways to support rural roads while the negotiations on federalism continue. There are plans for a sector-wide approach aimed at extending "best practice" to government and district development committee systems. However this will only secure lasting change if ways are found to identify and deal effectively with drivers of rent seeking and various adverse practices. Any solution will require effective political action, including strong leadership, as well as good field-based capacity building.

5.2.2. Labor Markets and Industrial Relations

Issues of employment legislation, trade unions, and labor relations are complex and sensitive,

and require very careful handling. In the current volatile political climate, the need is for careful, nuanced policy measures and for the rebuilding of effective institutions for regulating employment relationships, not for sweeping one-sided measures driven by broad prejudice, special interests, or ideology. The extent to which trade unions and the enforcement of employment legislation are perceived by employers as obstacles to investment efficiency seems to vary widely according to location, size of firm, and economic sector. As discussed in Chapter 3, while employers in the (declining) large-scale manufacturing sector perceive such problems, those in smaller scale enterprise or in the service sector, which is the largest and fastest growing part of the economy, do not.

The diagnostic study identifies key constraints of an institutional and political nature, arguing that the tradition of collective bargaining is both recent and undeveloped; that human resource management and business management generally are often weak; and that trade unionism in Nepal, as elsewhere in South Asia, is structured along ideological lines, with unions closely affiliated with Nepal's political parties. This results in issues or disputes that are more political than industrial in nature being brought to the workplace. Labor-management relations are further hampered by multi-unionism at the workplace, with rivalries as each union attempts to outbid the others for gains and for membership. The emergence on the scene of the Maoist trade union federation increased this competitive climate.

The history of exploitative employment practice has not yet been fully corrected. Workers want greater social protection in return for more flexible labor laws. The scale of disputes has risen but many have ended in some form of messy compromise (e.g., the union demand for a hotel service charge) and although new investors hang back, many existing businesses are hanging on.

Just as unions are politicized, so too are the employers' associations. The Federation of Nepalese Chambers of Commerce and Industry does not represent all employers. A recent split created the Confederation of Nepalese Industries. Employers in some key sectors (e.g., transport and hotels)

have their own associations. This makes collective action problematic as all want their own laws and regulations. In some ways, labor problems may be as much about the failure of leadership on the business side as on the union side.

Labor laws are widely regarded as overly restrictive (e.g., on hiring and firing) but capacity for enforcement is very low. The Ministry of Labor is believed to lack the skills to improve industrial relations; one reason may be that the ministry's responsibility for factory inspection has led to an emphasis on engineering skills.

The International Labour Organization is working with the government and the trade unions on revisions to labor laws and a plan for unemployment insurance that would cover both formal and informal sectors. Affordability may be an issue given the large scale of the looming unemployment problem.

5.2.3. Small, Narrow Industrial Base

Nepal's history of industrial policy has been disappointing. In the 1980s and 1990s, the government set up public enterprises in industry and services. But many were in areas where Nepal had little comparative advantage, had few backward linkages, or used few local raw materials. Many were relatively capital-intensive, high-cost processors of imported inputs. Most were poorly managed; heavily over-staffed; and, in the case of service providers, such as for water, petroleum, and electricity, suffered from huge inefficiencies due to excessive politicization. Public enterprises have been instruments of political patronage for rewarding political supporters and for providing employment. These practices have undermined the quality of management and accountability of public enterprises and saddled them with high labor costs and low productivity. The private sector initially responded well to liberalization in the 1990s, but in recent years industry has suffered a decline due in part to the conflict/civil war, security, and instability issues analyzed previously.

Experience from other countries, now well documented, indicates that countries need to acquire specific governance capacities to design, implement,

and enforce an effective industrial policy. This is particularly important for industrial policy aimed at acquiring technology (to increase productivity); when policy provides subsidies or rents to accelerate learning or remove bottlenecks, a key governance capability is the ability to withdraw subsidy if an industry fails to perform. Because picking winners is very difficult, the work must proceed by trial and error and this needs strong technical capacity as well as discipline. Nepal's current patterns of predatory rent seeking could make implementing such a policy difficult. A second key governance capability is the protection of investors from disruption of their operations and from predation; Nepal faces problems in this area too.

The difficulty in brokering a deal to export power does not make for confidence in Nepal's capacity to pursue an industrial policy. Help with identifying opportunities may nevertheless one day yield a high return. Lessons may also be drawn from the more positive experience with developing telecommunications. Some people argue for active promotion of business at the local level (apparently such schemes do not exist at present) to remove particular constraints on investment and production. This might also help to reduce extortion and harassment and a shift in attitude by politicians and policy makers to see the need to make business grow and be sustainable.

5.2.4. Economic and Social Exclusion

Income inequality has increased considerably in Nepal in recent decades. This is of particular concern given the historically very high degree of political and sociocultural inequality and exclusion and a current government dominated by political parties that are highly motivated to address those issues. A main driver has been access to overseas employment, which pays more for unskilled manual labor than can be earned in Nepal. Given substantial improvements in schooling in recent years (despite the conflict/civil war) and the likely continued growth of overseas demand for more skilled employees (in the medium term if not in the next year or two), it is in the national interest to encourage and facilitate this kind of temporary migration and to make such opportunities more widely available by improving

rural education. But the significant numbers unable to migrate need improved opportunities in Nepal.

The Maoist Party in particular faces particularly strong pressures to respond to rural needs. In future elections, candidates will have to make more tangible offers to rural voters, whether through policies likely to benefit broad categories of voters ("programmatic politics") or resources targeted to individuals or small groups of beneficiaries ("clientelistic politics"). Any future elected government is therefore likely to be more responsive to the concerns of poor rural people than past governments have been.

The important question, from the perspective of economic growth and inequality, will be how political parties define and interpret the concerns and needs of rural people. There is little doubt about the likely prevalence of clientelism. Politicians will seek support by offering resources targeted to individuals and small groups. This happens in democratic elections in many countries at Nepal's income level, and, for the rural poor, could deliver more than past voting for powerful "notables" with little expectation of getting much in return. Many resources allocated in this way, especially for local roads, schools, teachers, midwives, etc., are likely to be well used—basic public facilities are still scarce in much of rural Nepal. However, the potential long-term costs to society are considerable if these clientelistic concerns totally dominate rural politics and the allocation of public resources to rural areas.

In a poor agrarian country like Nepal, the sustainable generation of additional work and jobs is the prime way of reducing income inequality and poverty. Nepal badly needs more programmatic rural policies, including substantial allocations of public resources to agricultural development activities that are unlikely to be provided through the market and private enterprise. These include agricultural research, education, extension, large-scale irrigation and flood control, seed certification, etc. More effective policies to encourage agricultural development are needed both for economic growth and because this is likely to be the only major intervention government can make to arrest the increase in income inequality.

The agriculture sector in Nepal suffers from low productivity, has long been relatively stagnant, and is in decline. One set of reasons is the intrinsic challenge posed by low average landholding sizes, difficult terrain, and high rural transport and communication costs in much of the countryside, especially in the hills. But such constraints do not generally apply in the terai. Although the terai has high potential for agriculture, the same picture of stagnation nevertheless applies—in contrast to the situation just over the border in much of North India. Despite the willingness of some development partners to provide support, successive Nepalese governments have paid little attention, and given no priority, to agricultural development activities. This may have reinforced a trend by many external funding agencies to emphasize delivery of social services as opposed to the productive sectors in the drive to achieve the Millennium Development Goals.

A comparison with India helps explain the poor performance of the agriculture sector. In adjacent states of North India, agriculture constitutes a powerful political interest group. Elections are partly fought over issues of the price, quality, and/or availability of fertilizer, irrigation, research, electricity to power pump sets, etc. This is not always positive: it has helped produce large, inefficient public subsidies for fertilizer and rural electricity. But it does provide a constant performance incentive to the public sector providers of services to agriculture. Public services to agriculture are weak in Nepal partly because poor agriculturalists do not constitute a distinct, self-conscious political interest group. There is little incentive for the government to provide good services to agriculture, or to encourage others to do so.

Even in a democratic environment, poor rural people face major obstacles to engaging in sustained political activity at any level except the local. They rarely take the political initiative or shape policy agendas. Instead, they respond to agendas and organizations offered from above by local “notables”; political parties with urban roots; ethnic organizations; or political entrepreneurs, including people who live off government contracts. Such political mediation typically does not result in strong

programmatic demands for government action to develop small-scale agriculture. By contrast, in other major South Asian countries, these kinds of demands—as well as less constructive demands for large subsidies to fertilizer and rural electricity—are relatively powerful. Nepal, along with many other poor countries, is caught in a vicious circle. Lack of political support for agricultural development means that few young people are trained in agricultural colleges and there are few attractive government jobs in agriculture. Few able public servants go into agriculture-related services. There is thus little support for agricultural development from within the public services. In rural areas, the stagnation of agriculture helps focus energies on the alternatives: education and political connections to access jobs in towns or abroad.

Nongovernment and civil society organizations provide a little corrective power, but cannot address the core problem: the lack of central, coordinated effort to provide large-scale public goods and services such as research, extension, education, and irrigation—and the oversight needed to ensure that initiatives to provide them actually benefit agriculture and do not degenerate into rent-taking by politicians and public servants. Addressing these issues will require a government able and willing to take a programmatic approach to electoral campaigning in rural areas, i.e., to offer voters both targeted (“clientelistic”) benefits and a series of plausible policy measures to provide in the longer term the public goods and services that Nepal’s agriculture sector very much lacks. That this could plausibly be presented as a partial remedy for growing inequality might enhance its potential electoral appeal.

5.3. Implications for Development Partners

Work on the diagnostic has made clear that how development partners design and conduct their programs matters as much as, or even more than, what activities and reforms they support. The following summarizes key lessons drawn from the analysis.

Recognize the governance and political-economy constraints to growth. Political economy factors will continue to constitute the main binding constraint to growth at the macro level for the foreseeable future. Strengthening the political settlement and reducing conflict will therefore be central to Nepal's growth and development prospects in the medium term.

Do no harm. While the political economy challenges can only be addressed internally within Nepal as part of evolving processes of state building and of political negotiation, development partners have a key role to play in ensuring their interventions are conflict-sensitive and do not inadvertently contribute to undermining this fragile political settlement. This is as relevant to the growth agenda as it is to more traditional service delivery concerns. Development agencies and the international community must learn to live with a highly ambiguous situation, and not exacerbate the challenge of effectively governing Nepal.

Avoid overloading the government. Negotiating federalism, reestablishing local government, implementing land reform, and recruiting excluded groups to the public service pose particular problems. Development partners should leave room for the necessary domestic political compromises and not push too hard for complex, interdependent programs that are very vulnerable to failure at a few key points.

Identify “quick wins” and feasible policies at the sector level. Further analysis and dialogue are required to understand the governance and institutional factors that underpin the binding constraints identified in the growth diagnostic, with a view to releasing them. This specifically applies to hydropower, roads, agriculture, and the labor market—where the most severe constraints to growth have been identified. By better understanding how political economy and governance factors operate in these sectors, development partners will be better able to help government identify “quick wins” and develop appropriate policies and institutional arrangements in these areas. This type of analysis will also improve awareness of risks and opportunity and thus increase the impact of proposed investments.

Work with the government and private sector to develop mutual dialogue and trust. Future growth in Nepal will depend largely on the extent to which private sector investors have confidence in the government's ability to provide both support and protection. This confidence is currently lacking due to the prevailing security situation, rising trade union militancy, and wide-scale resource extraction by political party youth wings and criminal networks. Development partners can play a key role in facilitating a dialogue between government and private sector with a view to developing a shared understanding of the constraints and the steps necessary to address them.

National ownership is key. Development partners should offer dialogue and options, not prescriptions.

Chapter 6

Conclusions and Policy Recommendations

Nepal, under a succession of development plans, has committed to sustained growth of income and employment, poverty eradication, and improved income distribution. In pursuit of these goals, the government has undertaken a number of key reforms. However, the problems highlighted in the report suggest that more needs to be done.

Nepal's growth performance slowed sharply from a 4–5% per annum rate in the 1980s and 1990s to an average of only 2.9% per annum from 2001 to 2006, when other South Asian countries grew by 6–7% per annum. The pace of economic transformation in Nepal has also been slow. The agriculture sector's share of gross domestic product (GDP) is still relatively high at 33%, while that of industry contracted sharply, from 22% of GDP in 2000 to only 16% in 2007. Productivity growth has been equally slow. Nepal's total productivity growth was only half that of India (0.91% versus 2.08% per annum) during the 1980–2000 period and is likely to have fallen further behind in the current decade.

Despite poor growth performance, Nepal made impressive progress in reducing poverty during the latest period for which comparative data are available. The proportion of people below the poverty line fell from 42% in 1995/96 to 31% in 2003/04, with all areas of the country (except the rural Eastern hills) sharing this improvement. However, poverty is still unacceptably high in rural areas (35% compared with only 3% in the Kathmandu Valley and 13% in

other urban areas) and is well above the national average in the more remote rural areas. Moreover, income inequalities have increased sharply, with the Gini coefficient rising from 34% in 1995/96 to 41% in 2003/04—the highest level among South Asian countries.

Moving forward, the challenge for Nepal is to accelerate the current pace of growth while making it more inclusive. To meet this challenge, a key step is to identify the most critical factors that constrain growth and its inclusiveness. Once the most critical constraints have been identified and prioritized, targeted efforts at relaxing them may unleash profound spurts of growth and poverty reduction that can be sustained well into the future.

6.1. Key Constraints to Accelerating Inclusive Economic Growth

To achieve faster progress in reducing poverty, Nepal needs to grow more rapidly. Growth and development have been hampered by many constraints. While traditional explanations have included a long list of such obstacles, not all of them are equally binding. Based on surveys and discussions with the government, private sector, and other development partners, the study identifies the following as critical constraints to inclusive growth.

Critical constraints to investment and growth are

- weak governance and slow recovery from civil war/conflict;
- inadequate infrastructure, particularly related to electricity supply, irrigation, and transport;
- poor industrial relations and labor market rigidities; and
- an inability to address market failures, leading to slow structural transformation.

Critical constraints to inclusiveness are

- lack of productive employment opportunities, particularly in rural areas due to the sluggish performance of the agriculture sector;
- unequal access to opportunities due mainly to inequity in accessing education and skill development; unequal provision of infrastructure including roads, irrigation, and electricity; and unequal access to productive assets such as land and credit; and
- inadequate social safety nets.

Many of the critical constraints to economic growth and its inclusiveness are interlinked. Only when the political situation is stabilized can aspects of governance such as overall effectiveness, rule of law, control of corruption, and voice and accountability climb back to their levels prior to the civil war/conflict. Improved governance is essential to regain investor confidence. Insufficient infrastructure provision is a key constraint and a cause for high costs of doing business; however, substantial improvements in infrastructure will require an improved law-and-order situation, control of corruption, and enhanced government effectiveness. The return of stability, improvements in governance, and development of infrastructure may not be sufficient to attract investment unless they are accompanied by marked improvements in industrial (employer–employee) relations and reductions in labor market rigidities. However, the root causes of poor industrial relations do not rest solely on the shortcomings of the present labor law and related regulations, but also have political economy and governance underpinnings. Removing these three constraints—weak governance, inadequate infrastructure, and poor industrial relations—will result in increased private investment from domestic and foreign sources. But,

to ensure growth that is balanced and sustainable at a high level, the government will also need to address market failures to encourage investments in expanding and diversifying manufacturing and exports and in upgrading technology.

Sustained and high growth, resulting from eliminating the critical constraints, will create more productive employment opportunities. However, expanded employment opportunities may not lead to significant poverty reduction unless the growth is inclusive and inequalities in access to development opportunities and jobs are removed or reduced. At the same time, inadequacies in the social safety nets should be addressed to keep the most vulnerable groups from extreme deprivation.

Overcoming a number of these constraints, particularly inadequacies in infrastructure and inequalities in access to opportunities, will require substantially increased levels of development and recurrent expenditures, which may be greater than the resources available. Thus, any future strategy will need to include “creating fiscal space” (increasing finance). The urgency of addressing these constraints is even greater in light of the ongoing global crisis and its likely impacts on Nepal’s economy and people (Box 6.1).

Against this backdrop, the study proposes policy options to overcome the critical constraints to inclusive growth for the medium to long run. Several of the options may not be new and some may be being implemented. In such cases, the need is to increase or maintain the emphasis, and to ensure early completion.

6.2. Policy Recommendations

6.2.1. Accelerating Economic Growth

Although the government plays an important role in the economy, the private sector is responsible for much of Nepal’s production, employment, and income-generating activities. As discussed in Chapter 2, much of the recent downturn in the economy reflects the deterioration in the environment for private sector activities and investment, both domestic and foreign. Although

Box 6.1. Possible Impacts of the Current Global Economic Crisis and Slowdown

Nepal is a small economy and has a lower exposure to the global economy relative to that of other South Asian countries. However, some impacts of the current global economic crisis and slowdown are expected through a number of channels—trade, tourism, foreign direct investment, foreign aid and grants, and remittances. Because India has a large share in the total value of Nepal's exports (e.g., 63% in 2006/07), export-oriented industries may face some contraction resulting from slower demand from India. While tourists to Nepal come from many points across the world, as the spread and degree of the crisis intensify, tourist inflows may also decline. Nepal is dependent on foreign transfers, particularly for large-scale development projects such as hydroelectricity. As the crisis unfolds in the main investor countries (e.g., the People's Republic of China, India, and the Republic of Korea), the disbursement of the investments may be stalled temporarily or canceled. Similarly, due to challenging economic conditions in donor countries, their development assistance to Nepal may be reduced in the coming years. As about 55%–60% of the government budget is financed by foreign assistance, the reductions are likely to have a negative impact on the government expenditure and the provision of public services. Finally, the expected return of some of the migrants abroad is likely to result in a decline in remittances and an increase in unemployment rates. Because remittances have been one of the main drivers of the recent poverty reduction, this is likely to have negative impacts on poverty.

To some extent, however, Nepal may be resilient to the global downturn. For example, Nepal has room for maneuver in fiscal policy because cautious budgetary policies over the past few years have created some fiscal space for possible aggressive fiscal measures. Inflation has also been under control, partly because the government has been proactive in passing on the fall in crude oil prices to consumers. Moreover, Nepal has a reasonable level of foreign reserves that have been accumulated over the years through low imports and high exports and tourist inflows. Nevertheless, to minimize the effects of the global economic crisis and still achieve sustainable and inclusive economic growth, it is important for the government to address the critical constraints identified in this report.

Source: Bhaskaren (2009).

some subsectors, such as real estate, financial services, and telecommunications, have continued to do very well, they have been largely insulated from the economic downturn due to special factors, and their experience provides important lessons for industrial policy. But most of the traditional sectors in the economy have been severely affected by the critical constraints just noted.

International experience in developed and developing countries, including East and South Asia, provides examples of the policies needed to help stimulate private-sector-led economic growth. Such policies need to be adapted to Nepal's specific environment and needs. This is what the policy recommendations in this chapter seek to do. While the recommendations do not provide all the answers to the challenge of accelerating inclusive economic

growth, they include the most critical (short and longer term) actions necessary to remove the main barriers to faster inclusive growth in Nepal at this time.

Strengthen Governance

Poor governance has been an overarching constraint on public and private sectors alike. Numerous reports have highlighted problems due to corruption and leakages of resources, and the lack of transparency and accountability undermine the implementation of public projects and programs and the delivery of goods and services to the public.

The main focus of the diagnosis has been on what has gone wrong. The reasons why, the prioritization of options for how to solve the

problems, and identification of who needs to be involved should be the main focus of follow-up work. Building institutional capacity is likely to be a key element of most policies, and needs to be aligned with political capacity. Governance and institutional analysis and interventions need to be integrated into a problem-driven approach to addressing the constraints identified.

With the more representative, democratically elected government in office (33% of the Constituent Assembly's members are women, and the Dalit and Janajati are better represented than ever before) and mandated to draft the new constitution, the political transition processes are in place. The next challenge is to strengthen and entrench the peace settlement by establishing the structures and institutions of a democratic federal republic that will (1) be representative and responsive to the needs and interests of Nepal's population, including groups that have historically suffered exclusion from the political process; (2) provide services more effectively and accountably; and (3) establish a more stable environment to encourage the investment necessary for Nepal's growth. This will require both short-term measures to build confidence and to direct political activity into less economically disruptive forms, and a longer term process of institutional capacity development to strengthen democratic governance. Dialogue and consensus building are of central importance to these processes.

A possible agenda for short- and medium-to-long-term action could include the following:

Short Term (18 months)

- Complete, successfully and in a timely manner, the preparation of a new constitution that commands widespread acceptance across the political spectrum.
- Establish effective channels for improved dialogue between stakeholders on key policies and programs to help define feasible priorities for action and to direct political action and protest away from the economically disruptive forms that it is currently taking, while improving law and order to increase security and reduce impunity.
- Identify “quick wins” and high profile actions that can both build confidence that

the new political settlement can effectively deliver tangible benefits for the population and show that the government supports productive investment.

- Develop a strategy for strengthening capacity to plan and implement development policies, control corruption, build effective institutions of democratic governance, and begin to implement priority elements of the strategy where feasible.
- Put in place inclusive political mechanisms for local governments and strengthen their capacity.
- Identify constraints faced by underserved communities in accessing government services such as emergency obstetric care and education.

Medium to Long Term (2–5 years)

- Implement the strategy for building effective institutions of democratic governance, including the structures of federal government. Measures are likely to include
 - o successfully establishing and strengthening the capacity of new federal institutions,
 - o strengthening central and local governments' capacities for business promotion and stakeholder dialogue,
 - o reviewing and reforming procurement-related regulations and procedures; and
 - o promoting the concept of multiple identities among population groups to move them away from the notion of single identity.
- Make government services more responsive to underserved communities.
- Increase representation of marginalized communities in government service, e.g., increase the proportion of Dalits employed as teachers.

Accelerate Infrastructure Development

The second major bottleneck the report identifies is poor infrastructure. There is little doubt that major improvements in infrastructure would help accelerate inclusive economic growth by (1) relieving power shortages that are crippling economic activities, (2) improving connectivity, (3) reducing costs, (4) opening markets to exports, and (5) directly and indirectly improving competitiveness for Nepal's goods and services. Improved infrastructure can be

an important driver of employment generation and economic dynamism in outlying areas, particularly in underprivileged communities and regions. It can also provide significant complementary benefits by facilitating access of marginalized and target groups to essential social services, such as education, health, and drinking water and sanitation system.

To accelerate development of infrastructure in the key areas—power, road transport, and irrigation—the government will need to formulate and/or update the sectoral strategies and identify and prioritize investments for the medium term. Even the high-priority investments may far exceed the resources available in the public sector; domestic and foreign private investment will have to be mobilized to meet the infrastructure needs. Thus, a requisite underlying principle will be that the public sector should invest in areas that may not be attractive to the private sector and should not crowd out the private sector. At the minimum, the agenda for the short, medium, and long term can include the following:

Cross-Sectoral

Short Term (18 months)

- Strengthen government leadership of the policy process.
- Improve arrangements for sector planning, coordination, and decision making.
- Review and streamline the land acquisition and resettlement policies and related regulations in consultation with landless groups.

Medium to Long Term (2–5 years)

- Consolidate government leadership of the policy process.
- Continue improving arrangements for sector coordination, planning, and decision making.
- Build capacities of the National Planning Commission and relevant ministries and agencies to plan and implement labor-intensive infrastructure projects.

Power

Short Term (18 months)

- Formulate a power development plan and/or strategy covering hydropower and other

modes of power generation including solar, wind, biogas, and thermal. The plan/strategy must clearly delineate public and private sector roles, with the public sector mainly focusing on facilitating private sector investment and on areas that may not be attractive to the private sector.

- Repair/upgrade generation, transmission, and distribution infrastructure on an urgent basis to maximize system generation (both hydropower and thermal) and transmission and distribution efficiencies, based on the National Electricity Authority's action plan.
- Expand the transmission links to India on an urgent basis to enable imports in the dry period.

Medium Term (2–5 years)

- Clarify and liberalize connection and tariff policy to give private generators stable and economically viable market access.
- Enter into power purchase agreements with private power generators and develop infrastructure to link them to the national or local grids.
- Facilitate completion of projects that are under construction in both public and private sector domains.
- Do feasibility studies for medium and large hydropower projects for private sector investment, aiming to have at least one large-scale functioning hydropower project with storage in 5–10 years.
- Institutionalize a fast-track approval process for power projects.
- Expand and upgrade the transmission and distribution networks to improve system efficiencies and increase the electrification rate.
- Provide small and micro hydropower stations for local or regional consumption.

Long Term (5–10 years)

- Complete at least one large-scale hydropower project with the private sector.
- Allocate government budget for developing associated infrastructure (roads and distribution).

Road Transport

Short Term (18 months)

- Update the transport sector strategy and medium-term investment plan (MTIP), which identifies the priority projects. The strategy and MTIP must clearly delineate responsibilities between national and subnational (district and village) governments, and explore avenues of public–private partnerships.
- Enact and enforce relevant regulations to effectively tackle the syndicate system.
- Initiate feasibility studies for the high priority projects identified in the MTIP.
- Study the feasibility of channeling trade through the deep sea port in Mumbai.
- Revive and functionalize the Roads Board with appropriate levels of funding for operation and maintenance (O&M).

Medium Term (2–5 years)

- Complete feasibility studies of the priority projects.
- Construct at least one alternative trunk road, such as a north–south and east–west highway, preferably through public–private partnership.
- Provide year-round access to currently unconnected district headquarters.
- Continue to improve rural connectivity through district and village development committees and communities at both construction and maintenance stages.
- Ensure adequate O&M funding for the Roads Board by exploring and implementing options for cost recovery through improved collection of user fees, preferably with private sector involvement.

Long Term (5–10 years)

- Increase the private sector’s involvement in financing, construction, and O&M of priority projects.

Irrigation

Short Term (18 months)

- Update and/or formulate an MTIP that is closely linked with the MTIP for the power sector and the revamped Agricultural Perspective Plan. The MTIP must clearly delineate responsibilities

between national and subnational governments and communities, and should cover both surface irrigation schemes and groundwater exploitation.

- Repair and upgrade government-managed irrigation schemes, as needed.
- Explore improved cost recovery mechanisms to finance the O&M needs of the government-managed irrigation schemes.

Medium Term (2–5 years)

- Support farmer-managed irrigation schemes to meet urgently required rehabilitation.
- Strengthen farmers’ and water users’ associations and transfer small government-managed irrigation schemes to them.
- Facilitate exploitation of groundwater for irrigation, particularly in the terai.
- Introduce and institutionalize improved cost recovery mechanisms to ensure adequate levels of O&M.
- Identify projects that can be upgraded to provide year-round irrigation.

Long Term (5–10 years)

- Develop surface irrigation schemes in tandem with the development of hydropower projects with storage and irrigation potential, and with participation of the communities and water users associations.

Improve Industrial Relations and Make Labor Markets More Flexible

The private sector sees labor market issues as a major constraint to business. Excessive politicization of labor, frequent strikes and political interference, lack of flexibility in managing the labor costs due to difficulties of shedding labor when business conditions deteriorate, and excessive regulation are serious disincentives. The very sensitive issues pertaining to employment legislation, trade unions, and labor relations require careful handling. Effective policy and institutions for regulating employment need to be rebuilt taking into account the concerns of all parties and working to build their understanding of the various points of view and their capacity to discuss and negotiate solutions, especially given that imposed solutions are unlikely to work.

Several important initiatives that are ongoing will go a long way in removing rigidities related to the labor market and improving industrial relations. One prominent initiative is the reform of the labor law, the draft of which has been widely discussed with workers' and employers' federations. A top priority is to finalize and implement the law and associated acts and regulations. At the minimum, the agenda for the short, medium, and long terms can include the following:

Short Term (18 months)

- Complete the labor law reform by enacting the new Labor Act, Social Security Administration Act, and Unemployment Insurance Act. The new Labor Act should give flexibility to investors while protecting workers' security concerns.
- Actively involve the major political parties to improve the climate for industry.
- Establish the Labor Commission to provide a mechanism for the peaceful resolution of disputes, both individual and collective.
- Reform the Trade Union Act to incorporate agreed procedures and rules regarding (1) the right to strike and lockouts, and (2) union recognition at the workplace.

Medium and Long Term (2–10 years)

- Make the Labor Commission operational by developing the processes and procedures for nominating members representing all sections of society, installing and training the members, and supporting the commission by providing appropriate staff and facilities.
- Have the new acts and laws and the mandate of the Labor Commission disseminated jointly by the employers and workers federations and the government.
- Provide training to the employers and workers federations in collective bargaining, with International Labour Organization assistance.

Support Expansion and Diversification of the Industrial Base

To accelerate economic growth on a sustained basis, industrial activities and exports must be revived. Although improving the performance of the agriculture sector is the quickest way of reducing rural poverty, agriculture alone cannot generate

the income and employment opportunities needed for a growing workforce in the longer term. As productivity improvements, population growth, and limited scope for labor absorption in agriculture create labor surpluses in rural areas over time, industry and services will need to generate more, and higher paying, jobs. Political stability, law and order and security, and improved labor relations are especially important in this regard, but so are appropriate policies to promote industrial and export growth.

Nepal needs to revive and diversify its industrial base, which has suffered from the prolonged civil war/conflict and a lack of effective policies to overcome market failures. While industrial restructuring, diversification, and innovations are essentially private sector activities and should be driven by market forces, the government has the responsibility to provide an enabling environment and has a strategic and coordinating role to play. This responsibility involves putting in place the physical, institutional, and social infrastructure conducive to business and private investment. It also involves addressing market failures that could lead to underinvestment in knowledge and innovations, discourage entrepreneurship, and constrain diversification. At the minimum, the agenda for the short, medium, and long terms can include the following:

Short Term (18 months)

- Clarify government policy toward public enterprises, especially those that are operating at a loss.
- Establish a formal, structured mechanism for dialogue between the government and the private sector on issues related to the investment climate. The mechanism should have a high level of commitment from the government, resulting in prompt implementation of decisions.
- Formulate a new industrial policy that sets the rules of private investment and trade and allows the most successful firms to thrive. The policy should
 - o provide public support and incentives for new products and production processes;
 - o include clear benchmarks for successes and failures, and sunset clauses for phasing out

- o support;
- o provide sound institutional and governance structures in agencies that implement industrial policy; and
- o ensure a competitive real exchange rate.
- Identify nontariff barriers and negotiate with India for their removal in a bilateral agreement, similar to the recent agreement between India and Sri Lanka.

Medium and Long Term (2–10 years)

- Make the new industrial policy operational by developing relevant capacities in the National Planning Commission and the ministries overseeing trade, commerce, and industry.
- Create special economic and industrial and export promotion zones connected to sound infrastructure, with reliable access to electricity and with simple and swift regulatory and service functions.
- Expand technical and vocational training programs to build a base of skilled human capital, using examples of successful programs that are being implemented in Nepal.
- Significantly expand research and development expenditures.

6.2.2. Promoting Social and Economic Inclusion

Achieving high and sustained economic growth is clearly a major prong of any development strategy to reduce poverty. However, growth alone will not help to achieve this objective. Growth by itself generally does not benefit everyone equally, and benefits tend to accrue to those who control or have greater access to the key factors of production—capital, technology, and labor. In Nepal's context, where inequalities have increased during the last decade, special efforts are necessary to reverse these trends and help the poor and the excluded to catch up and to participate in growth on more equal terms.

For growth to make a significant dent in poverty and be inclusive, the government must ensure that the growth process generates sufficient productive employment opportunities and that they are within reach of every segment of society. In addition to

providing key infrastructure and services to un- or under-served communities, attention is needed to

- (1) providing access to employment opportunities,
- (2) providing expanded and more equitable access to education and training,
- (3) improving access and entitlement to productive assets, and
- (4) instituting more effective and better targeted social safety nets.

At the minimum the agenda for the short, medium, and long term can include the following:

Access to Employment Opportunities

Short Term (18 months)

- Expand technical and vocational training to excluded groups.
- Improve coordination among government, external funding agencies, and private sector agencies working in skills development.
- Secure opportunities in the short term for Nepali workers, including from poorer groups, to work overseas, building on lessons from World Bank–International Labour Organization research on migration.
- Focus on a rural infrastructure program for creating short-term jobs, linked to an improved and expanded minimum guaranteed work program such as that being implemented in the Karnali zone.
- Review and update the Agricultural Perspective Plan, particularly with respect to policies and approaches to fertilizers, research and development, extension services, and the roles of the private sector and cooperatives.

Medium and Long Term (2–10 years)

- Improve coordination and implementation of projects and programs in the agriculture sector by forming a high-level body to oversee implementation of the Agricultural Perspective Plan and the adoption of a sector-wide approach similar to that in the education and health subsectors.
- Develop agricultural marketing chains and related infrastructure (roads and cold storage facilities) to enable farmers in remote locations to access markets.

- Provide skills training to workers seeking overseas employment.
- Protect and promote the rights of workers who seek employment overseas by regulating recruitment agencies, controlling corruption and rent seeking, and establishing social or insurance schemes for migrant workers.
- Expand self-employment opportunities for skilled workers returning from overseas by providing access to microfinance.
- Significantly strengthen agricultural extension and research and development.

Access to Education

Short Term (18 months)

- Commence the next sector-wide education program, which is extended to cover all secondary and primary education. The program includes free lower secondary education up to grade 8 and a strong focus on improving the quality and governance in education. The program targets are to
 - o increase primary school enrolment to 100% by 2015 (from 92% in 2009),
 - o increase secondary school enrolment to 65% in 2015 (from 45% in 2009),
 - o increase adult literacy from below 54% to 98% by 2015, and
 - o ensure that 50% of teachers are women.

Medium and Long Term (2–10 years)

- Focus on expanding access to secondary and vocational education, especially among excluded groups and in the remote areas.
- Increase the proportion of female and Dalit teachers and teachers from other excluded groups.
- Improve the quality of education through investments in teacher training and provision of related infrastructure and materials.
- Assess the extent to which the scholarship system for students reaches poor and disadvantaged groups. Examine the advantages and disadvantages of conditional cash transfers for these groups.
- Provide separate toilets for girls and boys.
- Reward schools that retain disadvantaged groups and enable them to perform well.

Access to Productive Assets— Land and Credit

Short Term (18 months)

- Support the Land Reform Commission to develop viable policy recommendations on land reform, including tenancy rights and access to public and government land.
- Strengthen the government's capacity for negotiation, dialogue, design, and implementation of land management.
- Pilot test land-for-industrial-bond payments (e.g., with 1,600 households identified under the peace process).
- Introduce a new land compensation policy.
- Review the performance of the microfinance industry and constraints on its growth.

Medium to Long Term (2–10 years)

- Start implementing land reforms that provide incentives for investment in agricultural land.
- Continue strengthening the government's capacity for negotiation, dialogue, design, and implementation of land management.
- Hand over community forests to all communities with forest management plans.
- Build capacities of staff within microfinance institutions.
- Run information, education, and communication campaigns about available microfinance services.
- Encourage the flow of remittances through formal channels and into microfinance.
- Develop and mainstream microfinance into a viable subsector of the banking industry.

Access to Safety Nets

Short Term (18 months)

- Evaluate the performance and effectiveness of the current safety nets, in line with work that has been started by the World Bank and funding agencies.
- Establish an effective and credible monitoring mechanism to track performance of the safety nets and to ensure effective use of resources.

Medium and Long Term (2–10 years)

- Ensure adequate safety net coverage, with at least a minimum level of food security, for the

most vulnerable populations.

- Shift from untargeted to well-targeted safety nets and programs, as far as practicable.
- Undertake information, education, and communication campaigns about available safety nets.

6.2.3. Creating Fiscal Space

The agenda to alleviate the key constraints discussed in the report is challenging, and the financial needs to carry out these reforms and programs are large. Much of the expenditures required to remove the constraints to accelerating inclusive economic growth have to be borne by the government and public sector institutions. And the government's development agenda in this regard is ambitious, and will require large public outlays for several years. Nepal is currently enjoying the goodwill of its development partners—aid commitments that have been received so far are substantial. But, to carry out the proposed program, much more aid will be needed in the future.

Creating fiscal space—increasing finance—will require focus on both revenue mobilization and improvements in allocative and operational efficiencies.

Revenue Mobilization

- Review the value-added tax, including the rate and exemptions, and the size of businesses that are required to collect value-added tax.
- Review the income tax, including tax rates, exemptions, and reporting mechanisms.
- Improve import tax collections by improving import valuation.
- Improve tax administration by computerizing tax records.
- Undertake business and life style surveys to identify and control tax evasion and collusion.

Improved Allocative and Operational Efficiencies

- Strengthen the public expenditure management framework and make it a basis for ensuring that development and recurrent budgets of priority projects and initiatives that promote inclusive growth are adequately funded (Box 6.2).
- Restructure or retire nonperforming and nonpriority initiatives and public enterprises.
- Regularly review priority projects to ascertain their efficiency.

Box 6.2. Managing the Budget and Public Expenditure Program—Key Steps

The following are key steps to managing the public expenditure:

- (1) Formulate a realistic 3-year resource framework, including revenue, likely aid disbursements, and domestic borrowing.
- (2) Estimate total expenditure commitments for 3 years—including current expenditure, debt service, and government-funded off-budget expenditures.
- (3) Formulate, for the coming 3 years, an annual sustainable capital and development expenditure program, with cash and non-cash requirements.
- (4) Rank all projects and programs in the capital and development expenditure program, using ranking criteria derived from the overall development strategy.
- (5) Allocate the capital and development budget for sectors and projects on the basis of priority rankings. Prepare work programs.
- (6) Release funds to projects and programs on the basis of priority.
- (7) Regularly report on and monitor all projects. Revive the poverty monitoring system.
- (8) Undertake mid-year budget reviews and readjust allocations for the rest of the fiscal year according to progress.
- (9) Annually review the performance of the budget, well before the new fiscal year; repeat steps 1–5 to form the basis of the budget for the next fiscal year.
- (10) Prepare a medium-term expenditure framework annually on a rolling basis for 3 years.

Source: Authors.

- Revive the medium-term expenditure framework process and introduce it at the sector level, starting with leading sectors such as education.

6.3. The Way Forward

These policy recommendations form a huge task. They are intended as a menu of options grounded in robust analysis that government and other stakeholders can use in developing an agenda for moving forward. The agenda must take account of practical and political constraints. This diagnosis can only make suggestions and recommendations; ultimately, the government and people of Nepal must judge which are most appropriate, given limited resources and multiple challenges. Above all, it is important that development partners do not seek to overload the government of Nepal and that account is taken of the still fragile political context.

Any discussion of the way forward will need to be informed by further analysis of the political economy, for example in agriculture and power, to explain more fundamentally why things are the way they are and what policy options might appeal sufficiently to different stakeholders before agreeing on future action. This will require further mapping of the institutions involved, understanding each stakeholder's interests and incentives and the potential drivers of change. Such work will also need to identify who is responsible for taking forward agreed actions and ensure that the actors have the support required to implement recommendations.

However, there is also a need to act fast. Inclusive growth and jobs are needed now to meet popular expectations and to provide stability in Nepal for the long term. The government consulted with a broad range of stakeholders on its National Development Strategy. This report aims to add to the discussions.

As part of a continuing dialogue it is hoped that the government will establish a new Nepal business forum, where government and the private sector can engage at a strategic level on priorities for improving the investment climate and creating jobs. It may be the best institutional home for diagnostic work; further work on the constraints to inclusive growth

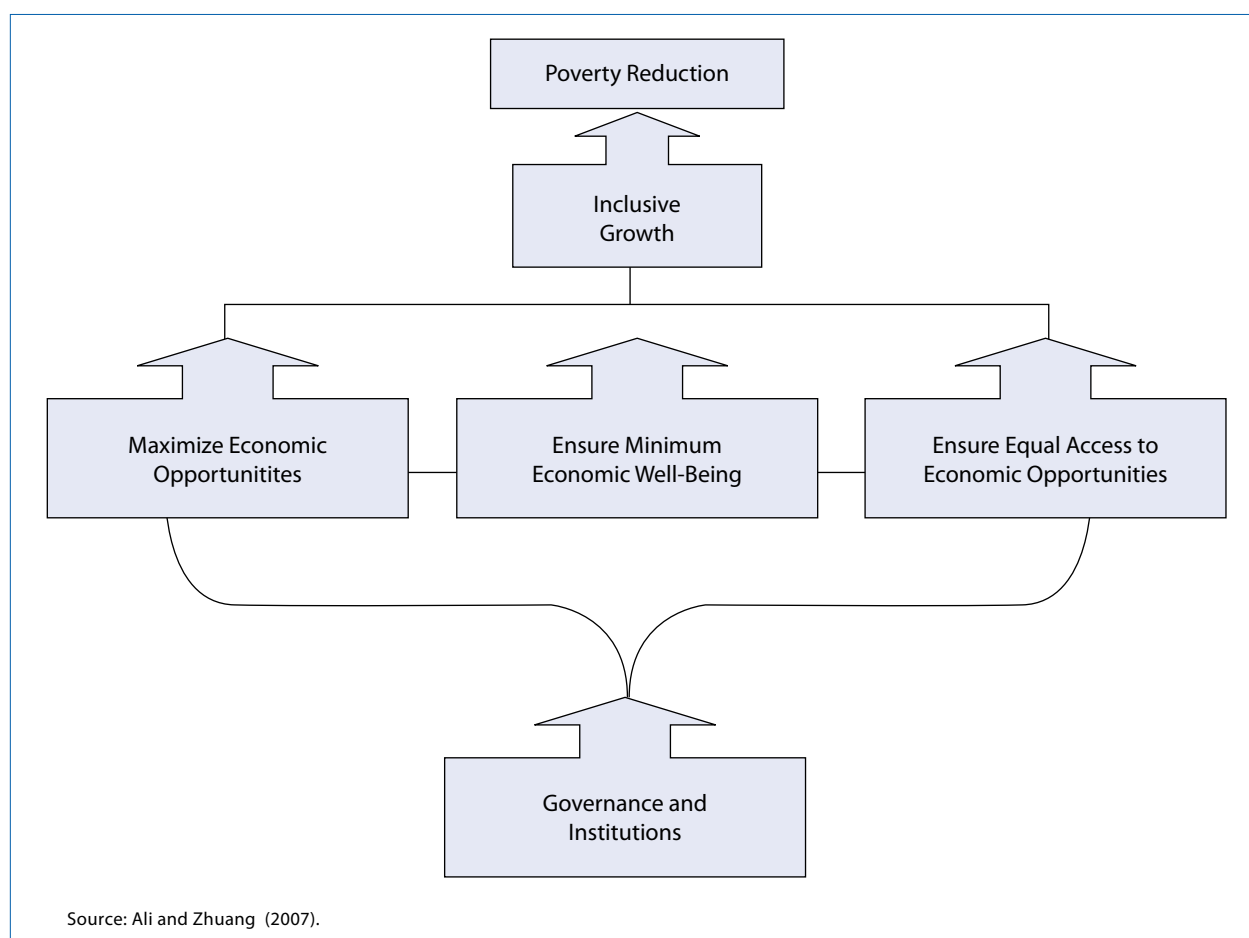
in Nepal; and other related work, for example, the investment climate assessment and the survey on migration opportunities, both being carried out by the World Bank.

Work will be needed to ensure stakeholders with interests in particular sectors are able to engage in decision making during and after the Nepal Development Forum. This is a process the government will need to oversee. A Nepal business forum could also be a home for this process. The new Centre for Inclusive Growth being supported by the United Kingdom's Department for International Development (DFID) will also provide support in facilitating discussions and consensus building at national and regional levels.

Lessons from this diagnostic work and other research need to be communicated effectively to a wide group of stakeholders and the people of Nepal as a whole so that the debate on inclusive growth in Nepal can be enhanced. International evidence suggests that a broad national understanding and consensus is needed for high growth to be truly sustainable. This report is one step toward stimulating the wider debate and reaching that consensus. Ideally, an initial consensus should be reached and then included as part of the 11th Five Year Development Plan for Nepal, due to start in July 2010. This is an ambitious goal but its achievement would put the government, the private sector, and the people of Nepal on the path to faster inclusive growth and help to build the peaceful and prosperous country that all Nepalis deserve.

6.4. Conclusions

Nepal's government, in its Three Year Interim Plan 2007/08–2009/10, highlights its commitment to a prosperous, modern, and just Nepal, the achievement of which will require a strategy for inclusive growth (Ali and Zhuang 2007). The strategy will need to rest on maximizing economic opportunities through high and sustainable growth, ensuring that the population has equal access to the economic opportunities, and guaranteeing a minimum economic well-being for all through effective safety nets (Figure 6.1).

Figure 6.1. Three Pillars of Inclusive Growth

Expanding investments in human, physical, and technological capital—together with promoting market access and exports—raises productivity and creates economic opportunities. Such outcomes permit families to increase their investments in education, training, and health. Enhanced human capacities enable all members of the society, especially those from disadvantaged groups, to participate in and benefit from the growth process and to take responsibility for their own well-being. Nonetheless, some disadvantaged individuals will find it difficult to seize opportunities, and their welfare hinges greatly on social protection and safety nets that government provides. All these require an enlightened and active government and good governance.

To sum up, easing the critical constraints identified in this report can trigger a growth process conducive to eradicating poverty and reducing inequality in Nepal. The return of political

stability will help to strengthen governance, which is a prerequisite to regain investor confidence. Addressing the issue of inadequate infrastructure, particularly in electricity, irrigation, and transport, as well as the issues of poor industrial relations and labor market rigidities, will also improve the investment climate. Upgrading technology and expanding and diversifying manufacturing and exports by tackling market failures will also contribute to the more balanced and sustainable economic growth that generates productive employment opportunities. Finally, to ensure that high economic growth leads to significant reduction of poverty and inequality, growth has to be inclusive, with equitable access to economic opportunities and the benefits of growth shared by all members of Nepali society. To promote inclusiveness, the government must ensure equal access to basic services and provide adequate social safety nets for vulnerable groups.

Bibliography And References

- Ali, I. and J. Zhuang. 2007. Inclusive Growth Toward a Prosperous Asia: Policy Implications. *ERD Working Paper*. No.97. Manila: ADB.
- Akhtar, S. 2007. Building Inclusive Financial System in Pakistan. DFID and HM Treasury Financial Inclusion Conference. London. www.bis.org/review/r070814f.pdf
- Asia Trade Hub. n.d. www.asiatraderhub.com/ (accessed December 2008).
- Asian Development Bank (ADB). 2002. *Poverty Reduction in Nepal: Issues, Findings and Approaches*. Manila.
- . 2003. *Technical Assistance Completion Report: Agriculture Sector Performance Review (Nepal)*. Manila.
- . 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Community-Managed Irrigated Agriculture Sector Project*. Manila.
- . 2006a. Education Sector Development Program I (2007–2010) Final Report (draft inputs). Vol. II. Public Expenditure Review for the Education Sector. Manila.
- . 2006b. Education Sector Development Program I (2007–2010) Final Report (final draft). Vol. V. Analysis of the Political, Social, and Economic Dimensions of Inclusive Education in Nepal. Manila.
- . 2006c. *Nepal Quarterly Economic Update*. August. Kathmandu.
- . 2006d. *Report and Recommendation of the President to the Board of Directors on Transport Connectivity Sector Project*. Manila.
- . 2006e. *Social Protection Index for Committed Poverty Reduction*. Manila.
- . 2008a. *Asian Development Outlook: Workers in Asia*. Manila.
- . 2008b. Equity in the Delivery of Public Services in Nepal. Draft Inception Report. September. Manila.
- . 2008c. *Social Protection Index for Committed Poverty Reduction*. Vol. 2: Asia. Manila.
- . 2008d. *Special Report—Food Prices and Inflation in Developing Asia: Is Poverty Reduction Coming to an End?* Manila.
- . various years. *Key Indicators*. Manila.
- . various years. Statistical Database System Online. Manila. www.adb.org/Statistics/sdbs.asp (accessed may-June 2008).
- Asian Productivity Organization (APO). 2004. *Total Factor Productivity Growth: Survey Report*. Tokyo.
- Bajracharya, M. 2008. Nepalis Rush to go Abroad for Higher Studies. *The Himalayan Times*. 10 August.
- Bangladesh Power Development Board. 2006. Dhaka: Ministry of Power, Energy and Mineral Resources.
- Bank of Thailand. n.d. Bangkok. www.bot.or.th/English/ResearchAndPublications/Report/PagesReport.aspx (accessed November 2007).
- Baral, L. 2009a. Power Crunch Forces Jhapa Factories Up Against the Wall. Kantipur Online. 02 January. www.kantipuronline.com/kolnews.php?&nid=173368 (accessed January 2009).
- . 2009b. Power Outage Hits Jhapa Industries Hard. Kantipur Online. 06 January. www.kantipuronline.com/capsule.php?&nid=174077 (accessed January 2009).
- Beck, T., A. Demircuc-Kunt, and R. Levine. 2000. A New Database on Financial Development and Structure. *World Bank Economic Review* (14)597–605.
- Bhandari, B. 2007. Highways Closed 165 Times in 7 Months. Kantipur Online. 13 August. www.kantipuronline.com/kolnews.php?&nid=119057 (accessed November 2008).
- Bhaskaran, Manu. 2009. The Impact of the Global Economic Slowdown on South Asia. Paper presented at the South Asia Forum on the Impact of Global Economic and Financial Crisis. 9–10 March 2009. Asian Development Bank, Manila.

- Bhatta, S. D., and S. K. Sharma. 2006. *The Determinants and Consequences of Chronic and Transient Poverty in Nepal*. CPRC Working Paper. No. 66. Manchester: Chronic Poverty Research Centre.
- Bhattarai, Raju. 2007. Open Borders, Closed Citizenships: Nepali Labor Migrants in Delhi. Paper presented at International Migration, Multi-local Livelihoods and Human Security: Perspectives from Europe, Asia and Africa. 30–31 August. The Hague.
- Biggs, T., J. Nasir, K. Pandey, and L. Zhao. 2000. *The Business Environment and Manufacturing Performance in Nepal*. Washington DC: World Bank and the Federation of Nepalese Chambers of Commerce and Industry.
- Brown, S., and G. Kennedy. 2005. A Case Study of Cash Cropping in Nepal: Poverty Alleviation or Inequity. *Agriculture and Human Values*. 22:105–16.
- Central Bureau of Statistics (CBS). 2004. *National Living Standards Survey 2003/04: Statistical Report*. Vol. 2. Kathmandu, Nepal.
- . 2005. *Poverty Trends in Nepal 1995–96 and 2003–04*. Kathmandu: National Planning Commission Secretariat.
- . 2006. *Agriculture Monograph: Agricultural Census, Nepal 2001/02*. Kathmandu.
- . 2008. Unpublished data.
- . various years. *Nepal Living Standards Survey, Vol I and II*. Kathmandu, Nepal.
- Central Electricity Authority. 2005. Chapter 9: Electricity Consumers and Connected Load. *General Review*. New Delhi.
- Ceylon Electricity Board. 2005. *Statistical Digest*. Colombo, Sri Lanka.
- Department for International Development (DFID). 2009. Industrial Relations and Business Environment in Nepal. Unpublished.
- Department of Education. 2007. Flash I 2007–08 Report. Kathmandu.
- Department of Roads. n.d. Road Statistics 2006/07. www.dor.gov.np/road_statistic_2008/tables.php
- Deraniyagala, S. 2005. The Political Economy of Civil Conflict in Nepal. *Oxford Development Studies* 33 (1):47–62.
- Fay, M., and T. Yepes. 2003. *Investing in Infrastructure: What is Needed from 2000 to 2010?* World Bank Policy Research Working Paper No. 3102. Washington DC. <http://ideas.repec.org/p/wbk/wbrwps/3102.html>
- Federal Bureau of Statistics. *Census of Electricity Establishments 2005–2006*. Islamabad.
- Ferrari, A., G. Jaffrin, and S. R. Shrestha. 2007. *Access to Financial Services in Nepal*. Conference Edition: United Nations Conference on Trade and Development (UNCTAD), 31 January–4 February 2000. Washington DC: World Bank.
- Foreign Policy. 2007. Failed States Index Scores 2007. www.fundforpeace.org/web/index.php?option=com_content&task=view&id=229&Itemid=366 (accessed February 2008).
- Ginting, E., 2007. *Is Inflation in India an Attractor of Inflation in Nepal?* IMF Working Paper, Asia Pacific Department. WP/07/269. Washington DC: IMF.
- Global Integrity. 2007 Global Integrity Report. Washington DC. <http://report.globalintegrity.org/>
- Hausmann, R., and B. Klinger. 2006. Structural Transformation and Patrons of Comparative Advantage in the Product Space. Center for International Development (CID), Harvard University, Working Paper 128. April. Cambridge MA.
- . 2007. The Structure of the Product Space and the Evolution of Comparative Advantage. Center for International Development (CID), Harvard University, Working Paper 146. April. Cambridge MA.
- Hausmann, R., D. Rodrik, and A. Velasco. 2005. *Growth Diagnostics*. Cambridge MA: John F. Kennedy School of Government, Harvard University.
- Hidalgo C. A., B. Klinger, A-L. Barabasi, and R. Hausmann. 2007. The Product Space Conditions the Development of Nations. *Science* 317: 482–7.
- International Energy Agency (IEA). 2006. *World Energy Outlook*. Paris: International Energy Agency.
- International Finance Corporation (IFC). 2007. *Nepal: Mini-Diagnostic of the Investment Climate*. Washington DC.

- International Labour Organization (ILO), ADB, and the Federation of Nepalese Chambers of Commerce and Industry (ILO, ADB, and FNCCI). 2008. *Enterprise Survey*. Unpublished.
- International Monetary Fund (IMF). 2006. *Nepal: Selected Issues and Statistical Appendix*. IMF Country Report No. 06/45. Washington DC.
- . 2007. *Nepal: Poverty Reduction Strategy Paper Progress Report*. IMF Country Report. No.07/176. Washington DC.
- . 2008a. *Nepal: Selected Issues*. IMF Country Report No. 08/182. Washington D.C.
- . 2008b. *World Economic Outlook. Financial Stress, Downturns and Recoveries*. Washington DC.
- . various years. *International Financial Statistics Online*. Washington DC. www.imfstatistics.org/ (accessed 26 November 2008).
- Jones, S. 2006. Infrastructure Challenges in East and South Asia, Promoting Growth, Ending Poverty, Asia 2015 Conference. 6–7 March, London.
- Kantipur Online. 2008. *Transport Strike in East—Day 4*. Kantipur Online. 12 August. www.kantipuronline.com/kolnews.php?&nid=156854 (accessed October 2008).
- Khatiwada, Y., and S. Sharma. 2002. *Nepal: Country Study Report*. Kathmandu: Institute for Development Studies.
- Kyloh, R. 2008. From Conflict to Cooperation: Labor Market Reforms that can Work in Nepal. Geneva: International Labor Organization. pp 162–3.
- Lokshin, M., M. Bontch-Osmolovski, and E. Glinskaya. 2007. Work-Related Migration and Poverty Reduction in Nepal. Policy Research Working Paper. No.4231. Washington DC: World Bank.
- Macro International Inc. 2007. *Trends in Demographic and Reproductive Health Indicators in Nepal*. Calverton: Macro International Inc.
- Ministry of Finance. Government of Afghanistan. 2009. New Tax Guide. www.mof.gov.af/lang=en&nid=220 (accessed December 2008).
- Ministry of Finance (MOF), Nepal. various years. *Economic Survey*. Kathmandu. www.mof.gov.np/publication/index.php (accessed May-June 2008).
- Ministry of Food, Agriculture and Livestock. 1997. On Farm Management Field Manual, Vol. VI. Irrigation Agronomy. Islamabad, Pakistan.
- . various years. *Nepal Five Year Development Plans and Interim Three Year Development Plan*. Kathmandu.
- Ministry of Industry, Commerce and Supplies (MOICS). 2004. *Nepal Trade and Competitiveness Study*. A study conducted as part of the Integrated Framework for Trade-Related Technical Assistance. Kathmandu.
- National Planning Commission (NPC). various years. *Nepal Five Year Development Plans and Interim Three Year Development Plan*. Kathmandu.
- National Sample Survey Organisation. 2006. Socio-Economic Survey (61st Round) 2004–2005. New Delhi: Ministry of Statistics and Programme Implementation.
- National Sample Survey Organisation. 2006. Socio-Economic Survey (61st Round) 2004–2005. New Delhi : Ministry of Statistics and Programme Implementation.
- National Statistical Coordination Board (NSCB). 2008. First Quarter 2008: Gross national Product and Gross Domestic Product. www.nscb.gov.ph/sna/2008/1stQ2008/2008gnpe1.asp (accessed 22 February 2009).
- Nepal Electricity Authority (NEA). various years. Annual Reports. Kathmandu.
- . 2004. Middle Marsyangi Hydroelectric Project Profile. www.nea.org.np/Anrep2004/Middle_marsyangdi.htm (accessed October 2008).
- Nepal Institute of Development Studies (NIDS). 2004. *A Study on Foreign Employment in Nepal with Particular Emphasis on Skill Requirements*. Kathmandu.
- Nepal Oil Corporation Ltd. n.d. www.nepaloil.com
- Nepal Rastra Bank (NRB). 2008. *Poverty Reduction Growth Facility and Nepal*. www.nrb.org.np (accessed October 2008).

- . various years. Banking and Financial Statistics. http://bfr.nrb.org.np/bfrstatistics.php?tp=bank_fina_statistics&&vw=15 (accessed May-June 2008).
- . various years. *Quarterly Economic Bulletin*. Kathmandu. http://red.nrb.org.np/publica.php?tp=economic_bulletin&&vw=1000 (accessed May-June 2008).
- OnlyAtNepal. n.d. www.onlyatnepal.com.np/ (accessed December 2008).
- Panikkar, Avanish K., ed. 2008. Water Profile of Nepal. In C. J. Cleveland, ed., *Encyclopedia of Earth*. Washington DC: Environmental Information Coalition, National Council for Science and the Environment. First published in the Encyclopedia of Earth 19 May 2007, last revised 8 February 2008). www.eoearth.org/article/Water_profile_of_Nepal (accessed 17 January 2009).
- Parajuli, D. 1999. External Efficiency and Equity in Nepalese Education. Washington DC. Mimeograph.
- Porter, M., and K. Schwab. 2008. *The Global Competitiveness Report 2008–2009*. Geneva: World Economic Forum. www.weforum.org/pdf/GCR08/GCR08.pdf (accessed September 2008).
- Pradhan, R., and A. Shrestha. 2005. Ethnic and Caste Diversity: Implications for Development. Working Paper Series. No.4. Manila: ADB.
- Pyakuryal, B., and R. S. Sainju. 2007. *Nepal's Conflict: A Micro Impact Analysis on Economy*. Kathmandu.
- Pyakuryal, B., and K. Uprety. 2005. Economic and Legal Impact of Conflict on State and People in South Asia with Specific Reference to Nepal. *Journal of Social, Political and Economic Studies*:30(4). Washington DC.
- Ravallion, M. 2001. Growth, Inequality and Poverty: Looking Beyond Averages. *World Development*. 29(11):1803–15.
- RTI International. 2008. *Equity Analysis of Health Care Utilization and Outcomes*. Research Triangle Park NC.
- Shahi, P. 2008. Long Wait for Marsyangdi Ends Finally. Kantipur Online. 13 December. www.kantipuronline.com/kolnews.php?nid=170266 (accessed 4 May 2009).
- . 2009. Power Outage to Hit 16 Hours from Sunday. Kantipur Online. 09 January. www.kantipuronline.com/kolnews.php?nid=174567 (accessed 4 May 2009).
- Thapa, G. B., and M. W. Rosegrant. 1995. Projections and Policy Implications of Food Supply and Demand in Nepal to the Year 2020. Winrock International. Kathmandu.
- The Himalayan Times*. 2008. www.thehimalayantimes.com (accessed 12 and 18 Aug 2008)
- The Weekly Telegraph*. 2006. Poverty Alleviation Measures and Programs in Nepal. www.nepalnews.com.np/contents/2006/englishweekly/telegraph/dec/dec27/national.php (accessed May-June 2008).
- Transparency International. 2008. *Global Corruption Report: Corruption in the Water Sector*. New York: Cambridge University Press.
- United Nations Commodity Trade Statistics (UNComtrade) Online Database. n.d. [www.comtrade.un.org](http://comtrade.un.org) (accessed 10 Dec 2008).
- United Nations Development Programme (UNDP). 2001. *Human Development Report: Making New Technologies Work for Human Development*. New York.
- . 2007. Fighting Climate Change: Human Solidarity in a Dividend World. In *Human Development Report 2007/08*. New York.
- . 2009. *Human Development Report 2007/2008*. New York.
- United Nations Educational, Scientific, and Cultural Organization (UNESCO). n.d. Institute for Statistics. <http://stats.uis.unesco.org> (accessed October 2008).
- United Nations Nepal Information Platform (UNNIP). 2008. *Nepal: Reports of Bandhs/Blockages—01 January to 31 December 2008*. www.un.org.np/reports/maps/OCHA/2009/2009-1-15-Bandhs-Blockades-Jan-Dec-2008.pdf (accessed 19 February 2009).
- . 2009. *Nepal: Reports of Bandhs/Blockages—01 November 2007 to 31 October 2008*. www.un.org.np/reports/maps/OCHA/2008/2008-11-17-Bandhs-Blockades-Nov-2007-to-Oct-2008.pdf (accessed 19 February 2009).

- United Nations Office for the Coordination of Humanitarian Affairs (UNOCHA). 2008. Map of Nepal: Reports of Security Incidents—1 November 2007 to 31 October 2008. 11 November. UNHCRRefworld. www.unhcr.org/refworld/docid/49242ce32.html (accessed 19 February 2009).
- . 2009. Map of Nepal: Total Reported Security Incidents in 2008. 6 January. UNHCR Refworld. www.unhcr.org/refworld/docid/497069172.html (accessed 19 February)
- United Nations Statistics Division (UNSD). various years. National Accounts Main Aggregates Database. <http://unstats.un.org/unsd/snaama/> (accessed May-June 2008).
- Water and Power Development Authority (WAPDA). 2008. *Annual Report 2006-2007*. Islamabad.
- World Bank. 2007a. Attaining the Health and Education Millennium Development Goals in Nepal. Discussion Paper Series. Report No.12. Washington DC: World Bank, South Asia: Human Development Sector .
- . 2007b. IDA Country Performance Ratings 2007. <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:20948754~menuPK:2648555~pagePK:51236175~piPK:437394~theSitePK:73154,00.html> (accessed February 2008).
- . 2007c. *Implementation Completion and Results Report on Road Maintenance and Development Project*. Washington DC.
- . 2007d. *Transport at a Glance*. Washington DC.
- . 2008a. *Doing Business*. Washington DC: World Bank.
- . 2008b. *Migration and Development Brief 8*. Washington DC: Migration and Remittances Team. Development Prospects Group, World Bank.
- . 2009a. *Doing Business*. Washington DC.
- . 2009b. *Global Economic Prospects*. Washington DC. web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGBLPROSPECTS/0,,menuPK:615470~pagePK:64218926~piPK:64218953~theSitePK:612501,00.html
- . various years. World Development Indicators Online. Washington DC. www.worldbank.org/data/olinedatabases/olinedatabases.html (accessed May 2008–February 2009).
- . n.d. Worldwide Governance Indicators 1996–2007. Washington DC. www.info.worldbank.org/governance/wgi/sc_country.asp
- World Bank and Department for International Development (DFID). 2006. *Unequal Citizens: Gender, Caste and Ethnic Exclusion in Nepal*. Kathmandu, Nepal.
- World Bank, National Planning Commission, Central Bureau of Statistics, Department for International Development, and ADB (World Bank et al.). 2006. *Resilience Amidst Conflict: An Assessment of Poverty in Nepal, 1995-96 and 2003-04*. Kathmandu.
- World Health Organization. 2006. *The World Health Report 2006*. Geneva.

Nepal: Critical Development Constraints

Nepal's pace of growth and poverty reduction has lagged behind that of other South Asian countries. The country diagnostic study—*Nepal: Critical Development Constraints*—inquires into the causes for Nepal's slow growth vis-à-vis that of other South Asian economies by posing three questions:

- What are the critical factors constraining investments, both domestic and foreign?
- What should policy makers do to revive investment, particularly by the private sector?
- How can the growth be made more inclusive?

The inquiry and the results thereof aim to assist the work of government, development agencies, and the private sector to achieve a higher, more equitable growth path to benefit the people of Nepal.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

About the United Kingdom's Department for International Development

One in six people in the world today, almost 1 billion people, live in poverty on less than \$1 a day. DFID supports long-term programs to help eliminate the underlying causes of poverty. DFID also responds to emergencies. DFID works in partnership with governments, civil society, the private sector and researchers. It also works with multilateral institutions, including the Asian Development Bank and International Labour Organization.

About the International Labour Organization

ILO is devoted to advancing opportunities for women and men to obtain decent and productive work in conditions of freedom, equity, security, and human dignity. Its main aims are to promote rights at work, encourage decent employment opportunities, enhance social protection, and strengthen dialogue in handling work-related issues.

ILO was founded in 1919 to pursue a vision based on the premise that universal, lasting peace can be established only if it is based upon decent treatment of working people. In 1946, ILO became the United Nations' first specialized agency.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4444
Fax +63 2 636 2444
www.adb.org/economics
information@adb.org

**Department for
International Development**
1 Palace Street London SW1E 5HE,
United Kingdom
Tel 44 845 300 4100
www.dfid.gov.uk/
enquiry@dfid.gov.uk

International Labour Organization
4 route des Morillons
CH-1211 Genève 22
Geneva, Switzerland
Tel +41 22 799 6111
Fax +41 22 798 8685
www.ilo.org
ilo@ilo.org