Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized

Report No. 29382-NP

Nepal
Development Policy Review

Restarting Growth and Poverty Reduction

March 24, 2005

Poverty Reduction and Economic Management
South Asia Region

Document of the World Bank

CURRENCY EQUIVALENTS

(Exchange Rate Effective June 17, 2004
Currency Unit = Nepalese Rupees (NRs)
US$1.0 = 73 NRs

FISCAL YEAR

July 15 – July 14

ACRONYMS

ADB	Asian Development Bank
ADB/N	Agriculture Development Bank of Nepal
AEC	Agro Enterprises Center
APP	Agricultural Perspective Plan
ASPR	Agriculture Sector Performance Review
BOT	Build Operate and Transfer
CBO	Community Based Organizations
CBS	Central Bureau of Statistics
CFUG	Community Forest Users Group
CLDP	Community Livestock Development Project
CMF	Center for Micro-Finance
CSCL	Community-based Self-help Cooperative Ltd.
DADO	District Agriculture Development Office
DALY	Disability adjusted life years
DDC	District Development Committee
DIMC	Decentralization Implementation and Monitoring Committee
DOLIDAR	Department of Local Infrastructure Development and Agricultural Roads
DOR	Department of Roads
EFA	Education For All
EHC	Essential Health Care
EPF	Employment Provident Fund
EU	European Union
FDI	Foreign Direct Investment
FFE	Food for Education
FNCCI	Federation of the Nepalese Chambers of Commerce and Industry
FNCSI	Federation of Nepal Cottage and Small Industries
FWDR	Far Western Development Region
FY	Fiscal year ending 14 July of the year specified
GDP	Gross Domestic Product
GOI	Government of India
GON	Government of Nepal
GWhr	Gigawatt hours
HDP	Hydropower Development Policy
HVC	High Value Crop
HH	House Hold
HMGN	His Majesty's Government of Nepal
ICD	Inland Container Depot
ICIMOD	International Center for Integrated Mountain Development
IDA	International Development Association
IFAD	International Fund for Agriculture Development
ILC	Irrigation Line of Credit
IMF	International Monetary Fund
INGOs	International Non-Government Organizations
IPM	Integrated Pest Management
IPP	Independent Power Producer
JT/JTA	Junior Technicians and Junior Technical Assistants
LB/LG	Local governments and local bodies
LRMP	Land Resource Mapping Program
LSGA	Local and Self Government Act
MCPW	Production Credit for Rural Woman
MFA	Multifibre Arrangement
MFIs	Micro Finance Institution
MFN	Most Favored Nations
MHP	Micro Hydro Power
MOAC	Ministry of Agriculture and Cooperatives
MOF	Ministry of Finance
MTEF	Medium-Term Expenditure Framework
MOICS	Ministry of Industry, Commerce & Supplies
MOLD	Ministry of Local Development
MOFSC	Ministry of Forest and Soil Conservation
MOT	Ministry of Transport
MOWR	Ministry of Water Resources
NARC	Nepal Agriculture Research Council
MPPW	Ministry of Physical Planning and Works
MTEF	Medium Term Expenditure Framework
MW	Megawatts
MWDR	Mid Western Development Region
NDF	Nepal Development Forum

FOR OFFICIAL USE ONLY

NEA	Nepal Electricity Authority
NPC	National Planning Commission
Nepal SIMI	Nepal Small Irrigation Management Initiatives
NGOs	Non-Governmental Organizations
NLSS	Nepal Living Standards Survey
NPDP	Nepal Power Development Project
NRB	Nepal Rastra Bank
NRs	Nepali Rupees
NTFP	Non Timber Forest Products
NTSC	Nepal Trade and Competitiveness Study
OAP	Old Age Pension
OWC	One Window Committee
OECD	Organization for Economic Cooperation and Development
PAF	Poverty Alleviation Fund
PDF	Power Development Fund
PPI	Private Participation in Infrastructure
PRSP	Poverty Reduction Strategy Paper
PSLP	Priority Sector Lending Program
PTC	Power Trading Corporation (India)
RCIW	Rural Community Infrastructure Works Program
REDP	Rural Energy Development Program
RMDC	Rural Micro-Finance Development Centre
RMDP	Road Maintenance and Development Project
RMRP	Road Maintenance and Rehabilitation Project
RNAC	Royal Nepal Airlines Corporation
RSF	Rural Self-Reliant Fund
RUPP	Rural Urban Partnership Program
SAARC	South Asian Association for Regional Cooperation
SARI/E	South Asian Regional Initiative for Energy Cooperation and Development
SASEC	South Asian Sub-regional Economic Cooperation
SEB	State Electricity Boards (India)
SFCL	Small Farmers' Cooperative Limited
SFDB	Small Farmers' Development Bank
SFDP	Small Farmers' Development Program
SIDA	Swedish International Development Agency
SME	Small and Medium Sized Enterprises
SPS	Sanitary and Phytosanitary Measures
SNV	Netherlands Development Organization
SPO	Sub Project Offices
TA	Technical Assistance
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
UP	Uttar Pradesh
VAM	Vulnerability Analysis Mapping Approach
VDC	Village Development Committee
WB	World Bank
WFP	World Food Program
WTO	World Trade Organization
WUA	Water Users' Association

Vice President:	Praful C. Patel, SARVP
Country Director:	Kenichi Ohashi, SACNP
Sector Director:	Sadiq Ahmed, SASPR
Sector Manager:	Kapil Kapoor, SASPR
Task Managers:	Ahmad Ahsan, SASPR & Sarath Rajapatirana, Consultant

Team Members. Lynn Bennet, Giovanna Prennushi (Poverty, MDGs and Exclusion); Roshan Darshan Bajracharya, Bigyan Pradhan, Sailesh Tiwari, (Fiscal and Financial Management); Christopher J. Costain, Sabin R. Shrestha (Finance and Private Sector), Mudassar Imran, Tenzin Dolma Norbhu, Binyam Reja (Infrastructure); Sakwa J. Bunyasi, Gloria Kessler (Agriculture); Robert P. Beschel, Vikram Menon, Geeta Sethi, (Governance, Decentralization); Rajendra Joshi, Qaiser Khan, Tirtha Rana, Robert J. Palacios, Tashi Tenzing (Service Delivery, and Social Protection); Bala Bhaskar Naidu Kalimili, (Data and Statistics); Shahnaz Sultana Ahmed, and Neena Shrestha (document production and logistics). Dr. Deva B. Shakya and staff of the Agro-Enterprise Center of the FNCCI provided a background paper on the "Agriculture Development Programme for Hills of the Mid-Western and Far-Western Regions of Nepal, A Concept Paper", May 2004. The team thanks peer reviewers Meena Acharya (Institute for Integrated Development Studies, Kathmandu), Brian Pinto (The World Bank), and John Williamson (Institute for International Economics) for very helpful comments. The team also thanks Dina Umalili-Deininger, Mark Dutz, Elena Glinskaya, Nick Manning, Daniel Sellen, Isabel G. Lavadenz Paccieri, Donna Thompson, and Salman Zaidi for comments and suggestions at various phases.

The team thanks Honorable Vice Chairman of the National Planning Commission, Dr. Shankar Sharma, Dr. Yuba Raj Khatiwada, Member, National Planning Commission and other members of the DPR Advisory Committee of His Majesty's Government of Nepal, Dr. Tilak Rawal, Governor, Nepal Rastra Bank, Dr. Bimal Koirala, Chief Secretary, Mr. Bhanu Acharya, Secretary, Finance, and the staff of the various Government, private, research, and civil society organizations, the DDC members from Parbat and other districts, and former members of the VDC (Chua) for their guidance during the DPR mission in January-February 2004. The team also thanks all Government officials and other participants in three workshops, chaired by Dr. Sharma and Dr. Khatiwada, held as part of the DPR draft consultations from October 10 to 12, 2004 in Kathmandu, Nepal.

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not be otherwise disclosed without World Bank authorization.

TABLE OF CONTENTS

Figures

Tables

EXECUTIVE SUMMARY

A. Overview

1. *Nepal – with a difficult geography, a feudal history and a late start in development – made good progress in overcoming these constraints within the short span of a few decades; but now this progress is under serious threat from conflict at home and a more competitive environment abroad.* Policy reforms starting in the mid 1980s significantly increased per capita income growth and there is emerging evidence of a significant decline in poverty in the second half of the 1990s that is corroborated by improving human development indicators. Still, as the intense conflict and political instability in Nepal indicate, progress was neither fast enough and nor were its benefits well distributed to meet the tide of rising expectations that accompanied the advent of democracy in 1990. Due to its extreme initial poverty, even after 15 years of reasonable growth ending in 2001, Nepal remained a very poor country with the lowest per capita income in South Asia.

2. *Further, inequality in income and human development left the mid- and far- Western hill regions and the Janajati (indigenous) and Dalit ("oppressed") groups lagging behind and feeling excluded.* This exclusion has helped to fuel an eight-year long Maoist insurgency and social conflict that has sharply escalated since 2001. A constitutional crisis following the suspension of parliament in 2002 has created further uncertainty. This conflict combined with a more competitive external environment has led growth to falter in the last three years and now threatens to reverse Nepal's progress. The extent of this threat cannot be over-estimated. If the threat posed by this conflict is not addressed through peace or mitigation, Nepal could join the few countries that achieved considerable progress but then went on to lose a decade or more of development during when poverty reduction and human development were markedly reversed.

3. *This report, the Nepal Development Policy Review (DPR) of 2004 provides an assessment of Nepal's progress in development and discusses the development policy agenda and priorities to accelerate development.* The aim of the review is to inform both Government policies and further refinement of its poverty reduction strategy as well as World Bank assistance and policy dialogue. It takes as its point of departure the 10th Five Year Plan (2002-2007) and its Summary/the Poverty Reduction Strategy Paper (PRSP) and presents a menu of policies that address three related development themes. The first is the need to restart and accelerate growth mainly through commercializing agriculture and increasing trade and competitiveness. The second is making growth more inclusive through focusing on developing agriculture and the lagging Western regions. The third is improving governance and public service delivery by strengthening institutions at both the national and local government levels. In discussing these issues, the DPR presents recommendations, at the end of this executive summary, to help Nepal achieve its development goals. But implementing many of these policies will require a political consensus and mitigating, if not ending, the adverse effects of the insurgency and political discord among the principal actors. It is important to note that it is outside the purview of this Review to discuss the political process of reaching such a consensus. However, following the 10th Plan/PRSP's approach, this review highlights the risks of an alternative scenario if a consensus is not reached and majority of the policies recommended are not implemented.

B. Constraints and Challenges

4. *Lack of Connectivity*: Because of Nepal's geography, transport costs are very high, hindering the growth of commerce and markets, and contributing to regional disparities in economic and human development. Given that many disadvantaged groups live in relatively remote regions, the lack of physical connectivity mirrors to some extent the lack of social connectivity. The high level of ethno-linguistic fractionalization and the isolation of mountain and hill population made it very difficult to

achieve better distribution of even the modest gains from growth that took place after 1985. This together with social exclusion may have contributed to the present crisis over time.

5. *Deficient policy regimes:* Until the mid-1980s, the policy regimes were interventionist, protectionist and public sector led. The exchange rate was overvalued. The policy environment resulted in limited private sector activity and depressed investment and foreign trade. GDP did not grow fast enough or have a broad base, being mainly confined to construction, trade and hospitality sectors, missing the benefits of the Green Revolution in agriculture that was taking place in neighboring countries. The policy regime created rents for some segments of the society, while others did not have access to opportunities to earn higher incomes or to public services.

6. *Limited governance and institutional development:* Good governance is hindered by a legacy of gender, ethnic and caste-based social stratification coupled with high ethno-linguistic diversity. The centralization of power in the Government and in the Kathmandu area has not helped to extend development to the mid-Western and Far Western regions. While there have been good efforts in recent years to address this issue through decentralization and devolution strategies, much remains to be done. Over-centralization of government in an ethnically and culturally diverse country also meant that economic opportunities and service delivery were poor in the remote regions. Consequently, the insurgency has planted its base firmly in those remote Western regions, further hampering the delivery of public services to those areas. Deepening the vicious cycle of lack of representation and poor service delivery, conflict has also led to the dismantling of local Governments in the past two years.

7. *External conditions have become more challenging.* An increasingly competitive external environment caused by the winding down of the Multi-fibre Arrangement, the loss of market share in key exports such as carpets, and a more restrictive trade treaty with India suggest that the rapid growth of exports and the non-agricultural sector in the 1990s cannot be sustained without implementing further policy reforms and improving infrastructure. Exports have sharply fallen since 2001. The progress in integrating with the world economy in the 1990s is likely to be reversed unless Nepal implements measures to raise competitiveness. Meanwhile, Nepal's competitors in its major exports have undertaken stronger reform measures making them more competitive compared to their past and in relation to Nepal. Thus, Nepal has a formidable reform agenda ahead to keep pace with its competitors.

C. Policy Reforms and Response

8. *A fiscal and external payment crisis led to reforms starting in the mid-1980s.* The reforms progressed in four phases. The first phase liberalized the import regime, investment and licensing regulations, the financial sector, and improved fiscal and financial management. In the second phase, in the early 1990s, entry of firms, trade and current account transactions, and financial sector policies were liberalized and important governance reforms such as an independent auditor general and parliamentary oversight were introduced. In the third phase, in the second half of the 1990s, the agriculture sector was liberalized, a VAT was introduced, and local government laws were passed. In the last three years, the fourth phase, the Government has implemented further tax reforms, improved public expenditure management, strengthened anti-corruption institutions, and infrastructure and financial sector regulatory frameworks. The Government is gradually devolving service delivery management to local communities to increase their power to monitor and discipline service providers and to increase accountability.

9. *Nepal's economy responded well to these reforms.* Per-capita income growth accelerated since the mid-1980s, the economy became more diversified, and income volatility decreased markedly. Per capita growth rate rose to 2.5% p.a. between 1986 and 2001. The economy became more open and diversified as the share of trade in GDP and in world exports almost doubled. The share of agriculture dropped from 70% to 40%. The pattern of growth also changed in the second half of the 1990s as agricultural growth

rates accelerated and its contribution to growth increased. Growth in incomes in this period also appear to have been pro-poor in the sense of leading to a proportionately greater increases in consumption by the lower two deciles.

10. *A preliminary analysis of the Rural Household Consumption survey (2001), the Demographic and Health surveys, and the Nepal Living Standards survey of 2003/2004 suggests that there has been a significant decline in poverty since the mid 1990s, though inequality across regions has persisted and poverty may have increased in the last three years given the lower GDP growth rate.* Initial results of the latest household survey suggest that poverty declined from 42% in 1996 to about 31% in 2003/04. Higher agricultural incomes combined with a swift increase in remittances were associated with these first signs of falling poverty. Consistent with the decrease in consumption poverty, surveys also show a perceptible improvement in related human development indicators, higher consumption of durables, and significantly greater access to services. Despite this progress, Nepal remains very poor given that it started its development from a very low base and late. Nepal is also unlikely to achieve key millennium development goals such as universal primary education, child malnutrition, maternal mortality, and access to safe drinking water. More importantly, the differences in poverty and human development indicators across different regions, ethnic groups and castes have persisted, which gives rise to social stress and conflict. Reduced GDP growth in recent years may have reversed gains in poverty reduction made until 2001.

11. *Further, Nepal's good progress over 1985 to 2001 could not be sustained in the face of conflict and a sharp slump in exports since 2001.* Nepal's GDP growth declined in FY 2002 and while a modest recovery is underway, per-capita GDP in 2004 will not have recovered to their 2001 level. The recovery is fragile as it is mainly based on a good monsoon and foreign remittances. Private investment – currently at around 12% of GDP compared to the average of 15% in the mid 1990s -- remains shy and key non-agriculture sectors, whose growth accounted for three-fourth of the growth in the 1990s, are performing significantly below trend. Sectors which enjoyed substantial export led growth (e.g. manufactures such as garments and carpets) in the 1990s are now facing low demand and adverse medium term prospects. Except for tourism (4% of GDP), most of the service sector is also similarly afflicted. But tourism itself is threatened by the insurgency and street demonstrations.

12. *After nearly two decades of better performance, three issues stand out as medium term challenges.* First, growth has to be restarted and accelerated to reduce poverty and cope with Nepal's population increase. Even with 2.5% per-capita economic growth between 1985 and 2001, large incidence and pockets of poverty persisted. And even if Nepal's fertility rate declines to the average level of selected Asian countries, Nepal will add 40 million to its population in the next 50 years.[1] Without faster growth of income and employment, Nepal will be unable to provide employment for the 2.8% growth p.a. in labor force that is currently taking place. Second, economic growth has to be more pro-poor, inclusive and spatially even. Of particular importance is the need to accelerate agricultural growth rates. Further, more attention has to be paid to the lagging regions. Despite plans to the contrary, investment in infrastructure in the poor and excluded Western regions lagged considerably behind, resulting in lower economic opportunities. Third, governance and public service delivery has to be improved by strengthening institutions at both the national and local government levels.

D. Development Agenda for Restarting Growth and making it Inclusive

13. *The Government is aware of the challenges and has included goals to address them in its strategy. Achieving the goals of the 10th plan and PRSP will require restarting inclusive growth while maintaining*

[1] Thapa, Shyam, "Population Growth in Nepal: The Challenges Ahead", Perspective, 2001. Dr. Thapa cites a UN Study's estimate of 21 Asian countries.

macroeconomic stability and undertaking reforms to increase competitiveness. The goals or the four pillars of the Government's poverty strategy are: (i) broad based growth, with special emphasis on agriculture; (ii) accelerating human development through renewed emphasis on effective delivery of basic social services and economic infrastructure; (iii) ensuring social and economic inclusion of the poor, marginalized groups and backward regions; and (iv) vigorously pursuing good governance as a means of delivering better development results and to ensure social and economic justice. In addition, public investment will be appropriately focused on developing social and physical infrastructure.

14. *Meeting the PRSP's first aim of reducing poverty through broad based income growth will depend critically on raising growth of agriculture to the PRSP target of 4% and above and through accelerating the growth of aggregate productivity from its current low rates.* Agriculture growth particularly in the lagging regions will also support the objective of social inclusion. Excessive reliance on raising investment rates significantly may neither be feasible nor advisable in a poor country where resources are highly constrained. The main thrust should be to raise overall productivity in the medium term by commercializing agriculture and increasing Nepal's trade and competitiveness. Achieving this will depend, in turn, on a sound macroeconomic framework and improving the investment climate and the incentive regime.

Macroeconomic Policy

15. *A sound fiscal policy, complemented by prudent monetary and exchange rate policies, underpinned Nepal's better economic performance in the 1990s; but, there are three impending fiscal challenges that have to be addressed to achieve steady and stable growth.* First, the most significant danger is contingent and off-budget liabilities arising from the financial sector related to two large, wholly or partly owned, Government banks that have a negative net worth of around 7% of GDP. Further, with the present liabilities of the Agricultural Development Bank of Nepal (ADBN), total financial sector liabilities can increase the fiscal burden by as much as 10% of GDP – or roughly of the same order as tax revenue collection. The second challenge to fiscal stability and sustainability is posed by the rapid growth in pension liabilities in the next decade that will further crowd out pro-poor spending. The third cause of fiscal vulnerability is low tax revenue collection (9 to 10% of GDP), causing Nepal to be excessively dependent on external assistance and constraining public services, growth, and future revenues in a vicious circle.

16. *Given the scarcity of resources, Government needs to make public spending more effective through four measures.* First, budget envelopes need to be made more realistic. The medium-term expenditure framework (MTEF) introduced in 2002 has been a good start for prioritizing development expenditures, but it only partly addresses the issue of unrealistically large development budget envelopes. A second measure would be to base the MTEF on program budgets that integrate and prioritize regular (current) and capital expenditures. This will also help the Government to improve donor harmonization. Third, regular tracking of expenditures and development outcomes along with publicly disseminating the findings will help to achieve development targets. A fourth way to increase the effectiveness of public expenditures would be to leverage private provision of services and infrastructure investment.

External Sector

17. *The external sector is crucial for the growth of a small-open economy such as Nepal and opportunities exist in several areas to increase competitiveness.* However, external sector adjustment is needed to avail these opportunities and restore growth of exports and the manufacturing sector. Export growth has fallen to 8% in the current year compared to 15% growth p.a. in the 1990s. The medium term outlook is clouded by the rescinding of the Multi-fibre Arrangement in 2005 that will put Nepal at a disadvantage vis-à-vis the duty free access of African garments exporters to the US market under the

African Growth and Opportunities Act. Yet, Nepal has opportunities to exploit to increase its competitiveness: its comparative advantage in a number of agriculture and manufacturing niche markets, its proximity to the large and fast growing Indian and Chinese economies, the availability of preferential access to Europe and to India, hydroelectric resources for power exports to the supply constrained Indian markets; its natural beauty and important religions and cultural sites that draw tourists; a growing pool of educated labor, and "catch up opportunities" to raise productivity.

18. *But Nepal has to undertake significant trade policy and behind- the-border reforms to improve the investment climate and to take advantage of these assets.* First, the remaining anti-export bias has to be reduced by adjusting tariffs away from their present cascading structure. Second, improvements in customs, duty drawback, trade facilitation, standards and quality, infrastructure and transport, and business support services will be crucial. Third, regulatory reforms in labor markets and in specific sectors such as garments, carpets, agriculture to remove price or entry restrictions have to be addressed.[2] These measures are needed to make the country more competitive both within and outside the region.

19. *Nepal can also take measures to benefit from the large and swiftly growing Indian market and the trade preferences its exports to India and EU enjoy. First, Nepal needs to broaden its agreement with India to include and attract Indian investment.* The aim should be to forge Indian capital, technology and market access to Nepalese capital, labor, and resources. To this end, Nepal has to pursue the proposed Bilateral Investment Promotion and Protection Agreement to provide further assurance on investment and trade rights to investors (including Indians). Efforts to forge formal agreement should be further complemented by advertising efforts to attract investment from India. Thus, Nepal should make a special effort to advertise its preferential access to Europe through the "Everything But Arms" initiative. Second, economic diplomacy with the Indian central government needs to be extended to the neighboring Indian states, for ensuring market access and easing transit rights. This is important as state governments wield discretionary powers that sometimes disrupt trade. Third, Nepal needs to harmonize border procedures, documentation, special economic zones (SEZ) rules, product standards and Customs software with India such that Indo-Nepal trade and transit is easily facilitated and third country oriented exports can also proceed with minimal transactions costs. Fourth, Nepal could facilitate Indian interests in Nepal by proceeding with building the Tibet-India transit routes and in return request more transit routes and shipping facilities at a variety of Indian ports including the efficient Mumbai port.

20. *A crucial challenge for Nepal now is to sustain the level of the current remittance earnings, which now account for about 12% of GDP.* Government is now preparing a new Act/Policy guideline relating to Migration and Foreign Employment. A formal memorandum of understanding has been signed with Malaysia and ratified. Talks are proceeding with Qatar, UAE, Hong Kong and Korea. Nepal could take three other measures to sustain foreign employment. First, the most important, for the long run is the need for continued investments in education, with special emphasis on the English language, to increase the demand for Nepalese labor abroad. Second, employment-seeking talks also need to be extended to countries such as Japan, where aging of its population will require the import of more foreign labor. Third, if the private sector is not forthcoming, Nepal needs to provide attractive financial instruments for Nepalese labor to transfer their salaries via formal channels. In general, service standards in the transfer of remittances that allow a quick and secure transfer of funds is important. Finally, Government also needs to ensure a joint public and private sector oversight body to ensure that Nepal's business reputation as a reliable source of educated and disciplined labor is maintained. Conversely, this oversight should also ensure that unscrupulous private sector operators do not defraud the hard-earned remittances by workers.

[2] See Ministry of Industry, Commerce and Supplies, HMGN, *Nepal Trade and Competitiveness Study*, 2004 for more details.

Improving the Investment Climate

21. *Aside from restoring peace, or at least significantly mitigating the conflict, improving the investment climate will be essential for restarting growth.* It will depend on three broad factors i.e. strengthening business environment regulatory framework to promote competition and efficiency, undertaking financial sector reforms to ensure access to credit, and improving infrastructure.

22. *Reform of the regulatory framework would include the following.* First, to reduce the costs of entry, there is need to clarify and simplify the implementation of the rules of entry. For this Government could reduce the number of institutions involved and adopt automatic clearances (e.g. company registration could be linked to the tax system). Second, the bankruptcy law needs to be modernized through the new Company and Insolvency Acts to allow easier and less time-consuming exit policies. Third, consensus needs to be built around an appropriate competition law for Nepal, emphasizing both traditional law enforcement (control of cartels, abuse of dominance and mergers) as well as enhanced competition advocacy – influencing the regulatory process to spur grass-roots entrepreneurship as well as influencing public awareness of all stakeholders regarding the benefits of competition. Finally, labor market rigidities need to be addressed. Legislative reforms are needed to allow flexible labor contracts under which employers could retrench workers with reasonable compensation (in fact, rigid labor laws encourage extra-legal contracts and hiring many foreign nationals because they are easy to get rid of). Due to the rigidity of the labor laws, formal-sector wage differentials between India and Nepal are becoming narrower than what differences in labor productivity would warrant. As labor reforms may take time due to political opposition, Government could proceed, as announced in the last budget speech, to set up Special Economic Zones and Export Processing Zones where more flexible labor market conditions could prevail.

23. *In the case of infrastructure, transport remains a key constraint.* Nepal has one of the lowest road densities for a landlocked country. In a terrain where roads are the main arteries of the economy, their lack means connectivity becomes a costly constraint. An estimated 3.5 million people (15% of the population) do not have road access in Nepal; some villages can be up to 13 days walk to the nearest road. To increase connectivity five issues need to be addressed. These are: (i) ensuring adequate funding for road maintenance (only 50% of the needed funds are available) and making expenditure more effective through institutional arrangements such as the Roads Board; (ii) expanding the domestic road network and increasing public funding for it through completing key North-South corridors, the fast track Kathmandu-Terai link, and expanding and upgrading rural roads; (iii) better coordinating public spending on roads to meet demands for private sector development and public services; (iv) creating room for greater private sector participation through improving the legal environment and institutional reform; and (v) ensuring that rural roads program supports local economic needs by transferring authority and providing technical assistance to District Development Committees (DDCs).

24. *Nepal has vast hydroelectric resources, which present a source of wealth and exports to India.* But, access to power is highly limited in rural areas and power costs are among the highest in South Asia. Despite this potential and a large increase of capacity in the last five years, only 522 MW has been developed so far. Only 40% of Nepalese households have access to electricity. The agenda of reform would include the following: (i) cut system losses that are still high at about 24% to gain efficiency and revenue and reduce business costs; (ii) examine alternative restructuring options to lower costs of the power sector through negotiating good contracts with private providers and using the growing prospect of power trading; (iii), explore the power export potential to India (since at present it exports only 10% of generation); (iv) promote more commercial and private sector led power exchanges and ratify the Power Trading Agreement between India; and (v) perhaps, most important, set up a competent and effective independent regulatory body for attracting efficient private investment.

25. *Developing telecommunications is a key to increasing connectivity and external competitiveness.* Despite strong growth, there is still considerable unmet demand and costs for firms are among the highest in the region. A reform agenda would involve increasing competition in the sector, rebalancing tariffs to reduce cross subsidization, expanding access to the rural areas, reforming institutions to clarify regulatory authority between the NTC and FMD and commercializing the NTC perhaps with a view to privatization of the services. There is also the need to clearly separate the government's policy-making and operational roles in the sector. The Government has started to implement these policies by creating Nepal Telecoms and proceeding to divest its stake.

26. *In addition to sector-specific regulatory agencies, Nepal would benefit from an improved legal and enabling environment for private sector participation and strengthened capabilities for contract design, bidding and monitoring across infrastructure sectors.* The lack of sufficient protection of investor rights in the existing Build Operate Transfer (BOT) Ordinance (2003) and Rules (2004), coupled with a potential exclusive emphasis on unconstrained sole source contracting, creates an undesirable environment that is not in the interest of the country as a whole. There is a need to professionally review the existing Ordinance and Rules within the context of the broader legal enabling environment for private sector participation, together with a decision on appropriate measures to strengthen the existing BOT cell within the Ministry of Physical Planning and Works. Such a review will help to ensure that all projects benefit from sufficient policy development, information sharing and implementation capacity.

Fostering Growth in Agriculture and the Lagging Regions

27. *Agriculture is central to poverty reduction and growth in Nepal.* It contributes about 40% of GDP; it employs more than two-thirds of the labor force. It is especially important to the poor, as it is the main source of income of the poorest households (90% of the bottom consumption quintile). Unsurprisingly, stagnant per-capita agricultural incomes over the last few decades were associated with Nepal's persistently high poverty rates until the mid-1990s. Conversely, accelerating agricultural growth has helped reduce poverty since the mid-1990s.

28. *Sustaining and improving the agricultural sector's growth performance over the longer term, will require emphasis on increasing farm productivity and agricultural marketing efficiency to strengthen farmer capacity to respond to growing domestic and international market opportunities.* This will involve policy and regulatory reforms to reduce the barriers to increased private sector participation and investments in the agricultural sector, including reforms of land and credit policies and regulations governing agricultural trade. It will require fostering increased public and private investments in rural infrastructure (roads, markets, electrification) and rural services (credit, agricultural research and extension, land administration, market information, export promotion, phyto-sanitary services, grading and quality control). Integral to the revival of the government's investment program will be institutional reforms of government agencies to ensure the improved delivery of rural-related public goods and services, including through greater participation of users and communities.

29. *Developing agriculture in lagging regions is a principal factor in poverty reduction and conflict resolution.* Developing agriculture in the mid-Western development region (MWDR) and the far-Western development region (FWDR) is a crucial issue for Nepal both for prosperity and peace. These regions lag significantly behind the rest of Nepal by most development indicators and poverty is more acute. Yet, these regions have considerable growth potential. The strategy for developing the lagging regions could include the following elements: (i) strengthening rural connectivity and access to markets and market services; (ii) regulatory and legal reforms to promote contract farming and producer marketing groups; (iii) developing innovative approaches to irrigation, such as drip irrigation; (iv) improving research and extension services, including through private sector and NGO participation, to improve access by farmers

to better technologies and farming practices, including support for diversification to high value crops such as horticulture; and (v) formulating market promotion strategies.

Addressing Social Exclusion and Improving Institutions and Governance

30. *Improving governance is constrained by a legacy of gender, ethnic and caste-based social stratification coupled with high ethno-linguistic diversity. Against this backdrop, there are four main challenges to improving governance.* These are (i) strengthening the accountability and representative institutions that Nepal has built up at the local government and national level; (ii) improving government effectiveness by making the civil service more accountable, disciplined and professional; (iii) restarting decentralization so that the government is more responsive to the heterogeneous needs and preferences of a diverse people, and (iv) encouraging government and public service providers to be more inclusive to reduce large gender, ethnic and caste based disparities. To implement these Nepal can draw on an unusually active community involvement – that is, the presence of active local social capital -- in development witnessed in many areas such as forest, education, roads, irrigation, water and sanitation.

31. *At the civil service level, the Government has several priorities.* First, the civil service has to be made more effective and professional through improving its skill mix, increasing incentives by raising the salaries of senior managers and professional staff, enforcing tighter discipline, better performance evaluation, and more diversity. A related issue is clarifying accountability between the civil service and politicians by changing civil service rules. As part of the effort to improve the effectiveness of the civil service, a second important priority will be to implement measures already outlined in the government's "roadmap" to promote greater gender, caste and ethnic diversity at all levels in the civil service.

32. *After having achieved a strong start, decentralization has now stalled as the tenure of the last local governments expired in 2002 and Government now needs to resolve key pending issues.* One indication of the recent slowdown is that although the Government has set up a high level Decentralization Implementation and Monitoring Committee (DIMC) this body has not met for the last two years. One way to restart the process is by making the DIMC resolve key pending issues such as the following: consolidating the size and number of Local Bodies to ensure that they have adequate revenue bases; implementing administrative decentralization through forming a local Government civil service clearly accountable to them; clarifying ambiguity between various political and administrative entities at the local level, including DDCs, VDCs, School Management Committees and line departments. This would require amending the provisions in 21 Acts that contradict the Local Self Governance Act. Alongside administrative decentralization, fiscal decentralization needs to be strengthened through clarifying overlapping and limited expenditure assignments and improving revenue decentralization and collection incentives, and bringing more clarity to the fiscal transfer system.

33. *With the 10th Plan/PRSP there has been explicit recognition of caste and ethnicity as factors affecting income and human development outcome, and the importance of social inclusion.* Besides grassroots development programs, there has been some recent advancement at the policy level. Although it still leaves some issues un-addressed, the passage of the 11th Amendment (known as the Women's Inheritance Bill) in 2002 was a step towards greater legal equality for women. Progress has been slower on caste and ethnic groups. Although there are laws setting punishments for discrimination against Dalits, many forms of discrimination are commonly practiced throughout the country. A further challenge to inclusion is to help non-Nepali speaking children from ethic and linguistic minorities to transition successfully into the Nepali-medium schools by providing bilingual teachers – preferably females from disadvantaged groups. On a broader front, the government has shown its concern for increasing the representation of excluded groups not only to the civil service, but also in elected government (at all levels) and in health, education and employment. This effort will need strong political backing and expert technical advice to look at a range of strategies adopted by other countries that have tried to redress

historical discrimination without undermining meritocracy or creating rigid and divisive entitlement systems.

Human Development Policies and Social Protection

34. *Nepal has achieved considerable progress in improving human development indicators in the past decade but significant disparities persist.* Initial results from a sub-sample of a recent household survey shows that the people perceive much improved access to education and health services compared to 8 years ago. Still, Nepal could fall below MDG targets and the goals of the Tenth plan in areas such as maternal mortality, child malnutrition, and sanitation. Further, large regional and social group based disparities persist.

35. *Education funding, quality, management by local communities and secondary and tertiary education are issues to be addressed.* After achieving 80% net enrollment rates in primary education Nepal faces many challenges in meeting the goal of universal primary education (UPE) along with ensuring quality. The first is to provide adequate funding, supplies and teachers for public schools so that the poor are not deterred by high costs of fees that schools feel compelled to charge to meet these needs. Second, faced with school bureaucracy or teachers that are not accountable to local communities, Nepal now has embarked on a program to empower communities to manage their own schools. This measure will have to be implemented with proper legal basis to resolve ambiguity of roles. Resistance from government officials will need to be countered by transferring the authority for hiring teachers to these communities. As this is a new initiative, there is need to monitor and evaluate its impact. Third, while major gains have been made in prioritizing primary education, more resources will be needed for secondary and tertiary education. This would require greater private sector participation and cost recovery.

36. *Health strategy needs to prioritize public spending and promote greater private sector participation.* Nepal witnessed many health status improvements in the 1990s. But, given the poor initial conditions and deficiencies in delivery systems, several health indicators (such as maternal mortality, child malnutrition) are among lowest in South Asia. There are also considerable differences in access to heath services based on income group, locality, caste, ethnic group and gender. Communicable diseases, maternal mortality, and poor nutrition cause most of the burden of disease. Although the Government's 10th Plan the Health Sector Strategy puts forward an Essential Health Care Program of four priority interventions, the allocations of public funds – mostly more tertiary care -- do not reflect these priorities. Alongside ensuring adequate resources, the other challenge for Government is ensuring that the priority interventions are well implemented. This will require the Government to follow through on its program to devolve public health posts to Local Health Management committees. Government will have to formulate a more systematic strategy to mobilize the private sector, which accounts for 70% of all health spending, for providing services for the poor.

37. *Water supply and sanitation coverage has grown but quality has emerged as an issue.* In the 1990s, the sector saw reforms that shifted from the supply driven approach to service delivery of the 1980s to a demand driven approach. It also adopted participatory decision making in delivering rural water and sanitation services. In addition, community participation has shifted from voluntary labor contribution to community empowerment and management. Though this approach had much success and officially 80% of Nepal's population has access to safe water, in practice poor maintenance has led to poor quality of water supply and doubts whether MDG targets can be reached. A host of issues need to be addressed for further progress in this sector. These include little coverage in the Eastern regions, poor coordination by overlapping sector institutions, unreliability of supply and water quality, lack of a adequate framework for community participation, thinly spread public expenditures, politicization of tariff adjustments for cost recovery and lack of good monitoring and evaluation systems.

38. *Social protection require better coordination and avoiding large potential liabilities*: Recognizing that accelerating economic growth is not sufficient for poverty reduction, the 10th Plan includes several targeted programs intended to protect the most vulnerable as part of its social protection pillar. But there are questions about the effectiveness of a patchwork of Government programs many with small numbers of actual beneficiaries and relatively high administrative overheads. The origin of many of these programs is ad hoc: either when Nepal signs international conventions (e.g. children, disabled etc.) or sometimes when they are leftover from donor funded programs that have lost external support. The main issue about social protection schemes in Nepal is that they need coordinating and better evaluation of their effectiveness to focus on a few effective programs such as the Old Age Pension scheme. The second issue is the potential financial liability as well as the labor market rigidities that Nepal's back-loaded formal pension systems create.

E. Medium Term Prospects

39. *Nepal is at cross roads today between the prospect of sustaining and accelerating appreciable gains in human development and poverty reduction and the dangers of serious reversals of these gains.* The PRSP presents two medium term scenarios – the normal case and the alternative case – to take into account the downside risks arising from the present conflict and constitutional crisis. Underpinned by a prudent fiscal framework that lowers public sector borrowing requirements to less than 1% of GDP in the final year, the "normal" scenario in the PRSP projects growth rate of 6.2% p.a. over the next five years – with growth rates reaching a maximum of 7.5% at the end of the plan. The alternative low-case scenario projects a 4.3% growth rate per annum. It is more likely that the alternative scenario is the relevant one given recent developments. Much depends on a return to peace. Otherwise, even the alternative scenario may not be feasible. Raising productivity will likely be the main driver in accelerating growth rather than raising savings and investments.

40. *There are considerable risks in the medium term arising out of the conflict, implementation capacity, and external conditions.* The risks are the following. The first and most important risk comes from conflict and the constitutional crisis that have created instability and uncertainty about institutions, rules and laws. The second risk arises from the tension between the substantial reform agenda and the Government's capacity to implement it. A more competitive external environment brought about by the forthcoming phasing out of the MFA and Nepal losing market share in other exports poses the third risk. The fourth risk is a long term risk, which requires intervention now. At current fertility rates, there will be more than a tripling of population in the next 50 years with tremendous pressure on land and other resources. The fifth risk is posed by the contingent liabilities of the non-performing assets of the two large banks whose negative net worth are estimated to be about 7% of GDP.

41. *The Development Policy Review has highlighted technical aspects of implementing of three key themes of the 10th Plan/PRSP – accelerating growth, making growth more inclusive, and strengthening institutions for good governance.* Implementing the specific recommendations will require willingness on the part of all parties to discuss, evaluate and come to an agreement on these specific measures. It is only then that the PRSP/10th Plan's normal case can be achieved.

Key Recommendations

Economic Management

Improve economic management through better high level monitoring of economic, trade, transport, and agricultural performance and hold regular consultations with private sector groups to identify critical areas for policy formulation.

Address emerging actual and contingent fiscal liabilities. Restructure the two main commercial banks and undertake pension reforms to maintain fiscal soundness and introduce an explicit reporting system on the financial operations, guarantees issued and balance sheets of public enterprises to monitor actual and contingent liabilities.

Raise revenues by devolving more administrative power and budgets to the DGs of Inland Revenue Department and Customs. Implement a Custom's modernization plan, computerize tax processing to reduce discretionary power and transactions costs.

Improve public expenditure management by: (i) preparing program budgets that integrate all expenditures in the MTEF; (ii) raising allocation and implementation of expenditures on key economic activities in roads; (iii) raising expenditures of non-salary current expenditures; (iv) tracking expenditure; and (v) increasing fiscal decentralization through transferring more functions and budgets for service delivery to local Governments.

Agriculture, Trade, and Investment Climate

Promote the commercialization of agriculture through the development of infrastructure, and improved delivery of agricultural services and legislation to make contracts, commercial farming and farmer marketing groups more legally secure; ensure supply of credit through MFIs as ADBN is restructured, and introduce matching grants; and secure land rights through better land records to remove all remaining ambiguity on the dual tenure system.

Adopt a comprehensive lagging regions strategy to develop the mid- and far- Western hills and mountain areas through providing roads, infrastructure, and policies to facilitate private sector and farmer group based commercial agriculture.

Set up an Apex Trade organization to implement proposals of the Government's Nepal Trade and Competitiveness Study to improve trade policy coordination, reduce customs and transport costs, improve facilities for standards and market access, improve conditions for FDI by reducing SME reservations, and address the specific supply side constraints in garments, carpets, tea, and other sectors. Use Nepal' access to the EU's EBA facility to attract capital and expertise from India and other countries to locate production in Nepal.

Amend the labor act to make the labor market more flexible by enabling contracts between employers and employees that allow flexible hiring and retrenchment arrangements on agreed terms. Provide exemptions from labor market constraints within export processing and special economic zones.

Attract PPI in transport, power and telecommunications sectors with revisions to existing laws such as the Build Operate Transfer Ordinance (2003) and Rules (2004) to protect investor rights while ensuring sufficient transparency and competition, strengthening capabilities for contract design, bidding and monitoring, and setting up independent regulators.

Corporatize Nepal Electricity Authority and proceed with unbundling of operations. Set up a formula approach to tariffs to avoid politicizing tariff setting. Ratify the Power Trading Act and the Power Trade Committee.

Increase transport connectivity by (i) improving road maintenance through increasing allocations to be spent through the Roads Board; (ii) extending the road network by completing the three North-South corridors in the Western regions, complete the Kathmandu-Terai fast track link and upgrading rural roads; and (iii) reducing transport costs through harmonizing border procedures and documentation with India and other neighboring countries for groups to identify and resolve key policy and implementation issues.

Key Recommendations

Improving Public Services, Empowering Communities and Promoting Inclusion

Strengthen institutions for accountability and transparency by restoring representative local Governments, financial management rules (such as making the Auditor General's Report accessible to the public) and introducing a Freedom of Information act missing in Nepal

Improve civil service performance and professionalism through salary decompression and increase in executive ranks, tighter enforcement of discipline, making transfers transparent and counter signed, and making civil service more inclusive through measures suggested in the report. Clarify accountability of political and civil service levels through sharper delineation of roles.

Restart decentralization and strengthen devolution by empowering local governments and communities by making service providers responsible to them. Create local Government civil service recruited on a centralized merit basis, but employed by local Governments. Transfer greater resources to local Governments through the DDC formula and make the formula more comprehensive; clarify all ambiguity with respect to functional authority of local Governments vs. central agencies.

Take advantage of Nepal's effective community group organizations and local social capital through devolving authority, responsibility and resources for service delivery to water user, road user, water and sanitation, and women's savings associations, school and health management committees. Clarify ambiguities concerning roles between local Government and community groups. Transfer recruitment authority of teachers to school management committees and stop centralized recruitment. Transfer all water and sanitation project maintenance to user groups after their rehabilitation is complete.

Introduce better performance evaluation of local Government and service groups through regular public expenditure tracking and core welfare and service delivery surveys to be carried out by independent parties and make this information available to all user groups.

Address the main diseases that contribute to the burden of disease by extending Essential Health Care package, in phases, with special focus on improving coverage of nurse-midwife attended births. Reform regulatory framework to encourage greater private and NGO participation in the delivery of basic health services.

Enforce new laws to increase representation of Janajati, Dalit and women in civil service and other public institutions. Set up a bilingual education program at the primary level for transition of children from non-Nepali to Nepali.

Rationalize social protection programs through evaluating their impact and cost-benefits. Expand small but good base of micro credit organizations to include savings and other micro-life insurance.

CHAPTER 1: ASSESSING DEVELOPMENT OUTCOMES - GROWTH, POVERTY REDUCTION AND SOCIAL INCLUSION

A. Difficult Initial Conditions and Challenges

1. *Nepal had a late start in development in the 1960s and faced formidable challenges, including a difficult geography and a history that left it extremely poor in terms of physical and human capital endowments.* In terms of geography, Nepal is a landlocked country with a difficult terrain that rises steeply from the plains of Terai in the South to the middle hills and to the Himalayan range in the North. Transport costs are very high, hindering the development of commerce and markets, and contributing to regional disparities in economic and human development. For more than a century after 1846, Nepal was ruled by the dynastic Prime Ministerial Rana family, whose principal objective was the extraction of resources from the land and the people to support a lavish lifestyle and repress any political or economic threat to its continuity. Thus, as late as forty years ago, Nepal had strikingly low levels of human and physical capital and infrastructure compared to its neighbors. Today Nepal is the poorest country in South Asia with a per-capita income of about $250.

2. *The problem of Nepal's difficult initial conditions was compounded by the policies that Nepal followed in the next two decades until 1985.* These policies, based on development thinking of those times, were interventionist, protectionist, state-led, and resulted, until recently, in a large public sector, dominance of state corporations, and a closed economy leading to low levels of investment and productivity.

3. *Thus between 1965 and 1985, the first two decades for which data are available, per-capita economic growth was stagnant at round 0.6% (see Table 1.1 next page) but with the additional burden of Nepal's rising population growth rate and without the fruits of the Green Revolution then taking place in the countries to the South.* With a significantly appreciated real effective exchange rate in the first half of the 1980s, economic growth was heavily concentrated in the non-tradable activities, mainly in construction and restaurants and hotels.[3] Further, suppressed interest rates and the overvalued exchange rates led to capital-intensive production and employment growth was too slow to match the growth of people entering the labor force.

4. *Private sector investment rates were low during this period (at 9% of GDP, see Table 1.1) and the economy remained closed and undiversified with agriculture accounting for close to 60% of GDP and more than 90% of employment at the end of this period - the mid 1980s.* Infrastructure was very limited at the end of the period. As recently as in 1985, 78% of the working age population of above 15 years had no schooling compared to 61% and 63% in India and Bangladesh respectively. Finally, excessive Government expenditures and burgeoning deficits pushed Nepal into a fiscal and external crisis in the early 1980s.

[3] The real effective exchange rate is defined as the relative price of non-tradables to tradables.

Table 1.1 Economic Performance Indicators in Pre-and Reform Periods, and Recent Years

	1971-1980	1981-1990	1991-2000	2001	2002	2003	2004 est	Pre-Reform 1965-85	Reform 1985-2001	Entire Period 1965-2001
Growth (%)										
Real GDP Per capita Income	0.8	2.2	2.4	3.1	-2.8	0.7	1.4	**0.6**	**2.5**	**1.6**
Real GDP	2.8	4.5	4.7	5.5	-0.6	3.0	3.7	**2.6**	**4.8**	**3.8**
Population	2.1	2.3	2.4	2.3	2.3	2.3	2.3	**2.1**	**2.4**	**2.2**
Investment and Savings (% of GDP)										
Investment (Including Stocks)	16.3	19.9	23.3	24.1	25.6	26.9	27.2	**17.6**	**22.6**	**20.5**
Public Fixed Investment	3.9	7.7	7.0	7.6	7.6	6.9	7.2	**5.0**	**7.2**	**6.1**
Private Fixed Investment	9.2	10.8	13.7	11.4	11.7	12.3	12.8	**9.4**	**12.6**	**11.0**
Gross Domestic Savings	9.0	10.5	12.8	15.0	12.0	11.4	11.3	**7.5**	**12.3**	**9.6**
Fiscal Indicators (% of GDP)										
Revenue	6.5	8.5	9.8	11.4	9.3	12.4	12.2	**6.3**	**9.4**	**7.8**
Expenditure	11.0	17.6	16.5	17.5	17.6	16.1	17.4	**11.3**	**17.0**	**13.8**
Deficit	2.2	6.5	5.3	6.1	8.3	3.7	5.2	**2.5**	**6.0**	**4.0**
o/w Domestic Financing	1.1	2.8	1.5	2.7	4.8	0.9	0.9	**1.3**	**2.0**	**1.6**
Public Debt	..	..	64.4	63.8	69.7	66.6	64.0	**..**	**58.3**	**..**
Public Savings				0.2	0.2	0.8	0.1			
External Sector (% of GDP)										
Export to GDP	11.4	11.7	21.0	24.1	19.3	16.9	15.7	**11.5**	**17.9**	**15.8**
Import to GDP	16.1	21.1	32.2	35.6	30.6	31.5	31.8	**18.5**	**28.6**	**25.2**
CAB to GDP	-0.4	-4.7	-4.8	4.8	4.5	1.8	1.0	**-2.0**	**-4.0**	**-3.2**
Gross Official Reserves in Months of Imports	6.7	3.6	5.4	6.1						
Money and Credit (% of GDP)										
M2	16.2	27.2	37.5	52.2	53.0	54.2	56.1	**16.6**	**36.3**	**25.6**
Domestic Credit (net)	9.6	24.9	32.6	44.7	47.4	49.4	51.1	**10.5**	**32.4**	**20.4**
Domestic Credit to Private Sector (net)	6.1	11.3	21.4	33.2	33.6	35.9	..	**6.1**	**19.6**	**12.4**
Prices and Interest Rates (%)										
Inflation	7.5	10.6	9.3	2.2	2.9	4.5	5.3	**7.5**	**8.8**	**8.2**
Lending Rates	13.5	15.6	12.4	7.7	..	..	..	**14.7**	**13.5**	**13.9**

Source. World Bank estimates from various sources.

B. Reforms and Response

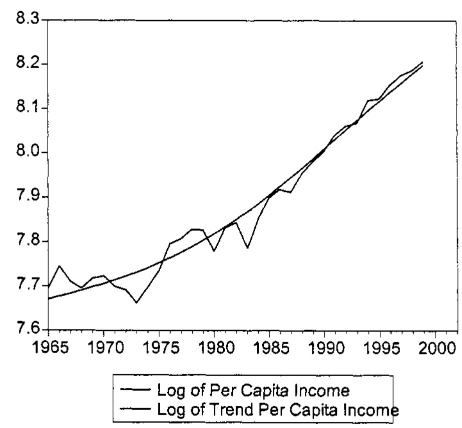
5. *Responding to balance of payments and fiscal crisis, Nepal started implementing economic policy reforms around 1985 that progressed over four different phases in the next twenty years.* In the first reform episode (1985-1986), public savings rose due to improvements in expenditure and tax policies. Importantly, a 15% step devaluation was undertaken to correct external imbalances that helped to offset a significant overvaluation of the exchange rate. Structural reforms made the first attempts to liberalize the import regime, introduced duty drawback and bonded warehouse schemes, and eased industrial licensing.

6. *In the second reform episode, in the early 1990s, the tax base was broadened, revenue administration improved and trade and industrial policies were further liberalized.* A steady reduction in tariffs was launched and quantitative restrictions virtually dismantled. In addition, the foreign exchange system was unified and Nepal attained current account convertibility. Interest rates were liberalized and banking sector entry was facilitated. The private sector expanded due to liberalization of entry through the new investment act and privatization. After stalling in the middle 1990s, the third reform episode around 1997 liberalized the agricultural sector, introduced a neutral VAT and strengthened local governments. In

the most recent reform episode since 2000, the Government has improved tax policy and administration, introduced a medium-term expenditure framework, restructured the management of Nepal's troubled two main commercial banks and strengthened financial sector regulations and anti-corruption efforts.

7. *As evident from Table 1.1 on the previous page, the economy responded well to these reforms.* First per-capita income growth accelerated markedly after reforms were launched in the mid-1980s (see also Figure 1.1) and the economy diversified (See Table 1.2) as the growth was led by industry and services. Second, the share of agriculture fell from 64% of the economy in the mid-1970s to less than 40% at the beginning of the 20th century. The share of industry increased from 12% to 21% thirty years later.

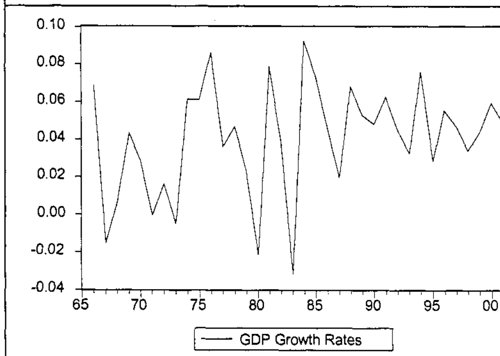
Figure 1.1 Logarithmic Level of Per Capita Income[4]



Source: World Bank estimates from CBS data

8. *Third, this diversification led to significantly lower volatility in incomes as evident in Figures 1.1 and 1.2* As the sources of growth moved away from agriculture to industrial and services sectors (finance and construction), and irrigation expanded, the dependence of the economy on rainfall declined. The standard deviation of per-capita GDP incomes fell from nearly 4 in the 1965 to 1985 period to around 1.5 in the second period. It is evident that achieving successful stabilization and better fiscal, financial and external sector policies helped to improve economic performance. Nevertheless, a considerable agenda remains pending.

Figure 1.2 Volatility in Incomes



Source: World Bank estimates from CBS data

9. *Notwithstanding these achievements, three significant development failures made the foundations of Nepal's development fragile, and sowed the seeds of the faltering economic performance and the violent insurgency in Nepal's countryside since 2001.* Foremost among the policy failures in the 1990s was the exclusion of certain regions and ethnic groups and castes from the benefits of growth and human development. In particular, the Western to Far Western hills region accounting for around 22% of the population and some specific ethnic and caste groups (the Dalits and indigenous Janajatis that account for 46% of the population[5]) were left lagging behind. A 1999 estimate suggests that incomes in the mid- and far-

Table 1.2 Nepal: GDP composition (% of GDP, Average of Period)

	1975-1977	1999-2001
Agriculture, fisheries, forestry	**64.2**	**39.0**
Industry	**10.6**	**20.4**
Manufacturing	4.8	9.0
Electricity, Gas, Water	0.3	0.8
Construction	5.4	10.1
Services	**25.2**	**40.7**
Trade, restaurants, hotels	4.1	11.2
Transport, communications, storage	5.4	8.5
Financial and real estate	8.5	10.1
Community and social services	7.2	10.9

Source: Estimated from CBS Data.

4 The trend of actual and logarithmic per capita GDP is derived from applying Hedrick-Prescott filters. This trend can also be seen as representing potential output suggesting that Nepal's economy achieved at or above potential in the 1990s, while less than so before that.

5 According to the 2001 Census.

Western hill regions were only one half of that in Kathmandu valley and Eastern Terai (Table 1.3). Similarly, these areas and excluded ethnic groups have lower education and literacy levels, and higher infant and maternal mortality rates.[6] Set against the high expectations brought by the advent of democracy in 1991, this exclusion led to disenchantment among the lagging groups and regions, which became the base of a violent "Maoist" insurgency.

Table 1.3 Disparity in Incomes and Human Development

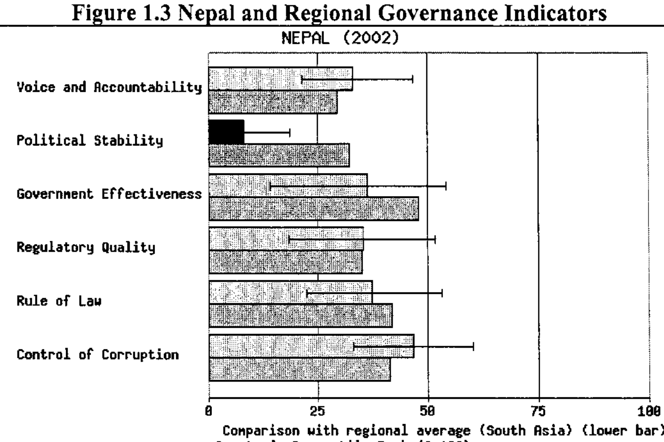
	Population (%)	Adult Illiteracy (%)	Human Poverty Index	Per Capita Income (PPP $)	Life expectancy (years)	Human development index
Urban	12	31	24	2133	71.1	.616
Rural	88	52	41	1094	58.7	.446
East	23	43	42	1073	62.0	.484
Central	35	52	41	1713	61.3	.493
West	20	48	40	1022	67.3	.479
Mid-West	13	52	43	861	53.2	.402
Far West	9	57	45	899	52.1	.385

Source: CBS and http://www.undp.org.np/publications/nhdr2001/chapter2.pdf

10. *The second policy failure was the inability to provide a policy environment to generate and sustain rapid growth to combat poverty.* Nepal's long-term per-capita growth rate of 1.7% p.a. between 1965 and 2001 meant that per-capita income grew from US$130 in 1965 to US$240 ($1350 in PPP terms) in today's dollars and exchange rates. Given that at the current trend of fertility decline Nepal's population is expected to grow to 77 million in the next four decades, it is clear that the population growth will be putting enormous demand on the country's resources and require a much faster growth in the demand for jobs. In the past slow growth also meant that growth of jobs was limited and did not keep pace with the growth of the labor force dampening the growth of wages. Of particular importance has been the lack of agriculture sector growth until the second half of the 1990s. On a per-capita basis, per-capita agricultural output remained largely stagnant over the thirty-five year period ending in 2001. As 85% of the population remains in rural areas and 80% of the labor force worked in the agriculture sector even as late as 1990, the stagnancy of the agricultural incomes largely explains the persistence of poverty into the mid-1990s. Conversely, the marked increase in agriculture growth, along with remittances, is likely the key factor behind poverty declining since 1996.

11. *The third policy failure lay in low Government effectiveness – i.e. the ability to implement its own policies -- combined with political instability.* The insurgency and the political conflict are undermining the credibility of public institutions. Comparison of measures of governance with neighboring countries (Figure 1.3) shows Nepal to rank poorly in several governance indicators but particularly so in political stability and government effectiveness. Moreover, in the last two years these indicators may have got worse.

Figure 1.3 Nepal and Regional Governance Indicators



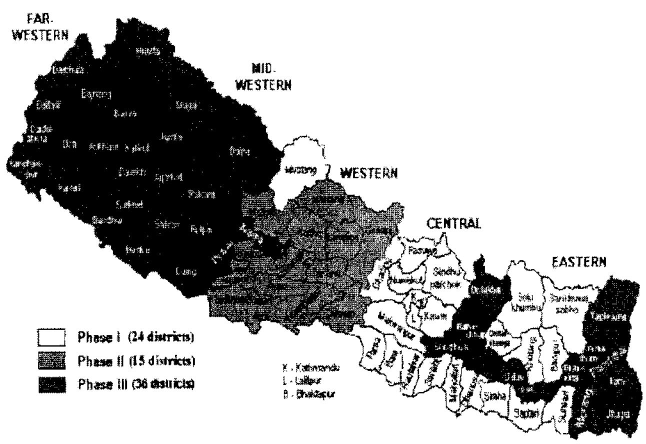
Source: D. Kaufmann, A. Kraay and M. Mastruzzi, 2003: Governance Matters III: Governance Indicators for 1996-2002 (http://www.worldbank.org/wbi/governance/pubs/govmatters3.html)

6 See Table 1.8 on page 12.

C. Development Under Threat – Recent Developments and Conflict

12. *Due to these policy failures, the achievements of the 1990s are now under threat of reversal from several directions and pose a considerable challenge to the Government.* An eight-year long insurgency that has claimed more than 10,000 lives - most of it since 2002 - has disrupted development and governance in big parts of Nepal, inflicting large costs of war (See Fig. 1.4 and Box 1.1). A more competitive external environment brought about by the rescinding of the MFA and steady loss in the market share of exports such as carpets suggests that the rapid growth in exports and the non-agricultural sector in the 1990s cannot be sustained.

Figure 1.4 Conflict Affected Districts in Nepal



Source: UN Notification, January 2004

13. *Indeed, in an early indication of Nepal's difficult medium term prospect growth has faltered from 2002 when Nepal was confronted by the confluence of adverse economic shocks -- excessive rainfall, a global slowdown that led to a collapse in exports, and a sharply escalated Maoist insurgency.* Nepal's GDP declined in FY 2002 and a modest and fragile recovery is underway with GDP growing by around 2.3 percent in FY 2003 and is expected to be close to 4% in FY 2004. Yet, the recovery is fragile as it is wholly based on a good monsoon and foreign remittances. Private investment – currently at around 12% of GDP compared to around 15% in the mid 1990s -- remains shy and key non-agriculture sectors, whose growth accounted for three-fourth of the growth in the 1990s, are performing significantly below trend. Sectors which enjoyed substantial export led growth (e.g. manufactures such as garments and carpets) in the 1990s are now facing low demand and adverse medium term prospects. Except for tourism (4% of GDP), most of the service sector is also similarly afflicted. But tourism itself is threatened by the insurgency and street demonstrations. Regenerating growth will require foremost the restoration of peace or at least a significant mitigation of conflict. But this requires an understanding of the origins of the conflict and its costs.

Box 1.1 The "Maoist" Insurgency in Nepal – Origins and Costs

The origins of the "Maoist" insurgency, which began in 1996 but became intense after 2001, lie in both ideological issues as well as regional, caste and ethnicity related exclusion issues. The ideological aspect is more related to Marxist-Maoist class conflict against "feudalism", whose main political demand is to hold a constitutional convention that would also consider the option of creating a republic as an alternative to the current system of constitutional monarchy. The caste and ethnicity based aspect is rooted in the exclusion of different caste and ethnic groups based on a specific hierarchy. The regional aspect concerns the mid and far western Hill regions that lag behind most development indicators where the Maoists' conflict originated (see Figure 1.4). Resolving the conflict will depend very much on the commitment of the different parties to agree to a common set of rules of the game with respect to politics as well as making economic growth more inclusive by different means discussed in the review.

The cost of the Conflict on the economy and the people are enormous. Currently the conflict is imposing high costs in terms of foregone growth and poverty reduction, through several channels:

-- dampened private sector investment and confidence due to insecurity and uncertainty;

-- extortion of rents and informal taxes by Maoists from large and small businesses; (Continued in next page).

Box 1.1 The "Maoist" Insurgency in Nepal – Origins and Costs (Continued)

-- lower public investment as development spending is curtailed;

-- lower sales of private firms by 20 to 25% to rural markets due to transport disruptions;

-- increase in transportation costs and time. For instance the transit time between Kathmandu to Birguanj/Raxaul, a key economic link, has been doubled due to the conflict;

-- direct costs to infrastructure, which is estimated at about $250 million;

-- human and capital flight away from conflict affected areas. Household survey data shows as many as 20% of male working age population have left some of the affected districts; and

-- disruptions in service delivery due to the dismantling of elected local Governments, and disruption of specific services. For example, compared to a national average of 75% of children being vaccinated, less than 37% of children had been done so in two conflict-affected districts surveyed recently. Education sector has suffered in particular due to attacks on teachers.

Overall, if one conservatively estimates that Nepal's GDP level and growth rates have fallen by 2% points p.a., this implies that in the next 5 years then per-capita-GDP will be more than 10% (if peace had been restored in 2002) to 14% lower (if peace is restored in the next few months) than it would be otherwise (See Chapter 7).

How could Nepal have grown reasonably rapidly, with significant decline in poverty, since 1996, in the midst of this conflict? The answer to this is the conflict has become truly intense since early 2002. Before that year, the conflict was a low-grade insurgency less disruptive than the typical political instability and frequent changes in Government that takes place in many developing countries.

14. *What can the Government do to mitigate the costs of conflict?* In addition to seeking political resolution to the conflict, one clear answer lies in much greater attention to economic opportunities and public services in lagging regions. One insight comes from looking at income and human development indicators in districts grouped according to the intensity of conflict (Table 1.4).

Table 1.4 Income and Human Development Indicators by Intensity of Conflict

Security status	Number of Districts	Population Growth Rate	Population 2001	Population Share	Area(km.²)	Human Development Index	Life Expectancy Years	Literacy %
Phase I	24	3.8	8626156	27.4	1555	0.38	63.3	39.4
Phase II (moderately affected)	15	3.8	16028936	50.9	1806	0.38	62.1	43.9
Phase III (highly affected)	36	1.6	6836412	21.7	83613	0.27	56.4	35.6

Source: World Bank estimates from various sources and UNDP circular, March 2004.

15. *According to the UN Security classification, significant conflict is now raging in 36 out of 75 districts (i.e. Phase III districts).* All together 51 districts (Phase II and III districts) are affected (see Figure 1.4). As table 1.4 shows the most conflict affected areas of Phase III, lag significantly behind in human development indicators such as life expectancy and literacy. Improving conditions in these districts in the Western and Far Eastern areas will require a focused agriculture strategy for these primarily hill regions, improvements in infrastructure and access, as well as improvement in public services and empowerment through effective decentralization. Since agriculture is at the heart of these

issues, a strategy for lagging regions is discussed in more detail in Chapter 4. More broadly though, the mitigation of the conflict will depend on Nepal's ability to restart growth of incomes and employment.

D. Policy Lessons from the Sources of Growth

16. *Seen from a long term perspective what are the policy lessons that can be drawn from Nepal's growth experience?* The stylized facts of Nepal's growth experience are its low average growth rate for the past 35 years (1.7% growth p.a. in per capita incomes, the lowest in S. Asia); the sharp acceleration that took place between 1985 and 2001 (2.5%) compared to the previous twenty years (0.6%); and the muted impact of growth on poverty reduction until the mid-1990s. The two proximate explanatory factors are low growth of the large agriculture sector and productivity. Growth in both cases improved and accelerated after 1985, and especially after 1995 in the case of agriculture. The underlying factor behind this acceleration was policy reforms that took place, starting in 1985, and then deepened, albeit haltingly, in the 1990s.

17. ***Improvement in Agricultural Performance and Diversification****. In sectoral terms, the most notable feature has been that per-capita agricultural value added has been flat over the thirty-five year span of 1965-2001.* During this period, aggregate GDP grew at just over 4%, the non-agriculture sector grew by 5.9%, while agriculture sector grew by 2.5%, i.e. roughly the same as population growth rate. Given that the importance of agriculture in Nepal's economy – accounting for more than two-thirds of value added in the beginning of the period and more than half of value added on average – its slower rate of growth dragged down overall per-capita growth rates. Further, given that 86% of the labor force was employed in agriculture on average during this period, this also helps to explain the persistence of poverty until well into the mid-1990s. Conversely, when annual agriculture growth accelerated to 3.7% in the second half of the 1990s, or about 1.5% p.a. in per-capita terms, this combined with remittances by Nepalese labor abroad, is associated with an appreciable drop in rural consumption poverty according to preliminary estimates.[7]

18. *The reasons for low agriculture growth are the following.* First, inadequate infrastructure development – the lack of roads and access to markets and irrigation – raises input and technology costs, lowers output prices and dampens commercialization and incentives for growth. The lack of infrastructure particularly lowers incentives for hills agriculture. Second, the consistent under-funding of public investment in agriculture and related infrastructure.[8] Third, the policy environment with restrictions on private supply of agricultural inputs due to the monopoly position of the Agricultural Inputs Corporation until 1997 hindered the supply of affordable high-yielding inputs. Finally, agriculture sector terms of trade fell for most of this period, excepting towards the end of the 1980s and the second half of 1990s.[9]

19. ***Trends in Productivity****. Another factor behind low growth in Nepal has been the low growth of productivity.* Aggregate productivity actually declined in the first two decades since 1965 as investments on less competitive non-tradable sectors such as construction dominated economic activity. After liberalization and stabilization reforms started in 1985 productivity increased significantly by more than 1.3% point p.a. i.e. from -0.8% in the previous period to 0.5% (see Table 1.5, below).[10] Thus, the growth in productivity can explain all of the acceleration of GDP growth.

---

7 See discussion below in Section E of this chapter.

8 Sharma, Shiva and Sonali Deraniyagala, "Agricultural Reforms and the Performance of Agriculture", Chapter 5, in *Macroeconomics of Poverty Reduction: The Case Study of Nepal*, UNDP, UN House.

9 Terms of trade movements have been measured via the changes in the ratio of agriculture to non-agriculture deflator. Note other studies also support this picture of the movement in the terms of trade.

10 The acceleration of growth in total factor productivity since the 1990s or the second half of the 1980s and onwards is found by a number of papers using different methodologies: e.g. Khatiwada, Y.R., Suman K. Sharma, Vikash R. Satyal, Ram S. Kharel, "Nepal Sources of Economic Growth", Institute for Integrated Development Studies, Nepal, 2002, Table 4.2. , Bajracharya, P. and Bajracharya, S. "Total Factor Productivity Growth in Nepal: An Estimate, *Economic Journal of*

Table 1.5 Growth of Factors and Their Contribution

	Growth Rate		Contribution of		Growth Rates		
	GDP	TFP	Capital	Human Capital	Capital	Human Capital	Labor
1972-1985	4.2	-0.8	3.3	1.7	6.8	3.3	2.5
1985-2001	4.9	0.5	2.7	1.7	5.7	3.3	2.5
1972-2001	4.6	-0.1	3.0	1.7	6.2	3.3	2.5

Source: Estimates by A. Ahsan, and B. Karmacharya, "Explaining Nepal's Growth", 2004, mimeo.

20. *Why did productivity growth accelerate in the 1990s?* Empirical analysis of the determinants of growth and productivity suggests the following: the adjustment of real effective exchange rates, current account liberalization, stabilization as indicated by higher foreign exchange reserves for needed imports, and an improvement in the terms of trade, all contributed to higher productivity. Trade policy reforms that took place steadily over the decade opened the economy to greater competition and exports, while at the same time facilitated the imports of raw materials and capital goods. While difficult to capture quantitatively, productivity in the 1990s should have also increased in response to regulatory and banking sector reforms that increased factor mobility in both real and financial capital. Agriculture sector reforms liberalized private sector trade in both agricultural inputs and outputs.

21. ***Policy and Institutional Factors.*** *A third insight to the sources of Nepal's growth comes from the policy and institutional variables, drawing on the results of more than a decade of research on determinants of growth across countries.* A good summary of the results of this research lists the major variables that have affected growth across time and across countries as presented in a variety of papers.[11] Using this framework, the acceleration of per capita growth rates in Nepal from 1.1 % during 1972-1985 to 2.5% during 1985-2001 is explained by good fiscal management, financial deepening, and openness of the economy. Conversely, inadequate investments in transport and communications and exchange rate overvaluation lowered growth. Chapter 3 discusses developments in these areas.

E. Poverty Reduction and Millennium Development Goals

22. *There was reduction in poverty but progress was delayed and uneven.* During the mid 1990s to 2001, there has been a significant reduction in poverty indicated by an increase in consumption, in the ownership of household durables and improvements in human development indicators.[12] Rural per capita consumption growth appears to have been "pro-poor" in the sense that it increased more for those in the lower deciles[13]. The sources of growth in this period, agricultural incomes and remittances from labor, could account for the relatively equitable pattern of growth. Yet, it is noteworthy that inequality between the regions has persisted with the mid- and far- Western regions continuing to lag behind. (see Box 1.2). The prevailing social structure, which excludes certain ethnic communities and "low caste" dalits has adverse impacts on both poverty reduction and empowerment. A mixed picture emerging with respect to

Development Issues, 2002, and Ahsan, A. and B. Karmacharya, Explaining Nepal's Growth Performance, Mimeo, World Bank, 2004.

11 Sources: From World Bank Growth website, downloaded in 2003.

12 The evidence comes from the Rural Household Consumption Survey of 2001, the Demographic household survey of 2001, and the preliminary analysis of the partial sample from the Nepal Living Standard Survey of 2003/04. *A cross-check on the robustness of these results is provided by a detailed analysis of food consumption, ownership of durables, and household amenities.* In FY01 rural households consumed 30% more eggs, 17% more milk, twice as much oil, more vegetables, fruit, meat (40%), and fish (60%) than in FY96. Consumption of foodgrains, which can be seen as "inferior goods", declined slightly. Encouragingly, consumption of higher-quality food items increased equally or more for people in the bottom four deciles of the consumption distribution than for the better-off. Similarly a higher percentage of households owns radios, televisions, telephones, and bicycles

13 Note: The figure refers to per capita consumption adjusted for temporal price changes and spatial price differences, with the Eastern Terai region being the numeraire. For details, see Lanjouw, Prennushi, and Zaidi (1998) and Prennushi (2004). Data sources: 1995/96 NLSS I and 2000/01 NRHCS.

the likelihood of Nepal achieving MDGs and underscores that growth must be maintained and service delivery must improve to raise achievements.

23. *Significant improvements appear to have taken place in all agro-climatic belts and regions, but the regional ranking does not seem to have changed.* The Western part of the country and the mountains remain poorer than the Eastern part.[14] The rural eastern Terai (which comprises the Terai belt of the Eastern and Central Development Regions) is the area where improvements in consumption levels seem most significant.

Box 1.2 Increase in Consumption in Rural Areas and Decrease in Subjective Perceptions of Poverty

Increase in Real Consumption in Rural Nepal

By Area	1995-96 Real per capita consumption FY96 prices	2000-01 Real per capita consumption FY96 prices	% increase p.a.
All rural	5938	6934	3.1%
Western Hills	5316	6214	3.2%
Eastern Hills	6771	7217	1.3%
Western Terai	5444	6245	2.8%
Eastern Terai	6111	7746	4.9%
Mountains	5564	6498	3.1%
Hills	6095	6734	2.0%
Terai	5867	7182	4.1%

Using survey-based food prices (cumulative increase: 50% over five years)
Source: RHCS 2001

Subjective Perceptions of Poverty

(% of respondents)	1995-96	2003-04
To the question during the last month, did your family have less than adequate consumption of :		
Food	51	32
Housing	64	41
Clothing	58	36
Health Care	59	28
Children's Schooling	45	21
During the last month, did your family have less than adequate total income :	73	67

Source: NLSS I & II

[14] For an analysis of regional differences based on the 1995/96 Nepal Living Standards Survey (NLSS I) see the 1998 Poverty Assessment (World Bank, 1998) and Prennushi (1999), as well as CBS (1996, 1997).

24. *These improvements in economic well-being are mirrored by improvements in some social indicators.*[15] Data from the Nepal Demographic and Health Surveys of 1996 and 2001 indicate a decline in all three malnutrition indicators in rural areas: height-for-age, weight-for-height, and weight-for-age. Infant mortality declined from 78.5 to 64.4 and child mortality from 118.3 to 91.2 per thousand. The total fertility rate went down from 4.6 children per woman to 4.1. School attendance increased as well, encouragingly more for girls than for boys. Some human development indicators have improved to a point where they are now comparable to those in other richer South Asian countries (see Table 1.6 above). But there is no assurance at all that these gains can be sustained without restarting growth.

Table 1.6 Comparative Human Development Indicators in Four South Asian Countries

	Nepal	Bangladesh	Pakistan	India
GDP Per Capita PPP	1350	1720	1940	2570
Child malnutrition (%)	48.3	47.7	38.2	46.7
Under-5 mortality rate	83.0	73.0	101.0	90.0
Access to safe water (% pop.)	88.0	97.0	90.0	84.0
Access to sanitation (% pop.)	28.0	48.0	62.0	28.0
Net primary enrollment ratio	82.2	86.6	66.9	83.3
% of cohort reaching grade 5 - male	57.2	63.4	..	59.2
% of cohort reaching grade 5 - female	69.2	67.8	..	58.7
Total fertility rate	4.2	3.0	4.5	2.9
Maternal mortality ratio	539.0	380.0	500.0	540.0
% of births attended by skilled health staff	10.9	11.6	20.0	42.5
Net primary enroll. ratio gap (M-F)	8.7	-1.8	19.8	15.0
Secondary school pupils - % females	41.0	49.7	39.5	39.6
Life expectancy at birth, female	59.6	62.7	65.1	64.2

Source: World Bank, PREM DEC Indicators Data Base. Nepal data has been updated for primary enrollment and maternal mortality.

F. Accounting for Poverty Trends

25. *A full confirmation and explanation of these trends will need to wait for the analysis of the nationally representative sample of the NLSS II, which is now ongoing.* Nevertheless, three factors can help to explain a large part of the reduction of poverty. The agriculture sector grew at a much faster pace between FY96 and FY01 than before, remittances from Nepalese abroad grew by 30% p.a. and the 2001 Census showed slower-than-forecast population growth over the previous decade.[16]

26. *The last two-and-a-half years have been difficult for Nepal.* The worldwide recession in 2002 and 2003 and a more restrictive trade treaty with India weakened demand for Nepal's exports and domestic policy uncertainty have contributed to a reduction in income growth. The domestic security situation worsened considerably, diverting scarce human, financial, and managerial resources to defense. As a result, growth has declined sharply and per capita income level in 2004 is less than what it was in 2001. The increase in consumption by the poor could have been reversed. Above all the worsened security situation has been the dominant factor for the poor performance and its resolution is a must to restore growth and address poverty reduction.

[15] This is noted also in the Tenth Plan/Poverty Reduction Strategy Paper 2002-2007 (HMG, 2003) for the Ninth Plan, which covers FY98-02.

[16] The population growth rate between 1991 and 2001 was 2.27%, based on the 2001 Population Census, lower than the 2.4% that had been projected on the basis of earlier trends (CBS, 1994).

G. Social Exclusion

27. *Poverty reduction and human development in Nepal in the 1990s is marred by continuing social exclusion of women and ethnic and caste groups.* There is considerable evidence that in Nepal *social exclusion* has a major influence on poverty outcomes. In addition to location, social identity in terms of caste, ethnicity and gender also continues to influence access to assets, opportunity and representation. Women and people from "low caste" and disadvantaged indigenous groups have a significantly higher risk of having lower human development indicators and of falling below the poverty line than other social groups.

28. *Gender disparities are wide in Nepal.* Government efforts have been focused on empowering women, but gender-based social exclusion remains strong. In terms of consumption poverty, since consumption is measured at the household rather than at the individual level, it is difficult to establish directly that women as a group are poorer than men. However, household survey data show that women receive lower wages in comparable jobs with males, spend less on self-consumption and have little or no access to credit. The majority still does not earn an identifiable individual income; women's basic needs are generally met from pooled family income, but married women are conditioned to eat last. By social circumstances, women consume less of any available "luxury" foods, such as meat.

29. *Human development indicators continue to show gender disparities even though Nepal has made rapid progress in reducing maternal mortality rates and increasing female life expectancy as well as improving female literacy levels and years of schooling.* At the aggregate level, female life expectancy surpassed that of males and Nepal is no longer among those few countries in the world where men outlive women; but in rural areas (especially in the hills and mountains) women still die earlier than men. And despite the improvement in female educational indicators the large gender gaps in literacy and years of schooling remain (Table 1.7).

Table 1.7 Gender Disparities in Key Human Development Indicators, 1996 and 2000

	Life Expectancy (years)				Adult Literacy (%)				Average School Going Years			
	1996		2000		1996		2000		1996		2000	
	Male	Female	Male	Female	Male	Female	Male	Female	Male	Female	Male	Female
Mountain	52.7	50.4	48.6	51.1	44.2	11.8	61.9	26.6	2.27	0.71	3.71	1.33
Hill	58.0	55.5	65.4	64.7	58.4	24.3	72.3	39.5	3.42	1.61	3.97	2.18
Terai	59.5	57.0	61.7	63.2	52.3	19.9	60.2	32.5	3.10	1.25	3.71	1.93
Urban	63.2	60.3	71.4	70.8	76.7	51.5	81.2	56.9	5.63	3.88	6.01	3.80
Rural	53.7	51.3	58.2	59.3	52.0	19.5	63.6	32.3	2.93	1.15	3.40	1.66
Nepal	**55.0**	**52.4**	**59.3**	**59.8**	**54.3**	**21.3**	**65.8**	**35.4**	**2.55**	**1.13**	**4.45**	**2.25**

Source: Nepal Human Development Reports, 1996 and 2001.

30. *In terms of empowerment, Nepali women are still largely without voice and influence in the public domain.* Their representation in Nepal's influential civil service and in all three levels of elected government lags far behind men's: women make up somewhat less than 8 percent of the overall staff of the civil service and only 4 percent of the officer level staff, lower than other South Asian countries. Women are also under-represented in Nepal's elected government. After the last elections they made up only about 6 percent of the lower house and 15 percent of the upper house (where some of the seats can be nominated by the King). In the lower District and Village level bodies, women have even less voice.

31. *Caste and ethnicity-based disparities are widely prevalent.* At the top of the social hierarchy are the priestly *Bahuns* or *Brahmins*, the warrior or ruler *Chetris* or *Kshatriya,* closely followed by the Newars or the people from the Kathmandu valley. The indigenous peoples of Nepal, many of whom live

in the middle or high hills were assigned the middle rung. The indigenous groups who call themselves *Janajati* are at the middle group. Below them are ranked the occupational castes called the *Dalit*, meaning literally "the oppressed". Janajatis and Dalits make up a considerable proportion of Nepal's population: some 31 and 16 percent respectively.[17] Table 1.8 reports Human Development Indicators for these different groups and shows that, on every indicator, Janajati groups fall below the national average and well below the Brahmins, Chetris and the Newars, and the situation of the Hill Dalits is even worse.

Table 1.8 Human Development by Caste and Ethnicity

Human Dev. Indicators	Average Nepal	Bahun/ Brahmin	Chhetri	Newar	Hill Janajatis	Hill Dalit
Life expectancy (yrs)	55.0	60.8	56.3	62.2	53.0	50.3
Adult literacy (%)	36.7	58.0	42.0	54.8	35.2	23.8
Mean yrs schooling	2.3	4.7	2.8	4.4	2.0	1.2
Per capita income (NR)	7,673	9,921	7,744	11,953	6,607	4,940
Per capita PPP (US$)	1,186	1,533	1,197	1,848	1,021	764
1. Life expectancy index	0.500	0.597	0.522	0.620	0.467	0.422
2. Educational attainment index	0.295	0.490	0.342	0.462	0.280	0.186
3. Income index	0.179	0.237	0.181	0.289	0.152	0.110
Human Dev. Index	0.325	0.441	0.348	0.457	0.299	0.239
Ratio of national HDI	100	135.9	107.3	140.7	92.2	73.6

Source: ESP, "A Strategy to Empower Nepal's Disadvantaged Groups", Document 1, page 7 (based on data from the Nepal Human Development Report, NESAC, 1999.

32. *Even relatively well off ethnic groups lack access to power.* Some Janajati groups like the Gurungs, Magars and Rais who traditionally went for army service in the Indian or British army have higher educational and income indicators as do groups like the Thakali and Sherpas who have done well in trading, tourism and other businesses. But in terms of empowerment, neither Janajati nor Dalits have been very successful in joining the civil service.

H. Progress towards the MDGs

33. *The Millennium Development Goals (MDGs) are a set of goals on poverty reduction, education, health, and the environment, that the international community agreed to try to achieve by the year 2015.*[18] For each goal, indicators have been selected and numerical targets to be achieved by 2015 have been set. The Nepal Tenth Plan/Poverty Reduction Strategy 2002-2007 also contains a set of targets for 2007 for some of these indicators. Table 1.9 presents selected indicators with baseline data and targets.

[17] Not surprisingly there is considerable controversy about these figures and different data sources – as well as different interest groups – give different figures. We have used the 2001 Census figures. It may be better to think of the Janajatis as making up 31 to 37 percent of the population and the Dalits accounting for between 12 and 16 percent – though certain Dalit organizations claim 20 percent of the population.

[18] The MDGs come from the Millennium Declaration, which was signed by 150 heads of state at the Millennium Summit in New York in September 2000. The MDGs draw on the agreement reached at the UN global conferences of the 1990s.

Table 1.9 MDG/PRSP Selected Indicators

	1990	mid-1990s	Around 2000	PRSP/ 10th Plan target 2007	MDG target 2015
Poverty and malnutrition					
Population below national poverty line	–	42[1]	–	30	20
Prevalence of child malnutrition (% of children under 3 years of age whose weight-for-age is low)	57	46.9[2]	43.6[2]	–	28.5
Universal primary education					
Net primary enrollment ratio (% of relevant age group) (survey data)	–	57[1]	65.8[3]	90	100
Net primary enrollment ratio (% of relevant age group) (MOES data)	64[4]		82.4	90	100
Gender equality					
Ratio of girls to boys in primary and secondary education (%)			86[3]	–	100
Ratio of girls to boys in primary education (GER %) (MOES data)	56[4]		86[4]	–	100
Ratio of girls to boys in lower sec. education (GER %) (MOES data)	41[4]		81[4]	–	100
Ratio of girls to boys in higher sec. education (GER %) (MOES data)			76[4]	–	100
Life expectancy (note: PRSP, not MDG indicator)				65	–
Adult literacy (15+) (note: PRSP, not MDG indicator)				63	–
Average years of schooling (note: PRSP, not MDG indicator)				–	–
Infant and child mortality					
Infant mortality rate (per 1,000 live births)		78.5[2]	64.4[2]	45	
Under 5 mortality rate (per 1,000)	161.1	118.3[2]	91.2[2]	72	54
Share of 1-yr-old children immunized against measles		45[2]	63.6[2]		100
Maternal mortality					
Maternal mortality ratio (per 100,000 live births)		536[2]		300	–
Births attended by skilled health staff (% of total)	7.4[2]		13[2]	–	–
Reproductive health					
Contraceptive prevalence rate (% or women ages 15-49)	24.1[2]	28.8[2]	38.9[2]	47	–
Environment					
Access to an improved water source (% of population)	46[2]		80[2]	85	100

Source: Source 1 is NLSS I,; 2. Nepal Family Health Survey and DHSs, 3. BCHIMES, 4. MOES data are for 2002. Cells where the source is not given (and are not targets) are from the UNDP MDG country report. See: CBS (1996); HMG/MOH, New ERA and ORC Macro (2002); CBS and UNICEF (2001); HMG/MOES (2002); and UNDP (2002).

34. *As discussed earlier, sufficiently fast progress has been made with some indicators to achieve the MDG target on current trends in those areas.* Figure 1.5, at the end of this chapter, presents projections based on extrapolating linearly the trends of the second half of the 1990s while its implications are summarized in the next paragraph. But these trends may not be sustained if growth were to falter, service delivery remained disrupted due to conflict, and social exclusion continued. Further, in general, it becomes progressively more difficult to raise human development indicators as the poorer groups are harder to reach.

35. With these qualifications, the prospects for achieving the MDG targets can be summarized as follows:

- The poverty target may be achieved, while the target of halving malnutrition would not, despite recent progress.
- The education targets may or may not be achieved, as current trends vary by data source. According to the Ministry of Education and Sports data, the target of universal net primary enrollment would be reached on current trends; according to household survey data, it would not. Further, given that many of the out-of-school children are from socially excluded groups, reaching them will require extra efforts.

- The gender education equality indicators would be met, according to MOES data.
- The infant and child mortality targets may be achievable, but projecting current trends out to 2015 is not very reliable in this case because improvements become more difficult as rates decline. The vaccination targets could be achieved; the percentage of children aged 12-23 months who are fully immunized by 12 months of age (which is an intermediate indicator for infant and child health) has increased, according to the NDHSs, from 36 percent in 1996 to 60 percent in 2001.[19]
- Data on maternal mortality are not sufficient to assess likelihood of achievement.
- The PRSP target of contraceptive prevalence (47%) may be achieved (there is no set MDG target for this indicator). Note that there was an acceleration in the diffusion of modern contraceptive methods in the second half of the 1990s compared to the first half (based on NDHS data), as evidenced in the greater slope of the second segment of the line in chart 6.
- The target for access to drinking water (100%) may be achieved given the current definition of access to water. But water quality has declined due to lack of maintenance of drinking water facilities, so the data would need to be revised. Universal access to safe water is unlikely to be attained unless measures are taken to improve maintenance alongside coverage.

I. Summing up

36. *At the end of this period of nearly two decades of better performance, four outcomes stand out as policy issues.* First, overall growth rates were neither fast enough to make a significant dent on poverty until the second half of the 1990s, nor could they be sustained as per capita income fell over the past three years. Growth has to be restarted and accelerated. Even a respectable 2.5% per-capita economic growth between 1985 and 2001 has not been able to increase per-capita incomes significantly or reduce poverty measurably. The improvement in poverty reduction indicated by the NLSS II data would have reversed after 2003. Second, economic growth was uneven across different regions and for a long while excluded agriculture. Growth has to be more pro-poor and spatially even by focusing on agriculture and lagging regions. Despite plans to the contrary, investment in infrastructure in the poorer and lagging Western regions fell considerably short of targets resulting in lower economic opportunities. Over-centralization of government in an ethnically and culturally diverse country also meant that service delivery was poor in the remote regions. A violent insurgency, which spread across Nepal, has planted its base firmly in those remote Western regions. It provides a substantial threat to further progress in policy reform, service delivery and effective governance in general. On the other hand, deepening economic reforms, providing greater opportunities to the socially excluded and improved service delivery to all groups and parts of the country are the essential ingredients for a return to economic, political and social progress and stability.

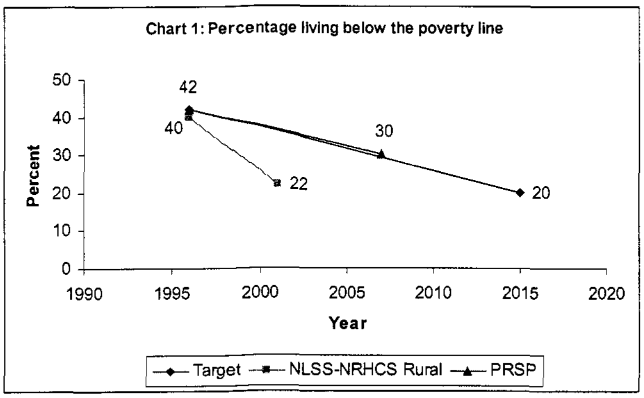
37. *Third, unless appropriate policies and adjustments are made, as discussed in other chapters in this review, to increase Nepal's competitiveness and restore the investment climate, Nepal is unlikely to repeat even the modest achievements of the 1990s.* A reversal of both income growth and human development is more likely. But most important, the current conflict and political uncertainty have to be resolved or at least significantly mitigated as it is severely taxing economic activity, development, and threatening the gains of the last two decades.

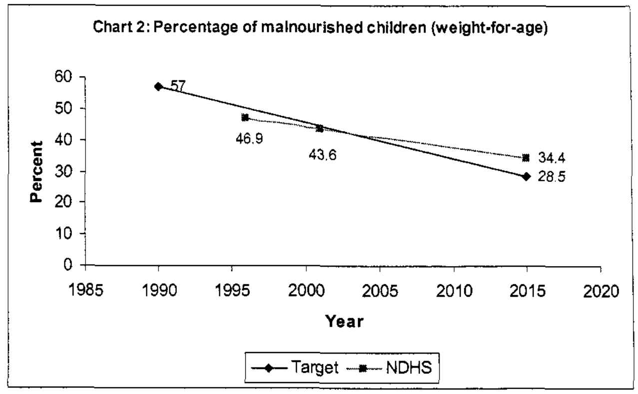
38. *Fourth, social exclusion had a major, adverse, influence on poverty outcomes and empowerment.* In addition to location, social identity in terms of caste, ethnicity and gender also continues to influence access to assets, opportunity and representation. Women and people from "low caste" and disadvantaged indigenous groups have a significantly higher risk of having lower human development indicators and of

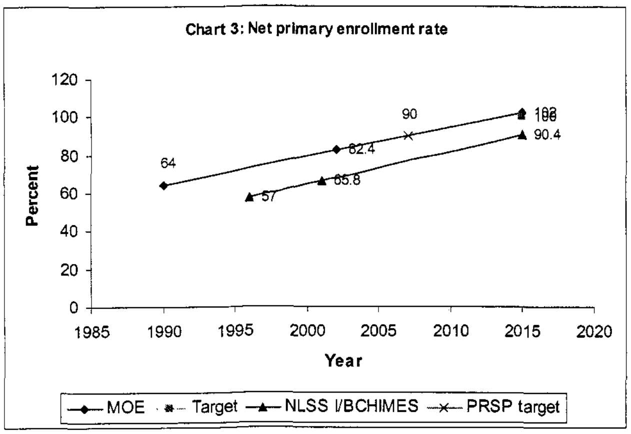
[19] Note that the MDG indicator is vaccination against measles, but separate data on this vaccination are not consistently available.

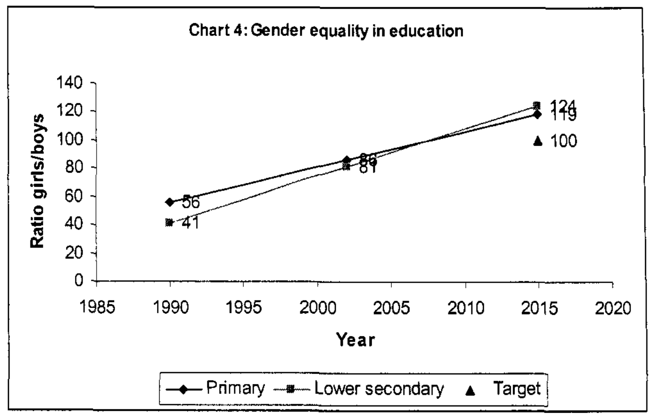
falling below the poverty line than other social groups. Even relatively well off ethnic groups lack access to power. Neither the Janajati nor Dalits have been notably successful in joining the civil service or gaining elected office. With respect to the attainment of MDG, progress has been made in some areas but not in others. Thus while halving of poverty could be achieved (by restarting growth) but not halving of malnutrition; while the education target may be achieved but not the coverage of children from disadvantaged groups; the target for drinking water could be achieved but water quality will remain poor. But even these achievements may not be sustained if growth were to falter, service delivery remained disrupted due to conflict, and social exclusion continued.

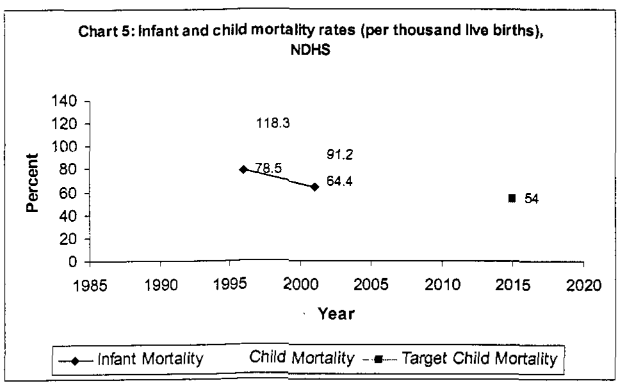
Figure 1.5 Trends and Projections of Millennium Development Goals

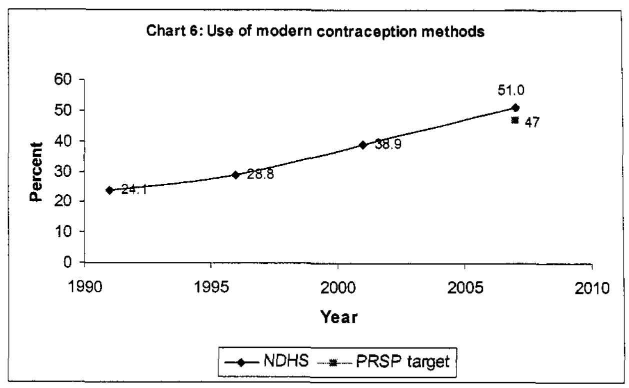


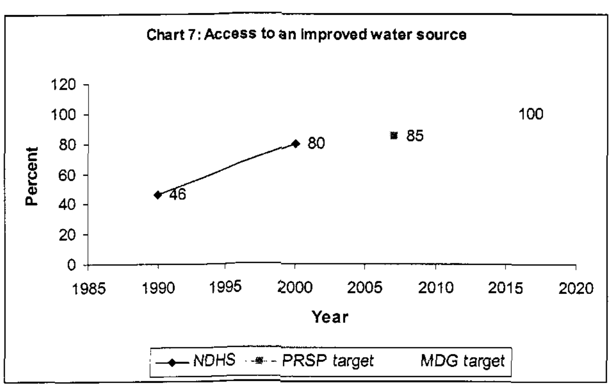












CHAPTER 2: IMPROVING MACROECONOMIC POLICIES FOR GROWTH AND POVERTY REDUCTION

A. Introduction: The Challenge of Restoring Growth

1. *After attaining a per capita income growth rate of 2.6% in the 1990s, Nepal's per-capita fell by – 0.5% between 2001 and 2003.* While a modest recovery is underway, per-capita income in 2004 will still not be restored to its 2001 level. The medium term outlook is cloudy. A violent insurgency covers large parts of the country and imposes steep costs on economic activity. Alongside the forthcoming rescinding of the MFA, Nepal's significant loss in the global market share of carpets and garments in recent years indicates Nepal's slipping position in an increasingly competitive global economy. It is clear from the discussion of the sources of growth in Chapter 1, Nepal – a small open economy, highly dependent on trade and exports -- will need important policy adjustments to increase trade and competitiveness to restore growth. Restoring economic growth rates to the trend of the 1990s, let alone achieving the 10^{th} Plan/PRSP's target per-capita growth rate of 4% and its human development goals, will be a formidable challenge.

2. *Sustained poverty reduction and human development, however, will require going one step further than just raising mean incomes: it will require a pro-poor pattern of growth, i.e. one, which raises incomes of poorer deciles, through higher agricultural incomes, job creation, and wages.* It will mean providing opportunities and better public services in Nepal's Western regions where the poor are disproportionately located. It will also require a special focus on Dalit ("the oppressed") and Janajati (indigenous) groups who lag systematically behind in human development (See Chapter 1). Finally, the experience of the 1990s also suggests that a pro-poor growth strategy will need to reduce income volatility as these have asymmetrically adverse effects on the poor. Towards these ends government strategy has to focus on fiscal, trade, and economic management issues

B. The Government's Strategy and Policy Issues

3. *The Government's 10^{th} Five Year Plan, whose summary is Nepal's Poverty Reduction Strategy, makes the achievement of broad-based growth, especially in the rural economy, one of the key pillars for achieving its targets.* Nepal's development policy agenda is well articulated in Nepal's Poverty Reduction Strategy (PRSP). It lays out a coherent four-pillar strategy consisting of: "i) broad based growth with special emphasis on agriculture; ii) accelerating human development through renewed emphasis on effective delivery of basic social services and economic infrastructure; iii) ensuring social and economic inclusion of the poor, marginalized groups and backward regions; and iv) vigorously pursuing good governance both as a means of delivering better development results and to ensure social and economic justice." The strategy is well anchored in a medium term fiscal framework that focuses resources on human development and physical infrastructure.

4. *In sectoral terms, the strategy envisages that more than $3/4^{th}$ of growth will come from the non-agriculture sector, but also a robust agriculture sector growth of 4% p.a.* A "quick rebound" of economic activity following peace and especially of non-agriculture sectors such as manufacturing, exports, construction and tourism will account for the growth of the private sector. The recovery of private sector investment (rising to 19% of GDP by 2007, compared to 12% currently) and trade and exports will lead the way to growth. Public investments in power, roads, and telecommunications are the instruments for encouraging private sector investment. In the rural sector, the implementation of the Agricultural Perspective Plan (APP), including ensuring the supply of fertilizer, irrigation, and the development of livestock, horticulture and high value crops in the hill regions will drive agriculture growth. Expansion of

rural roads, electricity and marketing networks, expansion and rehabilitation of irrigation networks and small-scale surface irrigation schemes in the hill regions will be the drivers behind agricultural growth.

5. *But the PRSP depicts this picture somewhat broadly.* First, the strategies for accelerating growth need more specificity. Second, policies need to be better prioritized. Another challenge will be to improve the institutions of economic management for better policy coordination along with improving monitoring so that mid-course corrections in policies could be made. Based on this, this review focuses on three key policy issues: (i) the strategy for restarting and accelerating growth, with especial emphasis on trade and agriculture as two key policy levers; (ii) improving public service delivery and governance; and (iii) strengthening social protection and inclusion policies. The rest of this chapter focuses on three strategic issues: fiscal management to raise resources and use them effectively for development, external sector policies to increase competitiveness and trade, and strengthening institutions for improving economic management, including aid coordination.

C. Fiscal and Fiduciary Management Issues

6. *Nepal's fiscal management has been prudent in the 1990s (Table 2.1).* Aggregate public sector debt has been relatively stable at around the 66% of GDP, though mainly because of negative growth in GDP in 2002 it increased to 69% in recent years. The share of short-term debt in public debt is less than 1% and debt servicing is about 1.5% of GDP. Analysis of public debt dynamics shows public debt to GDP ratios to fall rapidly in the next four years from 68% of GDP to around 54% of GDP by 2007, under relatively modest growth assumptions, low interest rates (negative real interest rates for public borrowing on top of large volume of grant financing) and a declining share of gross external financing need. A variety of stress tests suggest that, short of a major depreciation, public debt to GDP ratios will be contained to 60% of GDP or less.[20]

Table 2.1 Nepal: Fiscal Indicators, 1991-2003

	1991-1996	1997-2001	2000	2001	2002	2003
(% of GDP)						
Deficit (-) or Surplus (incl. Grants)	-5.4	-4.0	-3.5	-4.5	-6.2	-1.6
Deficit (-) or Surplus (excl. Grants)	-7.0	-5.7	-5.0	-6.1	-8.3	-3.7
Revenue	9.3	10.2	10.7	11.4	9.3	12.4
Grants Received	1.7	1.7	1.5	1.6	2.1	2.1
Expenditure	16.7	16.4	15.7	17.5	17.2	16.1
Financing						
Domestic borrowing (net)	1.9	1.4	0.9	2.7	4.8	0.9
Foreign borrowing (net)	3.5	2.7	2.6	1.8	1.4	0.7
Debt	64.7	64.0	64.6	63.7	69.6	66.6
Domestic debt	15.0	13.8	14.3	14.6	17.4	17.7
Foreign debt	49.7	50.2	50.2	49.1	52.1	48.9
Public Savings (From NAS)	0.7	1.0	1.1	0.2	0.2	0.8

Source: IFS and IMF.

7. *But three major challenges to fiscal stability have emerged.* These are contingent liabilities in the financial sector and possibly hidden ones in the public enterprise sector, the growing pension obligation, and the low tax collection. First, the most significant contingent liability threat comes from the financial sector. The two large wholly or partly owned Government banks have a negative net worth of around 7% of GDP. Additional liabilities also arise from the need to restructure the Agricultural Development Bank of Nepal. Thus a clear fiscal priority is that these Banks be restructured and privatized in an orderly manner and with external help, as otherwise these liabilities can increase the fiscal burden by as much as 10% of GDP – or roughly of the same order as tax revenue collection. A related issue here is the need to improve management of public enterprises. Currently, public enterprises (PEs) in Nepal, unlike in other

[20] IMF, Nepal - Staff Report for the 2003 Article IV Consultations, August, 2003, Table 5.

South Asian countries, have limited borrowing requirements of less than 1% of GDP. While there are known contingent liabilities in the form of overdue wages, pension contributions, severance pay and other benefits that amount to $300 million or 4.5 % of GDP, they are more than offset by assets estimated to be worth more than $1.2 billion. However, the poor quality of auditing of these enterprises and delays in producing financial reports suggests that dangers may be lurking.

8. *The second challenge to fiscal sustainability is posed by the rapid growth in pension liabilities.* The pension bill in 2003-04 is close to Rs. 3.3 billion, rising from 3.1 billion in 2002-03 excluding teachers' pensions.[21] This is financed directly from the budget and is now more than 20 percent of salaries and allowances. This fiscal burden will grow in the next decade due to the internal demographics of the different groups covered, the rapid turnover of military and police personnel and the maturation of the teachers' scheme. Preliminary estimates of the unfunded pension liability for core civil servants only is close to 6 percent of GDP suggesting that the net-present value of the total liability lies in the range of 10-15 percent of GDP, effectively implying that public debt is higher by this margin. As Chapter 6 discusses, the Government has started formulating a reform plan that would introduce a contributory pension scheme and accumulated funds towards offsetting this liability.

9. *The third cause of fiscal vulnerability is low revenue collection, which makes Nepal's dependence on external assistance acute and constrains public services, growth and future revenues in a vicious circle.* With a tax to GDP ratio of around 9% of GDP, Nepal's tax effort is, (alongside Bangladesh), the lowest in the region. An indicative analysis of resource requirements for MDG goals show there is a considerable resource shortfall in terms of requirements to meet the MDG (3 to 5% of GDP), which cannot be fully met by foreign assistance. Hence, raising revenues is a major priority.

10. *Nepal has made considerable progress with tax policy and administrative reforms in recent years.* Overall revenue collection remains low and two issues have to be addressed. First, improving tax administration to further strengthen the revenue effort and make the tax department more private sector friendly. The second is removing loopholes and price distortions arising from exemptions of some products and services and taxes and duties on others that create a bias against foreign trade. Some of these "other duties and charges" have to be removed over the medium term as part of Nepal's entry agreement into the World Trade Organization. Concerning administrative reforms, strengthening the administrative authority of the Director Generals of the IRD and the CD over their staff are important next steps. Currently they have no authority over appointments and transfers at the officer levels and their operational budget (e.g. 0.8% of collection in the case of the Inland Revenue Department) is significantly lower in comparison to international norms (3 to 4% for developing countries) and need to be increased.

11. *Several expenditure issues remain to be addressed.* First, on the allocation side there is an overemphasis on the development budget to the detriment of operations and maintenance expenditures. Non-salary regular budget expenditures on road maintenance and education are much lower in comparison to needs (See Chapters 3 and 6 for more details). Within the development budget, the shift away from economic expenditures such as agriculture, irrigation, and transportation to social sectors and security and its possible adverse impact on growth prospects needs a critical scrutiny. Second, budget implementation is affected by unrealistically large development budgets that regularly fall short in actual expenditures.

12. *The introduction of the Medium Term Expenditure Framework (MTEF) has also helped to better implement the development budget in a clear, prioritized expenditure framework in harmony with the PRSP, but there are several pending issues.* First, the MTEF needs to be extended to cover regular as well as development expenditures to make it a truly program budget, which for now can be loosely tied to a

[21] This excludes spending on teachers' pensions, which are not available immediately.

parsimonious set of performance indicators. Second, a related issue is to improve the classification of expenditures by reclassifying the regular and development expenditures into current and capital expenditures and present these together as integrated program budgets. Third, performance indicators need to gauge actual progress rather than just spending. Strengthening the MTEF through program budgets will also help to improve donor coordination, a high priority for Nepal. Fortunately, important progress has been made by the Government in this respect as presented in Box 2.1 below.

Box 2. 1 Donor and Aid Harmonization Efforts

Donor coordination is particularly important for Nepal given the large role aid plays in financing development. Accounting for 5% of GDP and more than a third of Government expenditures, aid affects budget realism, its execution and public expenditure effectiveness.

Budget Implementation: The availability of this funding can make or break a budget in any given year. Because aid decisions are often made without cooridinating it with the national budget, aid projections are necessarily based on indicative aid commitments and activities in the pipeline. This results in budget unrealism. These projections consistently overestimate availability of aid money and in absence of domestic sources (domestic revenue and borrowing) to close the funding gap; budget underperformance averages 10 percent each year. This delays investment projects from being completed, resulting not only in lower benefits but also weakened accountability of ministries. Aggregate budget implementation is also adversely affected. In an environment where there is little or no revenue surplus, any shortfall in aid flow results into either more domestic borrowing or failure to implement budget activities, both having economic costs.

Public Expenditure Effectiveness: *A second issue is lack of aid coordination lowers public expenditure effectiveness.* The aid that Nepal receives finances a large number of projects and programs, widely dispersed across sectors, and, again, with inadequate coordination with the budget. As Nepalese Government agencies and institutions by themselves have little incentives to refuse aid, donor suggested projects get ad-hoc scrutiny, often taken place outside the budget, and without adequate accounting. This leads to a very high degree of aid fragmentation, estimated to be among the highest in the world, and a lowering of public expenditure effectiveness.

What can the Government do about it? The Government can use sector program budgets and the Medium Term Expenditure Framework to integrate donor support more effectively into the budget cycle. Very recently, the Government has undertaken an important initiative to harmonize donor activities at program levels as well as on financial management aspects. On their side, donors need to commit to the discipline of financing programs only after the MTEF provides these priorities.

The three tier Aid Harmonization Program: This process of improving aid coordination got a good boost during the the National Development Forum 2004, where development partners committed to align aid with the Poverty Reduction Strategy through the Medium Term Expenditure Framework in a three-tier harmonization program. The main purpose of harmonization is to improve aid effectiveness, reduce transaction costs of aid delivery, and better align aid with national strategies. The three broad levels of harmonization are: a. harmonization at the overall program level – aligning donor support with government's own strategy and priorities underpinned by MTEF; b. harmonization at the individual program level – programmatic approach on a well thought out sectoral implementation plan and use of government's own financial procedures and reporting system; c. harmonization at the financial modality level – movement away from the activity based budgets to program budgets that not only reduces transaction costs significantly but also gives the government greater flexibility to adjust budget to priorities. This strategy is being implemented through presenting five sectoral business plans in the first ever donor harmonization meeting to be held in early 2005 as part of FY 2006 budget preparation.

Implementation Challenges: Implementation challenges remain however. Fiduciary concerns, weak accountability and monitoring system, aid agencies' need to identify their contributions during budget execution, low absorption capacity, and absence of sector strategy with prioritization of activities will be important challenges to implementing the harmonization plan. Donors have genuine concern about these issues and a reluctance to completely transfer to Government systems. Nevertheless, there is no clear evidence that direct involvement of development partners in project implementation have either enhanced sustainability or strengthened implementation capacity to better outcome results. The answer to donors' concerns lies in strengthening country's existing institutions implementation capacity and expenditure management and service delivery reforms---owned and lead by the country. A patient implementation of the three tier approach will catalyze processes within the government to produce sound strategies (business plan), rational spending programs (MTEF) and effective services as highlighted in the World Development Report, 2004, *Improving Public Services for the Poor.*

13. ***Fiduciary Management**: Nepal's legal and regulatory framework for ensuring public financial management is good for a country at its level of economic development, but unsatisfactory implementation in the past as well as the current suspension of many of its provisions appears to be increasing irregularities.* The Constitution and financial rules requires the Ministry of Finance to submit a detailed comparison of the financial results and budgets; it also accords the Auditor General (AG) complete legal and professional independence. The Public Accounts Committee (PAC) headed by a member of the main opposition party in Parliament used to be proactive, meeting year round, discussing public accounts and the Auditor General's (AG) annual report and recommendations as well as all aspects of public sector financial management. But more recently, the AG's annual report, which used to receive a wide public coverage both through the PAC and the media, has not been released in the last two years. Annual reports for 2002 and 2003 were prepared in a timely fashion by the Auditor General, and were forwarded to His Majesty the King, as required by the Constitution. But these reports now remain shelved perhaps due to the absence of parliament without any public disclosure and reports are that the volume of irregularities had increased. In addition to the suspension of financial rules, weak compliance of financial management rules due to low penalties, the lack of financial management trained personnel, and inadequate monitoring of actual implementation undermines financial management. Another pending issue is for the government to reform procurement laws to increase efficiency and transparency in procurement.

D. External Sector Issues

14. *With a trade to GDP ratio of about 50% and external remittances now accounting for 12% of GDP the role of the external sector is, after agriculture, the most important for growth and poverty reduction in Nepal.* While trade policy reforms led to the reduction in tariff rates from 32% in the early 1990s to around 14% in 2000[22] new duties and charges were added in the last three years to raise nominal protection to around 18%. However, it is noteworthy that there has been a nearly complete dismantling of quantitative restrictions. These reforms combined with achieving current account convertibility, easing entry, and the benefits of pegging of the Nepalese rupee to the Indian rupee led to rapid export growth at 15% per annum in the 1990s. Consequently, Nepal doubled its share in global exports while exports became more diversified as the share of manufactures increased to 66% from 30%. The growth of remittances in recent years and the rise in tourism earnings helped to increase the current account position and reserves. The growth of foreign exchange earnings enabled steady increase in the imports of capital goods at a steady annual rate of 10% per annum.

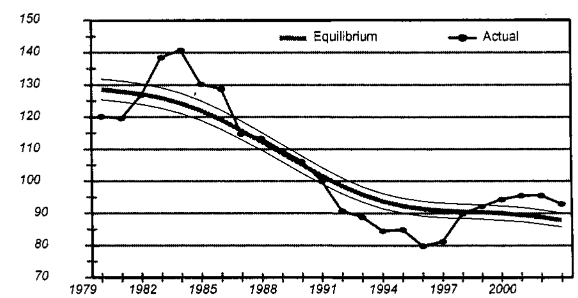
15. *Some trade policy reforms remain pending.* First, one feature of Nepal's tariff structure is that it has cascading rates. That is, tariff rates are higher, the higher the level of processing. This creates a bias against high value added activities, which means that in a labor abundant economy, a cascading tariff structure discriminates against employment. It is also true that raising domestic value added through opposite means (i.e. having lower tariffs on low levels of value added and high tariffs on high value added activities) can be equally distortionary and go against the country's comparative advantage. Second, exports continue to be disadvantaged due to the bias inherent in import tariffs not adequately off-set through duty drawback and easier customs procedures. The passbook scheme for duty drawbacks is not working well. In fact some exporters do not even claim duty drawback on their imported inputs because of the high transactions costs involved in claiming duty drawbacks. Similarly, export clearance processes

[22] Note that in the last three years Nepal has added 5 to 10% points of other duties and charges as agricultural and security levy, etc and raise nominal protection to around 18%. These include a local development fee of 1.5%, special fee of 1.0% when customs duties are equal or below 5% and 3% when customs duties exceed 5%. In addition, there is a 10% tax on cars and bicycles and a fee of 5% on some processed agricultural products such as rice of 10%. These taxes and duties (referred to as para-tariffs in WTO parlance) discriminate against foreign trade similar to general tariffs since they are not levied on domestic production. They raise protection of domestic production and act as a tax on exports.

are cumbersome. Nor is customs clearance of imports satisfactory, which raises transaction costs and curtails competition.

16. *Addressing trade and exchange rate issues have become important because the positive developments of the 1990s are now being reversed and even show signs of decline.* A combination of domestic conflict, increasing transport costs[23] and uncertainty, the appreciation of the Nepali rupee over the past year, persistent regulatory and infrastructural weakness and general lack of confidence in placing orders in Nepal have hit exports hard. In the current more competitive environment Nepal's exchange rate pegging arrangement to the Indian Rupee and its level will require continuous review (see Figure 2.1)[24]. Export growth has now fallen to 8% in 2003 compared to 15% growth in the 1990s. A particular issue is that export performance of the last few months and current policy inertia makes it all but certain that the garments exports – with its 50,000 jobs – could collapse after the MFA's phase out in January 2005 unless emergency actions are taken to increase competitiveness. These would include lowering transport costs sharply through activating the container-train running from Birgunj, providing export processing zone facilities at border points such as Birgunj, supporting industries to locate there, cutting down port handling time in Kolkata with support from Indian authorities, speeding up Customs transactions and inviting foreign collaboration to improve market access in Europe and the West.

Figure 2.1 Actual and Equilibrium Real Exchange Rate



Source: De Soto, R. "Estimating the Misalignment of the Real Exchange Rate in Nepal", mimeo, 2003

17. *Despite short term problems discussed above, in the medium term Nepal has several assets, which would make Nepal potentially more competitive.* These include: (i) having comparative advantage in a number of agriculture and manufacturing products (garments, carpets, pashmina, food products, being the main products); (ii) proximity to the large and fast growing Indian and Chinese economies; (iii) the availability of preferential access to Europe and India; (iv) its hydroelectric resources that provide the potential for power exports to the supply constrained Indian markets; (v) its natural beauty and important religions and cultural sites that draw tourists (4% of GDP); (vi) its growing pool of educated labor, and (vii) "catch up opportunities" to raise productivity. In particular, preferential treatment for duty free entry to Europe under the EBA initiative and to India, combined with lower wages and better investment climate than some neighboring states, can attract foreign and Indian investment with their know-how and market access for export oriented activities. There has already been joint investment or advanced proposals for large scale Indian and foreign investment in sectors such as garments and power. Given these factors, Nepal, with its small share in the world market, should be able to enter major markets without much resistance.

18. *As the Nepal Trade and Competitiveness Study identifies in detail, important policy and institutional reforms are needed for Nepal to exploit these opportunities.* [25] Its recommendations adopted by the Government, are grouped under six areas: strengthening trade policy and implementation institutions, trade facilitation in Customs and transport, improving labor market flexibility especially in

---

23 Trucks from Kathmandu to the Birgunj container port and border now take two days due to the inability to travel at night.

24 The real exchange rate is defined as the ratio of prices of tradable to non-tradable goods. The equilibrium real effective exchange rate is one which, for given sustainable values of other relevant variables such as taxes, terms for trade, capital and aid flows, results in the joint attainment of internal and external equilibrium.

25 His Majesty's Government of Nepal, *Nepal Trade and Competitiveness Study*, MOICS, 2004.

employment policies, improving the investment climate especially in FDI, and sector specific policies. Beyond these policies there are two other key variables in the external sector – Nepal's economic relationship with India and the employment of Nepalese labor abroad – that have significant bearing on Nepal's development.

19. ***The nature of Nepal's economic relationship with India is a key factor in Nepal's development.*** India is the destination of more than 50% of its exports and the source of half of its imports.[26] About 70% of Nepal's labor force abroad works in India. The 1750 kilometers of porous borders means that in addition to formal trade, there is a considerable volume of unrecorded trade in goods, exchange of labor and, accordingly, a close correlation of prices in Nepal, India and the neighboring states of Bihar, UP, and West Bengal (see Table 2.2). By some estimates, the 265 joint ventures with India accounts for more than a third of all FDI in Nepal.

Table 2.2 Correlation of Prices in Nepal and India

Nepal	Log(CPI) with AR(1)		
Agricultural Laborers	**R-Sq**	**Coefficient**	**T-st**
India	0.997	0.477	2.9
Bihar	0.998	0.399	3.3
Uttar Pradesh	0.994	1.022	20.9
West Bengal	0.998	0.501	4.0
India – CPI	0.996	1.094	66.0
India – WPI	0.996	0.514	1.4

Source: World Bank estimates from various sources.

20. *Nepal has attempted to maintain close relationship with India and cement it in bilateral treaties on trade and transit and an agreement to control unauthorized trade.* The first trade treaty and transit with India was signed in 1950 and subsequently renewed in 1960, 1971, 1978 (when trade was de-linked from transit), 1991, 1996, and 2002. These treaties provided duty free access of primary exports, for selected Nepalese manufactured exports, preferences to Indian manufacturing exports, and agreements on transit and transshipment. The most recent Indo-Nepal Trade Treaty renewed in March 2002, however, introduced several new restrictions in tighter rules of origin requirements and documentation, and the use of trade related quotas that will be triggered by export volume. [27]

21. *Given the importance of the Indian economy for Nepal, a key question is what are some policies that Nepal can adopt to benefit from its proximity to the large and fast growing Indian economy.* First, Nepal needs to broaden its agreement with India to include and attract Indian investment. The aim should be to forge Indian capital, technology and market access to Nepalese capital, labor, and resources. To this end, Nepal could pursue the proposed Bilateral Investment Promotion and Protection Agreement to provide further assurance on investment and trade rights to investors (including Indians). Efforts to forge formal agreement should be further complemented by advertising efforts to attract investment from India. Thus, Nepal should make a special effort to advertise its preferential access to Europe through the EBA. Second, economic diplomacy with the central Government needs to be extended to the neighboring Indian states, for ensuring market access and easing transit rights. This is important as State Governments wield discretionary powers that often disrupt trade. Third, Nepal needs to harmonize border procedures, documentation, special economic zones (SEZ) rules, product standards and Customs software with India such that Indo-Nepal trade and transit is easily facilitated and third country oriented exports can also proceed with minimal transactions costs. Fourth, Nepal could facilitate Indian interests in Nepal by proceeding to build the Tibet-India transit routes and in return request more transit routes and shipping facilities at a variety of Indian ports including the efficient Mumbai port.[28]

---

[26] Nepalese exports to India includes edible oil, toiletries and cosmetics, jute goods, polyester yarn, and a variety of agricultural goods such as pulses, hides and skins, herbs, cardamom, rice bran oil, ginger. Imports from India include mechanical equipment and spare parts, cotton textile, camber, cotton thread, chemicals, electrical equipment, agricultural equipment, etc. (source:www.south-asia.com/Embassy-India/indeprel.htm).

[27] See, HMGN, *Nepal Trade and Competitiveness Study*, MOICS, 2004, Box 2.1

[28] A study has shown that in the case of high value products such as carpets and the greater efficiency of the Mumbai port can more than off-set the higher costs of land transport.

22. ***A major economic development in the 1990s has been the growth of foreign employment of Nepalese labor abroad and private transfers.*** Currently about 800,000 Nepalese are employed abroad who together remit to Nepal approximately $800 million (12% of GDP) compared to $ 633 million in merchandise exports and $155 million in tourism receipts. Given that these remittance earnings have grown at a rate of 30% p.a., this implies that GNP growth has been significantly faster than GDP growth, with its concomitant effects on consumption and demand side effects on GDP growth. Increasing demand for labor abroad both due to higher incomes in the Far East, Middle East, and India, a tendency to switch demand to Nepalese labor instead of labor from traditional sources of labor supply, and the rising education of Nepalese labor have increased demand abroad. On the supply side, the lack of opportunities at home, and, perversely, the "push" factor due to the war, and the switch from informal to formal sources of transferring money home have all led to this higher recorded increase.

23. *A crucial challenge for Nepal now is to sustain the level of the current remittance earnings, which now account for about 12% of GDP.* Government is now preparing a new Act/Policy guideline relating to Migration and Foreign Employment. A formal memorandum of understanding has been signed with Malaysia and ratified. Talks are under process with Qatar, UAE, Hong Kong and Korea. Nepal could take three other measures to sustain foreign employment and remittances. First, most important, for the long run is the need for continued investments in education, with special emphasis on the English language, to increase the demand for Nepalese labor abroad. Second, employment-seeking talks also need to be extended to countries such as Japan, where aging of its population will require the import of more foreign labor. Third, if the private sector is not forthcoming, Nepal needs to provide attractive financial instruments for Nepalese labor to transfer their salaries via formal channels. In general, service standards in the transfer of remittances that allow a quick and fast transfer of funds is important. Finally, Government also needs to ensure a joint public and private sector oversight body to ensure that Nepal's business reputation as a reliable source of educated and disciplined labor is maintained. Conversely, this oversight should also ensure that unscrupulous private sector operators do not defraud the hard-earned remittances by workers.

E. Strengthening Economic Management

24. ***Strengthening Economic Management Institutions.*** *While many of the modern institutions and policies for economic management exist in Nepal, implementation is undermined by lack of adequate coordination and inadequate attention to monitoring and evaluation.* [29] Lines of responsibility between multiple organizations are often very unclear, adversely affecting implementation. Policy coordination at the Cabinet level appears to be weak partly due to the lack of substantive policy discussions (see Chapter 5) resulting in overall coordination problems. While the National Planning Commission (NPC) has a wider view of economic issues, its role is focused on development planning and it does not have executive powers. Recently the use of results oriented instruments such as the Immediate Action Plan and the Medium Term Expenditure Framework to prioritize policies and budgets show improvements in policy coordination. But, as widely recognized two areas, coordination and monitoring need further strengthening. The failure to implement the Agricultural Perspective Plan's (APP) Hills strategy, as it depended on the inter-sectoral coordination between agriculture, transport, commerce, finance and several other agencies is one example of this. A second is the inability to resolve the laws, the 21 Acts that inconsistently impinge on decentralization.

25. *Weak coordination is also the result of inadequate attention to monitoring of results and progress and need addressing at several levels.* Critical priorities are improving the weak national income accounts

[29] These include institutions and laws concerning property rights, contract enforcement, regulatory bodies, monetary and fiscal institutions, prudential regulations and supervision.

through support for the national statistical capacity building plan. Second, monitoring and evaluation of service delivery indicators such as immunization, enrollment, the provision of medicine, school supplies, absenteeism, also need to be implemented as part of the government's new monitoring plans. Lastly, more attention is needed for conducting periodic household surveys, and equally important, developing the capacity to use these surveys to inform policy making and poverty reducing interventions.

F. Summing Up

26. *With respect to the government's strategy for restarting growth, this chapter has analyzed and made recommendations on the following strategic areas: fiscal management, external sector reforms and economic management.* In the first case, measures recommended included policies to increase revenue collection, monitor and manage contingent liabilities, and improve the effectiveness of public expenditures. Opportunities to increase revenues through interim but significant improvements in tax administration were highlighted. The threat to fiscal sustainability of liabilities posed by the insolvent banking sector and the growing pension obligations and their remedies were highlighted.

27. *In the case of the external sector, the need for increasing competitiveness through higher productivity was stressed.* The priority is for the Government to implement the recommendations of the Nepal Trade and Competitiveness Study, which it has adopted. Two related areas were stressed: forging closer economic ties with India, and especially, inviting Indian investment to avail of Nepal's EBA preferences in Europe. Second, the importance of short term regulatory policies and long term education investment policies to sustain the foreign employment of labor was also highlighted. In addition, there is a trade agenda to be addressed including reducing tariffs to bring them closer to competitors' levels and reducing the tariff escalation.

CHAPTER 3: IMPROVING THE INVESTMENT CLIMATE

A. Introduction – Restoring the Investment Climate

1. *Poverty reduction in Nepal depends primarily on accelerating broad-based, labor intensive growth.* In keeping with the trend of the 1990s, the 10th Plan projects close to three-fourth of future growth in Nepal to come from the non-agricultural sector. This sector is assumed to grow at the rate of 6 to 7% p. a., with the private sector being the source of most of this growth. But as the developments in the last three years -- when non-agriculture sector growth, exports and private investment rates have dropped significantly – show Nepal's investment climate has worsened with the conflict in the near term. In the medium term not only will Nepal need to restore its investment climate, it has to go the extra mile to improve it significantly to offset its inherent geographical disadvantages of being landlocked, having relatively less developed human capital, and a perception of being investor unfriendly.

2. *Aside from restoring peace, or at least significantly mitigating the conflict, improving the investment climate will depend on three factors.* First, the regulatory framework governing private sector activity needs to be addressed in areas that lead to bureaucratic delays and high transactions costs, especially those concerning tax administration, inadequate bankruptcy laws, highly restrictive labor market regulations, and enforcing contracts. Second, Government will need to sustain the financial deepening that has been closely associated with economic growth in Nepal; here the biggest challenge will be to prevent an incipient banking crisis. Third, infrastructure will need to be improved. While there has been considerable progress in developing infrastructure in the 1990s, including through private participation, Nepal remains an infrastructure-constrained country, with considerable unmet demand, poor reliability and high costs. As infrastructure requirements and demands on scarce public resources are large, a key task will be to prioritize public expenditures. A particular challenge will be to improve connectivity and rural infrastructure. A closely related challenge will be to set up regulatory frameworks that can attract private participation in infrastructure.

B. The Regulatory Environment

3. *The investment climate of Nepal was improving until the escalation of the insurgency in 2002, but serious problems remain.* The liberalization of the trade regime since the early 1990s, the easing of entry regulations, the opening up of infrastructure investment to the private sector, relatively low tax rates and a robust growth in credit all helped to improve the investment climate (see Table 3.1 next page). Domestic private investment rates increased to 15% of GDP in the mid-1990s compared to 9% in the 1980s. But private sector perception of the investment climate continues to view it as unfriendly and Government policies to be the most important obstacle to business. A 1999/00 survey showed many of the firms (36%) specifically identified red tape, time delay and corruption as key obstacles. Beyond that, cumbersome and discretionary tax administration, lack of clarity and predictability of Government policies and labor regulations were cited as other key issues.[30]

[30] The Business Environment and Manufacturing Performance survey in Nepal, World Bank, Biggs (2000), for instance reported that 36% of firms viewed Government to be the biggest obstacle.

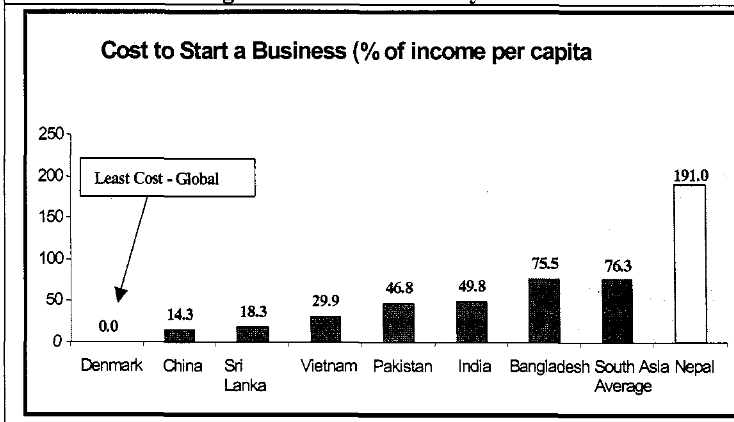
Table 3.1 Comparative Investment Climate Indicators

	Year	Nepal	Bangladesh	India	Pakistan	Sri Lanka
Private fixed investment/GDP (%)	(2002)	12.8	16.2	15.9	10.8	20.4
Stock market capitalization/GDP (%)	(2002)	8.6	2.5	25.7	17.3	10.1
Govt. intervention index (Heritage)	(2001)	2.0	3.0	3.0	3.0	2.0
Regulation index (Heritage)	(2001)	4.0	5.0	4.0	4.0	3.0
Wage & price control index (Heritage)	(2001)	4.0	4.0	4.0	3.0	2.0
Domestic Credit to Private Sector	(2001)	30.7	24.7	29.0	29.4	28.9
Private Investment/ Gross Domestic Fixed Investment (%)	(2000)	71.8	70.0	70.1	64.7	n.a.
Highest Marginal Corporate Tax Rate (%)	(2000)	20.0	35.0	40.0	n.a.	35.0
Institutional Investor Risk Rating	(2002)	24.4	27.3	47.3	20.0	33.6

Note (I): Data for stock market capitalization/GDP, and domestic credit to the private sector for Nepal is for the year 1999 and 2000 respectively.
Note (ii): Data for private investment/gross domestic fixed investment for India is for the year 1999.
Source (I): PREM/DEC Indicators for private investment/GDP, stock market capitalization/GDP, govt. intervention index (Heritage) and wage and price control index (Heritage)
Source (ii) World Development Indicators for domestic credit to private sector, private investment/gross domestic fixed investment (Nepal's figure obtained from IMF statistical appendix) and highest marginal corporate tax rate.
Source (iii): www.jolis.worldbankimflib.org/nldbs.htm#IJ for ICRG composite risk rating.
Source (iv): Institutional Investor, September 2002, for Institutional Investor Risk Rating,

4. ***Entry and Exit Policies:*** *In terms of the law, it is not too difficult to invest and to enter an industry in Nepal but in practice, multiple agencies that are responsible for investment approval do not coordinate and raise the costs of entry.* Together, the Amended Industrial Act of 1992 and the Foreign Investment and Technology Act of 1992 provide an adequate legal framework as well as incentives for investment. However, implementation has been problematical since responsibilities for implementation are diffused among a number of entities. They include the Ministry of Industry, One Window Committee, the Industrial Promotion Board and the Board of Investment and Fast Track Committees. Some of the important elements of these acts that created these institutions have been over ridden by other acts such as the Income Tax Act of May 2002. Industrial licensing, tax authorities and local authorities do not work together with the result the "one stop" entry process is stretched over many steps. This may explain Nepal's unusually high costs of starting a business and the country having the lowest amount of foreign direct investment in the sub-continent (see Figure 3.1).

Figure 3.1 Exit and Entry Policies

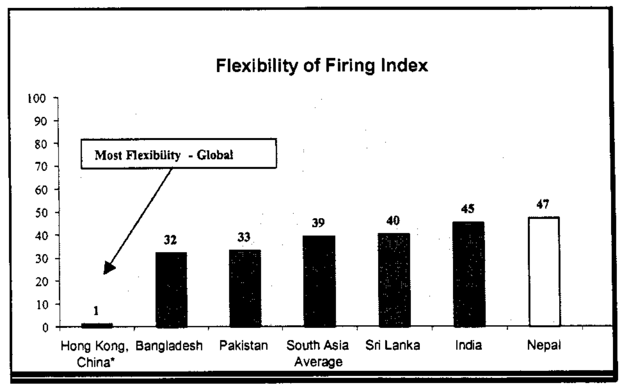


Source: Estimated from Doing Business Report 2004, The World Bank

5. ***Conduct Policies.*** *Frequent and unexpected changes in the policy regime such as import tariff schedules, customs valuation and classification processes create an uncertain business environment.*[31] Industrial licensing, tax authorities and local authorities do not work together. Examples of inadequate consultations and poor coordination are plenty. Many firms find it difficult to operate in the present environment given the economic uncertainty that adds to the already uncertain security environment. Many of them remain in limbo with no plans to expand operations or simply exit.

6. *A reform agenda for the regulatory environment needs to comprise the following.* First, improve the regulatory framework through the rationalization of institutions (to allow less conflict and duplication), clarify and simplify implementation by reducing the number of institutions involved and by adopting automatic clearances (e.g. company registration could be linked to the tax system). There is also scope to improve business and HMGN relations through joint committee approaches where the business community participates in the design of policies. Second, the bankruptcy law must be modernized through the new Company and Insolvency Acts to allow easier and less time-consuming exit policies. Finally, labor market rigidities need to be addressed. Legislative reforms are needed to make labor law consistent with labor contracts (see Figure 3.2). And, Government should allow dismissal with reasonable compensation. In fact rigid labor laws encourage extra-legal contracts and hiring many foreign nationals because they are easy to get rid of. Given that some of these reforms may be time consuming due to political opposition, Government should proceed to implement the setting up of Special Economic Zones and the Export Processing Zones where the current restrictive labor regulations can be relaxed.

Figure 3.2 Flexibility of Labor Markets



Source: Estimated from Doing Business Report 2004, The World Bank

C. Financial Sector

7. *The first task for the Government is to prevent a potential banking crisis by prudently restructuring the two Banks that account for 50% of banking sector assets.* Gross non-performing loans make up 60% of the assets of the RBB and the NBL, while together their negative net worth is estimated to be in the range of 7% of GDP. Thus, their insolvency endangers the banking sector as a whole, and with it future growth prospects. Government has set in process strong loan recovery mechanisms through the Debt Recovery Tribunal and the recent appointment of a Judge for the Appellate Court (redress mechanism). While efforts by the RBB and the NBL had some success in recovering loans and improving portfolios, they are currently running into strong "political" resistance as large willful defaulters continue to take refuge behind the weak judiciary system (in the form of stay orders by the courts) precluding the banks from taking further legal action for an indefinite period. Immediate priority is to stay the course in implementing banking sector reforms. This entails, first, amending the law concerning the Debt Recovery Tribunal to limit the scope of the courts in issuing stay orders. Second, encouraging the NRB to enforce the Blacklisting Directive more rigorously as there are instances of banks failing to carry out their duties as required under the Directive, and third, complete the restructuring of the assets of the two banks through setting up an Asset Management company.

[31] However, this aspect could be remedied with the WTO entry process underway.

8. *The second task ahead is to implement the banking supervision and regulatory reforms, including, most crucially, strengthening the role of Nepal Rastra Bank by providing it with autonomy in the conduct of monetary policy, banking system regulation and supervision, and the licensing of banks and non-banks.* Alongside amending Article 86 of the NRB Act to this end, the Government needs to increase the capacity of the NRB. For this it has to persist with the implementation of human resource management changes including rationalizing the staff through the VRS program to make it a more professional body. A second requirement would be to upgrade the NRB's archaic management and information system by introducing an automated clearing-house system, among other measures.

9. *The two major development banks need restructuring or liquidation.* Agricultural Development Bank of Nepal (ADB/N) is facing a number of challenges from its past performance and from the Maoist insurgency that has led to the closure of some 45 offices in the last five years. Similarly, Nepal Industrial Development Corporation has to be liquidated or privatized. ADB/N is one of the largest financial institutions in the country and has some 38%-48% of loans in the non-performance category. The bank has been a conduit for cheap credit in the past with long maturity periods involving huge subsidies for relatively large borrowers. It followed the past policy of meeting credit targets irrespective of financial viability and had little incentive to mobilize saving deposits or recover funds. It also lacked risk evaluation and monitoring capability. HMGN should also be mindful of the need to improve the profitability of the ADB/N and the very real limitations on the ability to operate branch networks outside the Kathmandu Valley due to the deteriorated security situation. The Nepal Industrial Development Corporation (NIDC), on the other hand, is a candidate for liquidation. Detailed analysis of the portfolio and the availability of trained staff suggest that it is unviable.

D. Infrastructure (Transport, Power and Telecommunications)

10. *Along with improving the policy environment in trade, regulation and financial sector policies, further efforts are necessary to use the current and limited infrastructure better and to create infrastructure that supports private sector development.* Given the country's geography and difficult terrain, access to infrastructure is the worst in South Asia by most indicators (Table 3.2). Transport, which is a key to private sector activities as well as the delivery of public services, remains limited. Of particular importance is inadequate road connectivity in Nepal.

Table 3.2 Comparative Infrastructure Indicators

	Year	Nepal	Bangladesh	India	Pakistan	Sri Lanka
Paved Roads, % of Total	(1999)	30.8	9.5	45.7	43.0	95.0
Internet Users (thousands)	(2000)	50.0	100.0	5000.0	133.9	121.5
Electricity Consumption per Capita (Kwh)	(1999)	47.1	89.0	379.2	321.2	255.3
Telephones Mainlines per Employee	(1997)	37.2	14.7	33.7	48.3	30.4
Road Density (Km/ sq. km of land)	(1999)	0.1	1.4	1.0	0.3	1.5
GDP per unit energy use (PPP $ per kg oil equivalent)	(1999)	3.5	10.8	4.7	4.2	8.1

Note (I): Data for telephone mainlines per employee for Bangladesh is for the year 1995, and for India is for the year 1996.
Source (I): World Development Indicators for paved roads, internet users, electricity consumption per capita, road density and GDP per unit energy use.
Source (ii) Social Indicators and Fixed Factors, for telephone mainlines per employee and radios per 1000 people.

Transport – Mainly Roads

11. *Transport remains a defining constraint to growth, public services, and poverty reduction in Nepal as recognized in the 10th Plan/Poverty Reduction Strategy.* Nepal has one of the lowest road

densities for a landlocked country. As roads are the main arteries of the economy in Nepal's terrain, the lack of roads makes connectivity a significant constraint. An estimated 3.5 million people (15% of the population) do not have road access in Nepal; some villages can be up to 13 days walk to the nearest road head. The Government's strategy for the transport sector is outlined in the Tenth Plan, which includes: (a) maintaining the road network in serviceable condition; (b) expanding the road network to link 10 district headquarters with a motorable road; (c) improving rural access and decentralizing the management and financing of rural roads to local bodies; (d) improving sector management; (e) encouraging private sector participation in road construction and operation; and (f) facilitating trade and transit. However, achieving the targets is likely to be difficult in the current security environment and if the Government cannot address the issues in the following paragraph.

12. *The Government currently funds only half of road maintenance requirements endangering the maintenance of this key asset.* The proportion of the strategic road network in good and fair condition had increased from less than 50% in 1992 to 90% in 2001 but that has deteriorated again to 69% in recent years due to lack of maintenance. Reversing this trend is an urgent priority. HMGN has recently established an autonomous Roads Board and Road Fund to provide stable funding for road maintenance from user fees. The Roads Board has this year generated about NRs500 million from fuel levies and other user charges, but this is only about half of what is required to fully fund Nepal's Strategic Road Network (SRN). [32] The maintenance gap could be met by increasing the fuel levy on fuel.[33] At the current consumption level this could raise about NRs1.8 billion (US$25 million), with the small shortfall met by counterpart funds from districts and municipalities.

13. *Increasing and prioritizing investment through revamping the priority investment plan is needed.* Nepal currently invests far less on roads program in comparison to its needs. In order to facilitate the 6.3% GDP growth anticipated in the Tenth Plan, Nepal needs to invest about 2.5% of its GDP (about US$145 million a year) in expanding and maintaining its road assets[34]. These estimates are substantially higher than the current $ 55 million expenditure in the road sector. Another way to look at the shortage of investment is at its current resource allocation of about US$30 million investment on new construction, it will take HMGN 19 years to complete the Tenth Plan targets and recent initiatives in the road sector. Three actions are implicit: increasing road expenditure allocation, prioritizing these more carefully, and, when possible, setting up regulatory frameworks for private sector participation.

14. *Expanding the road network and completing the North-South corridors are a high priority.* The road network in Nepal has increased from 7000 km in 1990 to 16000 km in 2003 (of which 4627 km are black top roads). But there are three priority areas for further road expansion, North South Corridors, a fast track Kathmandu-Terai link, and expanding and upgrading village roads. Perhaps most important, the North South Corridors and roads to several Western districts remain incomplete. The hill districts in Nepal are accessed through major North-South Corridors that link them to the East West Highway, which would in turn connect them to the Terai, India and to the rest of the country[35]. The total length required to complete road links in western Nepal is about 1184 km, of which only 581 km has already been opened into a track or is under construction for initial opening. Hence, completing these roads is a high priority.

32 SRN includes the main highway and feeder roads,

33 The current fuel levy transferred to the Roads Board is NRs1.5 on petrol and NRs 1 on diesel. to NRs5.5 (or 7 cents) per liter of petrol and to NRs5 per liter of diesel.

34 The estimates are only for the road sub-sector; air transport is not included. For comparison with other countries, China currently invests about 4 to 5% of its GDP on expanding and maintaining its transport system, while Korea, during its development stage, used to spend about 5.2% of its GDP. Brazil spends about 2.4% of its GDP, and Bangladesh spends about 2.5% of its GDP. Most OECD countries, with mature transport network, invest about 3% of their GDP on maintaining their transport assets.

35 Of the 17 district headquarters not served by road, 12 are in western Nepal, while the five are in the east. Road connection for eastern Nepal is progressing with assistance from DFID, RAP and own HMGN funding.

15. *Transferring rural road network development to decentralized management but with appropriate technical support will be key for rural development.* There are currently about 14,000 km of rural roads. Most of these are under the management of the respective DDCs; an estimated 4000 km of district roads, now under the Department of Roads management, will be transferred to district government management. But technical support to local Governments are needed to ensure that road planning is economically viable and avoid the mistakes of the past. Many unsustainable and environmentally damaging roads have been built or many kilometers of roads have been built for which there is little vehicular demand as the road may not be connected to the remainder of the network.

16. *Government needs to attach much more urgency to transport and trade transit issues.* Ninety percent of Nepal's foreign trade route depends on access to India's transportation system, where the nearest seaport, Kolkata, is located 1056 kilometers away in India. While the Government has built three Inland Container Depots (ICDs) in the border towns with India and focused on improving and harmonizing transit and customs procedures, the pace of implementation has been slow. Although, the road-based ICDs are operating effectively under a lease hold contract with a private Terminal Management Company, the rail-linked ICD has just commenced operations three years after all physical work, including rail spur line from Raxaul, has been completed. Aside from the direct financial costs, delays like this raises costs for firms, and more critically, creates policy uncertainty for firms preventing them from investing to increase their competitiveness.

Power Sector

17. *Nepal has vast hydro resources, which present a source of potential wealth and exports to India, but currently access to power is very limited in rural areas and power costs are among the highest in South Asia.* Despite this potential (estimated at 43,000 MW), and a doubling of capacity in the last five years, only 522 MW of generation capacity has been developed so far. Based on the 2001 census, 40% of Nepalese households have access to electricity. Recognizing the critical importance of energy access to poverty reduction, HMGN has made environmentally and socially sustainable development of Nepal's hydroelectric potential one of its key developmental objectives. The emphasis on power development follows the adoption of the Hydro Power Policy in the early 1990s and the revisions to this policy in 2001/02. This policy envisages increased and competitive involvement of private investors in the production, distribution, and management of electricity, while recognizing the need for institutional and structural changes in the power industry to meet the sector's development objectives. Development of small hydro projects and district level projects under decentralized schemes in hilly and remote areas has also been highlighted. In the meantime, private sector generation has increased in some areas while in other parts of the country Maoists activities have led to the closure of some plants.

18. *But while considerable progress has been made on many fronts, many issues and challenges remain that constrain the power sector's ability to support poverty reduction efforts to its full potential.* First, despite the efforts of NEA, the systems losses are still high at about 24%, considerable efficiency and revenue gains can be made in this area. More work is needed to examine alternative restructuring options to lower costs of the power sector in the context of greater private sector participation and growing prospect of power trading.

19. *Second, Government needs to have a more focused policy in attracting private sector participation in the power sector, including in rural areas.* On the financing side, the long term financing facility, which the Government aims to create under the Power Development Fund (PDF) can play a critical role in mobilizing private investments in Nepal's power sector and should be implemented on an urgent basis. But at least equally important will be the need for institutional and regulatory reforms. Here Government needs to remove overlaps in the power sector further in policy, regulatory, and operational

functions of public sector institutions operating in the power sector that create conflict of interest and send confusing signals to the private sector.

20. *Setting up a competent and effective independent regulatory body is perhaps the highest priority for attracting efficient private investment as there is no such body at present.* The Electricity Tariff Fixing Committee (ETFC) that has been established falls well short of a full fledged regulator. Partially because of the lack of a competent regulatory agency, the IPP costs in Nepal are very high, and the IPP's generate power in the low value wet season when already there is surplus energy. Although the prevailing political environment in Nepal is delaying the passage of the regulatory act, there are several actions that HMGN can take in the transition period. These include: widen the role of the EFTC in areas where the existing order can be used as a base; improve the quality of staff of the ETFC by attracting with suitable compensation packages the best available technically competent candidates; and draft the regulatory act based on best practice experience from other countries with similar country and sector situations. When Parliament is restored, these transition efforts would facilitate the establishment of a competent and independent regulatory authority, which can perform the functions of setting and enforcing rules under which the sector operates, including the important role of setting power tariffs.

21. *Third, to ensure demand for new capacity, more needs to be done to promote power trade with India, which is very limited at present.* In 2002, Nepal exported only 10% of its output to India. At present there is little or no commercial orientation to power exchanges and the Power Trading Agreement between India and Nepal has not been ratified by the Parliament. While recent developments include formation of a joint technical committee between India's Power Trading Corporation and HMGN/NEA; and preparation of term sheets on the volume of power and energy to be traded between Nepal and India, agreements and decisions on power trading transmission link with India need to be expedited.

Telecommunications

22. *In the last seven years, the telecommunications sector in Nepal grew at a rapid pace, but there is still considerable unmet demand and the need to increase competition.* The number of fixed line customers increased from about 84,000 in 1995 to about 350,000 in 2003, bringing fixed line penetration to over 1.8% (see Table 3.3 below). The introduction of prepaid mobile services by NTC and the start of services by the second fixed line operator, UTL also increased teledensity. The liberalization of the ISP and VSAT market has led to a rapid diffusion of internet services in Nepal, although mainly in Kathmandu and other bigger urban areas. There are approximately 1500 Internet hosts and about 35,000

Table 3.3 Comparative Telecommunications Indicators

	Cellular teledensity (%)	Fixed teledensity (%)	Total teledensity (%)	Estimated internet users (thousands)	Telephone Mainlines per Employee	Cost of a 3 Minute Call to the US (In US$) and utility providing the service.	
Bangladesh	0.81	0.46	1.27	204	55	1.24	BTTB
India	1.22	3.98	5.20	16,580	108	0.6	BSNL
Nepal	0.09	1.77	2.77	175	92	3.04/1.27	NTC/ Budget Calls
Pakistan	0.85	2.50	3.35	1,500	73	1.35	PTCL
Sri Lanka	4.92	4.65	9.57	200	131	0.7	SLT

Source: World Telecommunications Development Report 2003. ITU, Nepal's numbers were updated by HMGN in October 2004.

Internet subscribers, with the number of users estimated to be two or three times higher. Despite the growth of telecommunications, there is considerable unmet demand and costs are high. In particular, there is a waiting list for fixed services estimated at 200,000 subscribers (February 2004). Also, unlike neighboring countries, the cellular market did not witness higher growth despite the entry of few private operators owing mainly to the lack of competition in the mobile market and the delayed introduction of prepaid mobile services in mid-2003.

23. *Developing telecommunications is a key to increasing connectivity and external competitiveness.* A reform agenda would involve increasing competition in the sector, rebalancing of tariffs to reduce cross subsidization, expanding access to the rural areas, reforming institutions in the sector to clarify regulatory authority between the NTC and FMD and commercializing the NTC perhaps with a view to privatization of the services. There is also the need to clearly separate the government's policy-making and operational roles in the sector, with the restructuring and increased private ownership of NTC.

E. Summing up

24. *Nepal has to act on a number of fronts to raise its investment rate, particularly private investment to restart growth.* Towards this end, it has to improve the regulatory environment and adopt investment regime that is more friendly to private investment than perceived by the private sector at present. Restructuring and reforming the financial sector would be necessary to increase access to credit and also to increase efficiency in the financial sector. Infrastructure, particularly the lack of connectivity, has been a factor in low private sector participation as well as HMGN's ability to provide public services to the different parts of the country. It has retarded growth as well as skewed development to the detriment of welfare of different parts of the country. Roads will play a crucial role to increase connectivity and to facilitate trade both internally and with the rest of the world. Nepal has large power potential and this needs to be exploited with power exports to India. Similarly there is a policy agenda to be addressed in the telecommunications sector to allow the private sector to play a larger role by improving the regulatory environment for that purpose.

CHAPTER 4: FOSTERING GROWTH IN AGRICULTURE AND LAGGING REGIONS

A. The Central Role of Agriculture and Emerging Dynamism

1. *Agriculture and rural development are central to poverty reduction and growth in Nepal.* Although the sector's contribution to GDP has declined to about 40% in 2001, it employs more than two-thirds of the labor force and is the main source of income for 83% of the population. Agriculture in Nepal is to a large extent subsistence and smallholder-based. About 96% of land owned by agricultural households and 83% of the operational landholdings are less than 3 hectares. Agriculture is especially important for the poor, as it is the main source of income for the poorest households (90% of the bottom consumption quartile). Hence, agriculture's performance has widespread implications for the overall welfare of Nepal. Unsurprisingly, stagnant per-capita agricultural incomes of the last few decades were associated with Nepal's persistently stubborn high poverty rates until the mid-1990s. Conversely, acceleration in the growth of agricultural incomes from 1.5% in 1991-95 to 3.7% in 1996-2001, alongside the rapid growth of remittances, is associated with significant poverty reduction and demonstrates the sector's potential contribution to poverty reduction.

2. *Increasing productivity, cropping intensity and diversification to higher value products (i.e. crops, livestock), stimulated by a number of demand- and supply-side developments, contributed to agriculture's improved performance in the second half of the 1990s.* Rising incomes increasing domestic demand and improved export opportunities expanded markets for agricultural products. Indeed, the share of agricultural exports in total production value increased from 20% to 35% from the first to the second half of the 1990s. The agricultural sector's supply response was in turn facilitated by the Government Agricultural Perspective Plan (APP) led expansion of infrastructure – in particular, roads, which facilitated marketing and irrigation, which facilitated increased productivity – and credit, which facilitated farm investments. In addition important policy reforms contributed to improving the incentive environment for agricultural commodity and input markets. These included trade policy reform, which enabled increased agricultural exports, increased internal commodity market deregulation that encouraged greater private sector participation and investments, and input market deregulation particularly for fertilizer, which enabled improved farmer access and use. These policy reforms and investments contributed to improving the competitiveness of Nepal's agriculture and improved production incentives by farmers. The agricultural sector grew despite the lowering of import tariffs[36] and the removal of subsidies on fertilizer and on shallow tube wells.[37]

3. *Despite substantial constraints such as a difficult terrain and poor connectivity, there are opportunities on which to build.* Nepal is blessed with a broad range of agro-ecological zones and proximity to vast markets in India, Bangladesh, and China. The mountains have a natural advantage in animal production and livestock products, while the hills have comparative advantage in a variety of crops, such as off-season vegetables, tea, citrus, seed production, and spices. Despite the Terai's similarity to growing conditions in northern India (and the fact that Indian farmers are subsidised), this area is considered to have growth potential in vegetables, fruits, oilseeds, betel nuts, and some cereals. Another important asset is a culture of active community groups in Nepal's hills – in forest management, water and road user groups -- indicating the presence of significant social capital at the community level.

---

36 Nepal's agricultural tariff rates of around 14% are the lowest in the South Asia region.

37 Budgetary subsidies totalling about 0.2% of GDP exist in a few areas such as transport subsidies on fertilizer, a transport subsidy on food supply in the remote districts of the country, an irrigation subsidy for some surface schemes, interest subsidies on small loans extended by the Agricultural Development Bank, and a capital subsidy on bio-gas and small irrigation projects.

4. *Sustaining and improving on the agricultural sector's performance over the longer term, to maximize its contribution to rural growth and poverty reduction in Nepal would need government commitment to foster an enabling environment for the development of a high productivity, diversified, and commercialized agricultural sector.* This would be in line with the Government's 10^{th} Five Year Plan (2002-2007), which assigns a central role to the development of agriculture and the rural economy in poverty reduction. This is also in line with the Agricultural Perspective Plan's (APP) broad thrust, but differing in its greater emphasis on policy and institutional issues and a broader approach in its hills strategy. Achieving these goals would require measures to increase farm productivity and agricultural marketing efficiency by strengthening farmer capacity to take advantage of growing domestic and international market opportunities. These will require actions in two major areas. First, policy and regulatory reforms are needed to reduce the barriers to private sector participation and investments in the agricultural sector. These would include reforms of land and credit policies and of the multiple laws, rules and executive orders governing agricultural trade. Second, fostering increased public and private investments in rural infrastructure (roads, markets, electrification) and rural services (credit, agricultural research and extension, land administration, market information, export promotion, phyto-sanitary services, grading and quality control) will be critical. Integral to the revival of the government's investment program will be institutional reforms of government agencies to ensure the improved delivery of rural-related public goods and services, including through greater participation of users and communities.

5. *Recognizing the diverse agro-ecological conditions in Nepal (Terai, hills and mountains), regionally differentiated rural development strategies would be critical.* For example, the mid and far Western regions of Nepal lag significantly behind in infrastructure, incomes and human development than other parts of Nepal. Their characteristics and endowments offer unique potentials, opportunities and challenges, and will need special focus.

B. Government Strategy and Policies

6. *The Agricultural Perspective Plan (APP), launched in 1995, is the government's key policy on agricultural and rural development.* This Plan was launched during the 9th Plan Period but was only partially implemented. The APP strategy was expected to lead to a technology-based green revolution in agriculture, which would raise outputs, and incomes through increased use of yield increasing inputs (fertilizer, improved seed, reliable irrigation) and promotion of off-farm activities. The strategy was regionally differentiated between the Terai, which would focus on high yielding input based food grain production, and the hills and mountains, which would focus on horticulture and livestock production in prioritized pocket programs. The APP envisaged significant increases in public and private investments and an integrated package approach to exploit complementarities between public and private investments and with other sectors such as transport and energy. The APP included explicit investment targets focused on four priority inputs: fertilizer, irrigation, technology, and infrastructure.

7. *The 10^{th} Plan's growth strategies for agriculture sector are to modernize, diversify and commercialize crop and livestock production by expanding the use of technology, and increasing the access of farmers to modern agricultural inputs and credit.* Similarly, promoting the participation of the private sector and NGOs/INGOs in service delivery, market promotion and infrastructure development are other major strategies. To diversify and commercialize agriculture, the Plan intends to mobilize private and non-government service providers in partnership and on a contract basis; promoting cooperative and contract farming; devolving local agricultural programs to local bodies; strengthening agriculture stations as resource centers to ensure the supply of quality seeds, saplings, and breeds for subsequent multiplication for local needs; and providing technical backstopping.

8. *Going by the experience of the 9th Plan (FY 1997 to 2002), the key challenge for Government will be implementation.* In the past the promise of the APP was impeded, first, by actual investments which fell short of targets: on average only two-thirds of the planned development expenditures were realized. Second, inter-departmental coordination to implement the APP was weak. Beyond implementation, the APP suffered from the inadequate attention to incentives, marketing and demand issues, and the commercialization of agriculture. While the 10th Plan touches on these issues, it needs more specificity on the commercialization strategy as well as on addressing the continuing problems of coordination of the different agencies concerned with agriculture. The issues in output and factor markets that impede the growth of agriculture are described next.

C. Output Markets and Marketing

9. ***Output Trends:*** *The agricultural sector's growth performance improved markedly between the first and second half of the 1990s.* This improved performance was mainly led by a much faster growth of food grains (Table 4.1) as irrigation expanded which made output less volatile, fertilizer used increased, and new roads and markets improved incentives and facilitated private sector entry. Growth of livestock, a significant part of agriculture, also accelerated.

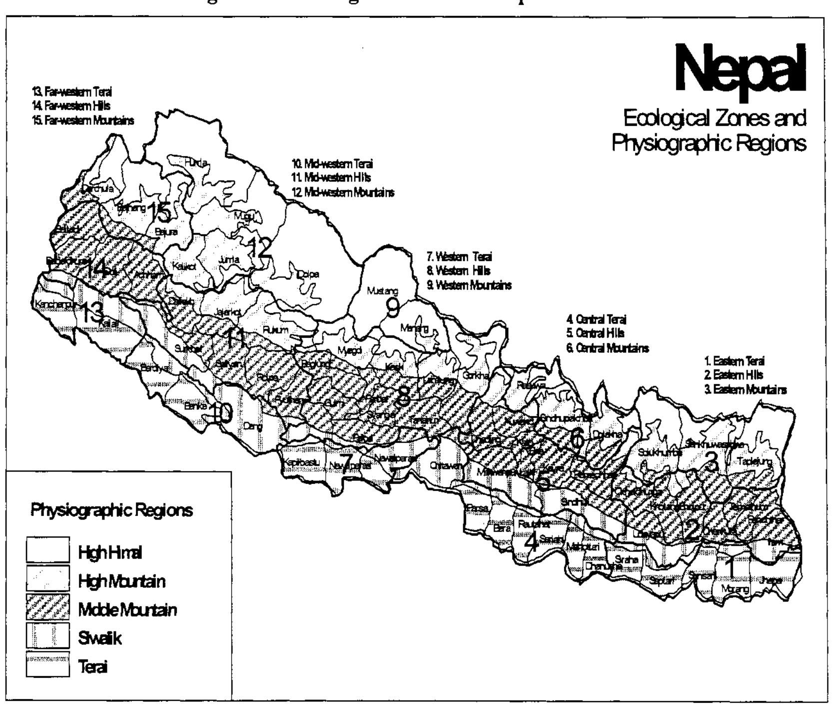
Table 4.1 Growth of Agriculture Sector and Composition

	Growth Rates	Growth Rates	Share of Value Added
	1990/91 to 1994/95	1995/96 to 1999/00	1995/96 to 1999/00
Agriculture, Fishery, and Forestry	1.75	2.97	100.00
Food grains	-0.88	2.32	34.70
Cash Crops	3.44	5.55	7.56
Other Crops	5.41	3.02	18.73
Livestock	1.62	3.57	28.97
Forestry	3.33	9.66	1.35
Fishery	2.51	0.26	8.70

Source: Based on data of Rebasing and Linking of National Account Series (CBS Occasional Paper 1/01)

10. ***Regional variation:*** *There is considerable variation in Nepal's agriculture among the different ecological zones and physiographic regions of the country: i.e. between the plains of the Terai, the central Hills (called the Shivaliks and middle mountains in Figure 4.1).* Terai plains, accounting for only 17% of total land area accounts for nearly 50% of total crop land. The most striking characteristic of the Hills and Mountains is their diversity of agro-ecological zones and their potential as a source of high-value crops. Livestock is more important than cereals. All these drive home the need to take a differentiated approach to agriculture in Nepal and to take into account the special features of its hills and mountains.

Figure 4.1 Ecological Zones of Nepal



11. ***Low Agricultural Productivity.*** *Because Nepal missed the Green Revolution that took place in most of South Asia in the 1970s and 1980s, productivity remains low for a number of crops compared to neighboring Indian states and Bangladesh (Table 4.2).* Limited availability and use of irrigation and inputs, such as improved seeds, fertilizer and technical advice contributed to low agricultural productivity. Only about two-fifths of the cropped land is irrigated and less than half of the irrigated land benefits from year round irrigation. Until recently, input monopolies raised prices of modern inputs. In addition, difficult terrain – a large share of Nepal's agriculture is in terraced hills, also makes agricultural production more complex. These factors limited yield growth. Between the early 1960s and the late 1990s, paddy yields in Nepal only grew at 0.6% per year, while neighboring countries achieved growth rates between 1.4% and 2% per year.

Table 4.2. Low Agricultural Productivity

Crop Yields in Nepal and its Neighbors					
	Wheat mt/ha	**Rice paddy mt/ha**	**Sugarcane mt/ha**	**Pulses Mt/ha**	**Maite Mt/ha**
Nepal	1.8	2.7	37.2	0.77	1.8
India					
Uttar Pradesh	2.7	2.0	54.8	0.8	1.6
Bihar	2.1	1.5	42.4	0.8	2.3
West Bengal	2.5	2.3	67.9	0.7	2.5
Bangladesh	2.2	3.5	40	0.83	1.5

Source: FAO

12. ***Trade and Markets.*** *The low productivity of Nepal's agriculture is associated with its subsistence nature, and low levels of marketing and commercialization.* At present, access to markets is difficult. Isolated and thin markets that are subject to local price swings and without adequate storage capacities inhibit investment in commercial production. The fragmentation of the market is evident from the significant differences in prices of agricultural commodities in different parts of the country.[38] Even in areas where market demand potentially exists, scarcity of market infrastructure such as collection centres, storage facilities and organised market places limit opportunities for commercialization.

Table 4.3 Percentage of Households Producing and Selling Different Products, Nepal

	% of households producing		% of households selling	% of output sold
	wet season	dry season		
Paddy	75		22	7.4
Cereals, including paddy	98	84	24	8.8
Other crops	75	79	29	12.9
Any crop	100	100	46	13

Source: NLSS 1995/96

Information about the demand for and the prices of agricultural commodities at different markets is also not easily available to the farmers. This can be quite costly for the farmers as they are forced to sell their produce at very low prices. Thus, as Table 4.3 shows, the 1995/96 survey revealed that less than half of households sold any crop in markets – and sold only 13% of their output -- compared to nearly all households in Bangladesh which sold some or the other crop. Markets in Terai bordering India are better integrated with Indian markets than with markets in the Hills and Mountains.

13. *Recent indications are marketing and commercialization are increasing even in the hills regions as evident from the growth of production of off-season vegetables, vegetable seeds, lentil, honey, spices, milk, and livestock.* In particular, agricultural exports have been increasing rapidly with their share increasing from an average of 14% in the first half of the 1990s to 19% in the second half of the 1990s. During the same period, growth of export of agricultural products increased dramatically from 20% to 35%. Much of the growth in agricultural exports was the result of increased trade with India, which is the destination for 90% of Nepal's agricultural exports. Four constraints have to be addressed, however, to build on this potential for commercializing agriculture.

---

38 See the discussion on Transport in Chapter 3.

14. *First, the lack of connectivity and especially roads is probably the single-most important constraint to agricultural growth, especially in the mid and far western regions.* Even though nearly 1,000 local haat bazaars and Government built up urban markets are operational in different parts of the country, particularly in the eastern, central and western regions, distance to markets remains a major issue. This exerts a strong impact on crop choice and diversification, use of inputs and the balance between farm and non-farm activity. Thus, the 1995-96 survey finds that vegetable production tends to occur within 3 hours' distance from an urban market. Cereals and pulses dominate production in areas within 8 hours' from markets. Beyond 8 hours travel time, the local economy is self-contained (subsistence based), showing little interaction with the market. Chemical and fertilizer inputs tend not be used beyond a distance of 5 hours. These distances raise transport costs, increase products losses during transit and create thin and segmented markets. Thus, transport and village to market roads will play a pivotal role in the move away from subsistence faming to high-value crops.

15. *Second, market facilities – markets, storage, processing and drying centres - are grossly inadequate in the mid- and far-western regions compared to the other regions.* All these contribute to limited markets, low prices and low productivity. Priority needs to be given to developing market infrastructures in these regions, especially in commodities, which have revealed their potential for commercialisation.

16. *Third, regulatory and legal reforms are needed to promote private sector and community organization participation in commercial activities, the developments of markets, and the introduction of standards.* Thus, there is a need to extensively streamline 66 laws, 38 rules and regulations, 39 executive orders and 39 by-laws that impinge on commercial and contract farming into a more manageable set. *Fourth,* experienced NGO or private sector based assistance in the formation and operation of a group approach to production, processing, and marketing of high value commodities will be useful given the small scale of Nepal's agriculture.

D. Factor Markets

17. *There is significant scope and need to improve policies and efficiency in land, water/irrigation, and credit markets.* Although there was significant expansion of irrigation and credit in the 1990s, which helped to boost agriculture, market rigidities (land), inefficient pricing and weak institutional incentives (water), and inadequate and unsustainable coverage (credit) pose major constraints at present.

18. ***Labor.*** *Currently, more than two-thirds of the labor force in Nepal is employed in agriculture.* This is significantly higher than other South Asia neighbors such as India (58%), Bangladesh (55%) and Pakistan (47%). This share of the labor force in agriculture, however, declined rapidly in the 1990s from more than 80% to 66%, with significant growth in the share of industrial employment (currently 13%) and employment abroad (approximately 9% of the labor force). Within the agriculture sector, self-employment dominates. There were only 180,000 permanent agriculture laborers – or less than 3% of the labor force in agriculture. Overall, less than 3% of households employed both permanent and casual workers. In the absence of employment opportunities and lacking assets, a good proportion of the farm labor pledge their services to land owners for long periods – effectively working as bonded labor. In Western Nepal, this practice becomes more formal with labor being tied to the land as Kamaiya (indentured) labor. While this practice was declared illegal and abolished in 2000, it continues in reality in the absence of other opportunities or programs to provide them with other assets. Wage data in Nepal is extremely weak. However, field visits and the household survey data suggests that the tightening of labor market has resulted in an increase in agriculture wage rates. Despite this, real wages in agriculture remain low relative to neighboring countries. This suggests employment intensive growth that would foster more rapid wage increases in rural areas will be critical to rural poverty reduction.

19. ***Land.*** *The agrarian structure in Nepal is dominated by small-land holdings.* The average size of land owned is about 0.8 ha, which is frequently fragmented, averaging 3.3 parcels. This is in part due to Nepal's Land Act of 1962, which imposes a stringent limit on land holdings. It allows for a maximum of 17 ha per holding in Terai, and 4 ha in the hills and mountains. In addition, cropping intensity is relatively low, and increases only slightly as farm size decreases. The small landholdings and their low productivity pose difficulties for many agriculture-based households in generating an adequate income and livelihood and are important determinants of poverty.

20. *Land rental and sales markets are constrained by land policy relating to land leasing and weak land administration systems.* Nepal's dual tenure system allowed both tenant and owners to lay claim on the same land. Lack of clear ownership rights thus discourages investments or renting of land to more productive users and can pose limits on the use of land as collateral. Only 9% of the land area was rented in 1994, but there is also considerable hidden tenancy. In a much welcomed move that would improve the functioning of land rental markets, this provision was repealed through an amendment of the Land Act in 1998. But its implementation and positive impact will take time. Land ownership records are very rudimentary. Measures to improve land administration systems, particularly cadastral and land title records, to provide greater security of ownership and reduce transactions costs will also be needed.

21. ***Water and Irrigation.*** *Two-thirds of Nepal's total cultivable land is potentially irrigable, but at the end of the Ninth Plan (2002) less than 40% was irrigated.* Of these, only 17% have year-around irrigation. Two thirds of Nepal's irrigated land is in the Terai, and 16% in the Hills. However, even in Terai year-round irrigation is limited to less than 20% of cultivable land despite high potential. Given the geographical differences between Terai and the Hills, with the latter exclusively dependent on surface irrigation, Nepal irrigation strategy needs to be regionally differentiated (Table 4.4). In Terai, the strategy for expanding irrigation should include a combination of surface and groundwater irrigation development. Large irrigation schemes (greater than 10,000 ha) can be developed with surface water sources. Groundwater development could be focused on crop specialization zones, governed by good aquifer management practices. Shallow tube wells (STWs) should remain viable in many areas even without subsidies. In the mountains and hills, innovative and a combination of approaches need to be taken, which are discussed in the next section.

Table 4.4 Irrigation Management Systems

Irrigated Area (ha) by system and source	Surface Water	Ground Water	Total
Government operated	290,000	30,000	320,000
Farmer operated	690,000	190,000	880,000
Total	980,000	220,000	1,200,000

Source: Poudel (2002)

22. *Many surface irrigation systems are plagued by low efficiency.* In many cases, only about two-thirds of the irrigation command area actually receives irrigation. Moreover, many surface irrigation systems suffer from inadequate maintenance leading to their rapid deterioration. Poor irrigation maintenance arises from inadequate budget allocation exacerbated by poor cost recovery, and lack of incentives and accountability for maintenance by irrigation agencies. At one level, the average cost recovery for operations and maintenance in the Government Agency Managed schemes is estimated at only 1.3%, and the pricing is seriously distorted by making it tied to the size of landholding rather than actual use of water. The cycle of deferred-maintenance and consequent costly rehabilitation undermines the quality of irrigation service delivery. Institutionally, participatory water user's associations have done much better than government agency managed systems at cost recovery and maintenance. But some large size surface irrigation facilities, which have a strong public good component, will continue to need Government management.

23. *With these considerations, Government can unbundle the maintenance strategy in the following manner:* (a) maintenance of the head-works and big structures should remain under government

responsibility. The Government can fund these works through an adequate budget appropriation for operations and maintenance; (b) maintenance of the secondary level (main canals) depending on their size, complexity and capacity of user groups could be taken over by federations of WUAs (as they do in the Hills), co-financed by the Government and WUAs. Collection of fees will of course require a clear link to quality of services delivered. The tertiary level (minor canals and watercourses) should be wholly transferred to water users. Adequate capacity will need to be built at the WUA level to ensure a smooth transfer and sustainability. WUAs would collect fees for the O&M of their scheme from their members and put in place the organizational structure and incentives for water distribution and management at their level. They would contract any services themselves.

24. ***Fertilizer.*** *Although increasing, fertilizer use remains low in Nepal. During the 1965-1990 period, fertilizer consumption increased by over 22%. Usage dropped in the early 1990s but increased significantly in the second half of the 1990s.* Data from a 2001/02 household survey indicate fertilizer consumption of 56 kg per hectare of cultivated land; the Agriculture Sector Performance Review found similar results at 58 kg/ha. Nevertheless, fertilizer consumption per unit of arable land is four to six times lower than Pakistan, which similarly does not provide fertilizer price subsidies (Table 4.5).

25. *In 1997, the government removed the fertilizer distribution and import monopoly of the Agricultural Inputs Corporation.* The entry of the private sector in both imports and distribution improved the domestic availability of fertilizers considerably. At the same time, the government also phased out fertilizer subsidies, and the prices of fertilizers were decontrolled at the wholesale and retail level. Notably, despite the elimination of fertilizer subsidies, fertilizer consumption still increased. Improved market incentives and expanding use of irrigation and access to credit also likely contributed to enhance the incentives for increased fertilizer use.

Table 4.5 Fertilizer Use, Nepal[39]

	Fertilizer Application Rate		
	Formal source (kg nutrients/ha)	Informal Source (kg nutrients/ha)	Total (kg nutrients/ha)
Before deregulation			
1992/93 - 1996/97	25	3	28
1996/97	22	4	26
After deregulation			
1997/98	15	5	20
1998/99	38	6	44
1999/00	35	7	42

Source: Shrestha (2000)

26. ***Credit.*** *The growth of agriculture in the second half of the 1990s was underpinned by a significant growth in agricultural credit from formal sources though its coverage is still limited and its sustainability is in question.* After being stagnant in the first half, the share of credit in agricultural GDP grew from 6% in 1994 to more than 10% by 2001, implying a doubling in real terms. But its coverage remains limited, especially for the poor. Only 8% of the households at the bottom income quartile had loans from formal sources, compared to 26% in each of the wealthier quartiles. On average, only 14% of households had access to formal credit (including provision by other banks and Grameen-type institutions. One major source of formal credit is the ADBN. The recent financial audit of the ADBN, the source of more than 85% of formal credit, has revealed that the ADBN's assets have sharply deteriorated in quality, placing future lending in jeopardy.

[39] ***Note:*** 1. It is conservatively assumed that 10 percent and 15 percent of the total fertilizer imported and distributed from formal source may additionally have been illegally brought in to Nepal from India before deregulation for the period of 1992/93 – 1996/97 and FY 1996/97.

2. The differences in the proportion of informal source of fertilizer are guided by the pricing structure adopted in Nepal. The higher the price of third country imported fertilizer is greater the tendency of farmers to purchase illegal cross border fertilizer. For instance, there was relatively a smaller contribution (10-15 percent) of informal source to total fertilizer application before fertilizer deregulation since the price differentiation between the imported fertilizer and illegal cross border fertilizer was small (10-12 percent).

27. *The challenge for the future is expanding access to credit especially to the poorer farmers. There are three approaches for addressing the issue on ensuring adequate credit.* First, Government, with the technical assistance from the Asian Development Bank, has begun the restructuring of the ADBN with the goal of separating its development lending from commercial banking and refocusing the development lending to medium and larger borrowers. This is being accompanied by a rationalization of the branch network and of the business processes and expansion of financial products. The restructuring of ADBN should have a beneficial fiscal impact and may indeed succeed in supporting the target group of commercially viable medium and larger borrowers. Second, the Government will need to provide more focus on expanding and ensuring a sound business environment for micro finance intermediaries (MFIs) and other rural finance intermediaries (trade credit providers and other informal sources). Third, Government has to consider addressing the issue of credit market failures – i.e. the less than optimal supply of credit for viable capital project and investments and maintenance – with the use of matching grants. Under these schemes, farmers can be partly reimbursed for capital costs they incur for a variety of agricultural implements – tubewells, to surface water canal maintenance, implements etc. This approach has the merit of being economically sound and better targeted for productive use. Nepal can draw on the considerable experience of using matching grants in the South Asian Region and elsewhere (see Box 4.1).

Box 4.1: Suggested guidelines for providing matching grants for income-generating activities

- Target matching grant assistance to very poor communities or groups that are beyond the current reach of micro-finance institutions. One way to do this is to make the grant amount large enough to be useful to the poorest, but too small to be worthwhile for better off groups.
- The income generating activities financed must be cost-effective ways of reducing poverty. This can be demonstrated by impact and cost-effectiveness indicators.
- The investments should not compete directly with private investment (existing or likely).
- Beneficiaries should always contribute at least partly in cash (no less than 5% of the total project cost), which will demonstrate commitment and can serve toward the initial working capital to operate the activity.
- Over generous subsidies may create false positive demand (even where beneficiaries contribute in the form of labor or cash). This may jeopardize future maintenance of the investment by beneficiaries. Subsidies used without tied commitments for repayment, user fees, or maintenance, may create perverse incentives for greater rent-seeking by beneficiaries.
- Grants should be combined with training and support to establish local savings and credit associations to capture increased income flows and finance future economic activities (group or individual) on a sustainable basis.
- Subsidies based on percentage cost-sharing of subprojects create an unknown contingent liability for government. This can be avoided by basing these on per capita amounts, or fixing a ceiling for government contributions with excess being met by beneficiaries.

Source World Bank, Agricultural Sourcebook, 2004.

E. Development of the Western Lagging Regions – Challenge and Potential

28. ***The Challenge.*** *The challenge of promoting more rapid rural growth and development and reducing poverty remains large in Nepal.* The mid-Western development region (MWDR) and the far-Western development region (FWDR) provide an important illustrative example. They lag significantly behind the rest of Nepal in terms of most development indicators. Poverty is much more acute in these regions with about 48% of the population below poverty line in the Terai and over 70% in the hills and mountains. Nine of the 10 hill districts produce less than required for minimum self-sufficiency and all 8 mountain districts have chronic food deficits. In terms of various development indicators, the bottom 13 districts of Nepal's 75 districts[40] lie in these two regions.[41] Further, the people of these regions have a

[40] ICIMOD/SNV, study of 1997.

[41] Agro-Enterprises Center, "Agriculture Development Programme for Hills of Mid-Western and Far-Western Development Regions of Nepal: A Concept Paper", Background Paper, May, 2004.

distinct sense of being marginal and excluded from a Kathmandu driven development process. Unsurprisingly, these regions now constitute the heartland of the Maoist insurgency. As the 10th Five Year Plan recognizes, a special effort is needed to develop these regions. This section sketches an outline of such a development strategy.

29. ***The Potential.*** *While the MWDR and the FWDR are backward, these regions have considerable economic potential – and in particular two assets -- waiting to be tapped.* If utilized properly, these assets and regions can become not only a driver of poverty reduction for the people in these regions, but an asset for Nepal's growth in general. The first asset comes from the agro-ecological diversity of these regions with its astonishingly large range of height. This leads to comparative advantage in high value horticulture and crops at different seasons. These include high quality fruits and vegetables, both seasonal and off-season, ginger (dry/fresh), lentil, vegetable seed, products such as vegetable ghee, medicinal and aromatic plant products, non-forest timber products such as rosin turpentine and some agricultural by-products, honey production, as well as livestock and forestry products. Several success stories have already emerged: e.g. bee keeping and the production of lentil in Dang, off-season vegetable in Dhankuta and Makwanpur; sunflower in the FWDR; tea and coffee, in many parts of Nepal from East to Far-West Development Regions. Another interesting feature is that in many of these cases, farmer organizations (groups, cooperatives, associations) consisting mostly of smallholder farmers have been active and are among the most productive farmers.

30. *This brings up the second asset of the hills: the traditionally strong community spirit – i.e. social capital -- that one witnesses in this area, the driving force behind an unusual success of community and user groups in forestry, irrigation, roads, and water and sanitation sectors.* Perhaps, the most acclaimed example on this comes from the one million hectares of previously degraded forestland (about 18% of the total forest area of Nepal) that was brought under successful community forestry program. More than 13000 user groups have been formed to manage forest areas where 1.45 million households or 35% of the population of Nepal are involved. This activity has been particularly intense in the MWDR and the FWDR by reportedly more than 3200 Community Forest groups who covered an area of about 278,750 ha of forestland and benefited almost 320000 Households.[42]

Elements of a Strategy

31. *As these two areas are predominantly rural and agriculture dominates economic activity, agricultural and rural growth built primarily on connectivity and commercialization is the key to development.* The poor development outcomes in the MWDR and FWDR can be largely attributed to subsistence farming and poor access to infrastructure. Despite the growth of the road network in Nepal[43] and a general increase in rural mobility, the extreme northwest (the Karnali Zone) and much of the MWDR and FWDR still remains extremely isolated.

32. *While the Government has already identified the key strategic thrusts required for economic development of Hills and mountain regions in its 10th Plan and the Agricultural Perspective Plan[44], it is not yet clear to commercial stakeholders in the MWDR and FWDR what strategies are currently in place to intensify agricultural production and its commercialization.* Two issues lower expectations in particular. First, as most dramatically illustrated by the lack of investment in rural roads in Chapter 2, the strategy of the APP has yet to be properly implemented in these regions. Second, more emphasis is needed on marketing and generating demand. One example of the lack thereof is the Crop Diversification

---

42 Baral, S.R. and B. Karki, (2002), "A Baseline Study on Non-timber forest products in Far Western Development Region, Neapl. Agro-Enterprises Center, Kathmandu.

43 See Chapter 3.

44 The identification of pocket areas for leading commodities, development of infrastructure, technology development and institutional upliftment

Project[45] -- one of the main projects particularly designed for MWDR and FWDR -- has no component on development of off-farm value adding programs and product marketing.

33. *Given these considerations, a more focused and comprehensive strategy is needed to speed up the development and commercializing agriculture in MWDR and FWDR by combining some elements of the APP with commercialization.* Such a strategy would consist of the following elements: (a) regulatory and policy reforms that facilitate private sector entry and the development of cooperative marketing; (b) improvement in infrastructure – roads, rural electrification and micro-irrigation; in particular development of north-south highway corridors that can link areas of products of identified potential to markets; and (c) developing market promotion strategies.

34. *Regulatory and legal reforms to promote private sector participation will be key. Global experience with regional development programs clearly indicate that successful programs are those that are private investment led, with the role of the Government being to provide confidence and policy credibility, and public goods such as infrastructure and research, and some risk mitigation measures such as providing credit and seed capital.*[46] But the first requirement for this is that the approximately 66 laws, 38 rules and regulations, 39 executive orders and 39 by-laws[47] that impinge on agricultural activities and trade and private sector investment be reformed. In particular laws to support contract, commercial and cooperating farming, and removing domestic barriers to trading will be particularly important.[48] The first is the Draft Bill for Commercial Agriculture Contract Act-2060 with the provisions for private sector or farmers to take government or local body owned land and other privately owned land into lease for a certain period for commercial agricultural production and also for legal validity of agreements for contract farming. The second is reforms in the Cooperative Act-2048 for the purpose of registration and management of cooperatives in the country. The cooperative approach in input marketing and easy access to credit has also been possible through different forms of saving and credit cooperatives. But, there have been few cooperatives, which are directly geared towards collective production and product marketing, partly because the existing Cooperative Act is silent on the legality of Marketing Cooperatives and nor does it allow cooperatives to function as a commercial entity. Finally, private sector participation will be boosted if standards can be fostered. Thus another priority is the Plant Protection Act-2060 under which plant quarantine offices across the country will be enforcing quarantine rules in compatible to SPS Agreement under WTO. Currently, both capacity and capability of Plant and Livestock Quarantine offices and Department of Food Technology and Quality Control for inspection/testing and issuing phyto-sanitary/quality certificates are limited.

35. *Improving connectivity and infrastructure in the MWDR and the FWDR by completing a few key road networks under construction will be necessary for connecting high value crop areas and markets and inviting more private sector participation.* The connectivity potential from these roads is sketched out in Table 4.6. Community projects would help, given the high social capital potential of region. But a particular issue here is the institutional vacuum created by the absence of local Governments. In the past

---

45 This is a project of the Ministry of Agriculture and Cooperatives (MOAC) and funded by the ADB.

46 Anwar Shah, "Bridging the Economic Divide Within Countries: A Scorecard on the Performance of Regional Policies in Reducing Regional Income Disparities", *World Development*, Vol. 31, 2003.

47 Pesticides Act-2048, Pesticides Rules-2050, Plant Protection Act-2029, Plant Protection Rule-2031, Seeds Act-2045, Seeds Rule-2054, Food Act-2023, Food Rules-2027, Nepal Standards (Certification Mark) Act-2036 and Rules-2039, Contract Act-2056, Local Self-Governance Act-2055, Local Self-Governance Rule-2056, Animal Health and Livestock Services Act-2055, Animal Health and Livestock Services Rule-2056, Cooperative Act-2048, Cooperatives Rule-2049 are some of the Acts and Rules promulgated by the government of Nepal that have been playing vital role in the agricultural development of Nepal.

48 Contract farming is a forward agreement between farmers and processing and/or marketing firms for the supply of agricultural products, frequently at predetermined prices. The purchaser provides a number of support measures to the farmers such as supply of inputs, and provision of technical advice, loan and transportation. The farmer provides a specific commodity, quantity and quality standards of which is determined by the purchaser (FAO 2001).

the Division of Local Infrastructure Development and Rural Roads and Agricultural Roads (DoLIDAR) of MoLD and its regional and district level units – which have the technical responsibility for the development of rural transport network – has worked with DDCs/VDCs. But now given their absence progress has slowed down.

36. ***Irrigation.*** *The lack of dry season irrigation is the greatest constraint faced by majority of the smallholder farmers engaged in upland farming in the hills of Nepal, particularly in the Western parts of Nepal where annual average rainfall is half that of the eastern parts of Nepal.* Here, the seasonal/perennial springs and streams or rainwater are the potential sources of irrigation and a wide variety of innovative irrigation schemes that are already in use, needs to be disseminated for efficient irrigation sources. Without such practices the goal of the 10th Plan to develop 10,000 ha irrigation through the adoption of these modern technology for the production of high-value crops will not be met. Among these practices are the drip and sprinkler technology promoted have proven to have water application efficiency in an order of 75% or more compared to 20 to 50% in other conventional surface irrigation (IDE, 2002).

Table 4.6 Potential Pocket Areas for Production and Non-Farm Activities in Three Highway Corridors of MWDR & FWDR

District	Veg	Fruits	Livestock	NTFP	Irrigation		Honey	Agri-process	Rural Electrification	Rural Communication	Collection Center	Market	Bridge	Rural Road	SFCL/SC
					Micro	Surface									
	Pockets								Numbers						
Doti, Dadeldhura, Baitadi, Drácula	36	41	18	13	14	1	4	1	0	3	14	12	0	12	1
Accham	2	2	3	1	0	0	1	0	0	1	1	2	0	0	1
Dang, Salyan, Rukum	44	28	11	6	4	9	3	0	1	5	10	5	2	9	5
Surkhet,Dailekh,Accham,Kalikot	35	30	28	10	15	12	0	0	6	4	8	4	2	12	3
Surkhet,Jajarkot,Rukum	5	2	1	1	0	4	5	0	0	1	3	1	0	2	2
Dailekh	1	4	4	0	1	0	1	0	0	1	1	0	0	2	0
Total	**123**	**107**	**65**	**31**	**34**	**26**	**14**	**1**	**7**	**15**	**37**	**24**	**4**	**37**	**12**

Source: Agro Enterprise Center, Background Note.

37. ***Extension and Research Services.*** *Agronomic and horticultural development in the Hill regions will depend on high quality extension and research activities to deliver improved seeds/saplings, farming technology, management practices etc.* Agriculture extension system will also have to address the needs of a wide range of clients from small farmers to large-scale commercial enterprises. There is also need to broaden the concept of extension to include support for development of input and output marketing, social mobilization, HVC farming, farm/orchard managements, business planning, natural resource management, post harvest handling and primary value addition. There is also growing concern with pesticide residues in agricultural products. Most of the WTO member countries, including recently the GOI, introduce stringent SPS measures to control the use of chemical pesticides in farming. Lately, even the GOI has adopted a SPS Measure to control the import of fruits and vegetables, tea etc. Hence, successful exports to India, and potentially, the Middle East and the Far East will require that farmers be thoroughly trained to use the pesticides judiciously by introducing IPM techniques. Given these varied and sophisticated demands a key need here is to improve the quality of extension and research services and it is clear that the incentive structure will be key.

38. *One important implication of this is that public sector institutions like DADO and NARC cannot be the sole or predominant extension service provider and there is a need to bring the private sector and NGOs in these activities.* Analysis of lessons of many projects and programs show widespread farmer dissatisfaction with the weakness of the research and extension system to provide effective services to commercial agriculture stakeholders. Experienced local and international private extension companies can be contracted to set up and run farmers' schools as well as providing improved training for extension workers (i.e. for junior technicians or junior technical assistants). Such training has to be purely

performance based. In addition, public agencies, private companies and NGOs can be give performance based contracts with farmer groups and local government to provide extension services to the farmers.

39. ***Developing Market Promotion Activities.*** *The commercialization of agriculture is occurring but there is considerable potential to expand this.* As commercialization of agriculture is relatively recent in the MWDR and the FWDR, programs for market promotion will be needed. The support activities will need to include activities such as: (i) strengthening of government quality testing/certifying units and quarantine inspection/certification units in MWDR and FWDR; (ii) facilitating the export of products through organizing agriculture trade fairs organization and participation in similar fairs in other countries; (iii) introduction of temporary support measures in the form of schemes/matching grant to assist value addition activities consistent with the export requirements (grading, packaging, quality certification, and sample exports); (iv) export counseling and international market information services; (v) training on agriculture product export practices, packaging/post-harvest handling, quality requirements; and (vi) organizing periodic interactions programs between importers and exporters for establishing marketing linkages, particularly bringing in importers from India.

F. Summing up

40. *The review of Government policies and strategy suggests that a wide range of policy reforms are needed to improve the efficiency of output and factor markets in order to sustain agricultural growth.* Key among these is the reforms of laws and regulations that restrain private sector investment and trade, contract farming and the development of cooperative farming in the sector. The importance of improving road connections of various kinds and marketing facilities is clear. On factor markets, the need to further strengthen land property rights by improving land records and removing the harm caused by dual tenure system and facilitating land exchange was emphasized. A need to link water charges more carefully to actual use and improving maintenance arrangements by increasing the role of farmer managed systems in all but large scale irrigation systems has emerged. The issue of sustaining and increasing access to credit became clear. A recommendation to use matching grants scheme to meet capital costs and investment requirements by farmers also becomes clear.

41. *Elements of focused strategy on the lagging mid- and far- Western regions that have considerable potential.* A common theme across all recommendations is the need to use Nepal's proven effectiveness of community and user groups to manage agricultural growth and the need to promote more private sector participation. Beyond this the importance of reviving and strengthening local governments to promote agricultural development becomes paramount. Thus, for instance, even the design of any Western regions development strategy, let alone its implementation, will need to be done by the local and regional governments. This issue of decentralization is addressed in the discussion on Governance in Chapter 5.

CHAPTER 5: IMPROVING INSTITUTIONS AND GOVERNANCE FOR PUBLIC SERVICE DELIVERY

A. Challenges to Good Governance

1. *Nepal succeeded in building up a wide range of good government institutions -- a system of laws and organizations, checks and balances -- in a short span of time, though their relative lack of history and tradition has inevitably also made these fragile.* Policies, infrastructure and economic and human development outcomes have steadily improved under these institutions, though clearly not fast enough to meet the tide of rising expectations that accompanied the advent of democracy in 1991. But Nepal can draw upon a number of important strengths in advancing its governance and public management reform agenda. The administrative and accountability framework is in place; a lively press and nascent but growing civil society are creating additional pressures for change. In this setting, HMGN should be able to take forward radical reform. However, set against these dynamics are the tremendous challenges confronting HMGN at the present time, whose severity cannot be over-estimated.

2. *The Challenge of History and Geography.* Nepal's history and geography contributes significantly to contemporary governance challenges. The high degree of ethno-linguistic fractionalization and the isolation of mountain and hill communities make it hard to consolidate services and realize the gains from economies of scale.[49] It has also complicated efforts to form a unified state in which all citizens are able to participate to their fullest potential. Historically, political and economic power has rested in the Kathmandu valley and has been concentrated in a small group of upper caste elites. Consistent with this tradition, the civil service has historically been heavily dominated by high-caste Nepalese from the Kathmandu valley.

3. *A Compressed History of Development.* From its background as an isolated, feudal state locked between India and China in the 1950s, with extremely low human development indicators, Nepal has made considerable progress in establishing the elements of a modern parliamentary democracy and public administration. Unlike most of South Asia, where the legal and administrative roots of Public Administration were established in the middle of the 19^{th} Century, it was only in 1951 that the civil service was established. The Constitution of 1990 accorded the Auditor General complete legal and professional independence and created a Commission for the Investigation of Abuse of Authority, the only independent anti-corruption agency in South Asia. The Nepali Parliament's Public Accounts Committee, headed by an opposition member and with open public access, has served as a vocal institution of accountability.[50] Government financial management systems functions relatively well and is more computerized than many neighboring countries.

4. *Political Instability throughout the 1990s.* Nepal's twelve year experience with parliamentary democracy has been characterized by chronic political instability, including no fewer than twelve prime ministers throughout this period. Ministerial positions have been utilized as a key reward for potential coalition partners, resulting in frequent changes at the top and corresponding changes in the bureaucracy. One study of Nepali politics from 1994 to 1998 revealed that, out of 265 members in Parliament, 121 were able to become ministers. This constant turnover has fundamentally affected implementation and made public administration hostage to electoral and political interests.

---

[49] It would, for example, take a witness, litigant or victim in the remote regions of Nepal's Dolpa district seventeen days to reach the nearest district court.

[50] Although the PAC, though proactive in the past, has lacked authority to take actions against non-compliance or to enforce its directives. One assessment in 1998, for example, revealed that the majority of ministries complied with less than 30 percent of PAC's directives. See, PAC Ninth Anuual Report, June 1998, cited from Surya Prakash Shrestha

5. *A State in Conflict*. Political flux and the inability of the state to solve the violent insurgency that has claimed over 10,000 lives have also led to a growing disappointment with the political and developmental processes. Government is widely viewed as having failed to meet the aspirations of the people, which could lead to a crisis of legitimacy. The Maoist insurgency has gained strength from the failure of institutions to deliver basic public services, to include the poor in accessing growth and services and to prevent corruption and instability. The insurgency has compounded the problems of reach and has meant that the remit of the government has shrunk largely to urban and semi-urban areas. Weak legitimacy can reduce the willingness of the public to comply with government directives or support political initiatives. It will also raise the risk that some of the administrative gains in recent years could be weakened or reversed by broader political developments. At worst, it could lead to regime collapse and the problem of a "failed state."

6. *Against this backdrop, this chapter discusses four main issues for good governance.* The first is restoring and strengthening the accountability and representative institutions that Nepal had built up at both national and local government levels under which Nepal has achieved good progress. Their absence and that of alternative institutions have created a vacuum that is undermining the legitimacy of the State. The second issue is improving the government effectiveness – i.e. the ability to implement its own policies. The key task here is to make the civil service more accountable, disciplined, and professional. The third issue concerns restarting decentralization to make Government more responsive to the heterogeneous needs and preferences of a diverse people. Decentralization of power and devolution of public services to local Governments and community groups is vital for bringing the Government closer to Nepal's widely dispersed people. This shortens the "long route of accountability" and enables service users and communities to monitor their governments, discipline their service providers, and have their voices heard. The fourth issue to make government and public services more inclusive to reduce the large gender, ethnic and caste based disparities now prevalent in Nepal.

B. Strengthening Central Government Institutions

7. ***Parliamentary Oversight and Transparency*:** For all its shortcomings and instability, the dissolution of Parliament in October 2002 has meant that a fundamental pillar of accountability and policy making has been weakened. This is most evident in the long queue of bills that lie pending, and the current lack of a functioning Public Accounts Committee. The Auditor General's annual report is now sent to the King, as per the Constitution, but it is not laid before Parliament—reducing the benefits of transparency and diminishing scrutiny. Nepal will need to re-establish this mechanism and ensure Parliamentary oversight of public expenditure.

8. ***Judiciary*:** Nepal has an independent Judiciary with three tiers including the Supreme Court, 16 Appellate Courts and District Courts in each of Nepal's 75 districts. In comparison with other countries in South Asia, Nepal's judiciary does not fare badly. According to a recent study by Transparency International, 42 percent of citizens who had regular interaction with the judiciary reported encountering corruption, as opposed to 100 percent in India and Sri Lanka; 96 percent in Pakistan; and 75 percent in Bangladesh.[51] A number of leading scholars have argued that Nepal's problems with legal and judicial reform are in fact much less intractable than those confronting its neighbors.[52] Dysfunctional practices are not so deeply entrenched and the number of cases pending is a fraction of what it is in India and Pakistan. There is stronger supervision of lower courts and data is better maintained and more accessible. The language of Justice is Nepali, which makes justice more accessible. While these findings provide reason for hope, much can be done to improve the functioning of the legal system. A detailed assessment of

[51] Nepal Law Society, pp. 11-12. Other survey data has placed the incidence of corruption even lower, at around 30 percent.

[52] Erik Jensen, Robert Moog and Shahid Kardar, *Understanding and Reforming the Nepalese Legal System*, Asia Foundation, 2001, pp. 5-6.

gender issues, for example, found consistent patterns of discrimination on the part of the judiciary – over 98% of whom are male[53] indicating the need for substantive training and professional development. The Supreme Court has recently approved a five-year plan formulated for the comprehensive development of the judiciary. An important priority is the amendment of inconsistent legislation.

9. ***Anti-Corruption:*** *Although comparative survey data by Transparency International indicates that, in comparison with other South Asian countries, the actual day-to-day experience of citizens with corruption is lower in Nepal (Table 5.1),*[54] *the data still paints a disturbing picture of a public sector corruption.* For instance, the average cost of bribes paid to the police was NRs 1,637 (around $US 22), or just under 10 percent of annual per capita GDP.[55]

Table 5.1 Comparative Corruption Scorecard for the Sectors

(Percentage of respondents reporting corruption in their interaction with the agency)

Country	School	Health	Power	Land Admin	Tax	Police	Judiciary
Bangladesh	40	58	32	73	19	84	75
India	34	15	30	47	15	100	100
Nepal	25	18	12	17	25	48	42
Pakistan	92	96	96	100	99	100	96
Sri Lanka	61	92	NA	98	NA	100	100

Source: Transparency International Report, 2003.

10. *During the last two years, HMGN has taken a number of impressive initiatives to combat corruption.* A National Vigilance Centre was set up located in the Prime Minister's office in 2002 to co-ordinate the anti-corruption function within the executive branch. Important pieces of legislation were passed in 2002, including the Commission for Investigation of Abuse of Authority (CIAA) Second Amendment Bill. Collectively, these laws clarified the procedures surrounding the impeachment of high-ranking politicians, government officials and the heads of constitutional bodies.

11. *The CIAA is the only constitutionally independent anticorruption body in South Asia and has the power to initiate cases against all top officials,* including *the Prime Minister and his Cabinet.* There has been a quantum leap in the number of complaints coming to the CIAA as well as in the disposal of cases. Action is being taken against over 600 public officials. This initiative is an important effort to attack corruption through the vehicle of disproportionate assets.[56] The anticorruption agenda has been one of the bright spots in Nepal's governance reforms. Considerable work remains in improving the capacity and professionalism of these units of both the CIAA and the NVC; in expanding the CIAA's presence into the districts; in expeditiously processing anticorruption cases and departmental disciplinary proceedings; and in strengthening the NVC and ensuring that it plays an appropriate role in helping to prevent corruption and facilitating public outreach.

12. ***The National Human Rights Commission*:** There is a broad consensus among many human rights groups that the situation within the country improved markedly after the establishment of multi-

---

53 *A Study of Gender and Judges*, Kathmandu: Pro Public, 1999. In nearly 60% of rape cases reviewed by researchers, the court declared a verdict of not guilty.

54 Transparency International, *Corruption in South Asia: Insights and Benchmarks for Citizen Feedback Surveys in Five Countries* 2003. It should be noted that, as a region, South Asia does not fare particularly well in global anticorruption surveys conducted by Transparency International and other organizations.

55 Transparency International, 2002, pp. 33-34.

56 See Keshab Poudel, "A Political Gimmick," *Spotlight*, Vol. 22, No. 8 (16 August, 2002). See also Transparency International Nepal, *Newsletter* Vol. 5, No. 1 (April, 2003).

party democracy in 1990. Nepal has ratified major international human rights agreements, passed the 1997 National Human Rights Commission Act, and set up commissions to address the rights of historically disadvantaged groups such as women, Janajatis and Dalits. The National Human Rights Commission (NHRC) was established as an autonomous and statutory body in 2000 and has the authority to probe incidents of human rights violations, present recommendations and guidelines. The Commission wields considerable power and authority and its status report of 2003 presents a comprehensive and balanced attempt to catalogue the status of human rights issues in Nepal. Still, there continue to be a number of legal contradictions between the Constitution, domestic legislation, and several of the international agreements to which Nepal is a signatory. Many human rights groups allege that efforts to achieve rights-based governance have been hampered by entrenched discriminatory practices and an administrative culture in which legal rights are often ignored or only weakly enforced.[57] These weaknesses in institutions are particularly highlighted in times of conflict and both the police and the Maoists are alleged to engage in human rights violations.

13. ***Information and Transparency***. Since the restoration of a multiparty system in 1990, Nepal has enjoyed a major expansion in the circulation and dissemination of information, but there are is no Right to Information legislation. There has been a rapid growth in the number of newspapers, radio stations and television operators and email service providers.[58] Some concerns remain though. After the proclamation of emergency in 2002, apprehension has multiplied regarding censorship and attacks upon journalists. Both the Army and the Maoists have been accused of harassing and even murdering journalists, prohibiting the gathering of news in areas under their control, and imposing censorship.[59] No Right to Information legislation currently exists within Nepal, although some discussion about the need for such a legal framework has recently taken place within government. A second concern centers on the state's lingering role in the media and the nascent capacity of many private sector news organizations.

Key Executive Branch Institutions and Functions.

14. ***Cabinet:*** *Nepal's cabinet is relatively small and the distribution of functions is reasonable.* Its 21 Cabinet ministries is significantly less than that in India and Bangladesh and less than half the number in Sri Lanka. Nepal is noteworthy in that it has largely resisted to temptation to fragment administrative units to accommodate the requirements of coalition politics.

15. ***Policy Coordination***: *Although Nepal has procedures in place for a formal Cabinet system, policy coordination, monitoring and implementation are weak.* Policy coordination has improved in the last few years through the efforts of the Government to prioritize its policies and expenditures in a consistent manner. The Immediate Action Plan, the Medium Term Expenditure Framework and the PRSP's preparation and implementation have helped to improve coordination and responsiveness. The merger of the Prime Minister's Office with the Cabinet Secretariat has created clearer functional responsibilities including tracking how directives are being implemented and coordinating HMGN's "good governance" agenda. Nevertheless, policy coordination in some key areas such as trade policy, implementing the APP, and monitoring and evaluation remains weak and needs addressing.

16. ***Civil Service***: *Relatively small, Nepal's civil service effectiveness is hampered by inappropriate skill mix, poor incentives both in terms of pay and lax discipline, and its exclusiveness.* The core civil

[57] A variety of human rights organizations have criticized the "culture of impunity" within government, including the National Human Rights Commission, Amnesty International, the Asian Human Rights Commission, the Damocles Network and Reporters Without Borders.

[58] See U.S. Department of States, *Background Note: Nepal*, 2001.

[59] For example, see the National Human Rights Commission, *Human Rights in Nepal: A Status Report 2003* (Kathmandu: The Asia Foundation, 2003), pp. 18-24; U.S. Department of State, *Nepal: Country Reports on Human Rights Practices*, 2002), pp 10-11.

service in Nepal comprises 99,264 (of which 87,000 are filled) positions, or roughly 0.43 civil servants per hundred population, which in per capita terms is one of the smallest in both South Asia and the developing world. Total public employment including teachers, police, and employees of municipal, district and local government is approximately 271,000 or 1.17 employees per 100 population. By way of contrast, Sri Lanka's total civilian government employment is nearly three and a half times larger than Nepal's on a per capita basis. But while public employment is not overly large, it suffers from problems of inappropriate skills mix, heavy wage compression, and low productivity. The composition of Nepal's civil service is particularly skewed towards the lower unskilled tiers.[60] The vast majority of employees (approximately 55 percent) are in the Administrative Service, followed by Health (18 percent), Engineering (9.6 percent) and Agriculture (5.5 percent).

17. *Recognizing the need to improve the skill mix of the civil service, the Government has made substantial improvements in human resource management in recent years.* A Personnel Information System (PIS) has been developed that, for the first time, is capable of providing accurate, real-time information on the size and composition of the civil service. The PIS will shortly be linked to the payroll system to create a comprehensive human resource database (essential for tracking posts, vacancies, transfers, and forecasting future salary and pension liabilities).

18. *The civil service's performance incentives are undermined by a heavily compressed wage structure, the worst in both South Asia and the developing world, and relatively very low salaries at professional and managerial levels in comparison to the private sector though this is not true at other levels.* The compression ratio (defined as the ratio of highest to lowest paid) in the Nepalese core civil service is 3.6 (for salary) and 3.3 (for total net compensation), which means that a ministry secretary is paid only three and a half times more than a peon in the same ministry.[61] In contrast, the compression ratio in Sri Lanka is around 7; in Bangladesh it is 10; and among various Indian states it varies from 5.6 to 11.7. Similarly, salary remuneration at senior levels (between US$160 to $225 for Joint Secretaries and Secretaries) can be less than a fifth of that in the private sector. These pay structures do not motivate employees or help to attract the best talent and increase the risks of corruption.

19. *Problems with performance evaluation also hinder performance and incentives for service delivery.* The current system is cumbersome and lacks transparency; it does not allow for intermediate feedback to enable corrective action. Clear job descriptions do not exist against which performance can be measured. Increasing the capacity and role of performance assessment is low and there is little understanding of its value as a managerial tool for performance improvement and staff development.[62]

20. A related problem is the ineffective disciplinary procedures that make it difficult to expeditiously sanction staff for malfeasance or poor performance. Only about 581 staff was subject to formal disciplinary procedures during the twenty-seven year period from 1976 through 2003. Only 6 civil servants were suspended and one dismissed from service throughout the entire twenty-seven year period.[63] Simplification of punitive measures and streamlining of the appeals processes is an important agenda for reform.

21. ***Recent Administrative Reforms**: Over the past five years, HMGN has implemented a number of important administrative reforms.* An Administrative reform Monitoring and Coordination Committee headed by the Prime Minister has been established to lead the governance reform program and take major policy decisions. A number of government organizations in areas such as aviation, telecommunication

---

[60] Source: IMF '*The Civil Service Sector: Key Issues and Reform Plans*' Nepal Selected Issues Paper, 2002.

[61] See IMF *The Civil Service Sector: Key Issues and Reform Plans*, p. 4.

[62] For an analysis of the issues around Performance Evaluation In Nepal see Dr. Surya Prakash Shrestha, *Governance Study: Nepal* (Manila: Asian Development Bank, 1999), p. 42.

[63] This data is derived from HMGN's computerized Personnel Information System.

and tourism have been transformed into autonomous bodies. Within the civil service, vacant positions have been frozen since 2001 and about 7500 of the 17,000 vacancies in the civil service have been abolished. Efforts are underway to standardize job descriptions, and clarify codes of conduct and punishment provisions for civil servants.

22. *The Government has recently put together an excellent road map of reforms to be implemented under the Governance Reform Program that cover a range of issues linked with ethics, capacity, efficiency and transparency.* The program contains 67 proposed reforms to be implemented under a variety of headings. Three of the most prominent recommendations include a draft Governance Act that seeks to clarify the division of responsibility between ministers and civil servants with regard to civil service transfers (among other initiatives); proposed amendments to the 1993 Civil Service Act; and the creation of a Local Civil Service, recruited into a national pool from which Local Governments would be free to hire staff. The latter represents an innovative approach to empower the DDCs and VDCs to employ their own staff while trying to ensure some quality control. To operate smoothly the program will need to ensure that information flows smoothly between the local governments and the new Local Civil Service Commission. The Commission would have to take up the challenge of having a pool of credible staff and improving career progression and salary incentives.

23. *Within this context, Nepal will require to focus reform on a number of critical areas to move forward and implement its design for public administration reform.* This could be done by:

(i) Implementing selected Civil Service reforms in Personnel Management and Administration to increase accountability and incentives. Procedures for monitoring staff performance need to be revised and updated to introduce greater transparency, feedback mechanisms and a stronger focus upon results. Disciplinary procedures need to be streamlined and made more effective. The salary structure needs to be overhauled and its heavily compressed structure rectified to increase incentives for its professional and executive ranks.

(ii) Making the Civil Service more representative. Information derived from the Public Service Commission from 1999-2001 underscores the non-representative nature of Nepal's civil service. Around 97 percent of those accepted for the senior civil service ranks were Brahmins, Chettris and Newars, even though these groups constitute only about 35 percent of the population. At the same time only 5 percent of those recommended for recruitment were women. A variety of initiatives should be implemented to make the civil service more representative of Nepali society as a whole. Barriers that have traditionally made it difficult for various caste and/or ethnic groups to enter the civil service need to be assessed and eliminated. This could include reforming the civil service examination to use a more vernacular version of Nepali or even some local languages; expanding the number of locations where the civil service examinations is offered; and tracking and making available public data on the ethnic caste and gender composition of new recruits.

(iii) *Defining Clear Boundaries between the Political and Administrative Spheres:* Civil service rules need to clarify responsibility and accountability between civil servants and the political level. At present one of the most dysfunctional features of Nepal's administration has been the politically motivated frequent transfers and lack of stable tenure within the bureaucracy. This had led to politicization of the civil service.

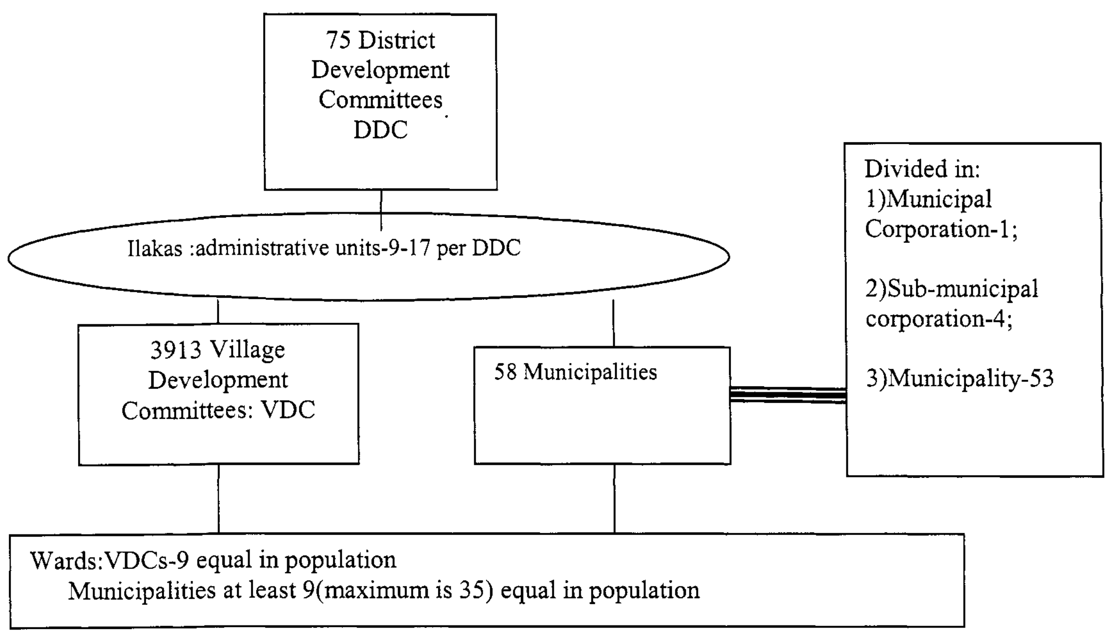
C. Making Government More Responsive: Restarting Decentralization and Empowering Communities

24. *Strengthening central institutions like the Parliament, the Judiciary and the Civil Service are critical to improving the accountability and service delivery.* However, if Nepal is to address the needs of heterogeneous and widely distributed population, it will also have to address demands for

decentralization, equality and inclusion. With 70 languages and dialects and more than a hundred caste and ethnic groups, Nepal has a very diverse population and one of the highest ethno-linguistic fractionalization comparable to many Sub-Saharan African countries. By bringing government closer to the people, decentralization allows better reflection of local preferences, needs and constraints in public decision-making. Administrative and political decentralization is also a necessary condition for making the civil service more inclusive and for bringing issues of "voice" into planning and monitoring of service delivery. Given this, the Government considers decentralization as key to improving service delivery.

25. *The Local Self Government Act and Raising Voice*: While different forms of local governments have existed in Nepal for more than four decades, the enactment of the Local Self Government Act (LSGA) in 1999 was, by far, the strongest attempt to establish roles and functions for service delivery and local decision making at the sub-national level of government. The LSGA defines three types of local bodies, municipalities for urban areas, Village Development Committees (VDCs) for rural areas and District Development Committees (DDCs) at the district level. The Act further defines functions and sectoral assignments for these bodies and endows them with revenue powers. In January 2004 there were 3913 VDCs, 58 municipalities and 75 DDCs in Nepal (See Figure 5.1). That this political structure was

Figure 5.1 The Structure of Local Bodies in Nepal, 2004



put in place after consultations by nine different governments (including six coalitions between 1994 and 2000), with near unanimous support, demonstrates the national consensus behind it. Unfortunately, after having achieved a strong start, decentralization has now stalled as the tenure of the last local Governments expired in 2002. One indication of this is although the Government has set up a high power Decentralization Implementation and Monitoring Committee (DIMC) this body has not met for the last two years. One way to restart the process is by making the DIMC focus on resolving key pending issues note below.

Issues and Next Steps for Restarting Decentralization

26. *Consolidate size and number of local bodies*. Some VDCs and DDCs, particularly those in more remote areas, have very small populations or revenue base [64] raising the issue of whether they can be effective centers for provision of services. Thus, there is a need to reduce the number of VDCs and DDCs by consolidating them into functionally viable units.

27. *Implement administrative decentralization through resolving administrative ambiguity and forming a Local Government Civil Service*. The second and related issue is the ongoing division of responsibilities between various political and administrative entities at the local level, including DDCs, VDCs, School Management Committees, line departments, etc (see Table 5.2). This would require

Table 5.2 Functional and Revenue Assignments of Local Bodies

	Villages and Wards	Districts and Municipalities.
Agriculture	Provide markets/veterinary services/ pasture.	Ensure supply of seeds and fertilizers.
Drinking Water	Implement water projects, clean ponds, wells.	Multi VDCs project, Operate Projects.
Transport	Build/maintain trails, roads, bridges, culverts.	Build/ maintain district roads / suspension bridges.
Education	Establish pre-primary schools; supervise/manage schools; offer adult/informal education, sports and libraries.	Prioritize schools; supervise/monitor schools; formulate policies for adult education and sports; Pre-primary Schools
Water/Irrigation	Build/operate irrigation, soil erosion and electricity projects, canals and dams.	Multi VDCs projects. Build/operate irrigation/solid waste disposal/electricity facilities. Control water/air/noise pollution.
Physical development	Build community buildings, prepare land use plan/ issue building permits plan; provide solid waste sanitation.	Protect unregistered land; Build/operate small hydro projects. Prepare land use plans/housing .
Health Services	Operate/manage health posts/sub-post(HP/SHP); Assist in Management.	Operate/manage district HP/SHP, hospitals Help with vaccinations/family planning; arrange medication supply.
Forest	Plant trees protect forest and environment.	Prepare forest plans and promote environment.
Language and Culture	Preserve religious places/rest houses;preserve languages, cultures, religions, inventory.	Preserve archeological objects; promote/ languages/religions/ cultures.
Tourism and Cottage industries	Preserve /develop tourism areas cottage industries.	Develop industrial zone; Protect natural/cultural/historical tourism sites cottage industries.
Varia	Encourage employment; assist cooperativeness; keep birth/death registry; help helpless/disabled; women /disadvantaged groups; encourage industry; prevent natural calamities.	Determine the district wage rates ;fight child labor Approve cinemas; Open libraries.
House /Land Tax/ IPT land/ land revenue tax	Yes – 75%	25% of VDC collected revenues. 100% in the case of Municipalities
Market fees	Yes	No for districts, Yes for Municipalities
Business/commercial/rent tax	Yes	No for districts, Yes for Municipalities
Natural resource tax	35% of revenue collected to VDC of origin	Yes 65%, No for Municipalities
Road tolls	Yes	Yes on district roads, None for municipalities.
Entertainment tax	Cinemas	Rafting, boating, fishing, and cinemas.

Source: LSGA. Ward: article 25;VDC: article 28; Municipality: article 96; DDC: article 189

---

64 The least populated district, Manang, has a population of 9,587 while the largest, Katmandu has 1, 081,845 residents. The average population per VDC in Manang is 737 while in Nepal as a whole, it is almost 5100. Yet Manang with an area of 2,246 is not much larger than the average district in Nepal at 1,962 square Km.

amending the provisions in various acts, which contradict the Local Self Governance Act.[65]

28. *Clarify overlapping and limited expenditure assignments.* Past legislation has made a reasonable job in defining the functions and roles of local bodies (Table 5.2). However, the roles of VDCs, municipalities, and DDCs remain somewhat confusing without clear separation of powers between the local bodies and line ministries, even for functions that have been devolved.[66] This is because key legislations have not been amended and are in conflict with the LGSA. This results in overlaps, excuses not to devolve resources and staff and undermined accountability to the public. Further local bodies expenditure is limited. For fiscal year 2003-2004, the share of local bodies in public spending was around 5%, largely financed by transfers from the central government. International best practice indicates that for a country with characteristics of Nepal, it should be at least twice the amount.

29. *Improve revenue decentralization and collection incentives*: With local government revenue constituting only 3% of all revenues, tax assignments and revenue efforts seem inadequate. For instance, the design of revenue sources for DDCs, based substantially on revenue sharing in other LGs taxes and central government taxes limits fiscal autonomy and accountability, since DDCs do not decide the corresponding tax rates. Currently DDCs in Nepal seem dependent on external sources with at least 60% of their financial resources coming from non-own-sources. Both VDCs and municipalities have been given independent revenue raising powers, but in neither case has it been effectively used.[67]

30. *Improve the fiscal transfer system*: The distribution arrangement of Central Government transfers to local bodies are improving but need to be improved further and made more predictable (see Box 5.1) to enable local bodies carry out their assignments effectively. Among these transfers, block grants constitute more than 65% of the income of local bodies (LBs) in 2000-2001, however the released amounts to local bodies were substantially lower in part due to the fiscal situation, and in part because of the conflict. There is need to increase transparency in transfers. At present transfers are based on import levy funded octroi replacement for districts, LDF grants for municipalities determined by posts, VDC's municipalities-salary grants and an amount set by HMGN districts and VDCs and municipalities development grants all allocated using different set of rules or formula. Lack of predictability and transparency reduces the incentive for a realistic budget, hampers implementation, and reduces accountability of the local bodies to their constituents. Further, the current design of the fiscal transfer system does not create incentives for local revenue mobilization, in part because of the lack of hard budget constraints. The transparency of transfers can be increased by replacing the historical octroi replacement by a formula that integrates all transfers (LDF, salaries, development) to municipalities and takes into account population and tax base (see Box 5.1).

31. *Create incentives for local capacity development*: It is generally claimed by the central government (MOF and line ministries) that local governments' institutional capacity is weak and constitutes one of the main constraints to fiscal decentralization. However, the assignment of both expenditure and revenue raising authority does not generate a real need for developing this capacity. Decentralization policy would include putting in place the following: a capacity window for funding capacity building for Local Bodies; a system to monitor fiscal decentralization and service delivery to facilitate redesign; a plan to increase central government capacity to manage and support decentralization; and a policy to ensure that donor funds flow according to the fiscal rules rather than through parallel mechanisms. Otherwise, donor financing for local governments will increase the dependency of local

[65] At present 23 Acts create conflicts or ambiguity with the LSGA. Fourteen acts have been redrafted but not enacted.

[66] For example, in 2000-2001 for functions devolved to local bodies (agriculture extension, livestock, education and health), only half of the total expenditures were through the local bodies (total expenditure was Rs. 10.5 billion).

[67] These include house and land taxes, property taxes (municipalities), vehicle and other local fees and taxes.

governments on donors replacing dependency on the central government and will relax local hard budget constraints.

Box 5.I The New District Fiscal Transfer Formula, Possible Improvements and Extending it to VDCs
A fiscal transfer formula has been put in place in 2003-2004 for the general block grant to DDC. This grant is allocated according to the following criterion; (i) 50% according to the inverse of the1996 Human Development Index produced by UNDP; (ii) 20% according to the official population (2001 Census); (iii) 20% according to a transport cost factor using food transportation cost data; and (iv) 10% according to the area of the district. This formula is a good first step, except it does not take into account fiscal effort. Further improvements can be made by combining salaries and development transfers into one formula based transfer. In the case of the VDCs the salaries transfers could remain unchanged but the equal-per-VDC development grants should be replaced by grants that take into account population size and density (implicitly district size) and the tax potential of the district (using the classification provision allowed under article 20 of the LSGA and thus modifying the criteria currently used in LSGA). Transfers reflect horizontal disparities in needs and revenue potential help enforce hard budget constraints and not provide disincentives for local revenue mobilization. For public services of a national nature, such as education and health, block grants with some additional amount conditional on performance (e.g. girl attendance at schools) could be considered.

32. *Develop a comprehensive plan for decentralization*: Finally, a decentralization plan needs to be developed with all the necessary components, including both administrative and fiscal decentralization arrangements, and based on the objectives that the Government has set. The plan can be implemented in an asymmetrical manner, proceed faster in areas where more capacity exists. To this end, HMGN needs to begin upgrading the skills of the Central Fiscal Commission to lead and monitor the reform program.

33. *Empower communities and user groups:* Despite being wracked by political strife for the past eight years, Nepal has been able to achieve MDG targets comparable to other South Asian countries which have been less conflict-affected. Although, service delivery by the central Government has been severely affected by the conflict, this has been mitigated in part by the large pool of community-based organizations and/or user groups that assure that community based services still function. Representing member interests, these local groups are well placed to assure the accountability relationship between the member and the service provider. These groups have been successful at extracting better services out of poorly managed Government provided public services. One nascent example is the performance of the publicly funded but locally managed community schools. These user groups are active in every sector from natural resource management to schools to micro-credit to governance and civil rights. They have been able to compensate for the administrative and financial weakness of the centrally managed and provided services despite the conflict. They have also managed to draw in external funds by providing successful development models to donors who are looking to get the best results from their resources. Through support to the Poverty Alleviation Fund (PAF) HMGN can further harness the strengths of Nepal's vibrant community groups

D. Addressing Social Inclusion

34. *While the government has been concerned about gender disparities since the 6th Five-Year Plan in 1982, it is only with the 10th Plan/PRSP that there has been explicit recognition of caste and ethnicity as factors affecting income and human development outcomes*. Although the government does not as yet have a coherent "strategy" for overcoming it, the identification of social exclusion as a development problem and the accompanying commitment to social inclusion as one of the four pillars of the PRSP is a significant step.

35. ***Recent programs and policy developments in gender rights***: In terms of development efforts, women's issues have been popular with the donors and over the last 20 years there have been many

donor-supported government projects and programs for women. These have to a large extent reflected the shifts in development community perspectives, moving from the view of women as child bearers and providers of health care in the '60s and '70s, to a slow realization of women's critical productive role in Nepal's rural economy in the '80s, to the recognition of women as citizens in need of equal legal and political rights in the '90s. Many of these programs use a group-based approach, first developed in Nepal through the government-sponsored Production Credit for Rural Women Program (PCRW) in the early '80s. From the beginning this approach had a strong focus on empowerment through awareness as well as through access to self-earned income. The program created the first cadre of Women Development Officers, many of whom continue to serve in rural areas and constitute an important presence at the district level. Women have also been increasingly incorporated into the user group approaches that have been successful in many sectors in Nepal including forestry, drinking water, agricultural innovation, literacy and sometimes health, though there are inconsistencies in the attention devoted to empowerment and social inclusion in the formation and operation of these groups.

36. *In addition to grassroots development programs, there has been some progress recently on inclusion at the policy level.* Although it still leaves many issues unaddressed, the passage of the 11^{th} Amendment (known as the Women's Inheritance Bill) in 2002 was at least a move towards greater legal equality for women. The PRSP has also committed to "affirmative action to increase women's role in public office" and to monitoring progress on its gender mainstreaming agenda. The creation of a National Women's Commission in 2002 is another step, although the Commission has not been able to get the bill for its formal establishment as a constitutional body passed by cabinet and the majority of its members are nominated by the party in power, without adequate representation of the NGO and academic communities.

37. *With respect to caste and ethnic groups progress has been slow.* Although there are now laws setting punishments for discrimination against Dalits, different forms of discrimination are commonly practiced throughout the country and particularly in the rural areas of the Far Western Hills and the Eastern Terai. Indeed, the Constitution's protection of "traditional practices" actually calls into question whether the practices associated with "untouchability" as a part of the religion and traditional based caste system can actually be outlawed.

38. *In terms of programs,* the PRSP has highlighted the need for affirmative action to "increase their representation/participation at various levels of public office and political process". In 1997 the government created the Dalit Committee within the Ministry of Local Development. The Committee has a budget to implement programs such as scholarships and training programs but the allocation of funds is controlled centrally from Kathmandu and accountability for expenditures is weak. In early 2002 the National Dalit Commission was set up by the government, but again the bill for its formal establishment as a semi-autonomous body has not yet been approved and the Commission suffers from the fact that (like the National Women's Commission) its members were all appointed from the various Dalit wings of the different political parties with no representation on behalf of Dalit civil society organizations. Both the national women's commission and the national Dalits commission are inactive at present, since the terms of their members expired in March 2004 and no new members have been appointed.

39. *The Janajati or indigenous peoples have so far received the least attention in terms of government or donor supported grass-roots programs.* Many in government have felt that since the Janajati category includes powerful groups like the Newars, the Gurungs and the Thakalis, it should not be treated as a single group for government support and welfare programs. Indeed, though some Janajati groups are concerned about the low socio-economic status of some of their member groups, others are concerned primarily with their low level of representation in the political and administrative governance of the country. The National Janajati Foundation, created in 2002, succeeded (unlike the National

Women's Commission and the National Dalit Commission) in getting the bill for its formal establishment as a constitutional body established.

40. ***Innovative steps towards inclusive education and civil service representation***: In addition to the central place that the PRSP has given to governance and social inclusion there are a few important concrete actions that the government is beginning to take, most notably in the areas of education and civil service reform. These actions, if implemented with commitment and persistence, could be an important signal that the government is committed to dismantling the old social and political institutions that have blocked pro-poor growth in this country and led to the current crisis of governance.

41. *In education, the government's program for primary education, the Nepal Education For All (NEFA) program, contains specific measures to reach out to lagging ethnic groups.* This program, supported by multiple donors, focuses on the transfer of responsibility and funding for primary schools to community School Management Committees (SMCs) (see Chapter 6 also). Hiring and firing of teachers would also be transferred to the SMC to make teachers more accountable to the community they serve. To address specific threats such as elite capture or politicization of the SMC, a possible solution is being sought by making the planned block grants to SMCs conditional on the involvement of women's and children's groups or other strong local organizations to work in partnership with the SMC. The NEFA has also addressed the problems faced by children who do not speak Nepali as their mother tongue (52% of the population). A bilingual home to school transition module for teachers is being developed and communities are given incentives to hire teachers (preferably women) who are able to speak the local language as well as Nepali in the classroom. Success in this area is critical for meeting MDG target. This may also help find a solution to the difficult issue of the use of mother tongues in primary education, where it is necessary to find a middle path between ignoring the problem of non-Nepali speaking children on the one hand and burdening the already strained education system with creating separate curricula in many different languages on the other. In any case, to make inclusive education a reality, some way must be found to ensure that non-Nepali speakers get the extra assistance they need to become successful students.

42. *In the area of civil service reform, the Ministry of General Administration (MOGA) has recently developed a draft "roadmap" for Civil Service Reform which contains clear steps towards affirmative action, including a proposal to target/reserve 40 percent of all new posts and vacancies for excluded groups (20 percent for women, and 10 percent each for Dalits and Janajatis).* One of the keys to introducing greater equity while maintaining the tradition of meritocracy seems to be establishing link between the move towards greater diversity and improvements in the quality of client service, which had not yet been done in the MOGA proposal. Only as part of the broader effort to improve public administration can affirmative action in Nepal escape from being seen as "patronage for special interest groups" and gain the broad public support it needs.

43. ***Remaining Challenges to Inclusion***: *These two concrete moves, discussed above, to operationalize the PRSP commitment to social inclusion and good governance are encouraging.* Nevertheless, it is necessary to temper the optimism generated by the efforts of reform-minded leaders in certain parts of government with implementation challenges at the middle levels of the bureaucracy and at the district level and below. There, formal institutions and the progressive reform policies interact with the dense network of informal systems of behaviors and values based on relations of kinship, party affiliation, business interests, caste, ethnicity and gender.

44. *When it comes to changing patterns of exclusion based on social identity, the influence of these informal institutions or the informal "rules of the game" can be especially strong, because these institutions are actually systems of value through which individuals and groups define their very*

identity.[68] Policy changes here challenge very fundamental relations of power and the self-identity and ways of interacting with others that follow from those relations. Though it is more comfortable to think of the "implementation gap" as due to "lack of capacity" and therefore something that can be addressed through painless donor-funded training, the major causes of poor implementation probably lie deeper; powerful informal systems, behaviors and norms are still very much at work. The "implementation gap" can be seen as a manifestation of informal social and political institutions that continue to be able to block the actual realization of government's stated intentions to get resources and decision-making power flowing more equitably to the excluded groups and remote regions. Overcoming this gap requires strong commitment and greater effort. But it must be done in such way as not to create special regimes based on ethnic and caste origin of persons. Otherwise, there is risk that affirmative action policies may end up recreating systems of patronage similar to those of feudal times. What can be done best is to create equality of opportunity and not guarantee equality of outcomes.

45. ***Closing the gap**: Reducing the "implementation gap" is critical to get the country back on a strong growth path and to achieve lasting peace.* Two possible ways to close this gap involve increasing the diversity among those who make the critical decisions about implementation and using social accountability tools to increase civic involvement and instill greater transparency in the allocation and use of public resources. Some important foundations of democratic governance have been laid in the past 13 years and the major strength of the PRSP is that it seeks to build on these. Tools like the Medium Term Expenditure Framework and the effort to develop a strong Poverty Monitoring and Analysis System may seem rather technocratic and uninspiring, and citizen's report cards and social audit may sound like the latest civil society fad. But such approaches may in the end be essential to both poverty reduction and sustainable peace in Nepal because they are on the critical path to a government that is accountable, that delivers on its commitments and ensures that all citizens are treated equitably.[69]

E. Summing up

46. *Governance: Nepal faces four challenges with respect to governance.* These are to strengthen the accountability of representative institutions both at the national and local levels, civil service reforms to make it more accountable, professional and disciplined; restarting decentralization and expanding community managed service delivery programs; and encouraging the government and public service to be more inclusive by reducing large gender, ethnic and caste based disparities.

47. *In the case of the central Government, this chapter has noted the importance of strengthening accountability and representative policy-making institutions so that stability is restored.* The need to make the civil service – the Government's main instrument for implementing its policies – more professional, merit-based, and inclusive has been highlighted. Decompressing salaries to raise incentives for the managerial and professional ranks, enforcing discipline, ensuring security of tenure through carefully delineating the roles of the civil service and political levels have also been identified as important. Some suggestions have been made to make the civil service more inclusive.

---

68 A recent survey in 8 districts in different geographical regions of Nepal found 205 different practices of caste-based discrimination. Fifty-four were related to denial of entry, to services, to common resources to kinship relations and to participation.; 81 were related to discrimination of different fields of occupation, to educational institutions, political rights, government or NGO programs or offices or religious or cultural activities. Of the 106 Dalit respondents to the survey 92 percent reported experienced it in their lifetime and even after democracy. Krishna Bhattachan, Kamala Hemchuri, Yogendra Gurung, Chakraman Biswakarma, 2003, Existing Practices of Caste-Based Untouchability in Nepal and Strategy for a Campaign for its Elimination, Action Aid, Nepal.

69 Drawn from Lynn Bennett, "Gender, Caste and Ethnic Exclusion in Nepal", Background note for the Nepal Development Policy Review, 2004.

48. *Given the wide heterogeneity, service delivery improvements will lie in strengthening local Governments and devolution of management and financing to communities.* This would entail consolidating the size of local bodies, implementing administrative decentralization, removing the ambiguities and overlapping expenditure and revenue raising assignments and providing stable fiscal transfers in line with agreed priorities and empowering local bodies such as school management committees and local user groups. The role of caste and ethnicity as factors affecting income and human development outcomes have been highlighted. Although the government has identified social inclusion as a development goal and while there has been some progress with gender exclusion giving greater legal equality to women, progress in including disadvantaged caste and ethnic groups has been slower. There is still discrimination against Dalit children and, in general, non-Nepali speaking children are put at disadvantage. While Government has passed legislation to address such unacceptable practices, more effort that will go beyond formal rules would be needed to address this issue. This would include political support, technical expertise to design systems that do not undermine meritocracy and avoid negative effects of rigid reservation policies.

CHAPTER 6: SOCIAL SECTOR POLICIES AND SOCIAL PROTECTION

A. Introduction

1. Starting much later in development, Nepal has made considerable progress in improving social indicators in the past decade, though it still remains a very poor country in terms of human development. Nepal is now comparable in indicators such as under-5 mortality, primary school enrollment, female enrollment, and access to safe water to its much richer South Asian neighbors (see Chapter 1). Initial results from a partial sample of the most recent household survey shows that the people perceive much improved access to education and health services. Still, its maternal mortality ratio, child malnutrition and sanitation indicators are among the worst in the world. Nepal could fall below Tenth Plan as well as MDG targets. Given widespread poverty and slow growth of income, greater effort has to be made in the delivery of social services in education, health and water supply and sanitation to serve especially those who do not adequately benefit from growth of income or those in areas where social service delivery hitherto has been deficient. This is an aspect of social inclusion. Moreover, the government should consider providing social protection to the poor and the vulnerable when they cannot benefit from growth alone.

B. Education

2. *Enrollment in primary education grew* rapidly *during the 1990s, as net enrolment ratio (NER) rose to about 80%, according to the MoES.* The Tenth Plan/PRSP aims at increasing the NER to 90% by 2007 and the Education for All (EFA) Program to 96% by 2009. Since the NER has been increasing approximately 1% per annum since 1995, these targets are not likely to be met. Moreover, enrollment data from household surveys are lower, as discussed in Chapter 2.

3. *Behind this improvement is a* significant *increase in public expenditures*. In the last five years, the share of public expenditure on education rose from 12% to 15%, and the share of primary education has risen significantly from 48% to 59% of education expenditures, driven by national and international commitments to make primary education universal. Although part of the increased allocation for the primary sub-sector came from the increased share of education in public spending a substantial part came from reduction of public spending on higher education. Spending on primary education has been equitable and the lowest income decile uses public schools as much as higher deciles.

4. *In spite of considerable investments in the basic and primary education sub-sector, the quality of education remains poor*. The grade 5 completion rate rose from 44% to 54% between 1998 and 2001, but this still means that almost half the children do not complete primary school. The EFA program aims at increasing the Grade 5 completion rate to 60% by 2009. Previous experience indicates that this aim will be hard to achieve without significant improvements in the way public schools operate. Public schools also perform poorly in terms of success rates in School Leaving Certificate (SLC) Examinations: the pass rate is 85% for private schools and 15% for public schools.

5. *The Government is preparing a sector wide program to support basic and primary education.* Among the innovative features of this approach is a move towards decentralized planning and implementation, based on school management at the local level. This is line with the emphasis placed by the 10^{th} Plan/PRSP on improving delivery of school services by transferring management of public schools to communities. This also partly responds to escalating conflict and political uncertainty due to which normal functioning of schools is threatened as the central agencies can no longer reach communities in many parts of the country. The new strategy includes a focus on results and improving monitoring and evaluation by using a common and simplified framework. Finally, the Government is

setting up a joint financing arrangement with aligned donor and government procedures for financial management, disbursement and reporting.

Issues

6. *Quality is hampered by lack of funds for supplies, textbooks, and teacher training, as well as by a freeze in hiring.* The *non-salary recurrent budget* of Rs. 300 per teacher per year for primary schools is grossly inadequate. Given a teacher-student ratio of 1:40, non-salary expenditure per student is only Rs 10 or less than US$ 0.05 per year. A closely related issue is that textbooks are not delivered in time. The Government has recently decided to gradually open textbook production and distribution to private sector to help ensure timely delivery of textbooks. The Government has also been freezing the number of teacher positions during the last few years while enrollment continues to rise. This, coupled with persisting uneven deployment of teachers, has led to a large variance in teacher student ratio. Female teachers from disadvantaged communities -- instrumental to ensure access for girls and children from socially excluded groups – are in short supply. In spite of Government policy to appoint at least one female teacher per school, more than half of primary schools still do not have a single female teacher.

7. *Access to education by the poorest is hampered by hidden costs.* Even though they are forbidden by the Education Act to levy any kind of fee, many primary schools impose admission and/or examination fees in response to dire financial needs. This makes access difficult for children from poor households. It also raises the quality gap between private and public schools, effectively denying poor children (who cannot afford private schooling) access to quality education. The Government has established various scholarships and fee waivers to help children from poor households access primary, secondary and tertiary education, but these interventions are poorly targeted and have not been evaluated. The need to help with work at home or on the family farm also discourages school attendance.

8. *The insurgency has affected the delivery of education. The* education sector continues to employ the same strategy for delivery of education throughout the country as if the insurgency had little or no impact. Block grants do help to address some of the issues arising from the insurgency, but they too need to be monitored. Block grants help to get funds allocated at the local level when the machinery of traditional delivery has been disrupted due to the insurgency. Similarly, technical support being provided by the government cannot reach many areas of the country. Alternative mechanisms of delivery and monitoring of resources and services need to be developed.

9. *Strengthening School Management Committees and the role of communities in managing schools can bring about improvements in school governance, but the legal framework supporting this policy needs more clarity.* The 7th Amendment of the Education Act provided the legal basis for transferring school management to communities, but its application has been slow until recently. As a part of its policy of decentralizing responsibility for service delivery, HMGN seeks to bring education services at the primary and secondary level under community school management. On the other hand, the Local Self Governance Act (LGSA) mandates the Village Development Committee (VDC) to monitor and manage schools within its territory. Likewise, it mandates the Municipality to assist in operation and management of schools within its territory. But the role of these local government authorities vis-a-vis School Management Committees needs to be clarified. Ongoing experience with transfer of management of schools to communities indicates that transferred schools are yet to gain meaningful autonomy, due in part to the confusion in the existing legal framework.

10. *Secondary and higher education needs more budgetary and institutional support.* Increased expenditures on primary education have crowded out investments in higher education. The share of higher education in public expenditures on education decreased from 20% to 10% during the last decade. Considering that around 40% of university enrolment is actually at the higher secondary level, the actual

share of expenditures for higher education is no more than 7%. This figure is considerably below the level of 15 to 20% recommended by the "Constructing Knowledge Societies: New Challenges for Tertiary Education" by a committee appointed to look into secondary and tertiary education. The existing legal framework fragments secondary education into lower secondary, secondary and higher secondary education. In spite of the Government's policy of integrating higher secondary education with the rest of secondary education, this agenda has remained unfulfilled for a long time. Lack of institutional autonomy in higher education undermines good management.

11. The second most important issue in higher education is developing a sound framework for formula based funding. Other critical issues in higher education are accreditation, support to disadvantaged students, funding for research and development of a credible action plan for phasing out proficiency certificate level in tandem with upgrading public secondary schools to higher secondary level. While the increasing expenditures on primary education to raise enrollment is important, the country will need to find the right balance as it cannot afford to neglect secondary and tertiary education because the success achieved in primary education will create demand for secondary and tertiary education, and also in the interests of long term growth.

Recommendations

12. *The Government needs to provide adequate grants to schools to meet expenditures on teachers as well as non-salary recurrent costs.* Particularly, central recruitment needs to be stopped for vacancies and be replaced by local level recruitment. But care needs to be taken that this does not lead to low and inadequate teacher/student ratios.

13. *Clearer legislation for transferring power to communities is needed, together with a more careful monitoring of the devolution of schools to communities.* Otherwise, the vested-interests opposing devolution will not allow its successful implementation.

14. *Inter- and intra- sectoral allocations will need to be reassessed to ensure appropriate level of funding for higher education,* while maintaining the level of funding for primary education compatible with commitments towards universal primary education.

C. Health

15. *Nepal also witnessed many health status improvements in the 1990, but given the poor initial conditions and deficiencies in delivery systems, health indicators remain poor. Infant mortality rate (IMR) declined to 64 per 1000 live births and total fertility rate (TFR) fell from 5.6 to 4.1 live births per woman of child bearing age.* Public expenditure on health as a proportion of GDP (0.9%) is comparable to other South Asian countries. There are also considerable differences in access to heath services based on income group, locality, caste, ethnic group and gender. These rates are still unacceptably high, and important challenges remain, including (i) a maternal mortality rate of 539 per 100,000 live births (ii) malnutrition affecting half of all children under five; and (iii) the emerging threat of HIV/AIDS. Infectious diseases, nutritional disorders, and maternal and prenatal diseases dominate the overall pattern of morbidity and mortality in Nepal, accounting for half of all deaths and two thirds of lost disability adjusted life years (DALYs) (Table 6.1). Non-communicable diseases, including tobacco and alcohol related, are beginning to increase in relative importance, though not to the same extent yet as they have in many low-income countries. Beyond the issues concerning burden of disease, another key challenge for Nepal is to hasten the decline in fertility and lower population growth rates.

16. *The highest risk groups are children under five, particularly girls, who account for 52.5 percent of all female deaths, and women of reproductive age.* Although children represent only 16 percent of the population, they account for over 50 percent of the total DALYs lost from all causes, and 80 percent of their deaths are due to Group I causes. Women 15–49 years old experience a 26 percent higher loss of DALYs than men in the same age group. Much of this excess loss is related to pregnancy related problems.

Table 6.1 Comparison of "Deaths by Cause" and DALYs Lost by Cause

Causes of Death	Cause-Specific Deaths as percent of All Deaths	DALYs Lost as percent of All DALYs Lost
Group I: Infectious diseases and maternal, pre-natal and nutritional problems.	49.7	68.5
Group II: Non-communicable and congenital problems.	42.1	22.8
Group III: Injuries and accidents.	6.9	8.7
Unclassified.	1.0	0.0

Source: Nepal: Operational Issues and Prioritization of Resources in the Health Sector, June 2000, World Bank

17. *Decentralization Challenge: The Government's main strategy is to promote the devolution of power for health service delivery from the center to local governments and promote community oversight.* Since there are no elected bodies at present, the devolution of sub-health posts has been limited to handing them over to Local Health Management Committees (LHMC) in district and village councils that have adequate representation of females and lower caste people. This arrangement has increased community oversight. MOH has begun training of LHMC officials and Government officials at the local level to promote effective decentralization of services. However, technical support from sector agencies based at district and central levels remains below what would be needed.

18. *Public Private Partnership: Recognizing the important health services that the private sector and NGOs already provide, Government has sought to build partnerships with these groups.* Agreements and operating mechanisms now exist between the MOH and NGOs and private providers.

19. *Implementation Capacity and Management: Although the Government has a well-articulated vision and strategy for health in Nepal, the capacity to implement is weak.* Some important functions are under-staffed with no organizational homes specified for activities such as environmental health, gender and social issues and public-private partnership. The shortage of physical facilities and technical capacity at the district level lowers motivation and productivity.

Recommendations to Address Unfinished Agenda

20. *Dealing with health of the poor through more focus on priority diseases: It will be crucial to target the interventions to the groups not served adequately.* Although Nepal spends 5.1 percent of its GDP on health, private-out-pocket spending finances more than 70 percent of this expenditure. In the medium term improving public provision of health services through more focus on preventive care and public services such as communicable diseases, maternal mortality, and nutrition is needed.

21. *Improving management of health service systems and moving towards a stewardship role*: While 85 percent of the nation's population lives in rural areas, only 51 percent of total public health expenditures serve rural areas. Aside from increasing resources, decentralization and devolution of services to community oversight and local Governments will be essential to increase the accountability of service providers.

22. *Developing the framework for public-private partnership. Private delivery of health services, already important in Nepal, will become even more so in the future.* There is scope and need for the

Government to make greater use of public-private partnerships to expand services for the poor. A transparent and supportive policy framework for private services, more government use of private bodies to deliver health services, transferring resources to local Governments and communities to increase their discretion to choose among competing suppliers are all needed.

23. *Strengthening Government monitoring and oversight capacity.* As the Government turns to local governments, communities, and the private sector for managing the delivery of services, it will need to increase its capacity to monitor the service delivery performance of different agents, make monitoring results available to the public, and take corrective actions as needed.

24. *A key challenge for Nepal is to hasten the decline in its fertility rate, which according to the 2001 census, is half of that of 21 other Asian countries.* While Nepal's current population policy targets well some of the key factors driving fertility -- early marriage and child bearing, son preference and uncertainty of child survival due to high child morality rates, alongside lack of education and poverty -- the policy is undermined by lack of a multi-sectoral approach and inadequate attention to supply side factors. Current family planning programs have sought to mobilize NGOs, private sector and community groups to raise awareness and provide contraceptives. Similarly mass media is used to promote family planning practices and surveys suggest a general awareness of these. But these efforts need to be made more effective by ensuring that supply side factors are also adequately addressed. These factors would include skilled and female service providers being available at health facilities, privacy and confidentiality, appropriate counseling, information material, and, most important, adequate supply of contraceptives at regional and district levels constrain service users. Also critical will be to ensure the availability of family planning services. Available data (NDHS 2001) suggest that contraceptive prevalence rate is only 39% despite the demand by 67% of married women of reproductive age for such services.

D. Water Supply and Sanitation

25. ***Sector Developments.*** *In the 1990s, the water supply and sanitation sector saw reforms that shifted from the supply driven approach to service delivery of the 1980s (the Water and Sanitation Decade) to a demand driven approach.* It also adopted participatory decision making in rural water and sanitation service delivery. In addition, community participation shifted from voluntary labor contribution to community empowerment and management. HMGN has defined sector objectives clearly: (i) to provide and ensure safe, convenient and adequate water supply to all Nepalese people with sanitation as an integral component, with a specific focus on disadvantaged groups; (ii) to reduce the incidence of water-related diseases; (iii) to lessen the burden of women and children who are traditionally involved in collecting water; and (iv) taking care of domestic sanitation and hygiene.

26. *The Government's policies in the sector are sound; the main issue lies with implementing them.* The National Water Supply and Sanitation Policy (1998) and the 10th Plan/PRSP define the role and responsibilities of the institutions clearly. The strategy emphasizes decentralization, seeks support and partnerships from NGOs, private sectors organizations, and involves user groups. It also determines tariff rates for urban water supply to move towards cost recovery and prescribes lower rates for low-income households, but with penalties to discourage waste. As the issues discussed below indicates the main challenge ahead lies in implementing these policies well.

Sector Issues and Recommendations

27. *Limited sector coverage*: The *10th* Plan/PRSP has set a target for water supply and sanitation coverage at the end of the Plan period of 85% and 50% respectively compared to 71% and 25% in the 9th Plan. Given the need for rehabilitation of 10% of the Government built schemes and major repair of some

9,500 of these schemes, the MDG targets may not be achieved without adequate investments and institutional arrangements to make these investments effective and sustainable.

28. *Multitude of sector institution and* coordination *challenges*: The present institutional arrangement in the sector involves a multitude of organizations. The principal public sector institutions are the Department of Water Supply and Sewerage (DWSS), the Nepal Water Supply Corporation (NWSC) and the Rural Water Supply and Sanitation Fund Development Board (the Fund Board) reporting to the Ministry of Physical Planning and Works (MPPW). This has lead to various approaches to service delivery as well as various interpretations of the sector policy and some confusion. This makes coördination among the different actors challenging. A related issue is donor coordination. In order to bring about efficiency in the sector and prevent duplication of efforts, the government would need to take responsibility in coordinating donors. While the Government could ask donors to assist in providing technical inputs/advice, it needs to coordinate donor agencies and assume full ownership of its decisions. This would ensure effective use of donor resources.

29. *Institutional deficiencies*: Institutional deficiencies, particularly, in the urban sub-sector, have led to unreliable, intermittent, inequitable and poor quality supply. Consumers thus make expensive investments on alternative sources like boreholes and tanker services and on installing pumps and storage devices. The leaks in the distribution system not only result in wastage of water but also expose the water supplied to contamination and forces households to spend considerable sums of money to boil and filter the water. There is also need to monitor effectiveness and further clarify the roles and responsibilities of sector agencies in the context of decentralization, to ensure that the best institutional set up to implement sector policies and achieve sector objectives is put in place.

30. *Over-programming of sector* financing: The sectoral budget as a percentage of the development budget has remained fairly constant around 6 to 7% in the last five years. In the past, there has been a consistent tendency to over program the budget, so actual expenditures tend to be lower than budgeted. In this context, a clear priority is ensuring efficient use of resources through performance based budget allocations through regular reviews and a well established framework to allocate resources among the different groups and users.

31. *Lack of consistent* framework *for community contributions/empowerment:* In the rural water supply and sanitation sector, decentralized participatory approaches with communities making contributions in cash and/or kind are an accepted general norm. However, the amount that communities are required to contribute ranges from 10% to over 30% depending on the implementing/funding agency. The level of community involvement/empowerment, in actual practice, also varies. There is a need to have a consistent policy framework.

32. *Resource mobilization/*politicization *of tariff increases*: The challenge is to ensure that resources are mobilized on a regular basis to improve the availability of resources for operation and maintenance. Further this needs to be done without burdening the people, as has often been the case, with costly lumpy, politicized *ad hoc* tariff increases required because of deferred maintenance leading, in a vicious cycle, to costly rehabilitation/replacements.

33. *A key mechanism to make investments more effective and achieve coordination would be to promote greater customer responsiveness and involvement and use monitoring and evaluation*: The different service delivery mechanisms, such as service delivery through the public sector – central government, local government - NGOs, community based organizations need to be more responsive to customer needs. Customer satisfaction surveys could be used for monitoring. The central government would need to concentrate its efforts on monitoring and evaluation both of service delivery and of water quality. Efficiency in monitoring would help to eliminate mismanagement of resources such as

personnel, vehicles etc. This would also provide an effective tool for the Government to weed out inefficient and costly service delivery approaches.

E. Social Protection

34. *In the 10th Plan, HMGN follows a two-part strategy: foster broad based growth to benefit principally the moderately poor (who are some 60% of the poor), and combine targeted programs with social mobilization to reach the very poor.* Social protection programs in Nepal also go beyond poverty reduction to pension and provident funds for the formal sector.

Social Safety Nets for the Poor and Vulnerable

35. *There are several uncoordinated government programs, many with small numbers of actual beneficiaries and relatively high administrative overheads, covering different beneficiaries, from children to the disabled to war victims* (see Table 6.2). That more than 400 budget lines exist to finance these programs, indicate the fragmented and uncoordinated nature of social safety net programs in Nepal. Many of these programs originated from the signing of international conventions (e.g. children, disabled etc.) or from donor-funded programs, which have lost external support. The Poverty Alleviation Fund (PAF) is emerging as a major instrument to consolidate these programs and thus reduce overhead and improve monitoring of costs and impact.

Table 6.2 Coverage of Major Social Protection Programs in Nepal [need to indicate source]

Program	Number of Beneficiaries	Cost in Rupees 1000s
Non-Contributory Schemes		
Old Age Income Security	192,000	348,264,
Helpless Widows Assistance	228,000	226,760,
Disabled Pensions	3,700	4,400,
Pensions for Civil Servants, Teachers, Military and Police	318,000	3,260,000,
Food for Work	300,000	350,000,
Food for Education	292,000	290,000,
Other Schemes for children, elderly etc.	Few Thousands	Few millions mostly in overhead

Source: World Bank team estimates.

Coverage and Assessment of Main Programs

36. *A number of programs appear to be of a short-term nature, being funded for one or two years and then terminated.* This may again be a response to changes in donor support, but may also reflect political pressures. Whatever the reasons, the inconsistent funding of programs leads to inefficiency and reduces effectiveness, with chronic under-funding of programs and termination after the initial investments. In addition, special projects may create parallel local administrative structures that undermine existing mechanisms. Monitoring and evaluation remains a problem for all programs and this is necessary as a first step to assess whether programs are cost-effective or need to be redesigned.

37. ***Food Based Assistance:*** *There is one major public works program, heavily supported by WFP until 2006.* The Rural Community Infrastructure Works (RCIW) program is a food-for-work intervention that involves poor households in the creation and maintenance of critical physical assets such as rural roads, irrigation, agro-forestry assets and river control. RCIW operates in 30 of Nepal's 75 districts, including some of the country's most remote and food-insecure areas. The program relies on a decentralized approach in which communities help select project activities. Nearly 300,000 beneficiaries are estimated to benefit from the program annually, with an annual cost of US$4.6 million. RCIW

operates through the Ministry of Local Development and receives extensive support from WFP, with technical support from GTZ, DANIDA and DfID.

38. *The Food-for-Education (FfE) program was started in 1996 with WFP assistance.* It currently provides food to public primary and lower secondary children in schools within 16 districts. Children receive a hot midday meal of blended food (haluwa). In addition, a de-worming program operates within the FfE in coordination with the WHO and Ministry of Health. The program is implemented by District Education Offices under the Ministry of Education and Sports. WFP estimates that FfE can serve 292,000 children annually at a cost of US$3.8 million.

39. ***Safety Net Programs for the Elderly:*** *The universal flat old age pension (OAP) of Rupees 100 to all people above 75 years was first announced on 26 December 1994.* Five districts from the five development regions of Nepal were selected on a pilot basis and the implementation of the pilot was carried out by the Ministry of Education and Sports and at the grass-roots level by the Village Development Committees. During the financial year 1995-96, OAP was extended to the entire country and was implemented by the Home Ministry. Since 1996-97, the Ministry of Local Development has administered the OAP, and the allowances have been distributed by the ward offices in the urban areas and Village Development Committees in the rural areas. Two additional transfers were introduced in 1996, namely the Helpless Widows Allowance for widows above 60 years of age[70] and a disabled pension[71], each paying Rupees 100 per month. During the International Year of Elderly Persons (1999), the ruling Nepali Congress raised the old age allowance from Rupees 100 to Rupees 150. All Nepalese men and women who are 75 years and older are eligible for the pension. According to the directives issued by the Ministry of Local Development, eligibility for old age allowance is strictly based on the age mentioned in the Nepalese Citizenship certificate. A Social Security Program Identity Card will be issued to those eligible. The combined number of beneficiaries exceeded 400,000 individuals or about 1.8 percent of the total population.

40. *In principle, this program overlaps with those covering formal sector employees.* On the other hand, coverage of the contributory schemes is likely to remain very low for decades to come, making the Old Age Pension Program the sole alternative to family support systems for the vast majority of the population. So its role is to fill a gap that is created by low coverage in the formal sector schemes.

41. *A preliminary analysis suggests that this program, along with the means-tested widows benefit, reaches a high proportion of the eligible population, but that there are sharp geographic differences.* There is also a tradeoff between administrative simplicity and inclusion on the one hand and budgetary limitations on the other hand that needs to be better understood.

Pensions and Provident Fund for the Formal Sector

42. ***Public Sector Pensions.*** *Approximately 320,000 civil servants, military, police and teachers belong to defined benefit schemes that pay pensions with provisions for survivors.* Currently, it is estimated that there are around 103,000 pensioners. The pension bill in 2003-04 was close to Rs3.3 billion rupees, rising from Rs3.06 billion in 2002-03, excluding teachers' pensions. This is financed directly from the budget and is now equivalent to 5.4 percent of regular expenditures. While an estimate of the

---

[70] All Nepalese widows who have crossed the age of 60 and do not have any economic source of income, those who don't get any care from family members, and those who don't get the pension of their late husbands are entitled.

[71] Disabled Nepalese citizens having the following physical infirmities and being at least sixteen years of age: blind, who do not have both hands or who have hands that don't work, who do not have both legs or who have legs that don't work.

present value of future spending has not yet been produced, based on international experience, the figure is likely to be of the order of 15-20 percent of GDP.[72]

43. *Hidden within these aggregates are important differences between sub-schemes*. Specifically, it is necessary to distinguish civil servants and teachers from military and police because eligibility requirements differ substantially. While civil servants typically retire at age 58 or above and are required to have at least 20 years of service in order to receive a pension, military and police personnel are not subject to an age requirement and may receive a pension after only 16 years of service.

44. *In order to accurately assess the financial status of the defined benefit system, it is important to disaggregate the key indicators, as shown in Table 6.3*. It is important to note that the ratio of pensioners to contributors would have been much higher if it were not for the recent doubling of the size of the army. Also important is the fact that teachers were only granted pension rights in 1996 so that the relatively high ratio of active employees to pensioners reflects the immaturity of this scheme. This ratio will rise rapidly as evidenced by the growth in the number of pensioners in this category from four to ten thousand in the last five years.

Table 6.3 Key indicators of public sector pension schemes in 2003

Category	Active employees	Pensioners	Ratio: active to pensioners	Spending 2003-4 (Rs millions)	Share of spending
Civil servants[1]	87016	30000	2.9		
Army[2]	80000	38000	2.2		
Police[2]	55000	25000	2.2		
Teachers[2]	96000	10000	9.6	n.a.	n.a.
Total	318016	103000	3.1	3260	

Note: 1/There are 99,398 positions but 12,000 are not currently filled. 2/Estimates by DPR team.

45. ***Employees' Provident Fund:*** *Public sector employees and private firms with at least 10 employees are required to either contribute to the EPF or set up provident funds meeting the same conditions*. The tax-exempt contributions mandated are set at 20 percent of basic salary, split evenly between employer and employee. Currently, there are an estimated 380,000 contributors to the EPF and an unknown number of employees covered by employer-administered provident funds. This represents an estimated 20 percent of employees in Nepal and 6 percent of the entire economically active population. Despite the high contribution rate, several factors limit the effective amount of forced savings destined to generate income at retirement. While withdrawals have always been allowed upon termination of employment, other types of withdrawals were allowed prior to retirement until this practice was ended in 2001. However, loans to members are permitted and this represented 32% of program assets in 2003.

46. *The long-run rate of return on EPF accounts in real terms has barely exceeded inflation until recently*. Although data on average covered wage growth are not available, the differential between EPF returns and wage growth is likely to be small or even negative. For example, income per capita has grown at about 1.5 percent per annum since 1970 while real returns on EPF balances have averaged about 1 percent during this period. Real wage growth for lower level civil servants appears to be much higher over the same three decades. Finally, since allowances are not included in the earnings base subject to provident fund contributions, the effective replacement rate that can be generated is reduced. In private

[72] See Holzmann, Palacios and Zvinniene (2001). "On the Economics and Scope of Implicit Pension Debt: An International Perspective", *Empirica 28 (2001)/1*, 97-129.

sector firms in particular, allowances can make up a significant share of total compensation. Overall, EPF plays a minimal role in old age income security even for the limited share of the labor force that it covers.

47. ***Next Steps in Reforming Pension Funds and the EPF:*** *The main impetus for pension reform in Nepal today is the growth in expenditures on civil service pensions.* This phenomenon poses a fiscal threat that has broader negative impact on the population through larger deficits or the crowding out of other programs. The fact that pensions are indexed to civil service salaries at present also complicates broader efforts to reform the public sector. Until recently, little attention has been given to the long term financial viability of this scheme so that recent growth trends have caused justifiable concern.

48. *Aside from the fiscal impact, the civil service pension scheme exhibits many design flaws at the microeconomic level with implications for labor markets and equity.* For example, labor mobility is hindered by the back-loaded benefit formula and vesting rules that create a substantial loss for a civil servant that shifts from public to private sector employment. The use of a benefit formula and position-specific indexation also introduce inequities within and across generations.

49. *These are common features of civil service pension schemes in South Asia and elsewhere and are now in the process of being reformed in many countries including neighboring India.* One set of reform options involves a range of parametric changes to rationalize within the current structure such as increasing the retirement age, lengthening of the earnings base used in the benefit calculation, reduction in accrual rates and a shift from wage to price indexation. Another approach would be to move towards a contributory pension system that resulted in an accumulation of assets that would be used to offset pension liabilities. These approaches are not mutually exclusive.

50. *Employee Provident Fund.* A thorough review of the overall pension system covering the entire formal sector would consider the merits of integration of public and private sector pensions to achieve better labor mobility, lower costs and common social policy objectives.

Microfinance

51. *Nepal has a fairly sophisticated group of micro-finance practitioners and donors who are well aware of global best practice that discourages mixing financial service delivery (where loans must be paid back promptly) with the delivery of grant money (which does not need to be paid back).* There is a great deal of successful experience in the country of savings-led micro-finance service delivery which has proved to be both operationally and financially self-sustaining after initial investments to build group capacity and social capital.

52. *Micro-credit is one of the principal methods of encouraging income generation and small business development in Nepal.* There are several targeted micro-credit programs operated through different ministries with different donors supporting them. The major credit initiatives include the Small Farmers Development Program (SFDP), the Production Credit for Rural Women (PCRW) and the Micro-Credit Project for Women (MCPW).

53. *In recent years, two trends have been evident in microfinance.* First, some organizations are increasingly turning to lending without collateral requirements to reach the poorest segments of the population. Second, formal financial institutions have become less directly involved in lending operations, relying instead on intermediary organizations such as NGOs and cooperatives to reduce operating costs. There has also been an emphasis on generating local funds either through revolving credit funds such as PCRW and MCPW or enforced group savings (Grameen clones).

54. ***Issues and Future Potential in Microfinance:*** *Despite Nepal's vibrant micro-finance sector, outreach to poor rural borrowers is still very low with something like 6.5 percent of poor men and women estimated to have access to micro-credit through formal public and private sector institutions.* Why has coverage remained so low? There is broad agreement in the micro-finance community that the constraints to scaling up include:

- Weak mainstream formal sector intermediaries – characterized by a cautious and rather bureaucratic banking culture and increasing politicization;

- Shortcomings in the policy and regulatory framework for micro-finance. Despite the fact that Nepal has adopted forward-looking policies which allow development banks with lower levels of capitalization, permit NGOs to register as financial intermediaries and grant limited banking licenses to cooperatives approved by the central bank, many flaws remain in the legislation and the central bank is overstretched in its regulatory role;

- General lack of rural infrastructure and markets which, in turn, limit the potential for high return rural farm and non-farm enterprises and the demand for money to finance these enterprises;

- Inadequate investment in social intermediation, capacity building of Micro-Finance Intermediaries (MFIs) and Business Support Services; and

- The security situation which has increased the general riskiness attached to all economic activities in the rural areas – and has particularly threatened the operation of micro-finance organizations and programs identified with the government.

55. *The security situation appears to have hampered the development of new approaches in micro-finance such as life and health insurance which can contribute to risk reduction and social protection.* Micro-finance organizations in Bangladesh and India are offering these types of products and even pensions but these have yet to reach Nepal despite its vibrant and large micro-finance sector. Technical support and possible partnerships with micro-finance NGOs in Bangladesh and India could help in the development of these new micro-finance products which could have significant impact on social protection.

F. Summing Up

56. *First, there are many social protection schemes in Nepal.* Their effectiveness is however reduced by not being coordinated; in some cases their impact is not clear. Some are assured funding only in the short term and their continuing funding is an issue. Assistance programs, which encourage good practices such as food for education, are dependent on food surpluses in World Food Program (WFP) donor countries that are beyond the control of the Government. The pension and provident funds in the formal sector unless reformed could create fiscal problems in the future and they have to be monitored carefully and reformed to be fiscally and financially sustainable.

57. *Second, apart from the fiscal implications, there are labor market implications for the pension and provident funds.* They tend to reduce the flexibility of the labor market as well as raise real wages for those involved in the schemes, unrelated to productivity gains. Labor mobility is hindered by the back loaded benefit formula used. There is a need to develop a new contributory pension scheme which allows labor mobility and where the benefits are not back-loaded.

58. *Finally, microfinance schemes can be seen as social protection even if the loans are market priced and savings are accumulated at rates that allow the funds to continue to the future.* Global experience as well as regional experience shows that the issue for poor has always been more about access to credit and less about the cost of credit. Microfinance in Nepal needs to develop and offer

financial products beyond credit to include savings[73] and micro-life insurance, which has been tried in Bangladesh and other countries.

[73] Again global experience shows that the poorest are better reached through micro-savings schemes which help provide a cushion against vulnerability.

CHAPTER 7. – ACHIEVING PEACE AND RESTORING PROGRESS

A. Medium Term Development Prospects

1. *Nepal is at a crossroad today between the prospect of sustaining and accelerating gains in human development and poverty reduction and the danger of serious reversals of these gains.* Despite a late start in development and a difficult geography, Nepal succeeded in building up a wide range of good government institutions - a system of laws and organizations, checks and balances - in a short span of time since the 1950s, though their newness and compressed history have also made them fragile. Policies, infrastructure, incomes, and human development outcomes steadily improved under these institutions. Economic growth accelerated in the 1990s, became more inclusive and less volatile in the second half of the 1990s. Evidence from several household surveys corroborate that poverty has declined appreciably since the mid 1990s. But now this progress is under threat of reversal from political instability and a domestic conflict that has sharply escalated in the past two years. Meanwhile conflict and an increasingly competitive external environment could prevent the country from reaching the high rates of export growth that it reached in the 1990s.

2. *Nepal's medium term prospects largely hinge on its ability to tackle these immediate threats by restoring a minimum degree of stability under which development can proceed and the country can undertake structural reforms to increase competitiveness.* While the immediate need is to reduce the severity of the conflict if not negotiate a complete settlement, Nepal's development strategy will need to confront the issues of the lagging regions, disadvantaged ethnic and caste groups, who feel excluded and disempowered. Focusing development efforts on these groups and regions through investing in better connectivity, agricultural development, public services and institutions to empower them will be key elements of the medium term strategy. Second, policy measures have to be taken to increase competitiveness and productivity, rather than rely exclusively on raising investment and saving (at present levels of productivity) to raise GDP. The latter is neither advisable nor feasible. Productivity gains can be achieved through improvements in transport and customs procedures and through policy reforms to make the labor market flexible and also by removing minimum support prices and SME reservations. Third, a more concerted effort to commercialize agriculture can all help to raise its growth prospects. All such measures will help Nepal to exploit its comparative advantage in agriculture, labor intensive manufacturing and tourism. In turn these measures can improve the country's medium term growth and poverty reduction prospects.

B. The Poverty Reduction Strategy and Growth Scenarios

3. *Nepal's 10^{th} Five Year Plan, whose summary is the poverty reduction strategy has four pillars*: (i) *broad based growth* with special emphasis on agriculture; (ii) *accelerating human development* through renewed emphasis on effective delivery of basic social services and economic infrastructure; (iii) *ensuring social and economic inclusion* of the poor, marginalized groups and backward regions; and (iv) *vigorously pursuing good governance* as a means of delivering better development results and to ensure social and economic justice. Planned public investment has been, appropriately, focused on developing social and physical infrastructure.

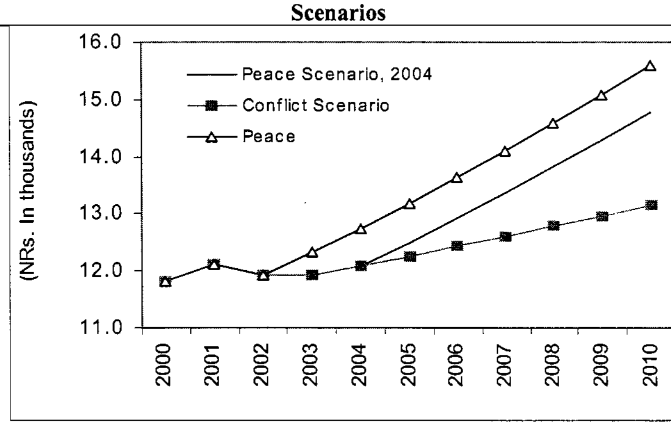
4. *The PRSP presents two medium term scenarios – the normal case and the alternative case – to take into account the downside risks arising from the present conflict.* Underpinned by a prudent fiscal frame work that lowers public sector borrowing requirements to less than 1% of GDP in the final year, the "normal" scenario in the PRSP projects a growth rate of 6.2% p.a. over the next five years – with growth rates reaching a maximum of 7.5% at the end of the plan. The low-case scenario projects a 4.3% growth

rate per annum. In sectoral terms, the normal scenario envisages that more than 3/4th of GDP growth will come from the non-agriculture sector in keeping with past trends.

5. *The normal case is contingent on a "quick rebound" of economic activity following peace, especially in the non-agriculture sectors such as manufacturing, exports, construction and tourism -- all based on private sector led growth.* The PRSP envisages a strong recovery of private sector investment (rising to 19% of GDP by 2007, compared to 12% currently) that would lead to strong trade and export growth. Public investments in power, roads and telecommunications are the instruments for encouraging private sector investment. In the rural sector, the implementation of the APP, including ensuring the supply of fertilizer, irrigation, and the development of livestock, horticulture and high value crops in the hill regions would drive agriculture growth. Expansion of rural roads, electricity and marketing networks, expansion and rehabilitation of irrigation networks and small-scale surface irrigation schemes in the hill regions will be the drivers behind agricultural growth in those areas.

6. *Unfortunately, the first two years of the 10th plan has made it clear that assumptions of the normal case are not holding and it has become evident that even attaining the "alternative case" scenario will be challenging.* Nepal's growth rate in the past three years has only averaged at around 2.0%. While growth in the last two years has been in line with the alternative case scenario, it has been possible only because of the resilient growth of the agricultural sector and not the non-agricultural sector. Except for tourism, growth in other sectors such as manufacturing, transport and communications has been considerably below the trend of the 1990s. This means that even attaining the "alternative case target" of 4.3% in a scenario of continuing insurgency would depend largely on good weather.

Figure 7.1 Nepal: Real Per Capita Incomes - Peace and Conflict Scenarios



Source: World Bank estimate

7. *The reason for poor performance of the non-agriculture sector is the cost imposed on the sector by the conflict.* These costs have turned out to be steep and consequently Nepal's export growth is much slower in the last three years compared to 1990s. A conservative estimate is that GDP growth rates have fallen by 2% points p.a. (i.e. to around 4%) due to falling investment (by more than 3% points of GDP), due to disruptions in economic activity and associated rising costs. This implies that in the next 5 years, per-capita-GDP would be 10% to 14% lower than what it would have been if peace had been restored in 2002. (see figure 7.1 – Real per capita GDP scenarios). Thus, clearly, the first requirement for sustaining growth and poverty reduction is peace and recovery, which is the main premise of the Government's poverty reduction strategy. The second premise is to raise export growth. In the 1990s, overall economic growth rates (5%) and non-agricultural sector growth rates (6.5%) were accompanied by export growth of around 15%. At present, export growth has been less than half of that pointing to an important weakness in the Government strategy – lack of adequate emphasis on trade.

8. *Overall, if peace is restored, the "normal case scenario does not look too unrealistic going by past trends and if Government can make the needed adjustments.* The economy showed considerable responsiveness to good policies in the past, achieving a trend growth rate of about 5% in the 1990s and attained a growth rate of 6% in FY 2001. Considering that both human and capital stock have increased substantially over the 1990s, infrastructure has improved markedly and currently a steady stream of remittances stimulates demand, medium-term growth prospects would seem favorable. But Government would need to focus more on two areas than it does in the 10^{th} plan. These are to provide an environment to increase productivity and efficiency instead of depending on higher investment and savings as well as encourage the commercialization of agriculture.

9. *Some growth arithmetic highlights the point on the excessive reliance of the PRSP on investment and savings instead of productivity.* The 10^{th} Plan envisages investment and private investment rates to more than double in real terms compared to the rates of investment during 1996 to 2001, a period of relative normalcy. Similarly, the consumption rate is expected to fall by 5 percentage points of GDP to provide a part of the savings for investment. But as may be expected from a low-income country such as Nepal, the recent household consumption surveys show that consumption has increased appreciably in regions and across income levels. Hence, clearly the premise of achieving significantly higher investment and savings rates is not tenable and more focus on growth of productivity is needed. As discussed earlier in Chapter 2, the empirical evidence from both aggregate analysis and firm level analysis suggests that productivity levels and growth are very low in Nepal. Aggregate productivity growth even after considerable improvement in the 1990s was still at 0.3% p.a. compared to say 2.5% growth in India.

10. *Nepal has the basis to increase its productivity by primarily focusing on four areas.* The first is commercializing agriculture to take advantage of its diverse agro-ecological zones and the variety of high value crops, horticulture, and livestock, some at off-season, that it can produce will raise agricultural incomes and productivity in the hills. The prospects for commercial agriculture are already evident in the faster growth of commercial crops, livestock and exports in the second half of the 1990s. Second, by focusing on trade competitiveness. Nepal has revealed comparative advantage in agriculture and manufacturing products (garments, carpets, pashmina, and edible oils, light manufacturing goods). The proximity to the large and fast growing Indian and Chinese economies and the availability of preferential access to Europe and to India, which many of its neighbors don't enjoy, lower wages and an arguably better investment climate than neighboring Uttar Pradesh and Bihar – in terms of infrastructure and governance -- could help to draw foreign and Indian investment with their know-how and market access for export oriented activities.

11. *This leads to the third prospect of growth and productivity, i.e. by attracting foreign direct investment.* At present, FDI is by far the lowest in South Asia. In comparison to Sri Lanka where 70% of ready-made garments exports come from foreign investors, in Nepal FDI share in that sector is virtually nil. A combination of conflict, political instability and unfriendly Government policies such as reservations on carpet manufacturing, restrictions on foreign supply of services, and high transactions costs have kept FDI shy away from the country. But with Nepal's accession to the WTO, its commitment to modernize Customs and liberalize a wide range of services that investors need, and its preferential access to India and Europe can make the country attractive to FDI. Starting from a low base, this could be a significant factor to spur productivity.

12. *The fourth source of future growth and productivity comes with its changing demographic composition with more and better education.* This raises the prospects of increasing productivity of both capital and labor. As more of Nepal's population enters the labor force and the dependency ratio declines, that would add to growth. For a long time, labor force growth rate and schooling growth rates have remained persistently low, but that changed in the 1990s as Nepal underwent a demographic transition. The share of working age population after increasing from 53.4% in 1996 to 54.8% in 2006 is expected to

increase at a faster rate to 57.8% by 2016 increasing the growth of productive labor even if participation rates remain the same. Alongside, the significant increase in schooling in the 1990s offers the scope for raising productivity. Although, it is worth emphasizing that these increases in productivity can only happen if there is investment in raising productivity and labor market flexibility provides greater incentives for both firms and labor to invest in increasing their productivity.

13. *Another asset, especially important for human capital development and growth, is the strong presence and vibrancy of Nepal's communities – i.e. local or community level social capital.* This is witnessed in the dynamism of its many user groups in various sectors such as forestry, irrigation, water and sanitation, micro-finance and women's savings. It is also witnessed in the good start of local Governments in Nepal, where even though development is in the early phases and at present it is arrested. Local governments have displayed considerable activism in development and organizing the delivery of public, specifically "club," goods that benefit the communities. This asset has enabled Nepal to achieve significant improvements in human development indicators despite weak public services and the disruptions due to political instability and conflict. It also offers Nepal a route to improve public service delivery through devolution. To some extent these assets are highlighted in the Government medium term growth and development strategy spelled out in the 10^{th} Five Year Plan and the PRSP.

C. Risks

14. *It is self-evident that risks in Nepal are very high, but the resilience of its economy and institutions are also high.* Despite significant instability and turmoil over the last decade, the economy grew at a respectable rate and considerable human development took place. Still, the escalating conflict of the last three years and growing street agitation shows that the main risk is political. The other downside risks arise from the changing foreign trade environment (such as the rescinding of the MFA) and Nepal's excessive dependence on remittances to maintain its current account balance. Other risks include the constraints on Government capacity to implement an inclusive growth strategy, address contingent liabilities, and tackle Nepal's population growth.

15. *The first and most significant risk comes from political instability and conflict that has created instability and uncertainty about institutions, rules and laws.* The roots of this instability lie in the relative exclusion of lagging regions primarily in the hills of the mid- and far-Western regions and the dalits and indigenous groups from having access to income and other benefits of public services. An eight-year long insurgency originating from these regions has claimed more than 9,500 lives - most of them since 2001 - has disrupted development, local governments, and public services in large parts of Nepal. The war has inflicted large costs to the tune of more than 2% of GDP each year and has large cumulative adverse effect on future growth. More recently, political unrest, transport blockades and street demonstrations every month have eroded business confidence. The suspension of laws and representative institutions have also led to greater uncertainty. It is unclear that Nepal will be able to attain its low alternative case growth scenario in this climate.

16. *The second risk comes from a more competitive external environment brought about by the forthcoming phasing out of the MFA*, the loss of its market share of carpets to cheaper machine made carpets, and a more stringent trade treaty with India. These factors suggest that the rapid growth in exports and the non-agricultural sector in the 1990s – that accounted for $3/4^{th}$ of all growth in the 1990s -- cannot be sustained without implementing further policy reforms and serving better access to Indian and foreign markets. Per capita income has fallen since 2001 as the shock of falling exports and escalating conflict combined with excessive rainfall in 2002. As the inexorable pressure of population grows and the share of working age population increases – as demographic trends predict – the challenge will be to stimulate growth and investment at a faster pace to create the jobs needed to employ the new entrants to the labor force.

17. *The third risk is posed by substantial reform agenda that the Government needs to implement to restart growth and to have more inclusive growth.* The insurgency and the social conflict make implementation of the various agenda items identified in this review and programs already identified by the Government difficult. In one sense the reform are the antidote to the conflict (such as policies to increase inclusion, increase transparency and provide better service delivery). But the implementation itself is constrained by the on going conflict. This calls for careful prioritization and phasing of the reform agenda.

18. *The fourth risk is posed by the contingent liability of the non-performing assets of the two large banks whose negative net worth is estimated to be about 7% of GDP.* The inability to restructure these assets in an orderly manner could lead to a significant fiscal burden and a sharp reduction in the access to credit. In either case, there would be crowding out of private investment.

19. *The fifth risk of losing the race against population growth is more long term risk, though it requires intervention now.* While Nepal's demographic transition into lower fertility rates has started it is very recent and slow. At its current rate of fertility decline, Nepal's population will grow to 77 million in the next 50 years. This will lead to overwhelming and unbearable pressure on its limited land resources and overwhelm growth and poverty reduction prospects. Alternatively, if Nepal is able to intervene through both supply and demand side of family planning practices leading to a decline in fertility similar to the average of 21 selected Asian countries[74], then population growth rate would slow down and grow to about 50 million in the next 50 years, leading to a much more manageable situation.

D. Summing Up

20. *Starting from a low base, Nepal has made good progress in developing a wide range of institutions – laws and organizations and checks and balances.* But their newness also made these institutions fragile and unable to deal with the foremost challenge of the exclusion of lagging regions and ethnic groups and castes. Their inability to cope with the tide of rising expectations that came with democracy in 1990 has led to widespread resentment particularly among the lagging regions and groups. This has fueled an eight-year long insurgency that has violently escalated in the last three years leading to the unraveling of key representative and accountability institutions. This now threatens to stall and roll back the progress that Nepal has achieved and more fundamentally the legitimacy of the state.

21. *This review has attempted to offer a menu of technical options that Nepal needs to pursue in order to restart growth, increase social inclusion and improve service delivery.* These options can be pursued only with a mitigation of the conflict. That in turn depends on the reaching of a political consensus. Without such a consensus, the country will not only endanger future growth and poverty reduction, but will face the prospect of reversing its achievements to date.

[74] Thapa, Shyam, "Population Growth in Nepal: The Challenges Ahead", Perspective, 2001. Dr. Thapa cites a UN Study's estimate of 21 Asian countries.

REFERENCES

Agro-Enterprises Center, (2004) "Agriculture Development Programme for Hills of Mid-Western and Far-Western Development Regions of Nepal: A Concept Paper", Kathmandu, mimeo.

Ahsan, A. and B. Karmacharya, Explaining Nepal's Growth Performance, Mimeo, 2004.

Baral, S.R. and B. Karki, (2002), "A Baseline Study on Non-timber forest products in Far Western Development Region, Neapl. Agro-Enterprises Center, Kathmandu.

Bhattachan, Krishna, K. Hemchuri, Y. Gurung, C. Biswakarma, 2003, Existing Practices of Caste-Based Untouchability in Nepal and Strategy for a Campaign for its Elimination, Action Aid, Nepal.

Holzmann, R., R. Palacios and Zvinniene (2001). "On the Economics and Scope of Implicit Pension Debt: An International Perspective", Empirica 28 (2001)/1, 97-129.

Bajracharya, P. and Bajracharya, S. (2002), "Total Factor Productivity Growth in Nepal: An Estimate", Economic Journal of Development Issues.

Bennet Lynn, "Gender, Caste and Ethnic Exclusion in Nepal", Background Note for the DPR, 2004

Biggs, T. et al. (2000), *The Business Environment and Manufacturing Performance in Nepal,* FNCCI and The World Bank, Washington, D.C.

CBS (2001): National Census 2001, Central Bureau of Statistics, National Planning Commission.

CBS (2003) : District Level indicators of Nepal for Monitoring Overall Development, HMG/Nepal, Kathmandu, Nepal, Dec, 2003.

Central Bureau of Statistics (1999), *Report on the Nepal Labour Force Survey 1998/99*, November, Kathmandu.

Central Bureau of Statistics (2001), *Population Census 2001*, Kathmandu.

Chapagain, D and H. Phuyal (2003), "A review of Agricultural Policies and Legal regime in Nepal- Main Report: A report prepared for Ministry of Agriculture and FAO/UN", September 2003, Kathmandu , Nepal.

Deraniyagala, Sonali, Ashwini Deshpande, Yubaraj Khatiwada, Rathin Roy and Shiva Sharma, *Macroeconomics of Poverty Reduction: The Case Study of Nepal.*

Dhakal, Ameet, et. al, "The Costs of War in Nepal", Draft, November 2003. Nepal Peace Campaign
Dixit, K. M. and S. Ramachandran, editors (2003), *State of Nepal*, Kathmandu, Himal Books.

DOR (2000): Road Statistics of Nepal 2002, Department of Roads, and Kathmandu Nepal.

FAO (2001): Contract Farming: Partnership for growth, Agriculture Service bulletin, Rome, 2001.

Gates, Scott and S. Mansoob Murshed, *Spatial-Horizontal Inequality and the Maoist Insurgency in Nepal,* United Nations University Centre, Tokyo, March 2003.

Gurung, H. (1997), in *Nationalism and Ethnicity in a Hindu Kingdom: The Politics of Culture in Contemporary Nepal*, Amsterdam.

His Majesty's Government of Nepal, (2002), *The 10th Five Year Plan.*

His Majesty's Government of Nepal, (2003), *The 10th Plan Summary/Poverty Reduction Strategy Paper*

His Majesty's Government of Nepal, (2004), *Nepal Trade and Competitiveness Study,* MOICS, 2004

His Majesty's Government of Nepal, *Expenditure Tracking Survey of Primary, Lower Secondary and Secondary Schools,* Kathmandu, June 2003.

His Majesty's Government of Nepal, *Water Resources Strategy, Nepal*, 2002.

Holzmann, R., R. Palacios and Zvinniene (2001). "On the Economics and Scope of Implicit Pension Debt: An International Perspective", *Empirica 28 (2001)/1*, 97-129.

ICIMOD (1997): *Districts of Nepal: Indicators of Development*, joint Publication of ICIMOD/SNV, Lalitpur, 1997.

IMF (2002) *Nepal , Selected Issues and Statistical Appendix*, Washington, D.C.

IMF (2003), Nepal - Staff Report for the 2003 Article IV Consultations, Washington, D.C.

International Finance Corporation and the World Bank (1998), *Nepal : Attracting Foreign Direct Investment to Nepal's Infrastructure*, Foreign Investment Advisory Service.

Jensen E., Robert Moog and Shahid Kardar, (2001), "Understanding and Reforming the Nepalese Legal System", Asia Foundation.

Karmacharya, B.K. (2002), "Explaining Nepal's Economic Growth Performances", Report presented to the World Bank.

Kharel, Ram Sharan, Yuba Raj Khatiwada, Vikash R. Satyal and Suman K. Sharma, *Nepal: Sources of Economic Growth,* submitted to SANEI by IIDS, Kathmandu. 2002

Khatiwada, I., (2001) *The Story of Household Incomes in the 1990s*, Boston , Mass INC.

Lanjouw P. G. Prennushi, and S. Zaidi (1998), "Poverty in Nepal", in *Nepal: Poverty at the Turn of the Twenty-First Century*, World Bank, South Asia Region Internal Discussion Paper, Report No. IDP 174.

Maskay, N.M. (2002), *The Exchange Rate Policy of Nepal vi-a-vis the Indian currency*, NEFAS.

MOAC/AEC (1999): Legal Provisions on Contract Farming, A Joint study, Ministry of Agriculture and Cooperative and AEC/FNCCI.

National Human Rights Commission, (2003), *Human Rights in Nepal: A Status Report*, Kathmandu

NLSS (1996): Nepal Living Standards Survey Report Vol.1, Central Bureau of Statistics, NPC, Kathmandu, and Nepal 1996.

NPC (2003): 10th Five Year Plan and Summary, National Planning Commission, Kathmandu Nepal, 2003.

NRB (2003): "Micro Economic Indicators of Nepal" by Nepal Rastra Bank, December 2003.

Poudel, Keshab "A Political Gimmick," *Spotlight*, Vol. 22, No. 8 (16 August, 2002). See also Transparency International Nepal, *Newsletter* Vol. 5, No. 1 (April, 2003).

Prennushi, Giovanna, (1999), *Nepal: Poverty at the Turn of the Twenty-First Century*, World Bank, South Asia Region Internal Discussion Paper, Report No. IDP 174.

Prennushi, Giovanna (2004), "Poverty Reduction and Progress in Achieving MDGs in Nepal", Background Paper for the Nepal Development Policy Review.

RUFIN (2003): Micro-Finance and Armed Conflict in Nepal, RUFIN/GTZ Working Paper No.3, by Ulrich Wehnert and Roshan Shakya, January 2003.

SAPPROS - Nepal (2001): A Study on Rural Hill Potentials and Service Delivery Systems - Final Report, submitted to IFAD, Rome, by SAPPROS Nepal, Kathmandu, Nepal,, January, 2001.

Shrestha, S. P., (2002), *Governance Study: Nepal*, Asian Development Bank, Manila.

Shah, Anwar, (2003) "Bridging the Economic Divide Within Countries: A Scorecard on the Performance of Regional Policies in Reducing Regional Income Disparities", World Development, Vol. 31.

Sharma, Shiva and Sonali Deraniyagala, (2003), "Agricultural Reforms and the Performance of Agriculture", Chapter 5, in Macroeconomics of Poverty Reduction: The Case Study of Nepal , UNDP, UN House.

Shiva Sharma, (2001), Policy and Strategy for Poverty Alleviation and Sustainable Household Food Security in Nepal 2001, Labour Academy /FAO.

Soto, Raimundo., (2003), "Estimating the Misalignment of the Real Exchange Rate in Nepal", mimeo, World Bank.

Thapa, Shyam. *Population Growth in Nepal: The Challenges Ahead*, The National Newsmagazine, 2001.

Transparency International (2003), *Corruption in South Asia: Insights and Benchmarks for Citizen Feedback Surveys in Five Countries.*

U.S. Department of State, (2001), Nepal: Country Reports on Human Rights Practices.

U.S. Department of State (2001), "Background Note: Nepal".

World Bank, (2001), *Nepal Priorities and Strategies for Education Reform.*

World Bank, (2003), *Doing Business in 2004*

World Bank (2004), *Agricultural Sourcebook*, Washington, D.C.

STATISTICAL ANNEX

Statistical Annex : Contents

Table 1.1: Nepal: Nominal Gross Domestic Product by Sector, 1994/95-2002/2003

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
	(In billions of Nepalese rupees, at current prices)								
Agriculture, Fisheries, and forestry	**85.6**	**96.9**	**108.8**	**112.5**	**132.4**	**145.1**	**151.1**	**160.1**	**169.7**
Industry	**46.6**	**53.5**	**60.0**	**63.4**	**69.9**	**78.7**	**84.0**	**84.5**	**88.9**
Mining and quarrying	1.1	1.3	1.5	1.6	1.7	1.8	1.9	2.1	2.2
Manufacturing	19.6	22.5	24.8	27.0	30.3	33.6	35.5	32.8	33.7
Electricity and water	2.9	3.6	4.5	4.4	4.6	5.9	7.0	7.4	8.5
Construction	23.1	26.1	29.3	30.5	33.3	37.4	39.6	42.2	44.5
Services	**77.8**	**89.0**	**100.8**	**113.9**	**127.7**	**142.4**	**158.5**	**159.9**	**169.9**
Trade, restaurants, and hotels	24.3	28.3	30.6	33.7	39.3	42.9	44.6	40.5	42.6
Transport and communications	14.0	15.9	19.3	22.6	24.6	29.3	33.3	34.7	37.1
Financial and real estate	20.5	23.5	27.2	29.8	33.2	36.9	41.6	43.9	46.9
Community and social services	18.9	21.3	23.7	27.8	30.6	33.3	39.0	40.8	43.4
GDP at factor cost	**210.0**	**239.4**	**269.6**	**289.8**	**330.0**	**366.3**	**393.6**	**404.5**	**428.5**
Agricultural GDP	85.6	96.9	108.8	112.5	132.4	145.1	151.1	160.1	169.7
Non-agricultural GDP	124.4	142.5	160.8	177.3	197.6	221.1	242.5	244.3	258.8
Value of imputed banking services	5.1	5.9	7.0	7.9	9.4	10.7	11.9	12.4	13.3
Net indirect taxes	14.3	15.5	18.0	18.9	21.5	23.9	28.6	29.2	31.0
GDP at market prices	**219.2**	**248.9**	**280.5**	**300.8**	**342.0**	**379.5**	**410.3**	**421.3**	**446.2**
	(Percentage share in nominal GDP)								
Agriculture, Fisheries, and forestry	**40.8**	**40.5**	**40.4**	**38.8**	**40.1**	**39.6**	**38.4**	**39.6**	**39.6**
Industry	**22.2**	**22.3**	**22.3**	**21.9**	**21.2**	**21.5**	**21.3**	**20.9**	**20.7**
Mining and quarrying	0.5	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Manufacturing	9.3	9.4	9.2	9.3	9.2	9.2	9.0	8.1	7.9
Electricity and water	1.4	1.5	1.7	1.5	1.4	1.6	1.8	1.8	2.0
Construction	11.0	10.9	10.9	10.5	10.1	10.2	10.1	10.4	10.4
Services	**37.0**	**37.2**	**37.4**	**39.3**	**38.7**	**38.9**	**40.3**	**39.5**	**39.7**
Trade, restaurants, and hotels	11.6	11.8	11.3	11.6	11.9	11.7	11.3	10.0	9.9
Transport and communications	6.7	6.6	7.2	7.8	7.5	8.0	8.5	8.6	8.7
Financial and real estate	9.8	9.8	10.1	10.3	10.1	10.1	10.6	10.8	10.9
Community and social services	9.0	8.9	8.8	9.6	9.3	9.1	9.9	10.1	10.1
GDP at factor cost	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Agricultural GDP	40.8	40.5	40.4	38.8	40.1	39.6	38.4	39.6	39.6
Non-agricultural GDP	59.2	59.5	59.6	61.2	59.9	60.4	61.6	60.4	60.4

Source: IMF.

Table 1.2: Nepal: Real Gross Domestic Product by Sector, 1994/95-2002/03

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
	(In billions of Nepalese rupees, at 1994/95 prices)								
Agriculture, Fisheries, and forestry	**85.6**	**88.8**	**92.7**	**93.5**	**96.2**	**100.9**	**106.4**	**108.8**	**111.1**
Industry	**46.6**	**50.7**	**54.0**	**55.3**	**58.6**	**63.7**	**65.4**	**63.3**	**64.7**
Mining and quarrying	1.1	1.3	1.3	1.4	1.4	1.5	1.5	1.6	1.6
Manufacturing	19.6	21.3	22.8	23.6	24.9	26.6	27.6	24.9	25.0
Electricity and water	2.9	3.4	3.5	3.3	3.5	4.0	4.4	4.5	5.0
Construction	23.1	24.7	26.4	27.0	28.8	31.6	31.8	32.4	33.1
Services	**77.8**	**82.4**	**86.3**	**92.1**	**97.0**	**102.5**	**107.9**	**106.4**	**109.2**
Trade, restaurants, and hotels	24.3	25.4	26.5	28.0	29.1	31.0	31.5	28.2	28.6
Transport and communications	14.0	14.8	15.9	17.2	18.4	19.6	20.9	21.2	22.0
Financial and real estate	20.5	22.1	23.1	24.5	25.7	27.0	27.5	28.4	29.5
Community and social services	18.9	20.1	20.8	22.4	23.9	24.8	28.1	28.5	29.2
GDP at factor cost	**210.0**	**221.9**	**233.0**	**240.8**	**251.8**	**267.1**	**279.8**	**278.5**	**285.1**
Agricultural GDP	85.6	88.8	92.7	93.5	96.2	100.9	106.4	108.8	111.1
Non-agricultural GDP	124.4	133.1	140.3	147.3	155.6	166.2	173.4	169.7	174.0
Value of imputed banking servioes	5.1	5.6	5.7	6.2	6.6	7.2	7.8	7.8	8.2
Net indirect taxes	14.3	14.6	15.7	15.5	16.2	17.5	18.6	18.5	19.0
GDP at market prices	**219.2**	**230.9**	**243.0**	**250.2**	**261.4**	**277.4**	**290.6**	**289.2**	**295.8**
	(Annual percentage change)								
Agriculture, Fisheries, and forestry	**-0.3**	**3.8**	**4.4**	**0.9**	**2.8**	**4.9**	**5.5**	**2.2**	**2.1**
Industry	**4.0**	**8.8**	**6.5**	**2.3**	**6.0**	**8.7**	**2.7**	**-3.3**	**2.3**
Mining and quarrying	3.5	13.0	6.8	1.3	3.7	4.5	4.5	1.0	2.9
Manufacturing	2.0	9.0	7.1	3.4	5.3	7.2	3.8	-10.0	0.4
Electricity and water	12.0	19.3	1.8	-4.1	5.7	14.3	9.6	1.7	11.5
Construction	5.2	7.1	6.6	2.2	6.8	9.6	0.9	1.7	2.4
Services	**6.0**	**5.9**	**4.8**	**6.7**	**5.4**	**5.7**	**5.3**	**-1.4**	**2.7**
Transport and communications	10.6	5.5	7.7	8.1	6.8	7.0	6.2	1.9	3.5
Trade, restaurants, and hotels	5.5	4.5	4.1	5.8	3.9	6.8	1.5	-10.4	1.4
Financial and real estate	4.3	7.6	4.7	5.9	5.0	5.1	1.7	3.3	3.7
Community and social services	4.8	6.2	3.6	7.6	6.6	4.0	13.1	1.7	2.2
GDP at factor cost	**2.9**	**5.7**	**5.0**	**3.3**	**4.5**	**6.1**	**4.7**	**-0.5**	**2.4**
Agricultural GDP	-0.3	3.8	4.4	0.9	2.8	4.9	5.5	2.2	2.1
Non-agricultural GDP	5.3	7.0	5.4	5.0	5.6	6.8	4.3	-2.1	2.5
Value of imputed banking servioes	12.0	11.0	1.5	8.4	6.9	9.4	8.3	0.1	5.1
Net indirect taxes	16.1	2.1	7.7	-0.9	4.5	7.8	6.4	-0.6	2.5
GDP at market prices	**3.5**	**5.3**	**5.3**	**2.9**	**4.5**	**6.1**	**4.8**	**-0.5**	**2.3**

Source: IMF.

Table 1.3: Nepal: Gross Domestic Product Deflators, 1994/95-2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
				(1994-95=100)					
Agriculture, Fisheries, and forestry	**100.0**	**109.1**	**117.3**	**120.3**	**137.7**	**143.9**	**142.0**	**147.3**	**152.8**
Industry	**100.0**	**105.5**	**111.1**	**114.7**	**119.4**	**123.5**	**128.4**	**133.4**	**137.2**
Mining and quarrying	100.0	106.3	110.9	113.8	119.0	122.6	124.4	131.4	136.2
Manufacturing	100.0	105.4	108.7	114.3	122.1	125.9	128.4	131.8	134.9
Electricity and water	100.0	105.4	128.3	131.6	131.6	147.6	158.7	164.0	169.5
Construction	100.0	105.5	111.0	113.1	115.5	118.5	124.4	130.6	134.2
Services	**100.0**	**108.0**	**116.7**	**123.7**	**131.6**	**138.9**	**146.8**	**150.2**	**155.5**
Trade, restaurants, and hotels	100.0	111.4	115.5	120.4	135.2	138.2	141.5	143.5	148.8
Transport and communications	100.0	107.7	121.5	131.5	134.2	149.3	159.6	163.4	168.8
Financial and real estate	100.0	106.4	117.4	121.6	129.1	136.6	151.4	154.5	159.1
Community and social services	100.0	105.8	114.0	124.2	128.0	134.0	138.9	142.8	148.6
GDP at factor cost	**100.0**	**107.9**	**115.7**	**120.3**	**131.1**	**137.1**	**140.7**	**145.3**	**150.3**
Agricultural GDP	100.0	109.1	117.3	120.3	137.7	143.9	142.0	147.3	152.8
Non-agricultural GDP	100.0	107.1	114.6	120.4	127.0	133.0	139.9	144.0	148.7
Value of imputed banking servioes	100.0	105.6	122.9	127.7	142.8	148.1	152.1	158.0	161.4
Net indirect taxes	100.0	106.2	114.5	121.9	132.1	136.8	153.7	157.9	163.2
GDP at market prices	**100.0**	**107.8**	**115.4**	**120.3**	**130.9**	**136.8**	**141.2**	**145.7**	**150.8**
				(Annual percentage change)					
Agriculture, Fisheries, and forestry		**8.5**	**7.8**	**2.5**	**14.4**	**4.5**	**-1.3**	**3.7**	**3.8**
Industry		**4.7**	**6.7**	**3.3**	**4.0**	**3.5**	**3.9**	**3.9**	**2.9**
Mining and quarrying		-11.4	15.4	2.6	4.6	3.1	1.4	5.7	3.7
Manufacturing		4.4	3.9	5.2	6.8	3.2	2.0	2.7	2.4
Electricity and water		3.4	25.0	2.6	0.0	12.2	7.5	3.4	3.3
Construction		5.5	6.6	1.9	2.2	2.5	5.0	5.0	2.8
Services		**8.5**	**6.2**	**6.0**	**6.4**	**5.5**	**5.7**	**2.3**	**3.5**
Transport and communications		7.7	11.8	8.3	2.1	11.3	6.9	2.4	3.3
Trade, restaurants, and hotels		16.3	-0.3	4.3	12.3	2.2	2.4	1.5	3.7
Financial and real estate		7.0	9.9	3.6	6.2	5.8	10.9	2.0	3.0
Community and social services		1.5	7.1	9.0	3.1	4.7	3.6	2.8	4.0
GDP at factor cost		**7.8**	**7.0**	**4.0**	**8.9**	**4.6**	**2.6**	**3.2**	**3.5**
Agricultural GDP	7.8	8.5	7.9	2.5	14.4	4.5	-1.3	3.7	3.8
Non-agricultural GDP	8.4	7.2	6.4	5.0	5.5	4.7	5.2	2.9	3.3
Value of imputed banking servioes		4.1	13.0	3.9	11.8	3.7	2.7	3.9	2.1
Net indirect taxes		6.3	7.8	6.5	8.4	3.5	12.4	2.7	3.4
GDP at market prices	**7.4**	**7.8**	**6.9**	**4.2**	**8.8**	**4.6**	**3.2**	**3.2**	**3.5**

Source: IMF.

Table 1.4: Nepal: Gross Domestic Product by Expenditure Components, 1994/95-2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
				(In billions of Nepalese rupees, at current prices)					
GDP at market prices	**219.2**	**248.9**	**280.5**	**300.8**	**342.0**	**379.5**	**410.3**	**421.3**	**446.2**
Consumption	**184.9**	**212.8**	**241.4**	**259.4**	**295.5**	**321.9**	**349.3**	**371.5**	**395.6**
Public	20.3	23.0	25.0	28.0	30.5	34.0	40.2	42.3	46.8
Private	164.6	189.8	216.4	231.4	264.9	287.9	309.1	329.2	348.8
Gross domestic investment	**55.2**	**68.0**	**71.1**	**74.7**	**70.1**	**92.3**	**98.3**	**103.6**	**116.3**
Gross fixed Investment	48.4	56.1	60.8	65.4	65.3	73.3	78.0	81.3	85.5
Public	15.1	17.6	19.4	22.6	23.9	26.4	31.3	32.0	31.5
Private	33.3	38.5	41.4	42.8	41.4	46.9	46.8	49.2	54.1
Change in stocks	6.9	11.9	10.3	9.4	4.8	18.9	20.3	22.4	30.8
Resource Balance	**-20.9**	**-31.9**	**-31.9**	**-33.3**	**-23.5**	**-34.7**	**-37.3**	**-53.8**	**-65.7**
Exports	54.7	56.8	73.9	68.7	78.2	88.4	91.8	67.7	65.2
Imports	75.7	88.7	105.8	101.9	101.6	123.1	129.1	121.5	130.9
				(Percentage share in nominal GDP)					
Consumption	**84.3**	**85.5**	**86.0**	**86.2**	**86.4**	**84.8**	**85.1**	**88.2**	**88.7**
Public	9.2	9.2	8.9	9.3	8.9	8.9	9.8	10.0	10.5
Private	75.1	76.2	77.1	76.9	77.5	75.9	75.3	78.1	78.2
Gross Domestic Investment	**25.2**	**27.3**	**25.3**	**24.8**	**20.5**	**24.3**	**24.0**	**24.6**	**26.1**
Gross fixed investment	22.1	22.5	21.7	21.7	19.1	19.3	19.0	19.3	19.2
Public	6.9	7.1	6.9	7.5	7.0	7.0	7.6	7.6	7.0
private	15.2	15.4	14.8	14.2	12.1	12.4	11.4	11.7	12.1
Change in stocks	3.1	4.8	3.7	3.1	1.4	5.0	4.9	5.3	6.9
Resource Balance	**-9.5**	**-12.8**	**-11.4**	**-11.1**	**-6.9**	**-9.1**	**-9.1**	**-12.8**	**-14.7**
Exports	25.0	22.8	26.3	22.8	22.8	23.3	22.4	16.1	14.6
Imports	34.5	35.6	37.7	33.9	29.7	32.4	31.5	28.8	29.3

Note: Exports and imports of goods and services reflect the revised coverage of the balance of payments

Source: IMF.

Table 1.5: Nepal: Savings and Investment, 1994/95-2000/01

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
	(In billions of Nepalese rupees, at current prices)								
Gross national savings	**44.9**	**47.1**	**60.8**	**65.4**	**65.3**	**73.3**	**78.0**	**103.6**	**116.3**
Public sector 1/	3.1	3.8	3.8	3.9	3.1	4.3	1.0	0.9	2.6
Private sector	41.8	43.3	48.8	52.9	64.0	71.0	81.8	55.2	45.9
Foreign Savings	0.0	0.0	7.9	8.5	-1.7	-1.9	-4.7	47.6	67.8
Gross domestic Investment	**55.2**	**68.0**	**71.1**	**74.7**	**70.1**	**92.3**	**98.3**	**103.6**	**116.3**
Gross fixed investment	48.4	56.1	60.8	65.4	65.3	73.3	78.0	81.3	85.5
Public sector	15.1	17.6	19.4	22.6	23.9	26.4	31.3	32.0	31.5
Private sector	33.3	38.5	41.4	42.8	41.4	46.9	46.8	49.2	54.1
Change in stocks	6.9	11.9	10.3	9.4	4.8	18.9	20.3	22.4	30.8
Saving-investment gap	**-10.3**	**-20.9**	**-10.3**	**-9.4**	**-4.8**	**-18.9**	**-20.3**	**0.0**	**0.0**
Public sector	-11.9	-13.8	-15.6	-18.7	-20.8	-22.1	-30.3	-31.1	-28.9
Private sector	8.5	4.8	7.4	10.1	22.6	24.1	35.0	5.9	-8.2
	(In percent of nominal GDP)								
Gross national savings	**20.5**	**18.9**	**21.7**	**21.7**	**19.1**	**19.3**	**19.0**	**24.6**	**26.1**
Public sector 1/	1.4	1.5	1.4	1.3	0.9	1.1	0.2	0.2	0.6
Private sector	19.1	17.4	17.4	17.6	18.7	18.7	19.9	13.1	10.3
Foreign Savings	0.0	0.0	2.8	2.8	-0.5	-0.5	-1.2	11.3	15.2
Gross domestic investment	**25.2**	**27.3**	**25.3**	**24.8**	**20.5**	**24.3**	**24.0**	**24.6**	**26.1**
Gross fixed investment	22.1	22.5	21.7	21.7	19.1	19.3	19.0	19.3	19.2
Public sector	6.9	7.1	6.9	7.5	7.0	7.0	7.6	7.6	7.0
Private sector	15.2	15.4	14.8	14.2	12.1	12.4	11.4	11.7	12.1
Change in stocks	3.1	4.8	3.7	3.1	1.4	5.0	4.9	5.3	6.9
Saving-investment gap	**-4.7**	**-8.4**	**-3.7**	**-3.1**	**-1.4**	**-5.0**	**-4.9**	**0.0**	**0.0**
Public sector	-5.4	-5.6	-5.6	-6.2	-6.1	-5.8	-7.4	-7.4	-6.5
Private sector	3.9	1.9	2.6	3.3	6.6	6.4	8.5	1.4	-1.8

Note: Defined as revenue less regular expenditure and estimated recurrent costs of development expenditure.

Source: IMF.

Table 1.6: Nepal: Social Indicators

	Latest single year			Same region/income group		
	1970-75	1980-85	1994-00	India	South Asia	Low income
Total population mid-year (millions)	13.1	16.2	23	1016	1,355	2,460
Growth rate (percent annual average)	2.0	2.1	2.4	1.8	1.9	2.0
Urban population (percent of population)	5.0	7.8	11.9	28.4	28.4	31.9
Total fertility rate (births per woman)	6.2	5.9	4.3	3.1	3.3	3.6
Total labor force (millions)	..	7	11	439	585	1,085
Females in labor force (percent)	..	39	40	32	33	38
Labor force participation rate	..	48	48	43	43	50
Poverty						
National headcount index	..	..	42	35	..	..
Urban headcount index	..	..	23	30.5	..	..
Rural Headcount index	..	..	44	36.7	..	..
Income						
GNP per capita (U.S. dollars)	120	170	240	450	440	410
Consumer price index (1995=100)	17	35	137	144	142	140
Food price index (1995=100)	..	33	144	137	..	..
Income/consumption distribution						
Gini index	..	..	36.7	37.8	..	..
Lowest quintile (percent of income or consumption)	..	..	7.6	8.1	..	..
Highest quintile (percent of income or consumption)	..	..	44.8	46.1	..	..
Public expenditure						
Health (percent of GDP)	..	..	1.3	0.8	0.9	1.2
Education (percent of GNP)	1.5	2.6	2.5	2.9	3.0	3.4
Social security and welfare (percent of GDP)	0.1	0.1	0.4	..	..	..
Net primary school enrollment rate (percent of age group)						
Total	..	60	78	77	77	86
Male	...	80	93	83	83	89
Female	..	37	63	71	70	82
Gross secondary school enrollment						
Total	12	27	32	49	..	..
Male	19	39	45	59	..	..
Female	4	14	18	39	..	..
Adult literacy (percent)	..	22	58	68	66	71
Female literacy	..	..	33	45	42	52
Access to safe water (percent of population)						
Total	8	24	81	88	87	76
Urban	85	79	85	92	92	88
Rural	5	20	80	86	85	70
Access to electricity (percent)	..	..	15	54	..	..
Population per physician	..	30,221	13,617	2,459	2,500	..
Population per hospital bed	..	5,719	4,308	1,503	1,429	1,152
Immunization rate (Percent under 12 months)						
Measles	..	34	73	50	53	57
DPT	..	32	76	55	57	57
Child malnutrition (percent under 5 years)	69	..	47	47	49	..
Life expectancy at birth (in years)						
Total	45	51	59	63	62	59
Male	46	52	59	62	62	58
Female	44	50	59	63	63	60
Mortality						
Infant (per thousand live births)	160	115	74	69	73	76
Under 5 (per thousand live births)	234	180	105	88	96	115
Adult(15-59)						
Male (per 1,000 population)	482	376	260	222	227	294
Female (per 1,000 population)	476	395	265	209	212	261
Maternal (per 100,000 live births)	..	..	830	440	..	..

Source: IMF.

Table 2.1(a): Nepal: Balance of Payments, 1995/96-2002/03
(in Millions of U.S. dollars)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
Exports, f.o.b.	**659**	**602**	**1160**	**856**	**763**	**971**	**942**	**754**	**633**
Merchandise exports	353	360	398	445	525	722	755	618	633
Re-exports	0	0	0	0	238	250	187	136	0
Imports, c.i.f.	**1277**	**1350**	**1750**	**1551**	**1390**	**1713**	**1773**	**1496**	**1630**
Trade balance	**-617**	**-748**	**-589**	**-695**	**-627**	**-742**	**-831**	**-742**	**-997**
Services (net)	**203**	**177**	**141**	**203**	**314**	**273**	**216**	**108**	**120**
Receipts	481	461	381	435	545	513	477	362	372
Payments	279	285	240	232	231	240	262	254	252
Private transfers (net)	**207**	**192**	**309**	**355**	**338**	**497**	**680**	**777**	**825**
Receipts	218	202	330	383	354	524	699	803	855
Recorded private transfers,	118	78	117	138	188	224	290	316	318
Estimated remittances	100	125	213	245	166	300	409	487	537
Payments	10	10	21	28	16	28	19	26	31
Current account balance (excluding grants)	**-207**	**-380**	**-139**	**-137**	**25**	**28**	**64**	**143**	**-53**
Official grants	107	137	102	88	137	133	108	143	161
Current account balance (Including grants)	**-100**	**-243**	**-38**	**-49**	**162**	**161**	**172**	**287**	**107**
Official capital grants and loans (net)	**283**	**144**	**170**	**430**	**248**	**237**	**181**	**236**	**78**
Official capital grants.	107	0	21	286	143	114	84	74	78
Official, capital (net)	176	144	149	144	105	123	97	162	
Loans	228	186	197	229	174	198	164	105	123
Amortization	52	52	48	44	47	53	61	66	73
Private (net)	0	0	0	22	29	4	-7	-1	-5
FDI	0	7	29	11	9	3	6	-4	-2
Private capital and errors and omissions	**-182**	**62**	**-95**	**-277**	**-315**	**-208**	**-320**	**-420**	**-137**
Overall balance	**1**	**-40**	**66**	**179**	**155**	**220**	**38**	**-25**	**92**
Memorandum items:									
Current account (excl. official transfers; percent of GDP)	-4.7	-8.4	-2.8	-2.8	0.5	0.5	1.2	2.6	-0.9
Current account (excluding gold)	-6	-9.1	-4.4	-3.6	0.1	0.2	2.2	2.6	-1
Current account (incl. official transfers; percent of GDP)	-2	-5.4	-0.8	-1.0	3.2	2.9	3.1	5.2	2
Gross foreign assets (eop; at period average rates)	869	805	870	973	1133	1347	1423	1371	1490
o/w: Central Bank	702	609	650	712	791	947	1020	1048	1177
(in months of imports of g&s)	5.4	3.7	4.4	5.3	4.9	5.6	7.0	6.7	6.9
Short-term debt as percent of gross foreign assets of NRE	7.4	16.0	27.2	28.0	28.1	26.1	21.8	18.9	18.3
Total external debt as a percent of GDP	n.a.	n.a.	50.5	52.7	53.7	51.8	49.9	52.9	52.2
Gross foreign assets of banking system as percent of rese	132.5	125.2	121.0	131.1	147.5	153.8	152.4	...	...
Debt service (in percent of exports of goods and services	6.3	6.8	4.8	4.7	5.1	4.8	6.1	7.5	7.4
and private transfer receipts)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NR/US dollar (period average)	50	55	57	62	68	69	74	76	78
NR/$ exchange rate (eop)	50	56	57	68	68	70	75	78	75
GDP at market prices (US$)	4401	4522	4919	4856	5034	5494	5582	5549	5738

Table 2.1(b): Nepal: Balance of Payments with India, 1995/96-2001/02
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Exports, f.o.b.	**309**	**553**	**855**	**423**	**557**	**540**	**512**
Merchandise exports	67	142	92	185	307	353	376
Re-exports	242	411	763	238	250	187	136
Imports, c.i.f.	**444**	**587**	**347**	**596**	**693**	**747**	**759**
Trade balance	**-135**	**-34**	**508**	**-173**	**-136**	**-207**	**-247**
Services (net)	**68**	**18**	**33**	**39**	**46**	**45**	**27**
Receipts	163	108	118	140	142	133	111
Payments	95	90	85	101	96	88	84
Private transfers (net)	**59**	**89**	**69**	**108**	**135**	**158**	**165**
Receipts	67	113	78	122	153	175	189
Recorded private transfers,	36	49	32	66	74	73	83
Estimated remittances	31	64	46	56	79	102	106
Payments	8	24	9	14	18	17	24
Current account balance (excluding grants)	**-9**	**73**	**411**	**-26**	**45**	**-4**	**-55**
Official grants	16	23	20	19	24	7	22
Current account balance (Including grants)	**7**	**96**	**431**	**-7**	**69**	**3**	**-33**
Official capital grants and loans (net)	**0**	**1**	**0**	**2**	**3**	**1**	**2**
Official capital grants.	0	1	0	2	3	1	2
Official, capital (net)	0	0	0	0	0	0	0
Loans	0	0	0	0	0	0	0
Amortization	0	0	0	0	0	0	0
Private capital Grants	0	0	0	0	0	0	0
Private capital and errors and omissions	**-15**	**-57**	**-369**	**-66**	**13**	**80**	**38**
Overall balance	**-8**	**40**	**62**	**-71**	**85**	**84**	**7**
Memorandum item:							
Current account balance (percent of GDP)	-0.2	1.5	8.3	-0.5	0.8	-0.1	-1.0

Source: IMF.

Table 2.1(c): Nepal: Balance of Payments with Third World, 1995/96-2001/02
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Exports, f.o.b.	**293**	**303**	**305**	**340**	**414**	**402**	**242**
Merchandise exports	293	303	305	340	414	402	242
Re-exports	0	0	0	0	0	0	0
Imports, c.i.f.	**906**	**964**	**1203**	**794**	**1020**	**1026**	**737**
Trade balance	**-613**	**-661**	**-898**	**-454**	**-606**	**-624**	**-495**
Services (net)	**99**	**187**	**107**	**274**	**227**	**171**	**80**
Receipts	298	328	263	405	371	344	250
Payments	199	141	156	131	144	173	170
Private transfers (net)	**134**	**266**	**241**	**230**	**362**	**522**	**613**
Receipts	136	270	253	232	371	524	614
Recorded private transfers,	42	89	85	122	150	217	233
Estimated remittances	94	181	168	110	221	307	381
Payments	2	4	12	2	9	2	1
Current account balance (excluding grants)	**-380**	**-208**	**-550**	**50**	**-17**	**69**	**198**
Official grants	121	96	73	118	125	87	121
Current account balance (Including grants)	**-259**	**-112**	**-477**	**168**	**108**	**156**	**319**
Official capital grants and loans (net)	**134**	**360**	**296**	**214**	**196**	**120**	**85**
Official capital grants.	0	215	147	109	73	17	46
Official, capital (net)	134	145	149	105	123	103	39
Loans	186	195	197	158	182	164	105
Amortization	52	51	48	53	59	61	66
Private capital Grants	0	39	0	32	26	65	22
Private capital and errors and omissions	**94**	**-151**	**179**	**-198**	**-206**	**-386**	**-465**
Overall balance	**-31**	**136**	**-2**	**216**	**124**	**-45**	**-39**
Memorandum item:							
Current account balance (percent of GDP)	-9.4	-4.3	-11.2	1.0	-0.3	1.2	3.6

Source: IMF.

Table 2.2(a): Nepal: Foreign Trade, 1995/96-2001/02
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Exports, f.o.b.	**601**	**856**	**1160**	**763**	**971**	**942**	**754**
Merchandise exports	**359**	**445**	**397**	**525**	**721**	**755**	**618**
Food and live animals	35	51	47	55	61	65	70
Tobacco and beverages	0	0	0	1	1	1	2
Crude materials and edibles	14	8	12	7	8	10	13
Animal and vegetable oil and fats	4	35	6	53	46	56	98
Chemicals and drugs	11	31	23	41	57	55	42
Manufactured goods, classified	189	188	194	199	230	257	224
Machinery and transport equipment	0	1	1	1	6	5	5
Miscellaneous manufactured articles	105	130	114	168	312	307	164
Commodities and transactions n.i.e. 1/	1	1	0	0	0	0	0
Re-exports	**242**	**411**	**763**	**238**	**250**	187	136
Imports, c.i.f.	**1351**	**1551**	**1750**	**1390**	**1713**	**1773**	**1496**
Food and live animals	87	79	95	112	157	81	92
Tobacco and beverages	9	13	10	13	13	12	11
Crude materials and edibles	88	112	96	92	101	102	89
Animal and vegetable oil and fats	101	267	126	227	273	357	305
Chemicals and drugs	51	33	41	49	64	76	102
Manufactured goods, classified	157	179	149	184	210	175	163
Machinery and transport equipment	510	526	784	377	498	558	424
Miscellaneous manufactured articles	277	270	242	266	297	312	245
Commodities and transactions n.i.e. 1/	69	64	70	63	97	98	63
	2	8	137	7	3	2	2
Memorandum items:							
Trade Balance (percent of GDP)	**-16.6**	**-14.3**	**-12.0**	**-12.4**	**-13.5**	**-14.9**	**-13.4**
Exports	13.3	17.6	23.6	15.2	17.6	16.9	13.6
Imports	29.9	32.0	35.6	27.6	31.2	31.8	27.0

Note: Includes classified exports and imports, and adjustments to reconcile figures with summary balance of payments data.

Source: IMF.

Table 2.2(b): Nepal: Foreign Trade with India, 1995/96-1999/00
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Exports, f.o.b.	**308**	**855**	**553**	**423**	**557**	**540**	**512**
Merchandise exports	**66**	**92**	**142**	**185**	**307**	**353**	**376**
Food and live animals	23	31	28	30	54	54	63
Tobacco and beverages	0	0	0	1	1	1	2
Crude materials and edibles	6	7	5	5	7	10	12
Animal and vegetable oil and fats	2	3	32	50	42	53	95
Chemicals and drugs	11	23	31	41	56	54	42
Manufactured goods, classified	22	27	41	48	81	121	131
Machinery and transport equipment	0	0	0	0	3	3	4
Miscellaneous manufactured articles	1	1	4	10	63	57	27
Commodities and transactions n.i.e. 1/	1	0	1	0	0	0	0
Re-exports	**242**	**763**	**411**	**238**	**250**	**187**	**136**
Imports, c.i.f.	**444**	**547**	**587**	**596**	**693**	**747**	**759**
Food and live animals	59	64	54	81	101	60	75
Tobacco and beverages	8	9	11	10	9	9	10
Crude materials and edibles	16	12	16	20	22	32	38
Animal and vegetable oil and fats	8	9	153	128	129	151	197
Chemicals and drugs	1	2	0	1	1	6	0
Manufactured goods, classified	64	71	85	81	91	90	69
Machinery and transport equipment	172	157	160	154	203	245	244
Miscellaneous manufactured articles	96	89	83	98	101	118	100
Commodities and transactions n.i.e. 1/	18	22	22	20	34	35	24
	2	112	3	3	2	2	2
Memorandum items:							
Trade Balance (percent of GDP)	**-3.0**	**6.3**	**-0.7**	**-3.4**	**-2.5**	**-3.7**	**-4.5**
Exports	6.8	17.4	11.4	8.4	10.1	9.7	9.2
Imports	9.8	11.1	12.1	11.8	12.6	13.4	13.7

Note: Includes classified exports and imports, and adjustments to reconcile figures with summary balance of payments data.

Source: IMF.

Table 2.2(c): Nepal: Foreign Trade with Third World, 1995/96-2001/02
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Exports, f.o.b.	**293**	**305**	**303**	**340**	**414**	**402**	**242**
Merchandise exports	**293**	**305**	**303**	**340**	**414**	**402**	**242**
Food and live animals	12	16	23	25	7	11	7
Tobacco and beverages	0	0	0	0	0	0	0
Crude materials and edibles	8	5	3	2	1	0	1
Animal and vegetable oil and fats	2	3	3	3	4	3	3
Chemicals and drugs	0	0	0	0	1	1	0
Manufactured goods, classified	167	167	147	151	149	136	93
Machinery and transport equipment	0	1	1	1	3	2	1
Miscellaneous manufactured articles	104	113	126	158	249	250	137
Commodities and transactions n.i.e. 1/	0	0	0	0	0	0	0
Re-exports	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Imports, c.i.f.	**907**	**1203**	**964**	**794**	**1020**	**1026**	**737**
Food and live animals	28	31	25	31	56	21	17
Tobacco and beverages	1	1	2	3	4	3	1
Crude materials and edibles	72	84	96	72	79	70	51
Animal and vegetable oil and fats	93	117	114	99	144	206	108
Chemicals and drugs	50	39	33	48	63	70	102
Manufactured goods, classified	93	78	94	103	119	85	94
Machinery and transport equipment	338	627	366	223	295	313	180
Miscellaneous manufactured articles	181	153	187	168	196	194	145
Commodities and transactions n.i.e. 1/	51	48	42	43	63	63	39
	0	25	5	4	1	0	0
Memorandum items:							
Trade Balance (percent of GDP)	**-13.6**	**-18.3**	**-13.6**	**-9.0**	**-11.0**	**-11.2**	**-8.9**
Exports	6.5	6.2	6.2	6.8	7.5	7.2	4.4
Imports	20.0	24.5	19.9	15.8	18.6	18.4	13.3

Note: Includes classified exports and imports, and adjustments to reconcile figures with summary balance of payments data.

Source: IMF.

Table 2.3: Nepal: Exports of Major Commodities, 1994/95 - 2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
				(In thousands of U.S. dollars)				
Carpets	154.5	147.9	155.7	137.0	144.3	142.5	116.4	80.8
Pashmina	n.a.	n.a.	n.a.	n.a.	n.a.	90.0	92.8	24.5
Ready-made garments	102.9	97.3	104.4	113.2	142.8	201.9	177.8	101.8
Hides and Skins	11.5	10.7	8.1	9.9	6.6	4.9	9.6	8.0
Jute goods	4.6	8.2	9.9	11.6	12.8	16.0	17.5	21.2
Pulses	9.2	12.0	19.2	17.1	17.6	15.3	16.5	15.8
Handicrafts	2.9	1.5	2.5	2.6	3.2	3.7	3.6	3.2
Cardamon	2.8	3.5	3.7	3.7	3.4	3.2	4.0	4.7
Catechu	0.1	0.5	1.0	1.1	1.7	2.9	2.0	2.3
Ghee	1.0	0.6	1.6	2.7	5.8	5.4	6.4	0.2
Mustard and linseed	1.3	1.0	0.6	0.2	0.3	0.4	0.5	0.1
Raw jute	1.7	0.6	0.1	0.1	0.0	0.0	1.5	0.1
Dried ginger	1.5	0.9	0.8	0.7	0.6	0.9	0.8	0.9
Herbs	1.0	0.9	1.2	1.1	0.6	1.1	1.3	1.2
Other Exports	58.1	74.5	89.2	119.4	185.5	238.4	304.1	264.7
of which: Vegitable Ghee	n.a.	n.a.	n.a.	25.5	46.3	39.7	48.2	91.6
Total Merchandise exports	353.2	360.0	396.9	444.6	525.3	721.7	754.8	618.4
				(Annual percentage change)				
Carpets		-4.3	5.2	-12.0	5.3	-1.2	-18.3	-30.6
Pashmina		n.a.	n.a.	n.a.	n.a.	n.a.	3.1	-73.6
Ready-made garments		-5.4	7.3	8.5	26.1	41.4	-11.9	-42.7
Hides and Skins		-6.9	-24.9	22.9	-33.1	-25.7	94.6	-16.4
Jute goods		77.4	20.7	17.5	10.0	24.7	9.7	21.0
Pulses		31.3	60.0	-11.2	3.2	-13.1	7.5	-3.9
Handicrafts		-49.0	68.3	3.3	25.8	13.2	-2.8	-11.6
Cardamon		28.1	3.4	0.5	-6.6	-6.0	25.1	15.1
Catechu		250.7	97.8	15.9	53.4	67.1	-29.6	12.5
Ghee and vegetable ghee		-36.0	146.2	70.8	114.0	-5.7	17.2	-97.4
Mustard and linseed		-25.6	-36.3	-75.2	85.0	49.8	21.0	-74.1
Raw jute		-65.3	-90.6	44.6	-100.0	..	..	-93.3
Dried ginger		-44.6	-4.7	-17.8	-9.7	42.3	-4.1	7.4
Herbs		-10.3	40.7	-15.0	-42.7	83.3	19.4	-6.2
Other Exports		28.3	19.6	33.9	55.3	28.5	27.6	-13.0
of which: Vegitable Ghee		n.a.	n.a.	n.a.	81.6	-14.2	21.4	90.0
Total Merchandise exports		1.9	10.2	12.0	18.2	37.4	4.6	-18.1
				(Share of total exports)				
Carpets	43.8	41.1	39.2	30.8	27.5	19.7	15.4	13.1
Pashmina	n.a.	n.a.	n.a.	n.a.	n.a.	12.5	12.3	4.0
Ready-made garments	29.1	27.0	26.3	25.5	27.2	28.0	23.6	16.5
Hides and Skins	3.3	3.0	2.0	2.2	1.3	0.7	1.3	1.3
Jute goods	1.3	2.3	2.5	2.6	2.4	2.2	2.3	3.4
Pulses	2.6	3.3	4.8	3.8	3.4	2.1	2.2	2.6
Handicrafts	0.8	0.4	0.6	0.6	0.6	0.5	0.5	0.5
Cardamon	0.8	1.0	0.9	0.8	0.7	0.4	0.5	0.8
Catechu	0.0	0.1	0.2	0.3	0.3	0.4	0.3	0.4
Ghee and vegetable ghee	0.3	0.2	0.4	0.6	1.1	0.8	0.8	0.0
Mustard and linseed	0.4	0.3	0.2	0.0	0.1	0.1	0.1	0.0
Raw jute	0.5	0.2	0.0	0.0	0.0	0.0	0.2	0.0
Dried ginger	0.4	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Herbs	0.3	0.2	0.3	0.2	0.1	0.2	0.2	0.2
Other Exports	16.4	20.7	22.5	26.9	35.3	33.0	40.3	42.8
of which: Vegitable Ghee	n.a.	n.a.	n.a.	5.7	8.8	5.5	6.4	14.8

Source: IMF.

Table 2.4(a): Nepal: Services and Current Transfers, 1995/96-2001/02
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Services and current transfers (net)	**496**	**679**	**541**	**788**	**903**	**990**	**1028**
Services (net)	**167**	**205**	**140**	**313**	**273**	**216**	**108**
Receipts	461	436	381	545	513	477	362
Freight and insurance	0	0	0	0	0	0	0
Transportation	64	67	60	56	64	56	33
Travel	172	160	150	179	175	159	113
Investment income	31	30	35	38	51	60	39
Compensation of employee	0	8	0	13	16	14	16
Government, n.i.e	88	99	70	191	128	102	116
Other	106	72	66	68	79	86	45
Payments	294	231	241	232	240	262	254
Freight and insurance	25	25	25	29	29	27	18
Transportation	34	34	27	36	43	45	45
Travel	146	85	105	77	69	75	75
Investment income	33	23	29	27	31	51	63
Compensation of employee	0	1	0	1	0	0	1
Government, n.i.e.	7	8	8	9	9	9	7
Other	49	55	47	53	59	54	45
Private current transfers (net)	**192**	**355**	**309**	**338**	**497**	**680**	**778**
Receipts	202	383	331	354	524	699	803
Privaft remittances	78	138	127	188	224	290	316
Indian excise refund	n.a.	n.a.	n.a.	19	19	19	22
Other estimated remittances	125	245	214	166	300	409	487
Payments	10	28	21	16	27	19	25
Official Current transfers (net)	**137**	**119**	**93**	**137**	**133**	**94**	**143**
Receipts	137	119	93	137	133	94	143
Payments	0	0	0	0	0	0	0

Source: IMF.

Table 2.4(b): Nepal: Services and Current Transfers with India, 1995/96-2001/02
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Services and current transfers (net)	**143**	**121**	**130**	**166**	**205**	**210**	**214**
Services (net)	**68**	**33**	**18**	**39**	**46**	**45**	**27**
Receipts	163	118	108	140	142	133	111
Freight and insurance	0	0	0	0	0	0	0
Transportation	12	11	10	11	16	10	6
Travel	98	62	56	53	55	47	37
Investment income	3	3	1	2	2	9	13
Compensation of employee	0	0	3	2	2	2	1
Government, n.i.e	1	1	0	47	35	36	30
Other	49	42	38	25	32	29	24
Payments	95	85	90	101	96	88	84
Freight and insurance	22	23	23	26	27	24	16
Transportation	3	3	2	2	5	4	7
Travel	43	35	37	43	33	32	34
Investment income	2	1	0	1	0	0	0
Compensation of employee	0	0	0	1	0	0	1
Government, n.i.e.	0	0	0	0	0	3	0
Other	25	23	28	28	31	25	26
Private current transfers (net)	**59**	**69**	**89**	**108**	**135**	**158**	**165**
Receipts	67	79	113	122	153	175	189
Privaft remittances	36	32	49	66	74	73	83
Indian excise refund	n.a.	n.a.	n.a.	19	19	19	22
Other estimated remittances	31	46	64	56	79	102	106
Payments	8	9	24	14	18	17	24
Official Current transfers (net)	**16**	**20**	**23**	**19**	**24**	**7**	**22**
Receipts	16	20	23	19	24	7	22
Payments	0	0	0	0	0	0	0

Source: IMF.

Table 2.4(c): Nepal: Services and Current Transfers with Third World, 1995/96-2001/02
(in Millions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Services and current transfers (net)	**353**	**420**	**549**	**622**	**698**	**780**	**814**
Services (net)	**99**	**107**	**187**	**274**	**227**	**171**	**81**
Receipts	298	263	328	405	371	344	251
Freight and insurance	0	0	0	0	0	0	0
Transportation	52	49	57	45	48	46	27
Travel	74	88	1.04	126	120	112	76
Investment income	28	32	29	36	49	51	26
Compensation of employee	0	0	5	11	14	12	15
Government, n.i.e	87	69	99	144	93	66	86
Other	57	25	34	43	47	57	21
Payments	199	156	141	131	144	174	170
Freight and insurance	3	2	2	3	2	3	2
Transportation	31	24	32	34	38	41	38
Travel	103	70	48	34	36	43	41
Investment income	31	28	23	26	31	51	63
Compensation of employee	0	0	1	0	0	0	0
Government, n.i.e.	7	8	8	9	9	6	7
Other	25	25	27	25	28	29	19
Private current transfers (net)	**133**	**240**	**266**	**230**	**362**	**522**	**613**
Receipts	135	252	270	232	371	524	614
Privaft remittances	42	95	89	122	150	217	233
Indian excise refund							
Other estimated remittances	94	168	181	110	221	307	381
Payments	2	12	4	2	9	2	1
Official Current transfers (net)	**121**	**73**	**96**	**118**	**109**	**87**	**121**
Receipts	121	73	96	118	109	87	121
Payments	0	0	0	0	0	0	0

Source: IMF.

Table 2.5: Nepal: Tourism Indicators, 1994-2002

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Tourist arrivals (in thousands)	325.6	363.4	393.6	421.9	463.7	491.5	463.0	362	216
(Percentage Change)	11.2	11.3	8.3	7.2	9.9	6.0	-5.8	-21.8	-26.7
Of which : Europe	135.2	137.7	139.8	143.4	157.8	171.6	166.3	137.8	..
India 2/	102.5	117.3	122.5	133.4	143.2	140.7	95.9	64.3	..
Japan	19.6	25.4	29.9	35.0	37.3	38.8	41.0	28.9	..
United States and Canada	26.1	29.7	30.6	36.3	43.0	46.9	49.0	39.1	..
Average days of stay	10.0	11.3	13.5	10.5	10.8	12.8	12.0	12	12
Per capita expenditure									
(In Nrs) 2/	14,400	24,617	24,344	23,226	31,282	32,550	32163.0	34345	..
(In US. dollars) 3/	394	474	430	402	476	479	454.0	467.3	..
(Percentage Change)	16.9	20.5	-9.3	-6.6	18.4	0.6	-5.9	2.9	..
									..
Hotel-bed capacity	17,730	21,807	25,638	27,612	28,878	32,214	34958.0	36163	..
(Percentage Change)	41.3	23.0	17.6	7.7	4.6	11.6	8.5	3.5	..

Notes:
1/ Estimated.
2/ By air only.
3/ Excluding Indian tourists.

Source: IMF.

Table 2.6: Nepal: Average Customs Duty by Main Category of Goods, 1999/2000 - 2001-02 1/

Chapter Numbers	Main Category of Goods	1999/00	2001/02
1-10	Live animals	5.0	10.5
11-20	Grains, vegetable extracts, sugars	15.6	16.7
21-30	Beverage, tobacco, mineral fuels, pharmaceuticals	11.7	13.6
31-40	Fertilizers, cosmetics, soaps, chemicals, plastics	15.3	20.6
41-50	Raw hides, skins, wood, paper, silk	10.9	11.7
51-W	wool, cotton, man-made fibres, carpets	13.2	11.2
61-70	Clothing. footwear, ceramics, glassware, stoneware	21.1	20.1
71-80	Iron, steel copper, nickel, aluminum, lead, zinc, tin	12.9	12.9
81-90	Tools, machinery, vehicles, aircrafts	11.9	11.9
91-97	Clocks, musical instruments, arms, furniture, art	20.6	21.1
	Total number of items	5,198	5,321
	Sum of duties	68,310	76,441
	Average customs duty	13.1	14.4

Notes:
1/ Harmonized System Classification; Average of customs duties for all item in each chapter.

Source: IMF.

Table 3.1. Nepal: External Debt and Debt Service, 1994/95-2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
				(In millions of US. dollars)				
Debt outstanding 1/	**2,295**	**2,370**	**2,482**	**2,561**	**2,702**	**2,848**	**2,786**	**2,933**
Total Medium and Long-term	**2,295**	**2,320**	**2,361**	**2,414**	**2,532**	**2,662**	**2,630**	**2,808**
Multilateral	**1,842**	**1,940**	**1,983**	**2,090**	**2,169**	**2,244**	**2,251**	**2,394**
AsDB	698	757	802	910	948	1012	1043	1132
EEC	10	9	8	8	7	6	6	6
IDA	1002	1052	1059	1080	1107	1123	1102	1156
IFAD	58	57	57	44	58	57	55	57
IMF 2/	55	43	34	25	21	15	10	7
NDF	8	11	16	18	20	20	19	20
OPEC	12	10	7	6	9	11	16	16
Bilateral 2/	**453**	**380**	**378**	**324**	**363**	**418**	**379**	**414**
Austria	0	6	5	5	4	6	5	5
Belgium	9	8	7	6	6	5	4	8
Finland	0	0	6	6	6	7	6	6
France	51	53	51	52	48	45	40	44
Korea	0	0	0	2	10	10	9	10
Kuwait	16	15	13	12	11	10	8	8
OECF	370	291	286	229	264	309	291	317
Saudi Fund	8	7	10	13	14	26	16	16
Short-term debt 3/	**...**	**50**	**121**	**147**	**170**	**186**	**156**	**125**
Total debt service	**82**	**84**	**84**	**86**	**84**	**83**	**98**	**132**
Amortization 4/	59	60	55	62	59	57	69	81
Of which : To IMF 5/	7	8	7	7	7	6	5	4
Interest 4/	23	24	28	24	25	26	29	51
Of which : To IMF	0.2	0.2	0.7	0.7	0.7	0.4	0.4	0.4
				(in percent)				
Debt service ratio 6/	**6.3**	**6.8**	**4.8**	**4.7**	**5.0**	**4.7**	**6.1**	**7.5**
Of which : To IMF	0.6	0.7	0.5	0.5	0.3	0.2	0.2	0.4
Outstanding debt/GDP	**52.1**	**52.4**	**50.5**	**52.8**	**53.7**	**51.8**	**49.9**	**52.9**
Of which: To IMF	1.3	1.0	0.7	0.5	0.4	0.3	0.2	0.1

1/ Consists primarily of medium- and long-tem public and publicly guaranteed debt excluding foreign liabilities of the banking system other than liabilities to the IMF.
2/ Amounts less than US$1 million were owed to Russia, United States and Australia in various years.
3/ Includes outstanding trade credits and amortization due in the following year.
4/ Includes principal and interest repayments of public enterprises and some private entities, as well as the central government.
5/ Excluding IMF trust fund.
6/ In percent of exports of goods and services (excluding re-exports) and private transfers.

Source: IMF.

Table 3.2: Nepal: Gross International Reserves, 1994/95-2001/02 1/

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
FOREIGN EXCHANGE RESERVES								
	(In millions of U.S. dollars, end of period)							
Nepal Rastra Bank (NRB)	**694**	**594**	**636**	**702**	**781**	**932**	**1007**	**1035**
Convertible	568	488	475	533	709	772	710	727
Nonconvertible	126	106	161	169	72	160	297	308
Commercial banks	**169**	**197**	**219**	**262**	**345**	**401**	**402**	**323**
Convertible	156	187	203	246	304	369	364	303
Nonconvertible	13	10	16	16	41	32	38	20
Total	**863**	**791**	**855**	**964**	**1126**	**1333**	**1409**	**1358**
Convertible	724	675	678	779	1013	1141	1074	1030
Nonconvertible	139	116	177	185	113	192	335	328
Other gross foreign assets of NRB	15	15	15	14	14	14	14	14
SDR holdings	0	0	0	0	0	0	0	0
Gold 2/	6	6	6	6	6	6	6	6
Reserve tranche position	9	9	9	8	8	8	7	8
Total gross foreign assets of NRB	**709**	**609**	**651**	**716**	**795**	**946**	**1021**	**1049**
Nepal Rastra Bank	(In months of imports of goods and services)							
Gross foreign assets	5.2	3.7	4.4	5.3	4.9	5.6	7.0	6.7

Notes:
1/ Totals differ from monetary sector figures owing to valuation effects.
2/ Valued at historical prices.

Source: IMF.

Table 4.1: Nepal: Summary of Central Government Operations, 1994/95-2002/03 1/

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
				(In billions of Nepalese rupees)					
Total revenue and grants	**26.9**	**31.6**	**35.5**	**37.1**	**39.3**	**46.4**	**53.6**	**54.4**	**64.3**
Total revenue	22.9	26.9	29.5	31.7	35.0	40.7	46.8	48.6	54.7
Tax revenue	19.2	21.7	24.4	25.9	28.8	33.2	38.9	39.3	42.0
Nontax revenue	3.7	5.1	5.1	5.8	6.5	7.6	8.0	9.2	12.7
Grants	3.9	4.8	6.0	5.4	4.3	5.7	6.8	5.8	9.6
Total expenditure	**35.0**	**43.7**	**46.4**	**50.5**	**52.8**	**59.8**	**72.1**	**72.6**	**72.7**
Regular expenditure	15.2	18.7	20.7	27.7	31.9	36.5	45.8	48.7	51.6
Development expenditure	19.8	25.0	25.7	22.9	20.8	23.3	26.3	23.9	21.1
Overall balance before grants	**-12.1**	**-16.9**	**-16.9**	**-18.8**	**-17.7**	**-19.0**	**-25.3**	**-24.0**	**-18.0**
Overall balance after grants	**-8.2**	**-12.0**	**-10.9**	**-13.4**	**-13.4**	**-13.3**	**-18.5**	**-18.2**	**-8.4**
Financing	**8.2**	**12.0**	**10.9**	**13.4**	**13.4**	**13.3**	**18.5**	**18.2**	**8.4**
Net foreign loans	5.4	7.1	6.9	11.5	8.7	10.0	7.5	6.0	3.1
Gross disbursements	7.3	9.5	9.0	14.2	11.9	13.7	12.0	10.8	8.6
Amortization	1.9	2.4	2.1	2.7	3.2	3.7	4.5	4.8	5.5
Net domestic financing	2.8	5.0	4.0	1.9	4.7	3.4	11.0	12.2	5.3
Bank financing	1.3	2.2	2.0	2.7	2.4	5.5	7.2	4.0	10.1
Nonbank financing	1.5	2.9	2.0	-0.8	2.4	-2.2	3.7	8.2	-4.8
				(In percent of GDP)					
Total revenue and grants	**12.3**	**12.7**	**12.7**	**12.3**	**11.5**	**12.2**	**13.1**	**12.9**	**14.4**
Total revenue	10.4	10.8	10.5	10.5	10.2	10.7	11.4	11.5	12.3
Tax revenue	8.8	8.7	8.7	8.6	8.4	8.7	9.5	9.3	9.4
Nontax revenue	**1.7**	**2.0**	**1.8**	**1.9**	**1.9**	**2.0**	**1.9**	**2.2**	**2.8**
Grants	1.8	1.9	2.1	1.8	1.3	1.5	1.6	1.4	2.2
Total expenditure	**16.0**	**17.6**	**16.5**	**16.8**	**15.4**	**15.7**	**17.6**	**17.2**	**16.3**
Regular expenditure	6.9	7.5	7.4	9.2	9.3	9.6	11.2	11.6	11.6
Development expenditure	9.0	10.0	9.2	7.6	6.1	6.1	6.4	5.7	4.7
Overall balance before grants	**-5.5**	**-6.8**	**-6.0**	**-6.2**	**-5.2**	**-5.0**	**-6.2**	**-5.7**	**-4.0**
Overall balance after grants	-3.7	-4.8	-3.9	-4.5	-3.9	-3.5	-4.5	-4.3	-1.9
Financing	**3.7**	**4.8**	**3.9**	**4.5**	**3.9**	**3.5**	**4.5**	**4.3**	**1.9**
Net foreign loans	2.5	2.9	2.5	3.8	2.5	2.6	1.8	1.4	0.7
Gross disbursements	3.3	3.8	3.2	4.7	3.5	3.6	2.9	2.6	1.9
Amortization	0.9	1.0	0.7	0.9	0.9	1.0	**1.1**	**1.1**	**1.2**
Net domestic financing	1.3	2.0	1.4	0.6	1.4	0.9	2.7	2.9	1.2
Bank financing	0.6	0.9	0.7	0.9	0.7	1.5	1.8	0.9	2.3
Nonbank financing	0.7	1.2	0.7	-0.3	0.7	-0.6	0.9	1.9	-1.1
Memorandum item:									
Nominal GDP (Billions Nrs)	219.2	248.9	280.5	300.8	342.0	379.5	410.3	421.3	446.2

1/ Fiscal years start on July 16.
Source: IMF.

Table 4.2: Nepal: Central Government Revenue, 1995/96-2002/03

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
				(In billions of Nepalese rupees)				
Total revenue 1/	**26.8**	**29.5**	**31.7**	**35.0**	**40.7**	**46.8**	**48.6**	**54.7**
Tax revenue	**21.7**	**24.4**	**25.9**	**28.8**	**33.2**	**38.9**	**39.3**	**42.0**
Taxes on income and profits	3.3	4.1	4.9	6.2	7.4	9.1	8.9	7.8
Taxes on property	1.3	1.1	1.1	1.1	1.1	0.6	1.1	1.4
Registration and land revenue	1.1	1.0	1.0	1.0	1.0	0.6	1.1	1.4
Other property taxes	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Taxes on goods and services	9.8	10.9	11.4	11.9	13.8	16.6	16.6	18.7
VAT/Sales tax 2/	6.4	7.1	7.1	7.9	9.9	12.0	11.9	13.4
Excise taxes	1.9	2.3	2.9	3.0	3.1	3.8	3.8	4.7
Other 3/	1.4	1.5	1.4	1.1	0.8	0.8	0.9	0.6
Taxes on international trade	7.3	8.3	8.5	9.5	10.8	12.6	12.7	14.3
Import taxes	6.3	7.1	7.2	7.9	9.0	10.6	10.0	10.6
Indian excise refund	0.9	1.0	1.1	1.2	1.3	1.5	1.7	2.4
Export taxes	0.2	0.2	0.2	0.4	0.4	0.5	0.9	0.9
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4
Nontax revenue 1/	**5.1**	**5.1**	**5.8**	**6.3**	**7.6**	**8.0**	**9.2**	**12.7**
Charges, fees, fines, etc.	0.9	1.1	1.2	1.4	1.7	1.9	2.0	2.3
Sales of goods and services	0.0	1.0	1.3	1.0	1.1	1.2	1.1	1.3
Dividends	1.4	1.1	1.3	1.8	2.5	2.3	2.5	3.0
Royalty and,fixed asset sales	0.1	0.4	0.6	0.2	0.6	0.9	0.7	1.9
Interest receipts	1.7	1.4	1.2	1.7	1.6	1.4	1.2	0.9
Miscellaneous	0.0	0.1	0.1	0.1	0.1	0.1	1.6	3.2
				(In percent of GDP)				
Total revenue 1/	**10.8**	**10.5**	**10.5**	**10.2**	**10.7**	**11.4**	**11.5**	**12.3**
Tax revenue	**8.7**	**8.7**	**8.6**	**8.4**	**8.7**	**9.5**	**9.3**	**9.4**
Taxes on income and profits	1.3	1.5	1.6	1.8	2.0	2.2	2.1	1.7
Taxes on property	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on goods and services	0.5	0.4	0.4	0.3	0.3	0.2	0.3	0.3
VAT/Sales tax 2/	0.4	0.4	0.3	0.3	0.3	0.1	0.3	0.3
Excise taxes	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on international trade	3.9	3.9	3.8	3.5	3.6	4.0	3.9	4.2
Import taxes	2.6	2.5	2.4	2.3	2.6	2.9	2.8	3.0
Indian excise refund	0.8	0.8	1.0	0.9	0.8	0.9	0.9	1.1
Export taxes	0.6	0.5	0.5	0.3	0.2	0.2	0.2	0.1
Nontax revenue 1/	**2.9**	**3.0**	**2.8**	**2.8**	**2.8**	**3.1**	**3.0**	**3.2**
Charges, fees, fines, etc.	2.5	2.5	2.4	2.3	2.4	2.6	2.4	2.4
Sales of goods and services	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5
Dividends	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2
Royalty and,fixed asset sales	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Interest receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Miscellaneous	2.1	1.8	1.9	1.8	2.0	1.9	2.2	2.8
Memorandum Item:								
Nominal GDP (Billions of Nrs.)	248.9	280.5	300.8	342.0	379.5	410.3	421.3	446.2

1/ Adjusted by taking out of non-tax revenue the principal repayments from corporations (classified as negative capital spending).
2/ Sales tax prior to 1997/98.
3/ Includes taxes on entertainment hotel, contracts, and air flight. Air flight revenues are now mostly retained by the Civil Aviation Authority.

Source: IMF.

Table 4.3: Nepal: Central Government Expenditure by Economic Classification, 1995/96-2001/02

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
			(in billions of Nepalese rupees)				
Total expenditure	43.7	46.4	49.9	52.8	59.8	72.1	72.3
Current expenditure 1/	18.7	20.7	27.8	31.9	36.5	45.8	48.7
Goods and Services	..	..	20.8	23.7	26.5	35.4	37.9
Wages, salaries and benefits	..	..	16.5	18.1	19.8	28.5	29.9
Core civil service	..	..	6.9	7.1	7.7	11.3	10.0
Police salaries	..	..	2.3	2.6	2.8	4.1	5.0
Defense salaries	..	..	2.1	2.5	2.9	3.6	4.5
Teacher salaries	..	..	5.2	6.0	6.4	9.5	10.4
Retirement facilities	..	..	1.0	1.2	1.3	2.1	2.8
Other Goods and Services	..	..	3.4	4.4	5.5	4.9	5.2
Interest payments	3.9	4.1	3.8	4.1	4.8	4.7	5.8
Domestic debt	2.6	2.9	2.4	2.5	3.2	3.0	4.0
Foreign debt	1.3	0.0	1.3	1.5	1.6	1.7	1.8
Subsidies and transfers	1.7	1.8	3.2	4.1	5.1	5.7	5.0
Capital Expenditure 2/	25.0	25.7	19.0	19.0	19.4	21.2	20.9
Acquisition of fixed assets	..	..	12.5	13.3	13.1	14.4	13.8
Purchase of stocks	..	..	1.9	1.6	1.3	1.1	1.5
Capital transfers (grants)	..	..	4.6	4.2	4.9	5.6	5.6
Net Lending	..	..	3.2	1.8	3.9	5.1	2.9
Investment in loans	..	..	4.4	4.0	6.1	7.1	4.8
Less repayment of loans	..	..	1.2	2.2	2.2	2.1	1.9
Total expenditure	17.5	16.5	16.6	15.4	15.7	17.6	17.2
Current expenditure 1/	7.5	7.4	9.2	9.3	9.6	11.2	11.6
Goods and Services	..	..	6.9	6.9	7.0	8.6	9.0
Wages, salaries and benefits	..	..	5.5	5.3	5.2	6.9	7.1
Core civil service	..	..	2.3	2.1	2.0	2.8	2.4
Police salaries	..	..	0.8	0.8	0.7	1.0	1.2
Defense salaries	..	..	0.7	0.7	0.8	0.9	1.1
Teacher salaries	..	..	1.7	1.7	1.7	2.3	2.5
Retirement facilities	..	..	0.3	0.3	0.3	0.5	0.7
Other Goods and Services	..	..	1.1	1.3	1.4	1.2	1.2
Interest payments	1.5	1.5	1.2	1.2	1.3	1.1	1.4
Domestic debt	1.0	1.0	0.8	0.7	0.8	0.7	0.9
Foreign debt	0.5	0.0	0.4	0.5	0.4	0.4	0.4
Subsidies and transfers	0.7	0.7	1.0	1.2	1.3	1.4	1.2
Capital Expenditure 2/	10.0	9.1	6.3	5.6	5.1	5.2	5.0
Acquisition of fixed assets	..	..	4.2	3.9	3.5	3.5	3.3
Purchase of stocks	..	..	0.6	0.5	0.3	0.3	0.4
Capital transfers (grants)	..	..	1.5	1.2	1.3	1.4	1.3
Net Lending	..	..	1.1	0.5	1.0	1.2	0.7
Investment in loans	..	..	1.5	1.2	1.6	1.7	1.1
Less repayment of loans	..	..	0.4	0.7	0.6	0.5	0.4
Memorandum Item:							
Nominal GDP (Billions of Nrs.)	248.9	280.5	300.8	342.0	379.5	410.3	421.3

Notes:
1/ Current Expenditure adjusted by subtracting payment of amortization on domestic and foreign loans.
2/ Capital expenditure adjusted by adding net lending.

Source: IMF.

Table 4.4: Nepal: Central Government Expenditure by Functional Classification, 1995/96-2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
				(In billions of Nepalese rupees)				
Total expenditure		43.7	46.4	49.9	52.8	59.8	72.1	72.6
Current expenditure		18.7	20.7	23.2	26.5	29.3	37.1	44.1
Social services		5.3	5.9	7.1	7.9	8.9	10.7	13.5
Education		4.3	4.8	5.7	6.0	6.7	8.2	10.4
Health		0.8	1.0	1.0	1.1	1.3	1.5	2.1
Other		0.2	0.2	0.3	0.7	0.8	0.9	0.9
Economic services		1.7	1.9	2.0	2.3	2.4	2.5	3.0
Agriculture related		0.4	0.4	0.4	0.4	0.5	0.5	0.6
Forestry		0.5	0.5	0.5	0.7	0.8	0.8	1.0
Infrastructure		0.6	0.7	0.8	0.9	0.9	0.9	1.1
Other		0.2	0.3	0.3	0.3	0.3	2.6	3.7
Defense		2.1	2.4	2.6	3.0	3.5	3.8	5.8
Interest payments		3.9	4.1	3.8	4.1	4.8	4.7	5.8
General administration		3.1	3.5	3.9	4.5	5.5	8.0	11.0
Other		2.5	3.0	3.9	4.7	4.3	7.3	5.1
Development expenditure		25.0	25.7	26.7	26.4	30.4	35.0	28.5
Social services		7.6	8.3	10.7	9.7	12.2	12.9	10.5
Education		1.7	2.4	2.4	1.6	2.6	2.8	2.3
Health		0.9	1.6	2.7	1.7	2.1	2.0	1.6
Drinking water		1.1	1.3	1.7	1.9	2.4	2.4	2.0
Other		3.9	3.0	4.0	4.5	5.1	5.7	4.6
Economic services		17.4	17.4	15.9	16.7	18.2	22.1	18.0
Agriculture related		5.4	5.0	4.8	4.9	5.6	6.6	5.4
Infrastructure		10.4	10.9	10.8	11.4	11.4	12.8	10.4
Other		1.6	1.5	0.3	0.4	1.2	2.7	2.2
				(In percent of GDP)				
Total expenditure		17.6	16.5	16.6	15.4	15.7	17.6	17.2
Current Expenditure		7.5	7.4	7.7	7.7	7.7	9.0	10.5
Development Expenditure		10.0	9.2	8.9	7.7	8.0	8.5	6.8
Social services		5.2	5.1	5.9	5.1	5.6	5.7	5.7
Of which: Education		2.4	2.6	2.7	2.2	2.4	2.7	3.0
Health		0.7	0.9	1.3	0.8	0.9	0.9	0.9
Drinking water		0.4	0.5	0.6	0.6	0.6	0.6	0.5
Econornic services		7.7	6.9	6.0	5.6	5.4	6.0	5.0
Of which : Agriculture related		2.3	1.9	1.7	1.6	1.6	1.7	1.4
Infrastructure		4.4	4.1	3.9	3.6	3.2	3.3	2.7
Defense		0.9	0.8	0.9	0.9	0.9	0.9	1.4
Interest payments		1.6	1.5	1.2	1.2	1.3	1.1	1.4
General administration		1.3	1.3	1.3	1.3	1.4	2.0	2.6
Other		1.0	1.1	1.3	1.4	1.1	1.8	1.2
				(In percent of total expenditure)				
Total expenditure		100.0	100.0	100.0	100.0	100.0	100.0	100.0
Current Expenditure		42.8	44.7	46.6	50.1	49.1	51.4	60.7
Development Expenditure		57.2	55.3	53.4	49.9	50.9	48.6	39.3
Social services		29.5	30.6	35.6	33.2	35.3	32.7	33.0
Of which: Education		13.7	15.4	16.2	14.5	15.5	15.3	17.5
Health		3.9	5.6	7.5	5.3	5.8	4.9	5.1
Drinking water		2.5	2.9	3.4	3.6	4.1	3.3	2.7
Econornic services		43.8	41.5	36.0	36.0	34.6	34.2	28.9
Of which : Agriculture related		13.2	11.5	10.5	10.1	10.1	9.9	8.2
Infrastructure		25.2	25.0	23.3	23.2	20.5	19.0	15.8
Defense		4.9	5.1	5.2	5.7	5.8	5.3	8.0
Interest payments		8.9	8.8	7.5	7.7	8.1	6.5	8.0
General administration		7.2	7.6	7.9	8.6	9.1	11.1	15.1
Other		5.8	6.4	7.8	8.8	7.1	10.1	7.1
Memo Item								
Nominal GDP (Billions Nrs)	#	248.9	280.5	300.8	342.0	379.5	410.3	421.3

Source: IMF.

Table 5.1: Nepal: Monetary Survey, 1994/95-2002/03

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	Est. 2002/03
	(In billions of Nepalese rupees, end of period)								
Net foreign assets	37.09	37.70	40.19	55.57	65.03	80.47	87.80	88.42	92.05
Assets	43.86	45.27	49.37	66.11	77.61	94.86	106.19	107.00	111.47
Liabilities	6.78	7.57	9.18	10.54	12.58	14.39	18.39	18.58	19.42
Net domestic assets	43.90	54.95	63.53	70.89	87.77	105.65	126.66	135.57	150.15
Domestic credit	69.60	86.62	98.27	112.82	130.97	154.35	183.43	200.31	222.76
Public sector	23.83	26.85	28.18	29.82	32.62	36.40	46.99	58.60	61.57
Government (net)	22.60	24.89	26.58	28.76	31.06	34.59	44.77	55.52	58.67
Nonfinancial public enterprises	1.23	1.96	1.60	1.06	1.57	1.81	2.22	3.08	2.90
Private sector 1/	45.77	59.78	70.09	83.00	98.35	117.95	136.44	141.71	161.19
Other item (net)	-25.70	-31.67	-34.74	-41.93	-43.20	-48.70	-56.78	-64.74	-72.61
Broad money	80.98	92.66	103.72	126.46	152.80	186.12	214.45	223.99	242.20
Narrow money	32.99	36.50	38.46	45.16	51.06	60.98	70.58	77.16	81.42
Quasi-money	48.00	56.16	65.26	81.30	101.74	125.14	143.88	146.83	160.78
	(Annual percentage change)								
Net foreign assets,		1.7	6.6	38.3	17.0	23.7	9.8	4.0	4.1
Net domestic assets	30.8	25.2	15.6	11.6	23.8	20.4	18.9	16.9	10.8
Domestic credit	25.1	24.5	13.4	14.8	16.1	17.8	19.3	13.5	11.2
Public sector	4.5	12.6	5.0	5.8	9.4	11.6	28.0	12.7	5.1
Private sector 1/	39.4	30.6	17.3	18.4	18.5	19.9	16.5	13.8	13.7
Broad money	16.1	14.4	11.9	21.9	20.8	21.8	15.2	4.4	8.1
Narrow money	15.7	10.6	5.4	17.4	13.1	19.4	15.7	9.3	5.5
Quasi-money	16.3	17	16.2	24.6	25.1	23.0	15.0	2.1	9.5

1/ Include credit to financial public enterprises.

Source: IMF.

Table 5.2: Nepal: Structure of Interest Rates, 1994/95-2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Refinancing Facilities of Nepal								
Rastra Bank to commercial banks								
Export bills	11.0	11.0	11.0	9.0	9.0	6.5	6.5	2.0-4.5
Industrial Sector	11.0	11.0	11.0	9.0	9.0	7.5	7.5	3.0-5.5
Agricultural sector	11.0	11.0	11.0	9.0	9.0	6.5	6.7	4.5-5.5
Service sector	11.0	11.0	11.0	9.0	9.0	7.5	7.5	3.0-5.5
Commercial banks								
Savings deposits	7.0-8.0	7.5-8.0	7.3-&0	6.5-8.0	5.75-8.0	4.0-6.5	3.0-6.5	2.5-6.25
Time deposits								
3 months	5.0-7.5	6.75-8.0	6.75-9.0	5.0-8.0	4.0-7.5	4.0-6.0	2.5-6.0	2.0-5.25
6 Months	6.0-8.0	7.25-9.0	7.25-9.0	6.0-8.5	6.0-8.0	5.0-6.75	3.5-6.76	2.5-6.0
1 year	8.0-9.25	9.5-11.0	9.5-11.0	9.0-10.5	7.25-9.5	6.0-7.75	4.5-7.75	3.5-7.0
2 years	negotiable	negotiable	negotiable	9.5-12.0	7.25-10.25	5.75-8.5	4.25-8.5	3.25-8.0
Loans								
Industry	14.0-18.0	15.0-17.5	15.0-17.5	13.5-17.0	11.5-17.0	10.5-15.5	9.5-15.0	7.0-14.5
Agriculture	13.0-15.5	14.5-16.0	14.5-16.0	14.5-15.5	14.0-15.5	12.0-14.5	12.5-14.5	12.0-14.0
Services	17.0-18.0	18.0	18.0	18.0	18.0	7.5-17.0	7.5-16.0	7.0-15.5
Export bills	12.0-16.0	13.0-16.0	14.5-16.5	12.5-16.0	7.5-15.0	7.5-15.0	7.5-12.5	6.5-12.5
Commercial loans and overdrafts	12.0-19.0	14.5-20.0	14.5-20.0	13.5-20.0	10.0-19.0	9.0-18.0	9.0-18.0	2.0-4.26
Agricultural Development Bank of Nepal								
To cooperatives	12.0-15.0	12.0-15.0	12.0-15.0	13.0-16.0	13.0-16.0	11.0-12.0	11.0-12.0	10.0-12.0
To others	14.0-17.0	14.0-17.0	14.0-17.0	15.0-18.0	15.0-18.0	12.0-16.0	12.0-16.0	10.0-16.0
Nepal Industrial Development								
Corporation	15.0-16.0	15.0-16.0	15.0-18.0	15.5-18.0	15.5-18.0	15.5-18.0	15.5-18.0	13.5-14.5
Government securities								
National savings certificates	9.0-15.5	9.0-15.5	9.0-13.25	9.0-13.25	9.0-13.25	8.5-13.25	8.5-13.25	8.5-13.25
Treasury bills (3 month) 1/	7.4	10.9	10.2	3.5	2.3	5.3	4.3	3.8
Treasury bills (1 year)	...	...	9.0-12.0	5.9-7.3	4.7-7.0	5.5-7.3	5.1	5.2
Development bonds	3.0-10.5	3.0-12.0	3.0-12.0	3.0-12.0	3.0-12.0	3.0-10.5	3.0-10.5	3.0-8.0
25-year special bonds	3.0	3.0	3.0	3.0	3.0	..	..	..
20-year special bonds	3.0	5.0	5.0	5.0	5.0	5.0	5.0	5.1
Special loan	1.0-14.0	1.0-13.0	1.0-13.0	1.0-13.0	1.0-9.5	1.0-9.5	1.0-9.5	1.0-9.0

1/ Annual weighted average.

Source: IMF.

Table 5.3: Nepal: Non-Performing Loans of Public Enterprises, 1996/97-2001/02
(In millions of Nepalese rupees, end of period)

	1996/97			1999/00			2000/01			2001/02		
	Principal	Interest	Total	Principal	Interest	Total	Principal	Interest	Total	Principal	Interest	Total
Nepal Food Corporation	0	0	0	7	5	12	0	0	0	0	0	0
Nepal Transportation Corporation	19	13	32	19	27	46	0	0	0	19	69	88
Himal Cement Company	2	0	2	0	0	0	0	0	0	29	61	90
Bhaktapur Tile and Brick Corporation	3	2	4	2	3	5	3	4	7	16	21	37
Raghupati Jute Mill	10	137	147	0	0	0	0	0	0	0	0	0
Rice Exporting Companies	13	100	112	3	32	35	3	32	35	3	8	11
Cottage Industrial and Handicraft Emporium	93	87	179	0	136	136	0	136	136	3	136	139
National Trading Ltd.	0	0	0	1	0	1	0	0	0	0	0	0
Agricultural Tools Factory	0	31	31	137	8	145	0	0	0	0	0	0
Hetadua Leather Factory	2	18	19	2	28	30	2	33	35	2	34	36
Hetadua Clothes Factory	0	0	0	37	8	45	37	15	52	0	0	0
Total	**140**	**387**	**527**	**207**	**247**	**455**	**45**	**220**	**265**	**72**	**329**	**401**

Source: IMF.

Table 6.1: Nepal: Agricutural Production and Yield, 1995/96-2001/02

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
	(In thousands of metric tons)							(Percentage Change)						
Production of Major Crops														
Foodgrains	6,256	6,395	6,331	6,465	6,985	7,172	7,247	15.6	2.2	-1.0	2.1	8.0	2.7	1.0
Paddy	3,579	3,699	3,641	3,710	4,030	4,216	4,165	22.2	3.4	-1.6	1.9	8.6	4.6	-1.2
Wheat	1,013	1,056	1,001	1,086	1,184	1,158	1,258	10.8	4.2	-5.2	8.5	9.0	-2.2	8.6
Maize	1,331	1,312	1,367	1,346	1,445	1,484	1,511	4.6	-1.4	4.2	-1.5	7.4	2.7	1.8
Millet	292	289	285	291	295	283	283	9.0	-1.0	-1.4	2.1	1.4	-4.1	0.0
Barley	41	39	37	32	31	30	31	36.7	-4.9	-5.1	-13.5	-3.1	-3.2	3.3
Cash Crops	2,604	2,722	2,782	3,203	3,428	3,678	3,877	5.8	4.5	2.2	15.1	7.0	7.3	5.4
Sugarcane	1,569	1,622	1,718	1,972	2,103	2,212	2,248	4.5	3.4	5.9	14.8	6.6	5.2	1.6
Jute	15	14	15	16	15	16	17	36.4	-6.7	7.1	6.7	-6.3	6.7	6.3
Oilseeds	116	119	109	120	123	132	135	13.7	2.6	-8.4	10.1	2.5	7.3	2.3
Potato	898	962	935	1,091	1,183	1,314	1,473	6.9	7.1	-2.8	16.7	8.4	11.1	12.1
Tobacco	6	5	5	4	4	4	4	-14.3	-16.7	0.0	-20.0	0.0	0.0	0.0
Distribution of Fertilizer 1/	133	122	109	157	148	146	141	-24.4	-8.3	-10.7	67.0	23.6	-1.4	-3.4
	(in thousands of hectares)							(Percentage change)						
Area under cultivation. 2/														
Foodgrains	3,242	3,267	3,243	3,253	3,321	3,314	3,296	4.3	0.8	-0.7	0.3	2.1	-0.2	-0.5
Paddy	1,497	1511	1,506	1,514	1,551	1,560	1,517	5.3	0.9	-0.3	0.5	2.4	0.6	-2.8
Wheat	654	667	640	641	660	641	667	3.2	2.0	-4.0	0.2	3.0	-2.9	4.1
Maize	792	794	799	802	819	825	826	2.7	0.3	0.6	0.4	2.1	0.7	0.1
Millet	260	260	262	264	263	260	258	4.0	0.0	0.8	0.8	-0.4	-1.1	-0.8
Barley	39	35	36	32	28	28	28	25.8	-10.3	2.9	-11.1	-12.5	0.0	0.0
Cash Crops	353	356	361	379	390	391	398	8.6	0.8	1.4	5.0	2.9	0.3	1.8
Sugarcane	45	46	49	54	58	59	59	7.1	2.2	6.5	10.2	7.4	1.7	0.0
Jute	11	11	12	12	15	11	12	22.2	0.0	9.1	0.0	25.0	-26.7	9.1
Oilseeds	185	182	179	190	190	188	188	8.8	-1.6	-1.6	6.1	0.0	-1.1	0.0
Potato	106	111	116	118	123	129	135	9.3	4.7	4.5	1.7	4.2	4.9	4.7
Tobacco	6	6	5	5	4	4	4	-14.3	0.0	-16.7	0.0	-20.0	0.0	0.0
	(In metric tons/hectares)							(Percentage change)						
Yields														
Foodgrains	1.9	2.0	2.0	2.0	2.1	2.2	2.2	13.5	1.4	-0.3	1.8	5.8	4.6	0.0
Paddy	2.4	2.4	2.4	2.5	2.6	2.7	2.7	13.8	2.4	-1.2	1.4	6.0	3.9	0.0
Wheat	1.5	1.6	1.6	1.7	1.8	1.8	1.9	10.6	2.2	-1.2	8.3	5.9	0.3	5.6
Maize	1.7	1.7	1.7	1.7	1.8	1.8	1.8	-1.1	-1.7	3.5	-1.9	5.1	2.0	0.0
Millet	1.1	1.1	1.1	1.1	1.1	1.1	1.1	2.1	-1.0	-2.1	1.3	1.8	-1.9	0.0
Barley	1.1	1.1	1.0	1.0	1.1	1.1	1.1	5.1	6.0	-7.8	-2.7	10.7	-0.6	0.0
Cash crops	7.4	7.6	7.7	8.5	8.8	9.4	9.7	-2.9	3.7	0.8	9.7	4.0	6.9	3.2
Sugarcane	34.9	35.3	35.1	36.5	36.3	37.5	38.1	-2.3	1.1	-0.6	4.2	-0.7	3.4	1.6
Jute	1.4	1.3	1.3	1.3	1.0	1.5	1.4	4.9	-6.7	-1.8	6.7	-25.0	50.0	-6.7
Oilseed	0.6	0.7	0.6	0.6	0.6	0.7	0.7	4.5	4.3	-6.9	3.7	2.5	8.1	0.0
Potato	8.5	8.7	8.1	9.2	9.6	10.2	10.9	-2.6	2.3	-7.0	14.7	4.0	6.1	6.9
Tobacco	1.0	0.8	1.0	0.8	1.0	1.0	0.9	0.0	-16.7	20.0	-20.0	25.0	0.0	-10.0

Notes:
1/ Private sector has participated in fertilizer trading activity since November 1997.
2/ Areas cultivated with more than one crop are incuded under each crop.

Source: IMF.

Table 6.2: Nepal: Manufacturing Production Indices, 1997/98-2001/02

	Weights 1/	1997/98	1998/99	1999/00	2000/01	2001/02	1997/98	1998/99	1999/00
			(Indices 1996/97 = 100)					(percentage ch	
Overall production	100.0	103.4	108.9	116.1	120.1	112.2	3.4	5.3	6.6
Food	26.2	111.6	118.1	127.3	134.5	127.3	11.6	5.8	7.8
Of which: Sugar	3.5	104	110.2	142.7	119.4	95.6	4	6.0	29.5
Vegetable ghee	1.5	115.6	111.5	118.9	153.1	188.5	15.6	-3.5	6.6
Rice	2.0	124	131.4	125.7	131	148.3	24	6.0	-4.3
Soybean oil	0.8	115	131.1	133.5	146.3	165.3	15	14.0	1.8
Processed milk	3.0	108	111.2	114.5	124.1	135.8	8	3.0	3.0
Beverage	10.5	111.4	120.2	131.1	139.8	117.5	11.4	7.9	9.1
Tobacco	13.8	92.2	98.8	108	113.9	112.1	-7.8	7.2	9.3
Textile	22.4	103.3	107	107.1	99.1	71.5	3.3	3.6	0.1
of which: Cotton cloth	1.5	94	79.9	70.6	65.9	59	-6	-15.0	-11.6
Synthetic cloth	3.0	106	93.3	99.6	101.5	103.8	6	-12.0	6.8
Woolen carpet	16.7	102.9	111.2	109.7	99.3	61.9	2.9	8.1	-1.3
Jute Goods	1.2	114	116.3	135.1	130.9	139.6	14	2.0	16.2
Readymade garments	7.2	96	103.7	123.5	122.1	88.7	-4	8.0	19.1
Processed leather	1.0	109	111.2	108.1	134.6	121.8	9	2.0	-2.8
Wood products	1.2	99	95.6	93.3	91.4	99	-1	-3.4	-2.4
Paper	1.9	101	103	111.3	125.5	123.6	1	2.0	8.1
Other chemical products	6.8	98.6	105.5	114.5	130.7	148.6	-1.4	7.0	8.5
Rubber products	1.5	96	98	96.5	96.6	101.2	-4	2.1	-1.5
Plastic Products	1.9	105	111.3	110.6	148.6	178.6	5	6.0	-0.6
Nonmetallic mineral products	13.3	104.7	114.5	120.6	117.9	124.5	4.7	9.4	5.3
of which: Bricks	3.9	83	96.5	96.3	96.5	100.9	-17	16.3	-0.2
Cement	4.3	124.1	130.6	142.4	137.1	145.8	24.1	5.2	9.0
Iron and Steel Basic Industries	5.1	107.9	107.4	120.4	134.1	139.7	7.9	-0.5	12.1
Electrical Industrial Machinery Apparatus, appliances, etc.	1.8	113	116.4	121.0	146.4	151.5	13	3.0	4.0
Others	0.5	93.1	89.3	98.9	92.6	101.7	-6.9	-4.1	10.8

1/ Weights are based on the Census of Manufacturing Establishments (1996/97).

Source: IMF.

Table 6.3: Nepal: Energy Consumption, 1994/95-2001/02

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Traditional	6,268	6,403	6,540	6,681	6,824	6,997
Of which: Fuelwood	5,574	5,694	5,816	5,941	6,068	6,217
Commercial	691	768	811	1,044	1,088	1,169
Petroleum	554	625	661	709	734	758
Coal	60	61	61	236	253	290
Hydropower	77	83	89	99	108	121
Total	6,959	7,192	7,376	7,754	7,954	8,205
		(Annual percentage change)				
Traditional	1.3	2.2	2.1	2.2	2.1	2.5
Of which: Fuelwood.	0.9	2.2	2.1	2.1	2.1	2.5
Commercial	6.1	11.1	5.6	28.7	4.2	7.4
Petroleum	9.3	12.8	5.8	7.3	3.5	3.3
Coal	-16.7	1.7	0.0	286.9	7.2	14.6
Hydropower	6.9	7.8	7.2	11.2	9.1	12.0
Total	1.8	3.3	2.6	5.1	2.6	3.2

Source: IMF.

Table 6.4: Nepal: Changes in the Consumer Price Index, 1994/95-2001/02
(Annual percentage change)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Overall National Index	7.6	8.1	8.1	8.3	11.4	3.4	2.4	2.9
By commodity								
Food and beverage	7.3	8.9	8.2	7.8	16.2	0.4	-2.4	3.7
Foodgrains	7.9	8.5	9.1	3.2	18.6	8.6	-13.7	2.1
Milk and Milk products	1.3	10.9	12.0	7.7	9.5	3.7	5.7	1.2
Oil and Fats	11.1	13.2	2.5	8.3	29.0	-22.6	-4.7	8.3
Beverages	3.9	6.9	9.2	14.8	8.7	3.7	2.0	5.0
Vegetables and Fruits	5.0	3.7	3.7	16.6	19.9	-16.9	4.1	7.5
Other goods and semces	8.1	6.7	8.0	9.0	5.8	7.1	8.1	2.1
Cloth, clothing, and sewing services	10.1	7.2	7.8	6.9	6.0	4.7	2.2	2.5
Fuel, light and water	3.2	3.9	11.2	7.5	2.8	13.3	22.3	-0.9
Regional Indices								
Kathmandu	8.0	6.0	7.8	7.3	8.2	3.7	3.2	2.0
Terai	7.4	9.5	8.1	9.0	13.3	3.1	1.1	3.4
Hills	7.8	9.5	8.6	8.0	11.6	3.7	5.2	2.5

Source: IMF.

Table 6.5: Nepal: Monthly Wages in Major Sectors, 1994/95-2001/02

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
				(In Nepalese rupees)				
Agriculture								
Kathmandu	2,550	2,800	3,000	3,000	3,000	3,000	3,000	3,000
Birgunj	1,350	1,500	1,500	1,500	1,500	1,625	2,425	2,550
Biratnagar	1,350	1,350	1,350	1,350	1,487	1,500	1,500	1,500
Industry 1/								
Skilled	1,610	1,610	1,610	1,960	1,960	2,276	2,276	2,276
Unskilled	1,450	1,450	1,450	1,800	1,800	2,116	2,116	2,116
Construction 2/								
Skilled								
Kathmandu	5,100	5,350	5,550	5,700	5,700	5,700	6,000	6,300
Birgunj	2,820	3,300	3,300	3,375	3,913	4,050	4,313	4,500
Biratnagar	3,600	3,600	3,600	3,950	4,473	4,500	4,575	4,800
Semi-skilled								
Kathmandu	4,500	4,625	4,675	4,950	4,950	4,950	5,050	5,550
Biratnagar	3,000	3,000	3,000	3,250	3,875	3,900	3,975	4,200
Unskilled								
Kathmandu	2,700	2,950	3,000	3,000	3,000	3,000	3,112	3,450
Biratnagar	1,800	1,800	1,800	1,925	2,375	2,400	2,400	2,400
				(In U.S. dollars)				
Agriculture								
Kathmandu	51.2	50.7	52.6	48.5	43.8	42.2	40.6	39.0
Birgunj	27.1	27.2	26.3	24.3	21.9	22.8	32.8	33.2
Biratnagar	27.1	24.4	23.7	21.8	21.9	21.1	20.3	19.5
Industry 1/								
Skilled	32.3	29.2	29.2	31.7	28.6	32.0	30.8	29.6
Unskilled	29.1	26.3	25.4	29.1	26.3	29.8	28.7	27.5
Construction 2/								
Skilled								
Kathmandu	102.4	96.9	97.3	92.2	83.2	80.2	81.3	81.9
Birgunj	56.6	59.8	57.9	54.6	56.9	57.0	58.4	58.5
Biratnagar	72.3	65.2	63.1	62.3	65.3	63.3	62.0	62.4
Semi-skilled								
Kathmandu	90.4	83.8	82	80.1	72.3	69.6	68.4	72.2
Biratnagar	60.2	54.3	52.6	52.6	56.5	54.9	53.8	54.6
Unskilled								
Kathmandu	54.2	53.4	52.6	48.5	43.8	42.2	42.2	44.9
Biratnagar	36.1	32.6	31.6	31.1	34.7	33.8	32.5	31.2

Notes:

1/ Minimum monthly wage, including allowances, which are the same in Kathmandu, Birgunj and Biratnagar.

2/ Carpenters and masons.

Source: IMF.