

# Chapter 1

## Introduction

### 1.1. Objectives

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

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

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

### 1.2. Methodology

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

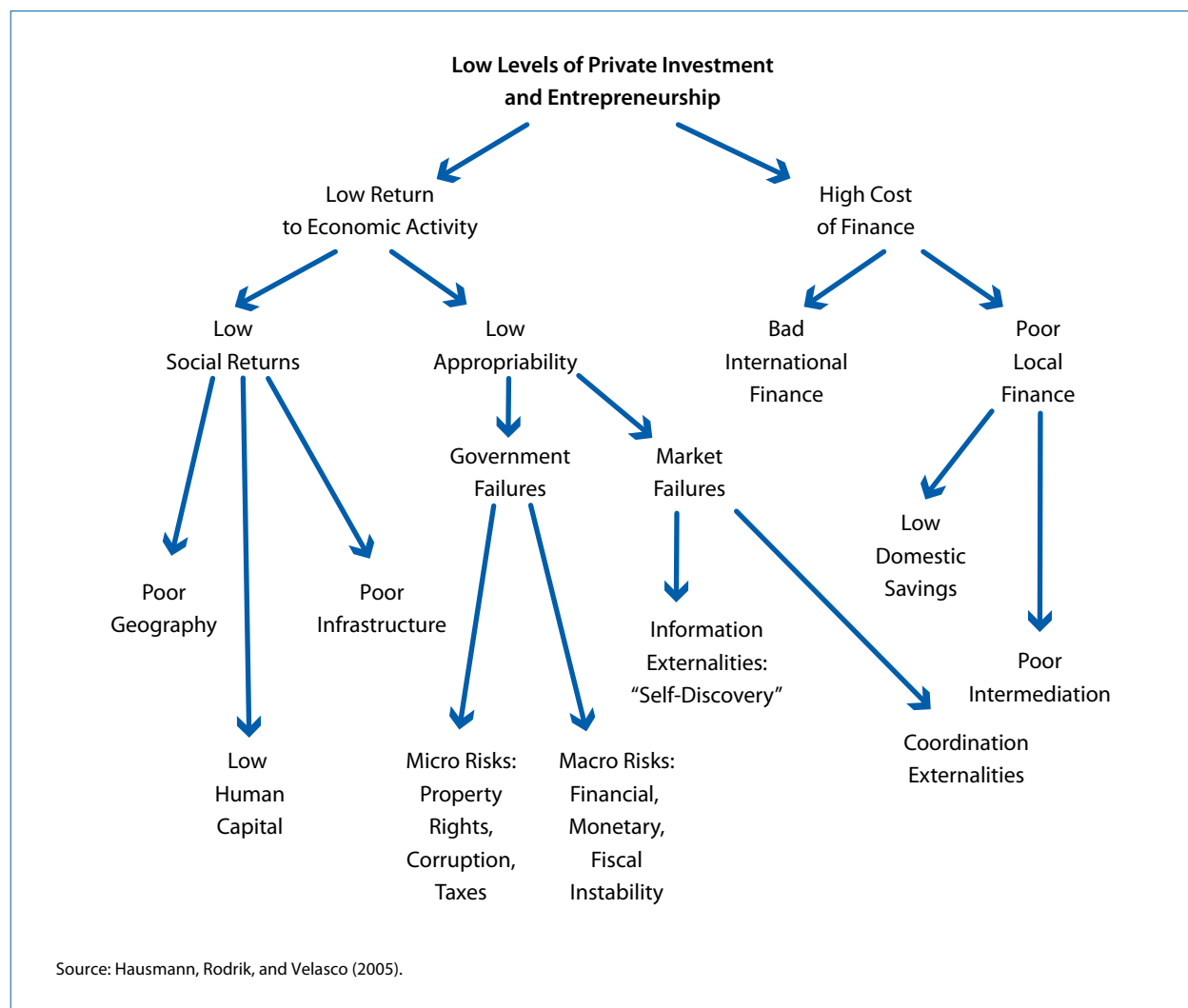
policy makers and development planners to use in formulating country-specific growth strategies. The application of growth diagnostics is one of the efforts in the search for new approaches to growth strategy after the Washington Consensus was questioned in recent years.

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

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

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

Figure 1.1. Growth Diagnostics Framework



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

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

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

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

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

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

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

### 1.3. Organization of the Study

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

Figure 1.2. Diagnostics Framework for Inclusiveness

