

Chapter 6

Conclusions and Policy Recommendations

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

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

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

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

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

6.1. Key Constraints to Accelerating Inclusive Economic Growth

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

Critical constraints to investment and growth are

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

Critical constraints to inclusiveness are

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

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

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

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

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

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

6.2. Policy Recommendations

6.2.1. Accelerating Economic Growth

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

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

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

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

Source: Bhaskaren (2009).

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

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

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

Strengthen Governance

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

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

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

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

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

Short Term (18 months)

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

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

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

Medium to Long Term (2–5 years)

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

Accelerate Infrastructure Development

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

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

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

Cross-Sectoral

Short Term (18 months)

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

Medium to Long Term (2–5 years)

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

Power

Short Term (18 months)

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

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

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

Medium Term (2–5 years)

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

Long Term (5–10 years)

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

Road Transport

Short Term (18 months)

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

Medium Term (2–5 years)

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

Long Term (5–10 years)

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

Irrigation

Short Term (18 months)

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

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

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

Medium Term (2–5 years)

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

Long Term (5–10 years)

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

Improve Industrial Relations and Make Labor Markets More Flexible

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

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

Short Term (18 months)

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

Medium and Long Term (2–10 years)

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

Support Expansion and Diversification of the Industrial Base

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

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

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

Short Term (18 months)

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

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

Medium and Long Term (2–10 years)

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

6.2.2. Promoting Social and Economic Inclusion

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

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

- providing key infrastructure and services to un- or under-served communities, attention is needed to
- (1) providing access to employment opportunities,
 - (2) providing expanded and more equitable access to education and training,
 - (3) improving access and entitlement to productive assets, and
 - (4) instituting more effective and better targeted social safety nets.

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

Access to Employment Opportunities

Short Term (18 months)

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

Medium and Long Term (2–10 years)

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

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

Access to Education

Short Term (18 months)

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

Medium and Long Term (2–10 years)

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

Access to Productive Assets— Land and Credit

Short Term (18 months)

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

Medium to Long Term (2–10 years)

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

Access to Safety Nets

Short Term (18 months)

- Evaluate the performance and effectiveness of the current safety nets, in line with work that has been started by the World Bank and funding agencies.
- Establish an effective and credible monitoring mechanism to track performance of the safety nets and to ensure effective use of resources.

Medium and Long Term (2–10 years)

- Ensure adequate safety net coverage, with at least a minimum level of food security, for the

most vulnerable populations.

- Shift from untargeted to well-targeted safety nets and programs, as far as practicable.
- Undertake information, education, and communication campaigns about available safety nets.

6.2.3. Creating Fiscal Space

The agenda to alleviate the key constraints discussed in the report is challenging, and the financial needs to carry out these reforms and programs are large. Much of the expenditures required to remove the constraints to accelerating inclusive economic growth have to be borne by the government and public sector institutions. And the government's development agenda in this regard is ambitious, and will require large public outlays for several years. Nepal is currently enjoying the goodwill of its development partners—aid commitments that have been received so far are substantial. But, to carry out the proposed program, much more aid will be needed in the future.

Creating fiscal space—increasing finance—will require focus on both revenue mobilization and improvements in allocative and operational efficiencies.

Revenue Mobilization

- Review the value-added tax, including the rate and exemptions, and the size of businesses that are required to collect value-added tax.
- Review the income tax, including tax rates, exemptions, and reporting mechanisms.
- Improve import tax collections by improving import valuation.
- Improve tax administration by computerizing tax records.
- Undertake business and life style surveys to identify and control tax evasion and collusion.

Improved Allocative and Operational Efficiencies

- Strengthen the public expenditure management framework and make it a basis for ensuring that development and recurrent budgets of priority projects and initiatives that promote inclusive growth are adequately funded (Box 6.2).
- Restructure or retire nonperforming and nonpriority initiatives and public enterprises.
- Regularly review priority projects to ascertain their efficiency.

Box 6.2. Managing the Budget and Public Expenditure Program—Key Steps

The following are key steps to managing the public expenditure:

- (1) Formulate a realistic 3-year resource framework, including revenue, likely aid disbursements, and domestic borrowing.
- (2) Estimate total expenditure commitments for 3 years—including current expenditure, debt service, and government-funded off-budget expenditures.
- (3) Formulate, for the coming 3 years, an annual sustainable capital and development expenditure program, with cash and non-cash requirements.
- (4) Rank all projects and programs in the capital and development expenditure program, using ranking criteria derived from the overall development strategy.
- (5) Allocate the capital and development budget for sectors and projects on the basis of priority rankings. Prepare work programs.
- (6) Release funds to projects and programs on the basis of priority.
- (7) Regularly report on and monitor all projects. Revive the poverty monitoring system.
- (8) Undertake mid-year budget reviews and readjust allocations for the rest of the fiscal year according to progress.
- (9) Annually review the performance of the budget, well before the new fiscal year; repeat steps 1–5 to form the basis of the budget for the next fiscal year.
- (10) Prepare a medium-term expenditure framework annually on a rolling basis for 3 years.

Source: Authors.

- Revive the medium-term expenditure framework process and introduce it at the sector level, starting with leading sectors such as education.

6.3. The Way Forward

These policy recommendations form a huge task. They are intended as a menu of options grounded in robust analysis that government and other stakeholders can use in developing an agenda for moving forward. The agenda must take account of practical and political constraints. This diagnosis can only make suggestions and recommendations; ultimately, the government and people of Nepal must judge which are most appropriate, given limited resources and multiple challenges. Above all, it is important that development partners do not seek to overload the government of Nepal and that account is taken of the still fragile political context.

Any discussion of the way forward will need to be informed by further analysis of the political economy, for example in agriculture and power, to explain more fundamentally why things are the way they are and what policy options might appeal sufficiently to different stakeholders before agreeing on future action. This will require further mapping of the institutions involved, understanding each stakeholder's interests and incentives and the potential drivers of change. Such work will also need to identify who is responsible for taking forward agreed actions and ensure that the actors have the support required to implement recommendations.

However, there is also a need to act fast. Inclusive growth and jobs are needed now to meet popular expectations and to provide stability in Nepal for the long term. The government consulted with a broad range of stakeholders on its National Development Strategy. This report aims to add to the discussions.

As part of a continuing dialogue it is hoped that the government will establish a new Nepal business forum, where government and the private sector can engage at a strategic level on priorities for improving the investment climate and creating jobs. It may be the best institutional home for diagnostic work; further work on the constraints to inclusive growth

in Nepal; and other related work, for example, the investment climate assessment and the survey on migration opportunities, both being carried out by the World Bank.

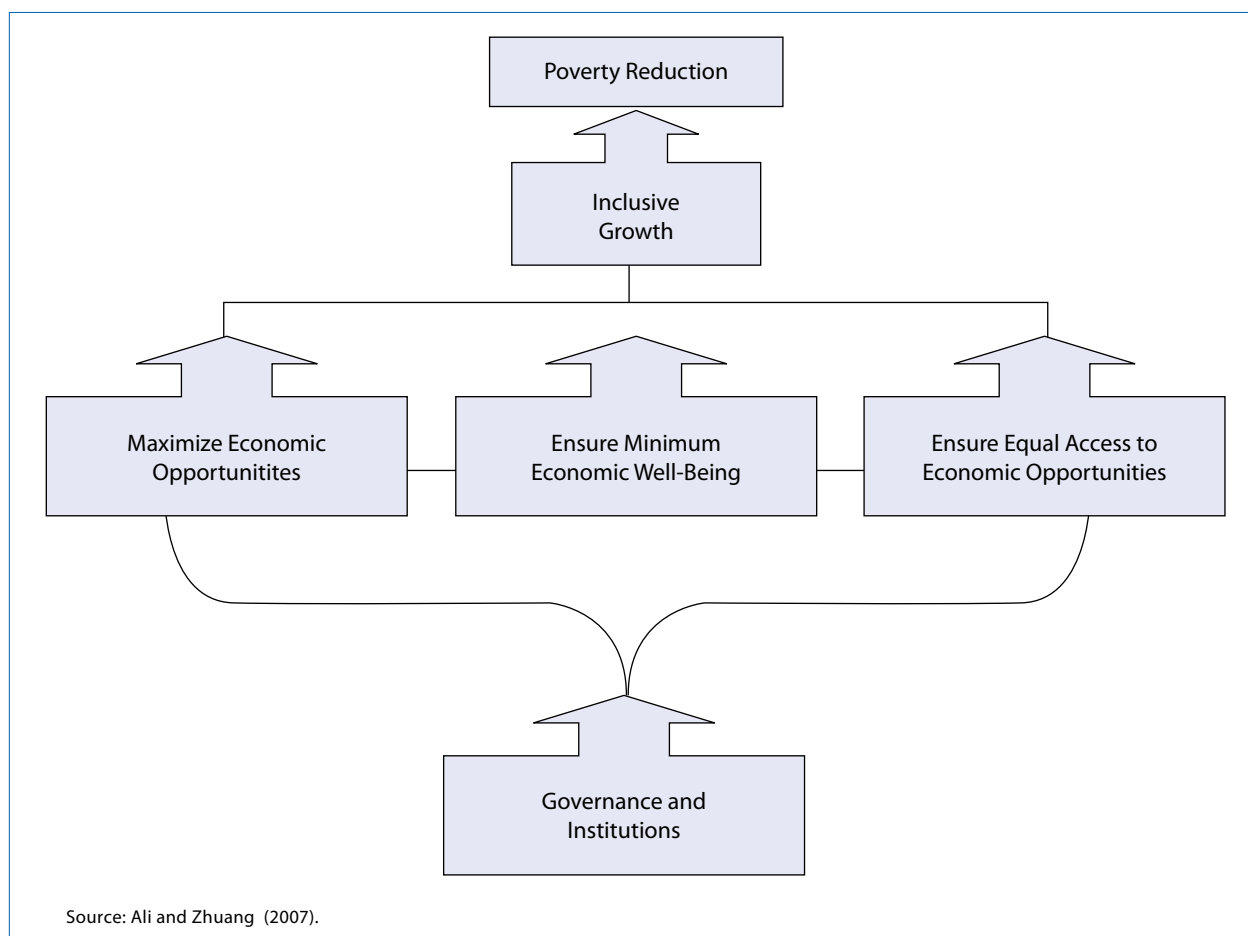
Work will be needed to ensure stakeholders with interests in particular sectors are able to engage in decision making during and after the Nepal Development Forum. This is a process the government will need to oversee. A Nepal business forum could also be a home for this process. The new Centre for Inclusive Growth being supported by the United Kingdom's Department for International Development (DFID) will also provide support in facilitating discussions and consensus building at national and regional levels.

Lessons from this diagnostic work and other research need to be communicated effectively to a wide group of stakeholders and the people of Nepal as a whole so that the debate on inclusive growth in Nepal can be enhanced. International evidence suggests that a broad national understanding and consensus is needed for high growth to be truly sustainable. This report is one step toward stimulating the wider debate and reaching that consensus. Ideally, an initial consensus should be reached and then included as part of the 11th Five Year Development Plan for Nepal, due to start in July 2010. This is an ambitious goal but its achievement would put the government, the private sector, and the people of Nepal on the path to faster inclusive growth and help to build the peaceful and prosperous country that all Nepalis deserve.

6.4. Conclusions

Nepal's government, in its Three Year Interim Plan 2007/08–2009/10, highlights its commitment to a prosperous, modern, and just Nepal, the achievement of which will require a strategy for inclusive growth (Ali and Zhuang 2007). The strategy will need to rest on maximizing economic opportunities through high and sustainable growth, ensuring that the population has equal access to the economic opportunities, and guaranteeing a minimum economic well-being for all through effective safety nets (Figure 6.1).

Figure 6.1. Three Pillars of Inclusive Growth



Expanding investments in human, physical, and technological capital—together with promoting market access and exports—raises productivity and creates economic opportunities. Such outcomes permit families to increase their investments in education, training, and health. Enhanced human capacities enable all members of the society, especially those from disadvantaged groups, to participate in and benefit from the growth process and to take responsibility for their own well-being. Nonetheless, some disadvantaged individuals will find it difficult to seize opportunities, and their welfare hinges greatly on social protection and safety nets that government provides. All these require an enlightened and active government and good governance.

To sum up, easing the critical constraints identified in this report can trigger a growth process conducive to eradicating poverty and reducing inequality in Nepal. The return of political

stability will help to strengthen governance, which is a prerequisite to regain investor confidence. Addressing the issue of inadequate infrastructure, particularly in electricity, irrigation, and transport, as well as the issues of poor industrial relations and labor market rigidities, will also improve the investment climate. Upgrading technology and expanding and diversifying manufacturing and exports by tackling market failures will also contribute to the more balanced and sustainable economic growth that generates productive employment opportunities. Finally, to ensure that high economic growth leads to significant reduction of poverty and inequality, growth has to be inclusive, with equitable access to economic opportunities and the benefits of growth shared by all members of Nepali society. To promote inclusiveness, the government must ensure equal access to basic services and provide adequate social safety nets for vulnerable groups.