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Highlights

Nepal: Critical Development Constraints

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1 Introduction

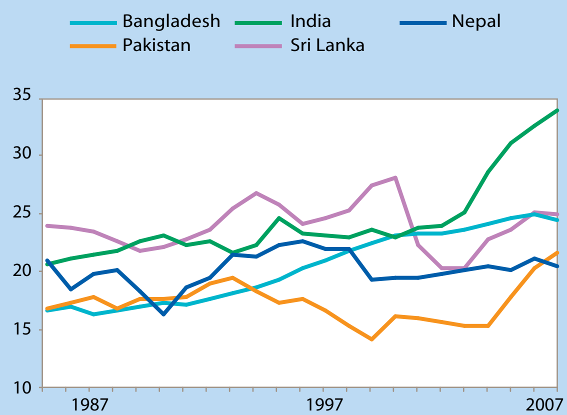
Nepal's performance on the economic development front since turn of the century has lagged behind that of the other South Asian economies. In per capita terms, growth was even less favorable; as a result, Nepal's per capita gross domestic product (GDP) remains the lowest in the region. In 2007, the per capita GDP in 2000 prices was estimated at $243 compared with $439 for Bangladesh, $660 for Pakistan, $686 for India, $1,144 for Sri Lanka, $1,277 for Bhutan, and $3,668 for Maldives. In terms of per capita 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.

On the poverty front, remittance flows and investments in rural infrastructure have helped reduce poverty incidence from 42% in 1995/96 to about 31% in 2003/04. However, poverty incidence remain high and may climb further if the global recession reduces remittance flows. An emerging concern is the sharp rise in inequality—in terms of the Gini coefficient, inequality increased from 0.34 in 1995/96 to 0.41 in 2003/04. Given that inequality is considered 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, i.e., that future growth is inclusive.

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 main agricultural crops and to a rise in tourist arrivals, and not due to major improvements in economic fundamentals. Although the total investment rate is reportedly high, this may be misleading as part of the rate is estimated as the residual value to balance the income and expenditure account and is prone to estimation errors and statistical discrepancies. The fixed investment rate (gross fixed capital formation), estimated using the materials/ inputs approach backed by surveys, is arguably a better indicator to gauge investment levels. This approach suggests that Nepal's investment levels may be the lowest in South Asia (Figure 1). Moreover, growth in total investment and fixed investment rate has also been the slowest in South Asia. Time series data are not readily available, but the break up of private sector investments in 2006/07 suggests that the investments remain low particularly in infrastructure development and agriculture.

This raises the problem of how the country can improve its pace of growth and poverty reduction. The challenges Nepal faces in achieving its growth potential are compounded by the slow transition from a kingdom to a republic and the related political processes, which aim to

Figure 1
Comparison of Fixed Investment Rate (% of GDP)



GDP = gross domestic product,
fixed investment rate = gross fixed capital formation.
Source: World Bank. *World Development Indicators*. www.worldbank.org/data, accessed 21 February 2009.

promise political and policy stability over next few years. Moreover, the global recession threatens to drastically reduce the inflows of remittances and tourists. The country diagnostics study, *Nepal: Critical Development Constraints,* attempts to address these issues by examining the following questions:

- What are the critical factors constraining investments and economic growth?
- What should policymakers do to revive investments?
- How can economic growth be made more inclusive?

Key findings from examining the three questions are presented in these highlights of the main report.

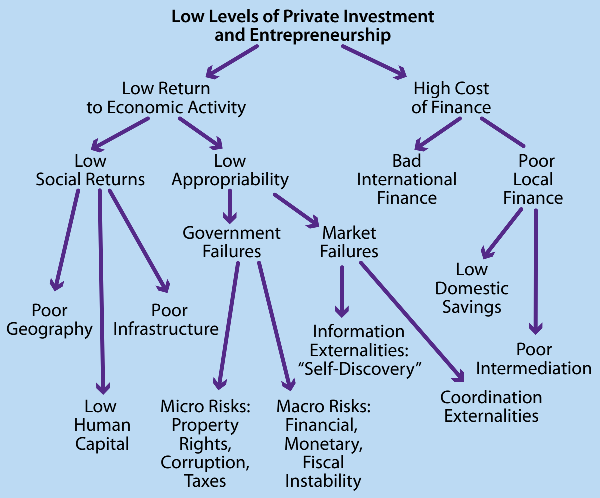
2

Critical Constraints To Investment and Growth

Many factors are at work in the growth and development process, but in the long run, a country's prosperity and the welfare of its people are determined by the pace of accumulating physical and human capital, by how efficiently the capital is used, and by how equitable access is to opportunities that growth and development generate.

According to the growth diagnostics framework (Figure 2), private investment will be weak if social returns to investment are too low, private appropriability of the social returns is too poor, and/or the cost of financing is too high. Low social returns to investment could be due to insufficient levels of complementary factors of production—in particular, human capital, technical know-how, and/or infrastructure. Poor private appropriability could be caused by government failures (such as macroeconomic instability, excessive taxation, and poor property rights and contract enforcement) or by market failures (due to information and coordination externalities). High cost of finance could result from low domestic savings, poor intermediation in domestic financial markets, and/or poor integration with external financial markets.

Figure 2
Growth Diagnostics Framework



Source: R. Hausmann, D. Rodrik, and A. Velasco. 2005. *Growth Diagnostics.* Cambridge MA: John F. Kennedy School of Government, Harvard University.

Following this framework and using a variety of evidence—macroeconomic, financial, and social indicators; findings from investment and business surveys; regression analysis; insights from in-depth case studies; and benchmarking with other similarly situated countries—the report identified the following critical constraints to private investment and growth in Nepal:

- 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

- inability to address market failures leading to slow structural transformation.

Weak Governance and Slow Recovery From Civil War/Conflict

The most immediate and urgent constraint is a cluster of interrelated governance factors that are directly political in nature: policy instability; crime and insecurity; political and criminal extortion from private business; strikes and road blocks; and trade union militancy, including competitive militancy among trade unions with different political affiliations. Many businesses find it difficult to operate or generate profits because of strikes, interruptions in supplies, difficulties transporting products, occasional violence, and the need to pay protection money to political/criminal networks. Both public and private sectors are also constrained by a lack of government capacity, authority, and leadership. Corruption and rent seeking impose high costs on and delays in decision making. In addition, businesses promote closed networks ("syndicates") to stifle competition despite government commitments to encourage a competitive business environment.

Governance was weakened by civil war/conflict. In 1996, Nepal was ranked above the South Asian average in 4 of the 6 governance-related indicators that the World Bank monitors (Table 1). However, its rank has since slipped in all indicators except regulatory quality. The most drastic decline was in the political stability indicator, where Nepal's percentile rank dropped from 26.9 in 1996 to 2.9 in 2007. During the same period, its percentile rank for voice and accountability dropped from 46.4 to 22.6, government effectiveness from 36.0 to 21.8, rule of law from 51.4 to 31.0, and control of corruption from 44.2 to 30.4. Consequently, Nepal's percentile rank slipped below the South Asian average for all aspects but regulatory quality.

Civil war/conflict and subsequent deterioration in governance led to deterioration in major economic indicators. Foremost among the economic indicators that were badly affected by the civil war/conflict and deterioration in the governance-related indictors were the savings and investment rates. Domestic savings and total savings rates, after peaking in 2000, have since then been considerably lower (Figure 3). In 2007, the domestic savings rate as a percentage of GDP was reported at less than 62% of the levels in 2000, and the total savings rate as a percentage of gross national income at about 92% of the 2000 levels. Investment rate as a percentage of GDP, after falling to about 88% of 2000 levels in 2003, has made a recovery and was estimated in 2007 at about 104% of the 2000 levels. Foreign direct investment was also badly affected, with aggregate investment volumes falling to only about $9 million during 2001–2007, or less than half the average annual investment volumes of 1996–1998. The impact on the domestic manufacturing industry was also severe, with the number of operating small and cottage manufacturing units declining by about

Table 1
Governance Indicators for Nepal, Percentile Rank (0–100)

Governance Indicators	1996	1998	2000	2003	2004	2005	2006	2007	South Asian Average 1996	South Asian Average 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

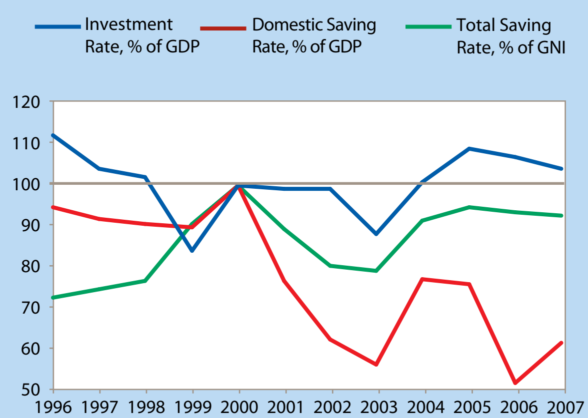
Source: World Bank. n.d. *Worldwide Governance Indicators* 1996–2007. Washington DC.

30% from 1999/2000 to 2003/04, and the fixed capital for these units declining by as much as 41% in nominal terms and about 50% in real terms.

Civil war/conflict also led to diversion of public sector spending from development activities to those related to defense and law and order. Review of central government expenditures suggests that defense and general public services rose from 2.4% of GDP in 1995 to 4.0% of GDP 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% of GDP in 2005. The cost of deploying security forces to tackle a strike alone amounted to about $100,000 daily in 2004/05—an amount that could have sufficed to construct and upgrade several kilometers of road or finance the annual development funds for 6–7 villages. With the peace and reconciliation efforts, the expenditures on defense and general public services declined slightly, to about 3.8% in 2007 of GDP, and consequently expenditures for economic services improved from 3.8% of GDP to 3.9%, which is far below what is required to meet Nepal's key infrastructure needs.

Civil war/conflict and deterioration in governance delayed some key development projects or initiatives. In particular, the deterioration affected the development of hydropower, as private sector investments have not reached significant levels despite the government's policy of actively seeking private sector investment since the 10th Five-Year Development Plan. An example is the Middle Marsyangdi hydropower project, which was delayed by about 4 years due to political instability, security, and other issues. Delays in constructing the project led to more than doubling of construction costs and denied the economy much needed power amounting to about 400 gigawatt-hours (GWh) per year, which could have cut power shortages by about one quarter.

Figure 3
Trends in Selected Economic Indicators (normalized with 2000=100)



GDP = gross domestic product, GNI = gross national investment.
Source: World Bank. *World Development Indicators.* www.worldbank.org/data, accessed 21 February 2009.

Civil war/conflict and subsequent deterioration in governance and investor confidence impacted investment and infrastructure. The average annual growth rate dropped from 4.9% during 1991–2000 to less than 3% during 2001–2006. Several studies have attempted to estimate the cost of civil war/conflict in terms of the damage to establishments and infrastructure and/or indications of the level of public expenditures in controlling the conflict. An Asian Development Bank (ADB) study estimated a loss of about NRs10 billion to NRs15 billion ($135 million to $205 million) for the 3 week strike in April 2006. The study notes estimates that, in the first 9 years of the conflict, about 5,100 establishments were destroyed or badly damaged and infrastructure worth $129.6 million was damaged. The estimated costs of the civil war/conflict are much higher when including the lost GDP growth. If the economy had continued to grow at the rate that it had attained in 1991–2000, the aggregate loss from 2001 to 2007 would amount to about $3.0 billion in 2000 terms.

Recovery in governance level has been slow. Although the civil war/conflict ended in 2006 and a democratically elected interim government then came into power, the negative impact of civil war/conflict on the level of governance and on economic activity has not fully dissipated and most indicators are still well below their levels prior to civil war/conflict. Investor feedback tends to support this conclusion, with most investors ranking political instability as a major constraint. The Global Competitiveness Report 2008–2009 notes that, when asked what was the most problematic factor for doing business, about 23% of respondents cited government instability and another 13.5% cited policy instability. Findings of the 2008 Enterprise Survey by the International Labour Organization (ILO), ADB, and the Federation of Nepalese Chambers of Commerce and Industry (FNCCI) also showed that respondent enterprises ranked political instability as the biggest impediment to growth and investment—72% of them considered it a very serious or major constraint. In addition, 26% of firms considered social unrest as a very serious or major constraint. With continued instability and frequent strikes, investor confidence is likely to remain depressed, preventing investment from reaching levels required for growth at par with regional neighbors.

Inadequate Infrastructure

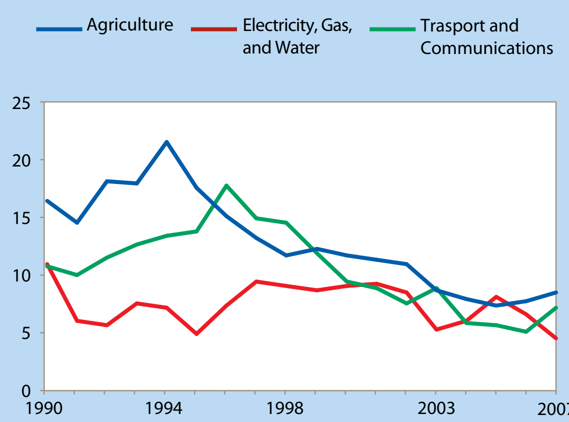
During 1990–2007, public sector development expenditures as a percentage of GDP shrank by as much as two thirds. Except for transport and communication, key infrastructure sectors and services have been receiving less and less funding (Figure 4). During 1990–2007, government spending on electricity, gas, and water as a percentage of total government expenditures declined by 58%; for agriculture, by 49%; and for transport, by 32%. At the same time, investment requirements have been rising rapidly due to increasing demand and to deterioration in existing infrastructure resulting from delayed and inadequate maintenance and damage from civil war/conflict.

Both public and private sector investments in infrastructure have been low. During 1990–2003, Nepal's private foreign investment as a percentage of GDP increased negligibly, but even that trend reversed in more recent years, with foreign direct investment levels drastically declining. These investment levels in infrastructure are well below the estimated annual investment needs, at 6–7% of GDP for South Asian countries.

Declining capital and recurrent expenditures have greatly affected the availability of key infrastructure. Comparative infrastructure indicators show that Nepal has the lowest coverage of infrastructure in South Asia (Table 2). In addition, the quality of infrastructure services is low, as indicated by the Global Competitiveness Report 2008–2009. Of 134 countries, the report ranked Nepal 130 compared with Pakistan (62), India (90), Sri Lanka (101), and Bangladesh (121). In quality of individual infrastructure services, Nepal ranked lowest in electricity and road transport, but was more comparable with other South Asian countries in communications.

Investors say that the lack of affordable and reliable electricity supply and a poor transport network constrain growth. Of about 120 enterprises responding to the ILO–ADB–FNCCI 2008 Enterprise Survey, 82% identified availability of electricity as a constraint and 61% considered it a major or very serious constraint. Similarly, 82% of the firms identified availability of transport as a constraint and 37% considered it a major or very serious constraint. In agriculture, field surveys supporting the Agriculture Sector Performance Review of 2001 noted that 51% of responding farmers cited lack of reliable irrigation as the major constraint in increasing production. In comparison, only 11% of the farmers considered availability of improved seeds and fertilizer to be a major constraint, and only 9% considered lack of extension services as a major constraint.

Figure 4
Expenditure on Selected Sectors
(% of Government Expenditures)



Source: ADB. 2008. *Key Indicators 2008: Comparing Poverty Across Countries.* www.adb.org/Documents/Books/Key_Indicators/2008/, accessed 15 December 2008.

Electricity Supplies are Inadequate, Unreliable, and Expensive

Electrification rates are the lowest in the region. The electrification rate in 2005 was 33%, similar to that of Bangladesh, but still the lowest in the region at 60% of India's and Pakistan's rates and about half that of Sri Lanka. The 33% electrification rate translates to about 18.1 million people in Nepal without access to electricity, primarily in rural areas and remote districts.

Electricity is poorly supplied. Average consumption levels per consumer amounted to about 1,782 kilowatt-hours in 2006, about 46% of the consumption levels in India and Pakistan and about 61% of those in Bangladesh. Nepal's low levels are due to the slow development of new power generation capacity and high seasonal variations, which significantly reduce the use of the installed capacity. During 2005–2007, Nepal's generation capacity grew by only 63 megawatts (MW), insufficient to bridge the gap between demand and supply. In terms of capacity utilization, 3.55 GWh were generated in 2007/08—only 66% of the maximum possible generation of 5.37 GWh. The low utilization rate was mainly because hydropower plants operated at only about 49% of capacity during the year due to the lack of water storage to smooth seasonal flows. As a result, power outages of up to 16 hours per day were common during dry periods in 2008 and early 2009. Continued focus on exploiting hydropower without accompanying water storage infrastructure will perpetuate highly seasonal power generation and will not address the dry season power outages that currently cripple economic activity and social services and daily life. Focus needs to be concentrated on developing generation capacity that is available year-round.

The power tariffs are some of the most expensive in the region. A 2004 study noted that the consumers in Nepal were paying $0.093 per kilowatt-hour—about 115% higher than tariffs in Bangladesh and India, 43% higher than in Pakistan, and 18% higher than in Sri Lanka. The higher tariff levels point to inefficiencies in the power sector. Given that Nepal is largely dependent on hydropower generation for its electricity supplies, other things being equal, its power costs should be low. Inefficiencies result from high transmission losses, partly because of unavoidably long transmission lines connecting the demand centers with the hydropower stations in remote areas. However, the inefficiencies also result from inefficient and poorly maintained transmission and distribution networks and, allegedly, corruption in billing, so that honest consumers are paying for the others.

Table 2
Comparative Infrastructure Indicators

Indicators	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, Percent of Total	9.5 (2003)	47.4 (2002)	56.9 (2004)	64.7 (2004)	81.0 (2003)
Telephone Lines – Fixed and Mobile (per 1,000 people)	224 (2007)	243 (2007)	64 (2007)	516 (2007)	538 (2007)
Internet Users (per 1,000 people)	3.6 (2007)	71.4 (2007)	15.0 (2007)	109.7 (2007)	38.6 (2007)
Irrigated land as Percent of Total Arable Land	56 (2002)	35 (2002)	36 (2002)	83 (2002)	68 (2002)
GDP Per Unit of Energy Use (in constant 2005 PPP dollars)	6.8 (2005)	4.5 (2005)	2.8 (2005)	4.5 (2005)	7.2 (2005)

GDP = gross domestic product, km = kilometer, km^2 = square kilometer, kWh = kilowatt-hour, PPP = purchasing power parity.
Note: Year indicated in the parenthesis.
Source: ADB. 2008. *Key Indicators 2008: Comparing Poverty Across Countries.* www.adb.org/Documents/Books/Key_Indicators/2008/, accessed 15 December 2008. World Bank. *World Development Indicators*. www.worldbank.org/data, accessed 21 February 2009.

Investment needed to exploit the country's abundant hydropower potential far exceeds available resources. To increase electrification to the 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. The investment requirements for raising both the electrification rates and the availability of power to the consumption levels that prevail in India are estimated at $5.1 billion in 2007 prices. Additional investment would be required to upgrade the transmission and distribution network, and would be substantial, which hints at the enormity of the investment requirements in the sector.

The Transport Network is Inadequate, Unreliable, and Expensive

Nepal's road network remains underdeveloped. Its road density is the lowest in the region, with 0.6 kilometers (km) of road per 1,000 people compared with 6.5 km in Bhutan, 4.7 km in Sri Lanka, 3.0 km in India, 1.9 km in Bangladesh, and 1.7 km in Pakistan. In terms of road density per square kilometer of area, Nepal ranks higher only than Afghanistan and Bhutan and substantially lags behind Bangladesh, India, Pakistan, and Sri Lanka. The averages mask regional disparities that are mainly due to Nepal's difficult topography. About 90% of Nepal's roads are concentrated in the Terai. From some mountain villages in remote areas, people must walk for as much as 13 days to reach the nearest road. In 2007, nearly 57% of the rural population did not have year-round access to roads. In comparison, only 15% of people in Pakistan, 35% in Sri Lanka, and 39% in India did not have access to an all weather road.

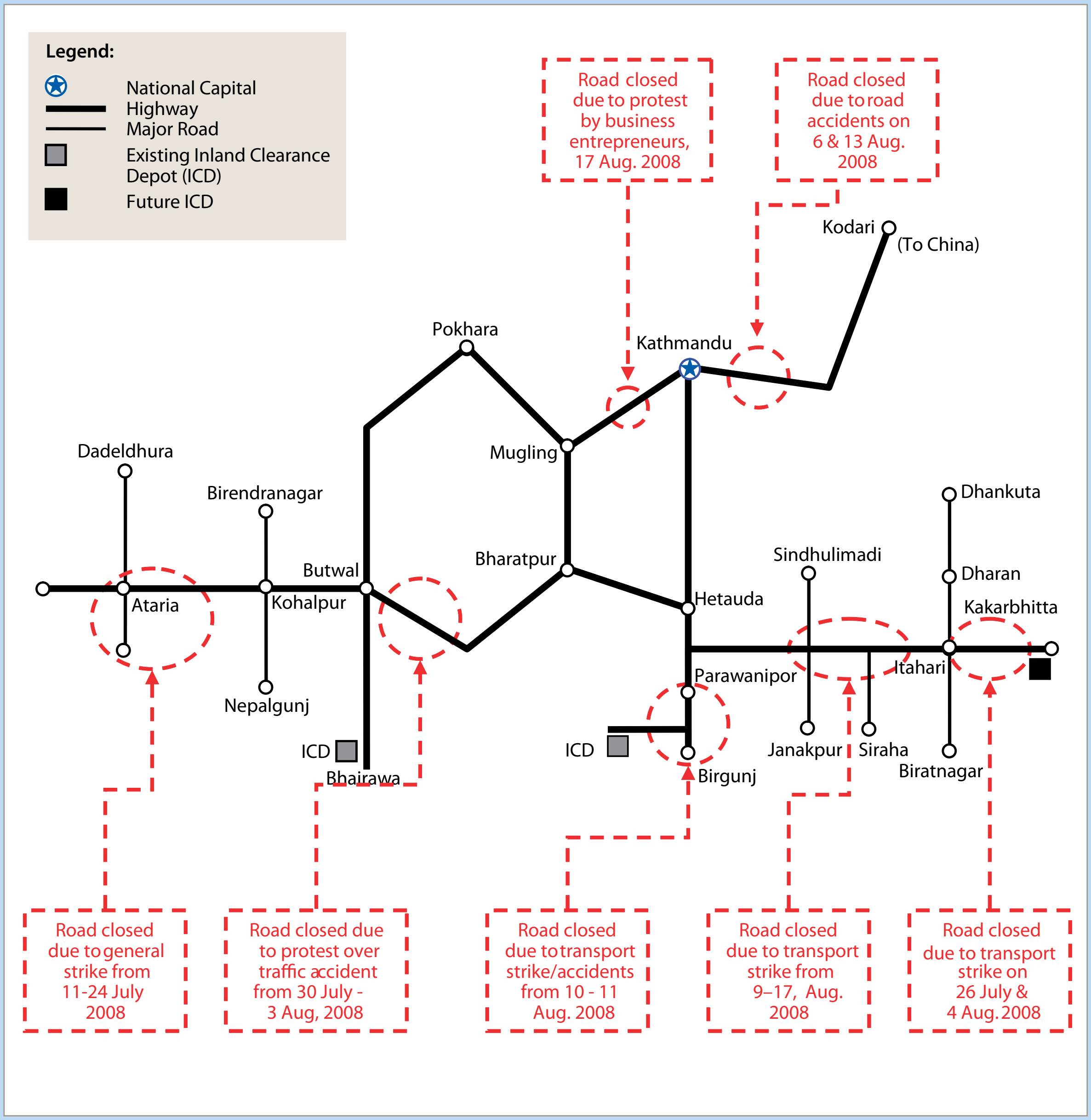
The road network expanded at an average rate of 5% during the last decade—a respectable rate; however, the expansion was mostly in the district and rural roads. As of 2007, only 38% of Nepal's 17,282 km of road was black-topped. About 25% of the roads had gravel surfaces and the remaining 47% were only passable in fair weather. At the district or village level, the quality of the road network is even poorer. A World Bank report noted that, in 2004/05, 80% of district or village roads were earthen and passable only during the dry season. Other studies note that at least 11 of the 75 districts were not connected to a road network at all in 2006/07.

Insufficient alternate transport routes hampers the efficient movement of people and goods and the delivery of services. The East-West highway is the main thoroughfare linking the country's eastern and western borders, and the major entry points into the country. Any disruption in traffic on this route or the roads linking it to border crossings and population centers leads to losses in trade and severe shortages of essential commodities. Disruptions south of the East-West highway are common and typically due to transport strikes rooted in politics or protests over traffic-related accidents. Between mid-July and mid-August 2008, traffic flow on the highway was severely disrupted by several such incidents (Figure 5). In addition, landslides often disrupt traffic flow on roads linking the East-West highway to population centers such as Kathmandu and Pokhara and to other routes in the hill and mountain areas.

The poor condition of road infrastructure and lack of sufficient alternate routes increase transportation costs. According to the 2009 Doing Business Report for Nepal, the cost of exporting a container from Nepal was estimated at $1,764 in 2008, mostly due to transport cost. In comparison, the cost of exporting a container was $970 from Bangladesh, $945 from India, and $611 from Pakistan. Similarly, importing a container to Nepal costs an estimated $1,900, compared with $1,375 for Bangladesh, $960 for India, and $680 for Pakistan.

The limited supply of trucks and high costs of transport services are also due to the "syndicate system" and collusion. The syndicate system prohibits firms from choosing their own trucking operator and increases cost by 25–30%. While the government of Nepal has recently taken steps toward abolishing the syndicate system, the ILO–ADB–FNCCI 2008 Enterprise Survey suggests that implementation of the abolition remains slow.

Figure 5
Disruptions in Traffic from 11 July to 17 August 2008



Source: Kantipur News Portal, www.kantipuronline.com/kolnews.php?&nid=119057, and www.kantipuronline.com/kolnews.php?&nid=156854, and The Himalayan Times www.thehimalayantimes.com, both accessed July-August 2008.

An underlying reason for inadequacies in infrastructure is insufficient funding for maintaining and rehabilitating the network and for constructing new road infrastructure. A 2005 World Bank report estimated that 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 GDP growth rate of 6%. Compared with the investment needs, the total expenditure including nondevelopment expenditures in 2006/07 was NRs6.89 billion or about $104 million—roughly 40% of the needs.

Irrigation Infrastructure is Inadequate and Poorly Maintained

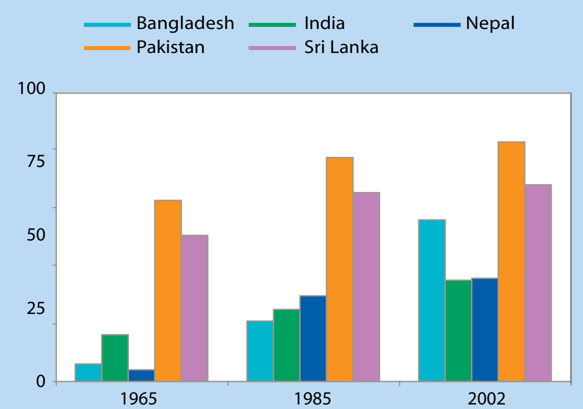
Productivity levels of the major agricultural crops are low, mainly due to inadequate coverage of irrigation services. Nepal's irrigated area as a percentage of total arable land is one of the lowest in South Asia (Figure 6). In 2007/08, even with good and timely rains, the average rice yield was 2.8 tons per hectare (t/ha) as compared with the maximum average yields for Asia of 4.8 t/ha. Similarly, the yield for wheat was 2.2 t/ha compared with the maximum average yields in Asia of 4.3 t/ha.

Productivity levels in agriculture are erratic, mainly due to insufficient irrigation facilities and lack of water storage to smooth seasonal irrigation flows. Figure 7 shows that rice and wheat yields fluctuate markedly. Fluctuations are not as frequent for wheat, but rice yields had sharp declines in 1997/98, 2000/01, and 2005/06. This is understandable as rice cultivation requires about four times the water that wheat requires. Yields of major crops during 1993–2004 were strongly correlated with average annual rainfall, indicating the dearth of irrigation.

The rate of expanding irrigated areas has slowed further in the last 5–6 years. During 2003–2006, the total area brought under irrigation was roughly 50,000 hectares (ha), equivalent to the new area brought under irrigation in 1999 alone. About 83% of irrigated land is not irrigated year-round, significantly reducing productivity by not allowing multiple crops in a year. Although the expansion in irrigated area increased in 2007 to about 27,000 ha, the rate of expansion remains very low, and, if it persists at the current level, Nepal will take about 40 years to irrigate the remaining 1.1 million ha of potentially irrigable land. The required investment could be as large as $3.3 billion at current prices—roughly one third of Nepal's GDP in 2007/08.

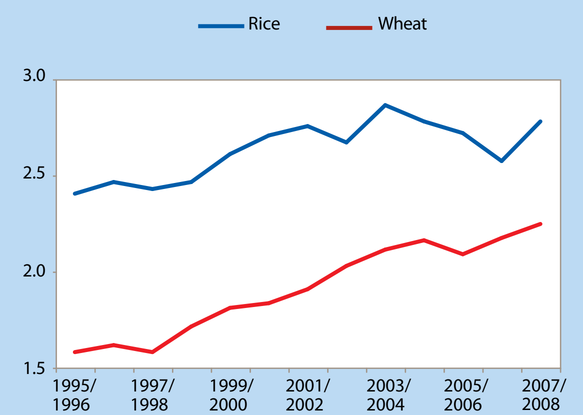
Irrigation infrastructure is poorly maintained and inefficient. While data on the status of irrigation infrastructure are not available for all irrigated land, schemes servicing 300,000 ha or 48% of the 620,000 ha managed by farmer's associations urgently require rehabilitation. The cost of irrigation rehabilitation averages $1,000–1,200/ha for recently rehabilitated schemes, implying that the farmer-managed irrigations systems alone would require $300 million to $360 million to rehabilitate. In addition, the annual cost to operate and maintain surface irrigated schemes is about $30 million.

Figure 6
Irrigated Land as Percentage of Arable Land in Selected South Asian Countries



Source: Alauddin, M. and J. Quiggin. 2008. Agricultural Intensification, Irrigation and the Environment in South Asia: Issues and Policy Option. *Ecological Economics*: 65(1)

Figure 7
Food Crops Yield (tons/hectare)



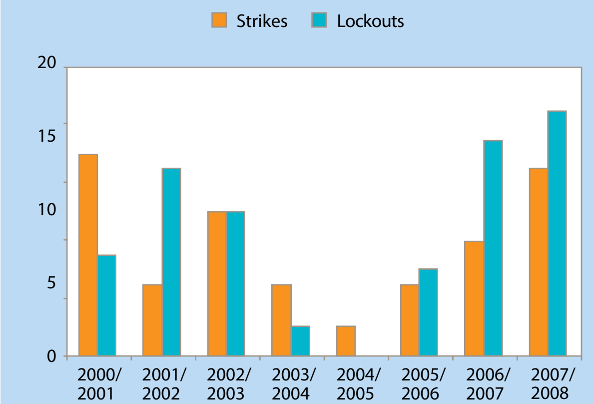
GDP = gross domestic product.
Source: Ministry of Finance. 2008. *Economic Survey*. Kathmandu.

Poor Industrial Relations and Labor Market Rigidities

The industrial relations climate remains poor and labor-related strikes and lockouts remain frequent. This is despite the historic peace accord of late 2006, abolition of the monarchy, and formation of a democratically elected coalition government. In fact, labor strikes and lockouts have been rising since lows in 2004/05 (Figure 8). The full economic impact of the 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 supplies. However, a review of the lost production time due to poor industrial relations does provide 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 9). Given that the strikes and lockouts increased during 2005/06–2007/08, the decline in lost work hours may instead be due to reduced operating time for manufacturing units due to other constraints, such as worsening power shortages.

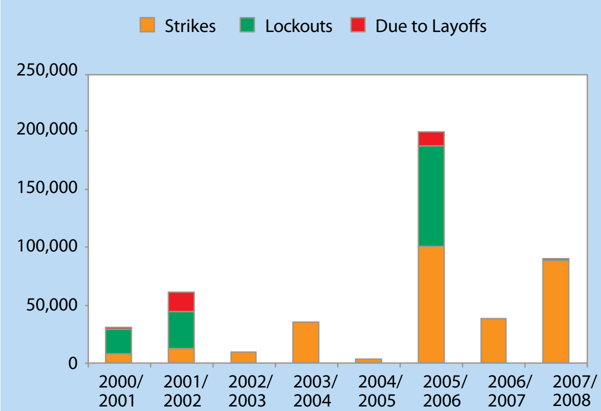
Poor industrial relations result from complex factors including institutional aspects and shortcomings in the labor law. Salient institutional factors include an underdeveloped tradition of collective bargaining, weak human resources and business management, and trade unionism structured along ideological 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, leading to unions trying to outdo each other for gains and membership. Last but not the 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 ILO–ADB–FNCCI 2008 Enterprise Survey tend to confirm the binding nature of poor industrial relations on investment and economic growth. When asked about the top two constraints in doing business, enterprises ranked strikes as the most critical constraint after political

Figure 8
Labor Related Strikes and Lockouts



Source: Department for International Development (DFID). 2009. Industrial Relations and Business Environment in Nepal. Unpublished.

Figure 9
Total Person-days Lost due to Strikes and Lockouts



Source: Department for International Development (DFID). 2009. Industrial Relations and Business Environment in Nepal. Unpublished.

instability. Shortcomings in the labor law and lack of motivation in the workforce were also identified as major constraints, ranking 4th and 6th, respectively.

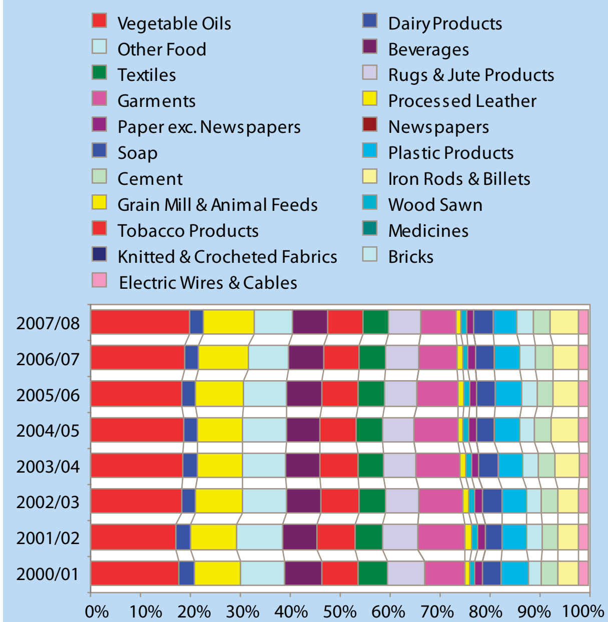
Labor-related laws and regulations in Nepal are some of the most rigid in South Asia. The World Bank's 2008 Doing Business Report ranked labor law in Nepal as the most rigid in South Asia. On the rigidity of employment index, Nepal scored 52—other South Asian countries ranged from 0 for Maldives to 43 for Pakistan. Findings of the report suggest that the law makes it difficult for the employers to both hire and fire the employees, which is different from other countries in the region where the rigidities in one aspect may be offset by those in the other. For example, while Indian labor law scores equally high in terms of difficulties in firing, it poses no difficulties in hiring. Similarly, difficulties in hiring are compensated by relative ease in firing under the labor law in Pakistan. These findings were confirmed by the feedback from ILO–ADB–FNCCI 2008 Enterprise Survey, where the respondents ranked difficulties in hiring and firing as the most problematic aspects of labor law. Other aspects that the enterprises considered problematic related to the minimum wage and compliance with the occupational safety and health provisions.

Market Failures Slow the Structural Transformation

The economy is dominated by services and agriculture, and industry's share of GDP is less than 18%. 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, inadequate infrastructure, and poor industrial relations, have contributed to poor performance in the manufacturing sector by lowering social returns to investment and/or private appropriability. Recent literature, however, points to another set of factors that could also lead to low private appropriability—market failures. Market failures in this context are believed to be caused by information and coordination externalities. The following broad symptoms suggest that such market failures are at work in Nepal.

Domestic manufacturing is low in technological quality and slow growing. Not only is the manufacturing subsector small, but it has not been growing in terms of value or sophistication (Figure 10). In real terms, the value added by manufacturing in 2007/08 was about 99.2% of the 2000/01 level. Construction-related materials (iron rods and billets, bricks, and electric wires and cables) largely

Figure 10
Composition of Domestic Manufacturing Value Addition (% of total)

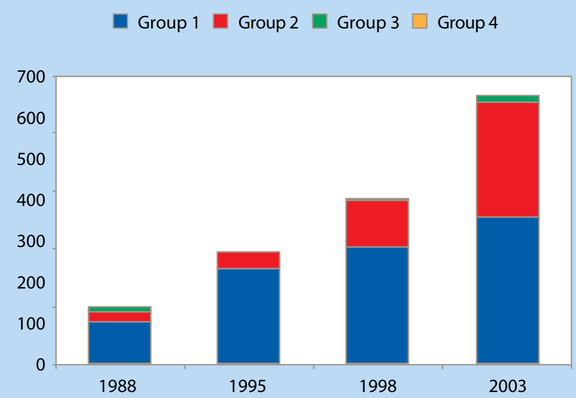


Source: Ministry of Finance. 2008. *Economic Survey*. Kathmandu.

aimed at the domestic market recorded the largest growth, due to growth in construction. The only other products with expanded production were milled grain and animal feed, processed leather, and sawn wood. Conversely, export-oriented manufacturing, such as textiles, garments, rugs and jute products, paper, dairy products, and food products, decreased from 2000/01 to 2007/08. In recent years, more manufacturing units are being closed than set up, and capacity utilization rates for most of the major types of manufacturing units are 30–75%.

Exports are small and low in 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. The slide has meant that Nepal has South Asia's lowest level of exports as a percentage of GDP: exports in 2007 for other countries in the region ranged from 12.1% of GDP for Pakistan to 23.9% for Sri Lanka. During 1988–2002, when Nepal's volume

Figure 11
Evolution of Nepal's Exports ($ million in 2003 prices)



Notes: Groups are based on the PRODY scores, which indicate measure of technology sophistication using the average gross domestic product per capita of countries that export the good. Higher PRODY scores signify more sophistication. Group 4 goods have PRODY scores greater than 24,000; group 3 goods score 16,001–24,000, group 2 scores 8,001–6,000, and group 1 score below 6000.
Source: Asian Development Bank staff estimates based on COMTRADE data, http://comtrade.un.org/

of exports grew from 5.9% of GDP to 12.8%, the trends in terms of sophistication were not as clear (Figure 11). Compared with 1988, when about 73% of the exports were concentrated in Group 1 and 19% in Group 2, Nepal's share of Group 1 exports had fallen to about 55% in 2003 and its share of Group 2 had risen to 42%. While there were shifts between Group 1 and Group 2 toward greater sophistication, the share of exports belonging to Group 3 shrank from 9% to about 3%. A smaller share of Group 3 exports in 2003 also represents a recovery from 1995 and 1998 levels, when there were hardly any exports of these groups of products.

Other Constraints on Investment and Growth

This report looked at other possible constraints to investment and growth, such as the adequacy of domestic savings, the efficiency of domestic financial intermediation, and the stock of human capital, but found them to be less critical. However, in the longer term, some constraints that are currently less critical could become more so. These include the need for a higher level of domestic savings and for a higher skill and knowledge base to support the development of new and emerging industries.

3

Critical Constraints to Inclusiveness of Growth

Despite the poverty reduction from 1995/96 to 2003/04, the evidence suggests that Nepal's recent economic growth has had limited inclusiveness. While the growth diagnostics approach was developed to identify the binding constraints to growth and associated policy priorities, the approach can also be applied to identify critical constraints to inclusiveness of growth, or (more specifically) constraints that prevent certain groups of people from benefiting from and contributing to economic growth.

According to the framework (Figure 12), limited inclusiveness can be caused by the lack of economic opportunities due to poor growth, unequal access to opportunities, formal and informal structures and institutions that exclude or act as a barrier to particular groups such as women, and/or the absence of effective and adequate social safety nets. 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 and contributing to the growth process on an equal basis regardless of their circumstances. In some cases, the terms of inclusion are unequal and result in, for example, women earning less than men or Dalits earning less than higher castes for similar work. Each of these can, in turn, be due to a number of factors, including exclusion, market failures, and/or government failures to deliver adequate public services. In the case of Nepal, exclusion has multiple dimensions—social, geographical, and economic—and is a cross-cutting issue that needs to be addressed for the country to attain its development objectives.

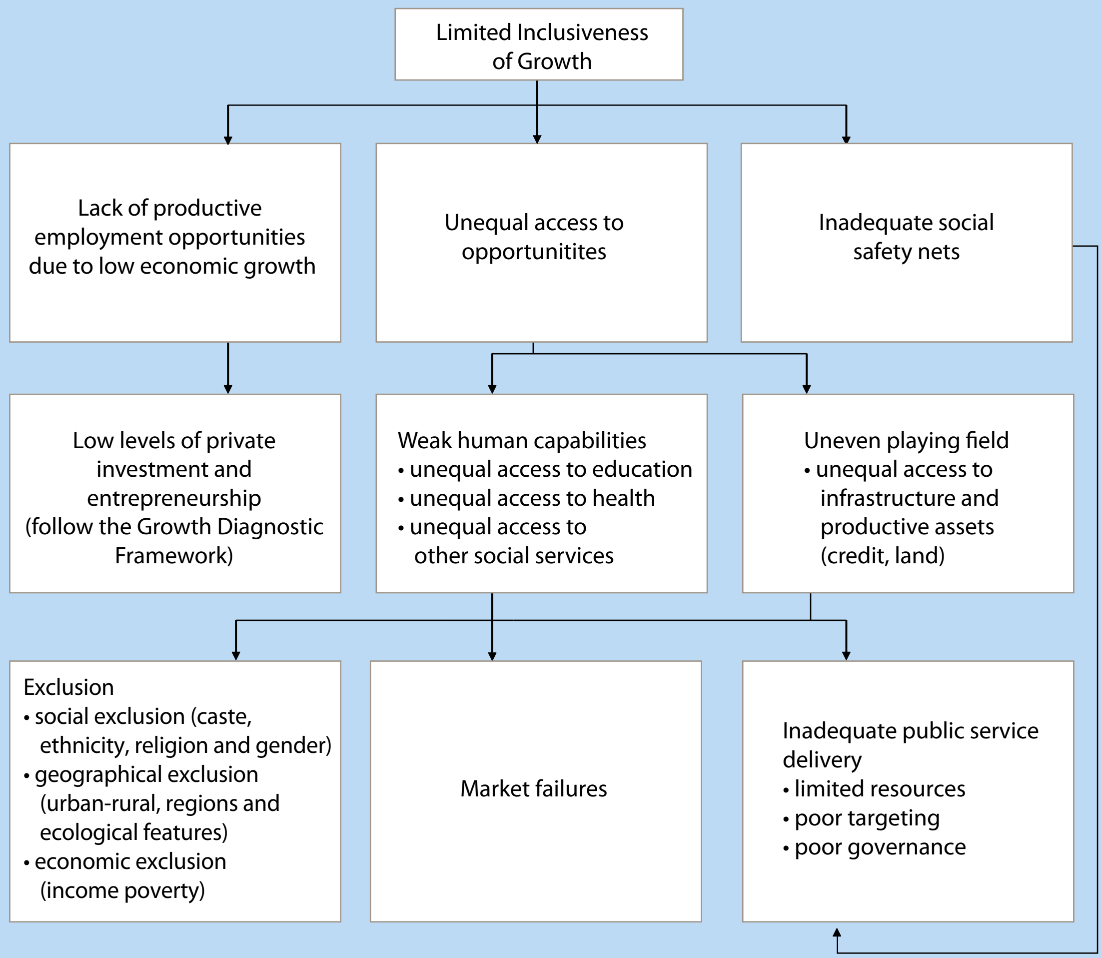
Based on the framework, the report identified the following critical constraints to inclusiveness of Nepal's economic growth:

- lack of productive employment opportunities, particularly in rural areas, due to the sluggish performance of the agriculture sector;
- unequal access to opportunities—opportunities to improve agricultural productivity; to engage in nonagricultural activities; and to migrate abroad, especially to countries other than India—due mainly to unequal access to education and skill development, provision of infrastructure, and access to productive assets;
- formal and informal rules and structures that consistently disadvantage particular groups on the grounds of caste, gender, ethnicity, or religion; and
- inadequate social safety nets.

Lack of Productive Employment Opportunities

The availability of productive employment opportunities is a key factor in households' ability to improve their livelihoods. Although the labor force participation rate is relatively high

Figure 12
Diagnostics Framework for Inclusiveness



Source: Authors.

and unemployment is low in Nepal, this is likely because the poor cannot afford to be out of work.

Underemployment rates are high. Nepal's labor productivity or GDP per worker is the lowest in South Asia. In 2006, Nepal's GDP per worker was estimated at $614 in 2000 terms, which was about two thirds of labor productivity in Bangladesh, one third that in India and Pakistan, and one fourth that in Bhutan and Sri Lanka. Underlying these observations is the dearth of productive employment opportunities in the country.

In Nepal, the problem of disguised unemployment, particularly in rural areas, can, at least partly, be explained by the agriculture sector's sluggish performance. Nevertheless, self-employment in agriculture, followed by agricultural wage employment, continues to be the most important source of household income in Nepal. Agriculture's performance is, therefore, a key to ensuring inclusive growth.

In agriculture, land is the single most important productive asset. In Nepal, about 77% of the population owns land, but the size of landholdings varies significantly across regions, ethnicity and caste, and expenditure quintiles. Traditionally, certain groups, such as Dalits, did not own land and are therefore over-represented among the landless. Women's ownership of land has recently risen since the Land Tax was waived for women. About 2.8 million households have no farmland and 7.5% of rural households hold over one third of the cultivated land area, significant parts of which are currently idle. While land productivity is higher in small farms in terms of gross crop output and real profits per hectare, large farms perform considerably better in per worker terms given higher rates of mechanization and therefore smaller numbers of workers per hectare. Underemployment among farmers with small landholdings tends to be high. Providing more productive employment opportunities, particularly to people in subsistence or near-subsistence agriculture, the youth, people internally displaced by the conflict, and former People's Liberation Army members, will be a challenge for Nepal for the coming years.

Increased migration, internal and international, indicates limited employment opportunities in certain parts of the country. Although the most common destinations for migrants are within Nepal or to India, they are now going to new destinations, including Malaysia, Qatar, Saudi Arabia, and other Middle Eastern countries. While migration offers a new source of employment opportunities for Nepalese workers and a potential means to reduce poverty, such opportunities are not shared equally among the population.

Unequal Access to Opportunities

While the lack of productive employment opportunities is a possible cause of high poverty, the report finds that unequal access to opportunities is also a critical constraint to inclusiveness, in particular opportunities to improve agricultural productivity; to engage in nonagricultural activities; and to migrate abroad, especially to countries other than India.

Opportunities to improve agricultural productivity are unequally distributed. The three important determinants of agricultural performance are access to land; access to inputs; and ability to commercialize and diversify agricultural activity, i.e., move away from subsistence agriculture. In Nepal, the combination of subsistence agriculture from small landholdings and unequal access to irrigation poses a constraint to improving agricultural productivity for certain groups of the population, particularly the poorest. Despite some improvement in recent years, access to key inputs such as improved seeds and fertilizers also remains unequal. Although commercialization has increased in recent years, agriculture remains largely subsistence or semi-commercial in Nepal. Moreover, cereals continue to be the main agricultural product for many households and diversification is still limited.

Availability of nonagricultural employment opportunities is concentrated in main urban centers. While self-employed agricultural activities provide employment for many Nepalese workers, there is a significant variation in occupations across the country. In terms of geography, for instance, nonagricultural employment opportunities are much more available in Kathmandu and, to a lesser extent, in other urban areas than in rural areas. In terms of income levels, poor households tend to depend much more on agriculture for their livelihood than do the non-poor. However, the labor market has tightened in the agriculture sector, resulting in agricultural wages increasing between 1995/96 and 2003/04. This seems to result from increased opportunities for migration, easier commuting to urban centers, and the development of the rural nonfarm sector, which may all have lowered the agricultural labor supply in local labor markets. Nevertheless, while agricultural and unskilled nonagricultural wages increased by about 25% and 20%, respectively, from 1995/96 to 2003/04, skilled professional wages increased by about 51% for those with 8–10 years of schooling and by about 250% for those with 11 or more years of schooling. In other words, despite the increase in agricultural wages, a significant increase in skill premia has widened wage differentials. The gap between male and female wage rates has increased as has the gap between Dalit and higher caste wage rates.

Opportunities to migrate are not equitable. Migration has become a growing source of income for Nepalese households in recent years. Although a relatively large percent of migrants still migrate internally and to India, the proportion of migrants going elsewhere increased steadily between

1995/96 and 2003/04. The change is most apparent for the highest expenditure quintile households.

Similar trends can be observed for remittance flows over this period. The proportion of Nepalese households that received remittances rose from about 23% in 1995/96 to about 32% in 2003/04. The increase was particularly large for remittance inflows from abroad other than India, and was again greatest among the highest expenditure quintile. Thus, some groups of households seem to have better opportunities to migrate abroad than other groups. India still provides an alternative place to earn income for households whose heads are illiterate or are Dalits or Muslims, who tend to fare badly within Nepal. This suggests that exclusion on the grounds of caste or religion and relatively limited employment opportunities at home prompt these households to search for jobs outside the country.

The amount of remittances received by households varies widely depending on the education level and ethnicity or caste of household heads. Although households with relatively less-educated heads are more likely to receive remittances, the amount of remittances received in per capita terms is greater for households with more-educated heads. In terms of ethnicity and caste, Brahman and Chhetri and Hill Janajatis tend to receive higher remittances than the average. Furthermore, households in the highest expenditure quintile receive a significantly higher amount of remittances than do other expenditure groups.

Such observations suggest unequal access to economic opportunities in Nepal as well as abroad. The report suggests that this is due mainly to inequity in accessing education and skill development, unequal provision of infrastructure, and unequal access to productive assets.

Despite progress in school enrollment rates, particularly primary education, access to education and vocational training remains inequitable and is partly responsible for unequal access to opportunities. According to the diagnostic framework (Figure 12), education plays an important role in enhancing access to economic opportunities by strengthening human capabilities. However, Nepal shows a great disparity in education level among working-age population. People residing in Kathmandu or other urban areas, Brahman, Chhetri, Newar, men, and the highest expenditure group, tend to have more years of schooling than others. Individuals aged 15 or older in the highest expenditure quintile had about 6.3 years of schooling, while those in the lowest expenditure quintile group had only 1.3 years of schooling in 2003/04. Only 8% of Dalit women in the Terai are literate. Such a disparity becomes a concern particularly given that people with higher education earned very large premiums in 2003/04. As a result, per capita expenditure grew by 76% for highly educated people during 1995/96–2003/04, while it grew by only about 42% for the population as a whole. Thus, to promote inclusiveness of growth, children, the future force of labor, must have equal access to schooling and be enabled to complete primary education and make the transition to secondary school.

Nepal has made a significant progress in primary school enrollment during the last decade, particularly among the disadvantaged groups, including girls, people living in the rural Western Hills and Terai, Dalits, Terai Janajatis, and lower expenditure groups. These pro-poor trends result from government policies, private sector expansion, and increases in household demand for education. Nevertheless, a disparity remains in primary school enrollment rates. For example, the net primary school enrollment rate for the poorest quintile was 16.6 percentage points below the national average in 2003/04. There is also a room for girls to catch up with boys. In addition, Muslims had the lowest net enrollment rate in 1995/96 and the smallest increase in the rate from 1995/96 to 2003/04.

In secondary education, improvements were less impressive than in primary school education. The progress was particularly limited for upper secondary school enrollment rates. In lower secondary school, children living in Kathmandu and those belonging to Brahman, Chhetri, Newar, and higher expenditure quintile groups (i.e., relatively advantaged segments of society) had the greatest increase in enrollment rates during 1995/96–2003/04. This has widened the gap in accessing lower secondary education across the country.

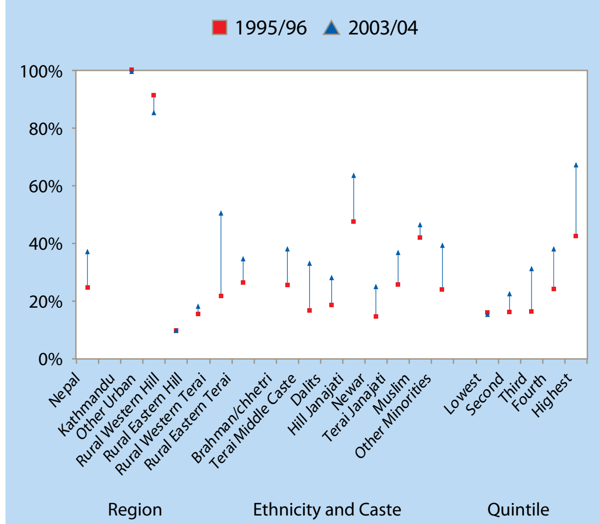
The Council for Technical Education and Vocational Training, established in 1989 under the Technical and Vocational Act of 1988, is responsible for managing a limited number of public technical schools across the country. There is, nonetheless, an urgent need for cost-effective skill development schemes for the wider population, particularly those who have little access to technical education or vocational training opportunities.

Relatively well-off households seem to have benefited most from the improved infrastructure. Access to a road has an important impact on household welfare in Nepal and other landlocked countries. Roads ease access to basic services such as education and health and to economic opportunities. Roads can facilitate migration for work, which could provide new employment opportunities or an additional source of income to smooth household consumption and cope with risks.

Nepal has made efforts to improve its road networks during the last few decades. The percentage of households that can reach a paved road within 30 minutes increased from about 24% in 1995/96 to about 37% in 2003/04 (Figure 13). Given that accessibility was already high in urban areas, much of the improvement took place in rural areas. However, there remains great room for improving connectivity. This particularly applies to mountain and hill parts of the country. In terms of ethnicity and caste, the disadvantaged groups, particularly Dalits and Hill Janajatis, appear to have more limited access to roads than do other ethnic groups. There are also differences among expenditure groups. The highest expenditure quintile group has the best access, and enjoyed the greatest improvement in accessibility during 1995/96–2003/04. Thus, although efforts to provide roads were made in rural areas during this period, relatively well-off households seem to have benefited most from the improvement.

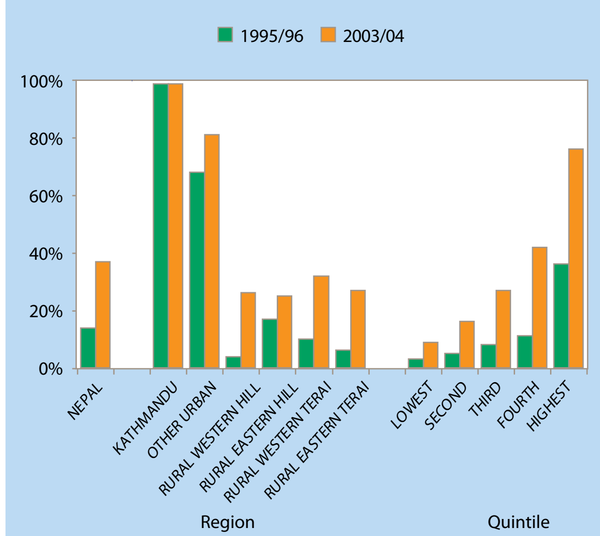
Access to electricity also needs improvement. Despite the country's hydroelectric

Figure 13
Access to Paved Road by Regions, Ethnicity/Caste, and Expenditure Quintiles (1995/96 and 2003/04)



Central Bureau of Statistics. various years. *Nepal Living Standards Surveys.* Kathmandu.

Figure 14
Access to Electricity by Regions and Expenditure Quintiles (1995/96 and 2003/04)



Central Bureau of Statistics. various years. *Nepal Living Standards Surveys.* Kathmandu.

resources and some improvement in accessibility during 1995/96–2003/04, a majority of households did not have access to electricity. As Figure 14 clearly illustrates, limited access to electricity is primarily a rural phenomenon— almost all households in Kathmandu had access to electricity, but only about 25% of those in the rural Eastern Hills had access in 2003/04. The disparity in access also occurs among expenditure quintile groups, with households in the upper end of expenditure distribution benefiting most from the recent improvement.

Unequal access to productive assets such as land and credit critically constrain equal access to economic opportunities. Land is one of the main productive assets, particularly in countries like Nepal where the majority of the poor are engaged in the agriculture sector for their livelihood. Equality in accessing land is thus an important issue for enhancing the inclusiveness of economic growth. In Nepal, landownership is also a broader indicator of socioeconomic status. Land titles are, for example, perceived to be a requirement for obtaining a citizenship certificate or for accessing a number of productive services.

Table 6 shows that about 77% of households owned land in Nepal in 2003/04. But the size of landholding indicates an unequal distribution of land. While average landholdings declined by about 24%, from 1.04 ha in 1995/96 to 0.79 ha in 2003/04, the reduction was highest among the poorest expenditure quintile group. As a result, the average size of land owned by the poorest expenditure quintile was less than half that owned by the richest expenditure quintile in 2003/04. Inequality is even greater for irrigated land. The significant improvement in access to irrigation seems to have benefited the wealthier expenditure quintile groups relatively most (Table 3). Hence, the relatively limited size and poor quality of land (especially in terms of access to irrigation) are critical constraints to inclusiveness, perhaps more so than land ownership per se.

Accessibility to financial services also plays a key role in ensuring equal access to economic opportunities. Access to financial services enables poor households to smooth consumption and manage risks. The country's financial sector has become deeper and there has been a rapid increase in the number and type of financial intermediaries in the past few decades. Nevertheless, access to financial services remains limited and has actually been deteriorating in recent years. Given that the share of loans from the informal sector tends to be high among relatively worse-off households and informal sector interest rates are generally higher than those in the formal sector, the poor are likely to face a greater burden than others in repaying loans.

One of the challenges Nepal faces is to channel remittances into productive sectors of the economy. The data show that the bulk of foreign remittances is used for consumption and to repay loans (loans most likely incurred by workers to migrate abroad). As a result, remittances are often a missed opportunity for increasing access to formal financial services in Nepal.

Inadequate Social Safety Nets

Inadequate social safety nets can also constrain inclusive growth. The importance of social safety nets cannot be overemphasized in countries like Nepal where deep-rooted exclusion of certain segments of society exists. One way of examining the adequacy of social safety nets in Nepal is to compare its provision with that of other countries. An ADB study constructed an internationally comparable social protection index—a summary indicator of the overall level of social protection activities in a country. The index 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.

This index ranks Nepal 24th of 31 countries. Although Nepal's ranking is higher than that of Bhutan and Pakistan, it is lower than that of other countries in South Asia. Nepal also scores below the average for all four components of the index. Total expenditure on social protection was about 2.3% of GDP in 2002/03, or about $5.5 per capita. The relatively small share of social protection expenditure in GDP indicates the country's limited financial capabilities. In addition, almost half of total social protection expenditure is spent on 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.

While the coverage rate varies across programs, the overall rate was only 18% of key target groups, such as the unemployed, the elderly, the poor, and the 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 relief, including microfinance, food for work, and educational assistance. Nonetheless, only 35% of the poor are estimated to be receiving some form of social protection assistance.

Recent years have seen increasing efforts to implement social inclusion and targeted programs in response to the 10th Five-Year Development Plan's recognition of the importance of inclusion. To eliminate the prevailing regional, caste-based, and other inequalities, the current Three-Year Interim Plan (2007/08–2009/10) focuses on inclusive and targeted programs by reducing the gap between the available opportunities and

Table 3
Land Ownership and Access to Irrigation (1995/96 and 2003/04)

	Land Ownership (%)		Average Land Area (ha)		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 and 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
Dalits	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
Muslims	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**

ha = hectare, NLSS = Nepal Living Standards Survey
Note: Land area and share of irrigated land are means for those who owned land.
Source: Central Bureau of Statistics. various years. *Nepal Living Standards Surveys*. Kathmandu

access. Although the share of 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 that the targeted population is experiencing.

Other Constraints on Inclusiveness

The report considered other possible constraints to inclusiveness, such as access to heath services, safe drinking water, and sanitation systems. Given the significant improvement in health outcomes in recent years, access to these services may be less critical for inclusiveness at present. Nevertheless, in the long run, the government may want to continue its efforts to improve the provision of such key social services.

4

Overcoming Critical Constraints To Inclusive Growth

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 a lot more needs to be done.

Many of the critical constraints to economic growth and its inclusiveness are interlinked. Only when the political situation is stabilized can various 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. Yet 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 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 investments from domestic and foreign sources. But, to ensure high 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 the manufacturing sector 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 substantial increases in levels of development and recurrent expenditures, which may be greater than the resources available. Creation of fiscal space will therefore need to be another area in any future strategy.

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.

Strengthen Governance

The main focus of the diagnosis has been on what has gone wrong. The reasons for the problems, the prioritization of options for how to solve them, 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 a more representative, democratically elected government (33% of the Constituent Assembly's members are women, and Dalits and Janajatis are better represented than ever before) in office 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 through establishing the structures and institutions of a democratic federal republic that will be representative and responsive to the needs and interests of Nepal's population, including groups that have historically suffered exclusion from the political process; provide services more effectively and accountably; and 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 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, to control corruption, to build effective institutions of democratic governance, and to 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. This is likely to include, among other measures,
    - 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

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, and there will be a need to mobilize domestic and foreign private investments to meet the infrastructure needs. Thus, an underlying principle would need to 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 existing 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, with the aim 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 private sector participation.
- Allocate government budget for associated infrastructure (roads and distribution) for development.

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 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 of the alternative trunk roads 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 both at construction and maintenance stages.
- Ensure adequate O&M funding for the Roads Board by exploring 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 ground water 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 needs.
- Strengthen farmers' and water users' associations and transfer smaller government-managed irrigation schemes to them.
- Facilitate exploitation of ground water for irrigation, particularly in the Terai region.
- 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

Several important initiatives that are ongoing will go a long way in removing rigidities related to the labor market and improving industrial relations. One of the more prominent initiatives 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 the right to strike and lockouts, and 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 ILO assistance.

Support Expansion and Diversification of the Industrial Base

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 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.

Promote Economic and Social Inclusion

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 Nepalese workers, including from poorer groups, to work overseas, building on lessons from World Bank–ILO 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 Karnali zone.
- Review and update the Agricultural Perspective Plan, particularly with respect to policies and approaches on 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 sectors.
- 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 oversees 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. This includes free lower secondary education up to grade 8. There will be a strong focus on improving the quality and governance in education. The program targets are to
  - o increase primary school enrollment to 100% by 2015 (from 92% in 2009),
  - o increase secondary school enrollment 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 micro-finance industry and constraints to 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 micro-finance institutions.
- Run information, education, and communication campaigns about available microfinancial 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.

Create Fiscal Space

"Creation of 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.
- Restructure or retire nonperforming and nonpriority initiatives and public enterprises.
- Regularly review priority projects to ascertain their efficiency.
- Revive the medium-term expenditure framework process and introduce it at the sector level, starting with leading sectors such as education.

The Way Forward

These policy recommendations form a huge agenda. 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. Such an agenda must take account of practical and political constraints. This diagnosis can only make suggestions and recommendations. Ultimately it is the government and people of Nepal who 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 on the way forward will need to be informed by further political economy analysis, 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 these actors have the support required to implement recommendations.

However, there is also a need to act urgently. Inclusive growth and jobs are needed now to meet popular expectations and to provide stability in Nepal for the long term. The government has developed its National Development Strategy Paper, which it is presenting for discussion at the Nepal Development Forum in May 2009. This report aims to add to these discussions, at the forum and thereafter, so that a well-informed consensus can emerge.

As part of a continuing dialogue it is hoped that the government will also announce at the National Development Forum 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 this report, and for further work on the constraints to inclusive growth in Nepal. The secretariat of the Nepal business forum could also be given the responsibility of drawing together this research with other related work, for example, the investment climate assessment and survey on migration opportunities, both being by the International Finance Corporation (IFC), International Labour Organization (ILO), and 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 this 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, 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.

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Highlights of *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*—attempts to identify the causes for the slow growth by examining three questions:

- What are the critical factors constraining investments and economic growth?
- What should policymakers do to revive investments?
- How can economic growth be made more inclusive?

This highlights of the main report present the key findings from examining the three questions.

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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.

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ILO was founded in 1919, in the wake of a destructive war, 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. ILO became the first specialized agency of the UN in 1946.

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