Understanding
Reforms in Nepal

POLITICAL ECONOMY AND INSTITUTIONAL PERSPECTIVE

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ABOUT THE AUTHORS

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Preface

At a time when the world was entering into the twenty-first century, profound changes were underway in the sphere of economic policy making at both global and national levels. It was already established that an import substitution oriented development strategy implying a proactive role for the government could wreak disaster from the point of view of both sustained growth and poverty reduction. Many developing countries that had pursued such a strategy failed to overcome underdevelopment. Collapse of the socialist system in the former Soviet Union reinforced this. Similarly, predominance of neoclassical thinking in economic policy making was also threatened and put under constant scrutiny in the aftermath of the East Asian crisis of 1997 and failure of the Washington Consensus. In the meantime, the widening gap between the haves and have-nots in many poor countries was generating anger and resentment among the toiling masses of the world leading to world-wide anti-globalisation protests in general and denouncement of the existing practices and policies of the multilateral agencies in particular.

The economic miracle accomplished by the East and South East Asian nations in the post-independent period through private sector led and outward oriented growth and development had inspired many countries to follow a similar development model. The multilateral donor agencies were also prescribing a similar development paradigm for other developing countries through programmes aimed at economic stabilisation and structural adjustment from the beginning of the early 1970s in the aftermath of the first oil crisis. Economic liberalisation and globalisation was further accentuated in the developing countries with launching of the Enhanced Structural Adjustment Programme in the early 1990s. The process gained momentum after the establishment of WTO in 1995. However, the serious and unforeseen economic crisis in the East Asian countries and their contagion in 1997 compelled many development thinkers to review the development paradigm dominated by the neoclassical thinking. Failure of the Washington Consensus also underlined the need for such a review.

These developments compelled bringing back aspects of institutions and political economy in the orbit of economic reforms and their processes although, unlike in the past, on different footings and perspectives. It is worth noting that Gunnar Myrdal in his Asian Drama had very strongly advocated the necessity of adopting a broad institutional approach for the development of Asian countries. He had criticised the theories that were ignoring attitudes, cultures and institutions. Myrdal argued that opportunistic stances and political compromises of the ruling elites comprising powerful proprietor classes tended to perpetuate inequalities in the underdeveloped countries in order to remain in power were inimical for change. In recent years institutional economics has been advanced in the writings of Douglas North and others in which they argue that institutions are critical in improving economic performance as they determine the incentive structure and economic efficiency.

The new institutional approach advanced in recent years is radically different from both neoclassical economics and traditional development economics. Adherents of the former have implicitly assumed that institutions (economic as well as political) do not matter and that the static analysis embodied in allocative efficiency should be the guide to policy, that is, getting the price right by eliminating exchange and price controls. Similarly, development economists have treated the state as either exogenous or as a benevolent actor in development. Both these extreme lines of thinking have now been found to be deficient in addressing the complex processes of evolving policy reforms, in really helping to resolve economic crises, and in fostering socio-economic development. It is now increasingly recognised that a successful development policy internalizes the dynamics of economic change within the framework of analysis so as to ensure better attainment of the desired consequences. By the same token, the dynamic model of economic change incorporates as an integral part analysis of the polity since it is the polity that specifies and enforces rules.

Indeed, it was against this background that the concept of PRSP was advanced in the late 1990s by the World Bank and the IMF in which, unlike in the past, priority is given on internalisation of ownership of policies and programmes in the developing countries. The PRSP demands that a regular mechanism is developed for ex-ante poverty impact assessment of macroeconomic polices in order to ensure that the poor and other most vulnerable socio-economic groups of the society are not adversely affected in the reform process. This latter aspect is closely associated with both politics and economics. On the whole, the PRSP approach and MDGs demand building institutional and politico-economic issues in the policy making exercise if sustained growth and poverty reduction are to be accomplished within a stipulated timeframe. However, to what extent they are being operationalised at the practical level in countries like Nepal is yet to be verified and substantiated.

It has now been recognised that a well-run civil service and an efficient judiciary are pre-requisites for enhancing the efficiency of government institutions and ensuring better outcomes and delivery of economic reforms. Reforms are also considered necessary to ensure that government institutions do not take advantage of their monopoly position. For the same reason, studies advocate the necessity of restructuring public institutions particularly in the less developed countries for lowering transaction costs and enforcement of property rights and contracts, which are either nonexistent or weak, or poorly devised and implemented. In such countries, the state is either too weak to act as a guarantor of these rights or non-responsive to broader public interests. For a dynamic socio-economic transformation of the LDCs development of institutions is a necessity even though it may entail painful and socially contested decisions. This is again constrained by the preexisting power relations and structures that ultimately determine the behaviour of the political institutions. In many of these countries bad governance and exclusion of the majority of the people have often been manifested in violent social conflicts due mainly to the incapacity or malpractices of political institutions. In this way, the reform, unlike the neoclassical or orthodox thinking, is now considered to be broad-based and encompassing the whole gamut of market to state institutions, including the political ones. The processes followed in involving various stakeholders have been found to be decisive in the pattern, sequencing and speed of reform, which result in divergent implications on the economy in general, and various contending classes and socio-economic groups in particular.

This book is the outcome of a research undertaken at the Institute for Policy Research and Development following similar approaches advanced in recent years. In Nepal economic reforms were started in the mid-1980s and were intensified and augmented in the early 1990s immediately after the restoration of democracy in 1990. Because of the big bang approach followed in some areas during the course of reforms, Nepal now stands as one of the most liberalised countries in the South Asian region. In the aftermath of democracy accompanied by economic reforms, some noteworthy successes were made that continued especially up to the mid-1990s. However, at a time when the economy was picking up, both political instability and violent conflict started and got intensified undermining the reforms. Today, Nepal is at the crossroad facing a triangular confrontation. In addition to the crisis generated by the violent conflict, the king's recent undemocratic move has compounded the situation further. This move has stood in direct opposition to any peaceful solution of the violent conflict and against strengthening of the democratic system and processes. As the study has tried to seek answers to three questions, viz., why reform, what kind of reform, and how well did the reform perform, some of the underlying reasons for such a sorry state of affairs are identified in this book. We hope that this book, by-product of a research undertaken from a new perspective, will be useful to the academicians, researchers, university graduates, as well as development practitioners.

This book could not have been possible without financial and technical support from the Global Development Network (GDN). On behalf of the Institute and research team I would like to express our sincere gratitude to GDN. We are particularly grateful to Lyn Squire, President, GDN, and Gary J.R. McMahon, Chief Economist, GDN, for their constant support and help during the course of the study. Jose Maria Fanelli of the Center for the Study of State and Society of Argentina coordinated the global research on behalf of GDN. His comments and suggestions were immensely helpful in improving the quality of research. I express our sincere thanks to him. Earlier drafts of the report were presented at the Cairo and Delhi Conferences of GDN in 2003 and 2004, respectively. Comments made by Prof. Alka Basu of Cornell University and Dr. Isher Ahluwalia, member of the Governing Body of GDN, were particularly valuable. The interaction and discussion with Prof. Mariano Tommasi of University of San Andres, Argentina, were also equally very useful. Mr. Rajan Bhattarai contributed to the initial drafts on institutional aspects. On behalf of the study team I express our indebtedness to all of them. Dr. Devendra P. Chapagain, founder member of IPRAD, went through the painful job of reading the manuscript and editing it. We are grateful to him. Mr. Anil Belbase, computer expert of the Institute, performed the tedious job of typing the text umpteenth times. We are thankful to him. There were many institutions, individuals and experts within and outside the Institute who have contributed to the successful completion of the research, but it is not possible to mention all of them here. Nonetheless, I would like to record our appreciation of all of them. We sincerely hope that readers will inspire us for similar endeavours in future by providing valuable comments and suggestions.

Dilli Raj khanal
Study Team Coordinator, and
Chairman, IPRAD

September 2005

Acronyms

ADB	Asian Development Bank
ADB/N	Agriculture Development Bank Nepal
AGOA	Africa Growth and Opportunity Act
AIC	Agriculture Input Corporation
APP	Agriculture Perspective Plan
ASYCUDA	Automated System of Custom Data
B-O-O-T	Build Operate Own and Transfer
BOP	Balance of Payments
BOT	Build Operate and Transfer
BOVO	Build Our Village by Ourselves
CAAN	Civil Aviation Authority of Nepal
CBPASS	Commercial Bank Problem Analysis and Strategy Study
CBPTA	Caribbean Basin Trade Partnership
CBS	Central Bureau of Statistics
CBOs	Community Based Organisation
CIAA	Commission for Investigation of the Abuse of Authority
CIB	Credit Information Bureau
CLAC	Central Labor Advisory Committee
CNI	Confederation of Nepalese Industries
CPN (UML)	Communist Party of Nepal (United Marxist and Leninist)
CRR	Cash Reserve Requirement
DDC	District Development Committee
DFID	Department of International Development (United Kingdom)
DSC	Development Study Consultants
ERP	Effective Rate of Protection

ESAF	Enhanced Structural Adjustment Facility
ESP	Economic Stabilisation Programme
FNCCI	Federation of Nepalese Chamber of Commerce and Industry
FCGO	Financial Controller General Office
GDP	Gross Domestic Products
GFONT	General Federation of Nepalese Trade Union
HMG	His Majesty's Government
IBP	Intensive Banking Programme
ICD	Inland Container Depots
IDS	Integrated Development Studies
IFC	International Finance Corporation
IIDS	Institute of Integrated Development Studies
ILO	International Labour Organisation
IMF	International Monetary Fund
IPP	Industrial Perspective Plan
IPRAD	Institute for Policy Research and Development
ISI	Import Substituting Industry
LDCs	Least Developed Countries
LGP	Local Government Programme
LSMS	Living Standard Measurement Survey
MABP	Monetary Approach to Balance of Payment
MIGA	Multilateral Investment Guaranty Agency
MOA	Ministry of Agriculture
MOAC	Ministry of Agriculture and Cooperative
MOF	Ministry of Finance
MOPA	Ministry of Public Administration
MOPE	Ministry of Population and Environment
MP	Member of Parliament
MTEF	Medium Term Expenditure Framework
MT	Metric Ton
NBL	Nepal Bank Limited
NC	Nepali Congress
NCC	Nepal Chamber of Commerce
NDF	Nepal Development Forum
NEA	Nepal Electricity Authority
NEFAS	Nepal Foundation of Advanced Studies

NEPSE	Nepal Stock Exchange
NESAC	Nepal South Asia Centre
NGOs	Non Government Organisations
NIDC	Nepal Industrial Development Corporation
NLSS	National Living Standard Survey
NPA	Non Performing Assets
NPC	National Planning Commission
NRB	Nepal Rastra Bank (Central Bank of Nepal)
NTA	Nepal Telecommunication Authority
OAG	Office of the Auditor General
OGL	Open General Licensing
OMOs	Open Market Operations
PAC	Public Account Committee
PAN	Permanent Account Number
PCRW	Production Credit for Rural Women
PDDP	Participatory District Development Programme
PERC	Public Expenditure Review Commission
PEs	Public Enterprises
PRSP	Poverty Reduction Strategy Paper
RNAC	Royal Nepal Airlines Cooperation
RBB	Rastriya Banijya Bank
SAARC	South Asian Association of Regional Cooperation
SAF	Structural Adjustment Facility
SAFTA	South Asia Free Trade Arrangements
SAL	Structural Adjustment Loan
SAP	Structural Adjustment Programme
SAPL	Second Agricultural Programme Loan
SAPTA	South Asia Preferential Trading Arrangements
SEBO	Security Exchange Board
SEBON	Security Exchange Board of Nepal
SFDP	Small Farmers Development Programme
SOEs	State Owned Enterprises
STWs	Shallow Tube Wells
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organisation
USAID	United States Agency for International Development

VAT	Value Added Tax
VDC	Village Development Committee
WB	The World Bank
WECS	Water and Energy Commission Secretariat
WTO	World Trade Organisation

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chapter one
Introduction

1.1 Background

Nepal is one of the least developed countries in the world. It is sandwiched between India and China, the two fastest growing economies. It is landlocked. In terms of human development indicators, Nepal ranks 140 from the top and 38 from the bottom. The average citizen of Nepal earns US $ 230 per year. Culturally, Nepal is primarily a feudalistic society. Various forms of discriminatory practices perpetuated in the political, social and economic life of the people have constrained improvement in human development and people's livelihood. Agriculture predominates the national economy with two out of every three Nepalis deriving their livelihood from this sector. This sector contributes two-fifth of the total value added. Nepal is bestowed with extremely rich biodiversity in terms of plants, vegetations, flora and fauna, resulting from the diversity in altitude and climate. This represents a vast unrealised potential.

Nepal started late in modern development with the beginning of democracy in 1951. Ushering in of democracy heralded a new era of politico-economic awakening and realisation of the need for major reforms in the feudal agrarian structure in order to enhance people's access to land—the major productive resource—and equitable distribution of livelihood opportunities. During the period 1952-1959, Birta[1] and similar forms of land ownership were abolished to some extent. Entitlement to the tenancy right of the cultivator was introduced in 1964. The first national budget was prepared in 1952, coinciding with the beginning of foreign aid inflow in Nepal. Nepal's drive at planned development started in 1956 with the launching of the first five-year plan.

Like many other developing countries during those times, Nepal also pursued an inward looking and state-led development strategy. Consequently, a number of enterprises were established in the public sector. The most modern components of industry and trade sectors were controlled by the state through licensing and quotas. Industries were protected through high tariff walls. An overvalued exchange rate policy was supplemented by stringent foreign exchange regulations. In the agriculture sector, policies were introduced subsidising essential inputs such as seed, fertilizer and institutional credit. The state controlled distribution system was also simultaneously strengthened. Many state owned agricultural farms were established with a view to providing technologies and extension services to the farmers. A Co-operative bank was established that later became the Agricultural Development Bank providing concessionary loans to the farmers. This drive was further augmented by a priority sector-lending programme requiring commercial banks to invest a certain percentage of their total loan or deposit portfolio to the agriculture, cottage industries and services sectors. All such interventions led to a gradual expansion of an economic structure dominated by the public sector.

Politically, the country was governed by an autocratic party-less Panchayat system, introduced in 1960 following the royal coup d'etat against a nascent parliamentary form of government. Lack of accountability and transparency in governance led to rampant rent-seeking practices. Poverty and livelihood problems deepened further. As a result, the authoritarian regime encountered a series of political and social upheavals. In order to calm down the mass protest, a referendum was declared in 1979, granting people the right to choose between a reformed party-less Panchayat and multi-party democratic system. The officially declared outcome favoured continuation of the party-less regime by a narrow margin. Nevertheless, the party less system's fiscal profligacy reached its zenith in the aftermath of the referendum.

The unprecedented rise in the magnitude of budgetary deficit fuelled current account deficits. This resulted in huge BOP deficit precipitating a serious foreign exchange crisis. The country's BOP remained in the red for three consecutive years, in 1982/83 through 1984/85. This forced Nepal to negotiate a standby credit arrangement with the IMF. Accordingly, Nepal implemented an economic stabilisation programme in 1984/85. This was followed by the Structural Adjustment programme of IMF and the World Bank in 1986/87. These programmes comprised various market related reforms forcing Nepal to change its economic policy stance from being a largely state regulated to market-oriented one. As a first step, the Nepali currency was devalued by 14.7 percent on November 30, 1985. This was complemented by the introduction of some liberal policy measures in the areas of trade, industry and monetary field. In the agriculture sector, the state sponsored co-operatives were granted the mandate to sell inputs including fertilizer to the farmers. A policy of maintaining fertilizer prices close to prices prevailing in India was pursued.

As will be demonstrated later, moves toward economic liberalisation were unable to trigger any significant growth in the economy. In fact, these measures contributed to further widening the gap between a relatively small privileged class and the vast majority of the people. More importantly, the much needed reform in reorienting the feudal agrarian structure toward a more democratic, participatory and decentralised one was completely neglected and government policy remained insensitive to other reforms aimed at addressing the widespread poverty and unemployment. These policy insensitivities fuelled by a lopsided liberalisation drive resulted into the outburst of people's movement in 1990. The absence of political freedom galvanised mass uprising, which further deepened the magnitude of political crisis. This ultimately resulted into the advent of multiparty democracy in 1990 by overthrowing thirty year long autocratic Panchayati regime.

The democratic change of 1990 brought wide-ranging changes in the macroeconomic policy environment. The rising expectation of the people further fuelled by various commitments made by the political parties resulted into drastic reforms on the economic policy front. This was also a period following the breakdown of the Berlin Wall when call for economic liberalisation was sweeping across world. Economic liberalisation and privatisation policies were intensified from 1992 onward with the implementation of the Enhanced Structural Adjustment Facility (ESAF) programme. Given the open border and special trade relations with the southern neighbour, the speed and direction of reforms were also affected by the reform drive pursued in India. Since then reforms have either been continued or deepened in the modern economic sphere of trade, industry, finance, exchange rate, and monetary and fiscal policies. As a result, Nepal now stands as one of the most liberalised and open economies in the South Asian region. However, the general trends of the economy do not show positive outcomes commensurate with the pace of reforms. The overall growth rate is either low or decelerating. The head-count poverty level is still in the neighbourhood of 38 to 42 percent with very high intensity among majority of the underprivileged socio-economic groups. All these underscore the need for reviewing the whole gamut of reforms ranging from features, sequencing, processes and outcomes in terms of gains and losses to the various classes and groups of the society.

1.2 Rationale

A number of macro and micro level studies have already examined the features and outcome of reforms. Attempts have been made to gauge the efficacy of reforms and their underlying strengths and weaknesses[2]. However, these studies assess reforms either without taking into account the political economy and institutional perspective, or lack comprehensiveness because of their narrow focus on few specific areas of the economy. If recent developments and experiences of a number of countries pushing ahead with reform are any guide they indicate toward the necessity of evaluating the whole gamut of reforms including reforms in the structure of the state, political institutions as well as policy related aspects.

In the aftermath of the East Asian crisis and its contagion in the neighbouring countries of the region, institutions including the political ones have been recognised to have played a crucial role in the overall reform process. In this context, institutions are defined as rules, enforcement mechanisms, and organisations evolved and implemented overtime to foster better policy choices and promote development (World Bank, 2002). Economic historians argue that institutions contribute to stronger economic performance either by enhancing the incentive structure, or by promoting efficiency (North, 1990).

The new institutional approach advanced in recent years is radically different from the traditional development economics espoused by orthodox neo-classical paradigm. Generally, development economists have treated the state as either exogenous or as a benevolent actor in development. On the other hand, neo-classical economists assume that institutions (economic as well as political) matter less. Both these extreme lines of thinking have now been found to be deficient in addressing the complex processes of evolving policy reforms in really helping to resolve economic crisis and augment socio-economic development.

Recent studies suggest that market-based economies need institutions for protecting property rights, upholding the rule of law and controlling corruption, providing appropriate regulation, and counteracting the sources or consequences of factor and financial market failures. Market friendly institutions are supportive of macroeconomic stabilisation, social cohesion and stability, including guarding against extremes of poverty, reducing civil conflict, and mitigating the adverse consequences of economic dislocation and change (Rodrik, 1999, 2002; and Frankel, 2002). Two standard schools of thoughts have enriched supportive arguments for market-based economies. One school of thought is associated with the theory of imperfect information. This school advocates the underlying necessity of institutional arrangements and contracts (formal or informal) under the condition of asymmetric information faced by different classes and groups. Another is the theory of transaction costs that are closely linked to market institutions. In western societies complex institutional (legal and corporate) structures have evolved over time with a view to preventing overtly costly transactions, which result in larger-scale productivity gains and improved technology. These institutions include trademarks, limited liability, bankruptcy laws, formal contracts and guarantees. Such an institutional structure insulates property rights, which result in large corporate organisations with governance structures that limit problems of agency, and what Williamson (1985) has called ex-post opportunism (Bardhan et al, 1989, Hoff et al, 1993). These studies underline the necessity of examining reforms taking institutional factors into account.

A well-run civil service and an efficient judiciary are now recognised as pre-requisites for enhancing the efficiency of government institutions and ensuring better outcomes of reforms within the stipulated time frame. Reforms are also considered necessary to ensure that government institutions do not take advantage of their monopoly positions by providing sub-optimal level of services to the people. Therefore, studies indicate that public institutions need restructuring so as to provide incentives for efficient production and gains in productivity (World Bank, 2002; and UNDP, 2002). Moreover, in less-developed countries some of the institutional structures necessary for low transaction costs, and enforcement of property rights and contracts are either nonexistent or weak, or poorly devised and implemented. In such countries, the state is either too weak to act as a guarantor of these rights or non-responsive to broader public interest. For dynamic socio-economic transformation of the LDCs development of institutions is a necessity even though it may entail painful and socially contested decisions. This is again constrained by preexisting power relations and structures that ultimately determine the behaviour of the political institutions. Therefore, in the best interest of these countries motivation, strength and capacity of political institutions to deliver public goods and maintain coordination among different interest groups and classes becomes critically important (Bardhan, 2001 and Khan, 2002). In developing countries the need for a comprehensive reform of political institutions is often neglected. This poses big challenges. In many countries bad governance and exclusion of majority of the people have often manifested in violent social conflicts due mainly to incapacity or malpractices of political institutions (Tommasi, 2002; and Ruis, A. and Walle N. van del, 2003). In this way, the reform, unlike the neoclassical or orthodox thinking, is now considered to be broad based and encompassing the whole gamut of market to state institutions including the political ones. The processes followed in involving various stakeholders have been found to be decisive in the pattern, sequencing and speed of reform, which result in divergent implications on the economy in general and various contending classes and socio-economic groups in particular.

So far a definite and uniform view has not yet evolved in relation to features, direction, sequencing and speed of reforms. Some advocate gradualism in reforms (Stiglitz, 2002) and some others advocate radicalism (Klaus, 2002). Trade liberalisation and financial market deregulation were the hallmark of the southern cone reform attempts of the seventies (Fanelli et al, 2003) whereas in the early 1980s, under the aegis of the World Bank (WB) a consensus of sorts was developed on the sequencing and speed of reform to include the following elements:

1. trade liberalisation should be gradual and buttressed with substantial foreign aid,
2. an effort should be made to minimize the unemployment consequences of reform,
3. in countries with very high inflation, fiscal imbalances should be dealt with very early in the reform process,
4. financial reform requires the creation of modern supervisory and regulatory agencies, and
5. the capital account should be liberalised at the very end of the process, only after the economy is capable enough to expand its export successfully (Edwards, 2002).

Up to the late 1990s, the Washington Consensus constituted the core package of the first generation of reform with ten different elements (Williamson, 2003)[3]. This Consensus was, however, controversial right from the start. The reform package embodied in it were primarily guided by the neo-liberal school of thought and hence too much emphasis was placed on expediting liberalisation and privatisation of the economies of developing countries either without foreseeing the overall ramifications of such reforms or examining the state's capacity to carry them out by satisfying the needs of various contending classes and socio-economic groups. Therefore, those who propounded the first-generation of reforms have conceded their weaknesses and now they themselves prescribe second-generation of reform that is inclusive of institutional reforms and reforms related to income distribution (Williamson, ibid). Similarly, some others have provided ten areas of reform[4] that would improve equity without reducing growth (Birdsall and de la Torre, 2001). Furthermore, over the course of the last three decades, policy reform has proven to be more successful in middle-income economies, and less so in low income ones (Ruis et al 2003). Unlike the more recent practices of adopting donor prescribed uniform reform packages, reform programmes have varied widely in intensity and scope across countries and time. Also, the goals pursued have been quite divergent ranging from poverty reduction to increasing efficiency and promoting capitalism (Fanelli et al 2003).

Despite the increasing realisation to follow a new methodology in assessing reform, there is no single standard method, which is suitable for all countries and in every context. The divergence in initial conditions including the persistence of informal institutions, and socio-economic and political factors result in varied outcomes of the same polices in different countries. Therefore, the historical context and analytical narratives are critically important. To convert descriptive historical accounts into analytical ones it is necessary to cross-check the theoretical foundation of reforms in terms of in-depth case studies in an iterative process. History and narratives matter because repeated games can yield a multiplicity of equilibrium. In this context, it is crucial to identify the forces that shape the selection of a particular equilibrium. In drawing lessons for better outcomes of reforms in a particular country's context in future it calls for an in-depth and systematic analysis of institutional and structural factors influencing reforms and their macro and micro level impacts. The present case study is intended to fill this gap in the Nepali context.

1.3 Objectives of the Study

The broad objective of this study is to analyse and understand the reform programme in Nepal and thereby draw lessons for the future. The specific objectives are to:

1. understand reforms. The study identifies imperatives against which reforms were initiated. This is needed to understand the dynamics leading to the initiation and implementation of economic reforms in Nepal.
2. make an in-depth study of the framework under which economic reforms were introduced. This sheds light on the approaches and features of economic reforms.
3. evaluate the sequencing and speed of reforms. The study tries to capture the socio-economic, political and institutional processes and factors leading to influencing both sequencing and speed of reforms across the sectors.
4. assess the outcome of the reforms and draw lessons for future.

1.4 Research Questions and Methodology

1.4.1 Research Questions and Study Hypotheses

It is critically important to understand the economic and political viability of reform in terms of three key questions. These are: Why reform? what kind of reform?, and how well did the reform perform? Against this backdrop, this study formulated the following research questions:

a. Why did Nepal initiate reforms?
b. What factors motivated Nepal to adopt reforms and how did these factors contribute to shaping the design of reform and its implementation?
c. Did the reform fulfil the intended objectives? What are the outcomes and shortcomings?

In the process of understanding reform the study tested the following major hypotheses:

1. Foreign exchange crisis and regime change were instrumental for reforms.
2. Both domestic and external factors including geographical factors played a key role in the design and sequencing of reforms

3. Both economic and institutional reforms were carried out simultaneously for providing adequate incentives to the producers and for better enforcement
4. Various stakeholders including the actors of social change and political forces representing the interests of diverse socio-economic groups were deeply involved in the reform process for better policy-coordination, and.
5. Reforms contributed to improved economic outcomes and ensured more equitable distribution of benefits.

1.4.2 *Study Framework and Methodology*

The analytical framework is largely descriptive. It mainly tries to test the research questions and study hypothesis in the form of analytical narratives. The political economy and institutional approaches are the major basis of analysis and evaluation. When the politico-economic approach is followed in the study, both politics and economics come to the forefront. In the political science literature politics is defined as the study of power and authority, and the exercise of power and authority. Power, in turn, means the ability of an individual (or group) to achieve outcomes, which reflect his/her objectives. Similarly, authority "exists whenever one, several, or many people explicitly or tacitly permit someone else to make decisions for them in some category of acts" (Lindblom, 1977). On the other hand, economics is the study of the optimal use of scarce resources and it contains an implicit, but crucial, assumption when applied to policy choice, namely, that once the optimal policy is found, it will be implemented.

The political economy begins with the observation that actual policies are often different from optimal policies, the latter defined as subject to technical and informational, but not political, constraints. Political constraints refer to the constraints due to conflict of interests and the need to make collective choices in the face of these conflicts. Positive political economy thus asks the question of how political constraints may explain the choice of policies (and thus economic outcomes) that differ from optimal policies, and the outcomes those policies would imply. The political constraints are associated not only with the existing institutional framework, but also with the design or structure of political institutions. The policy decisions thought out to be the best by the government might not be so from the point of view of the society or certain groups. A distinction between Pareto-efficient outcomes and the outcomes that result from the best response of the players in the policy reform game is required. This places the analysis of the incentive structures that are implicit in the existing rules of the game (i.e., the institutions) and the distributive conflict (i.e., the political economy of reform) at the center stage.

If individuals make decisions, how is it that "the government" takes decisions? And, more generally, who are the social agents in the policy reform game and how do they take decisions? This second query implies identifying the stakeholders of reform and calls attention to collective action problems. This is also associated with policy coordination and distributional conflict.

At the same time, once a reform is implemented, other complementary reforms become necessary for changes in the rules to be effective and to avoid either stalling or reversals depending on the initial conditions and the ensuing course of reform involving economic institutions, the political system, or informal institutions associated with social, ethnic or regional cleavages. Similarly, according to Acemoglu (2003), to understand the political economy of reforms we must consider the interactions that take place within a "cluster" formed by economic and political institutions and the state as the locus of power. The consideration of this cluster effect implies checking for the internal consistency of the policies in the reform package. It also requires the authorities to respond quickly when a shock occurs in order to control for spillover effects generated by the cluster effect.

Rius and van de Walle (2003) suggest using Tommasi's (2002) hierarchy of rules to make the definition of reforms more precise. Specifically, in such a hierarchy of rules (i.e., of institutions), policies are lower rules (RL) that regulate, say, the behaviour of economic agents—for instance, a policy that defines tax bases and tax rates. The intermediate level rules (RM) determine who has the power, and under what procedures, to legislate economic issues. Finally, the high-level rules (RH) are the deeper politico-institutional rules as reflected in the Constitution, electoral rules, and other related (even informal) practices of the polity. RH, together with a number of contextual and informal elements, determines the actual workings of the policymaking system. According to Aoki (2001), the economy in turn is constituted by a myriad of domains and for the same technology (i.e., exogenous rules of the game). Multiple institutions are possible and institutions can evolve across different domains linked by the strategic choices of agents. He sees overall institutional arrangements as a synchronous set of institutions across constituent domains in the economy and believes that we need to discover the regularities that prevail across different overall institutional arrangements. This means that some degree of analytical success is needed in understanding these hierarchies and regularities to grasp the effects of the "cluster" effect in the course of reform efforts.

A successful reform also has to accomplish that after the change of rule the new situation must be sustainable and functional. In other words, results from the change of rule must give rise to a new equilibrium for sustainability.

Thus the multidisciplinary approaches advanced by the researchers call for a sufficiently flexible research methodology. For these reasons, analytical approaches with different steps to evaluate the narratives are suggested in the literature. The present study has also adopted a similar approach and methodology to answer research questions and test hypotheses. It follows a multidisciplinary approach. The study is based primarily on secondary information and government's published documents. Empirical evidences available in earlier studies in this area are also used.

The study begins with the testing of Hypotheses 1 and 2 outlined above. Both internal and external factors driving the reforms have been analysed in this respect. Among the internal factors, the economic crisis or political crisis, people's expectations, developmental goals or new development perceptions or approaches initiated by the political class or otherwise are especially examined. Similarly, the landlocked position, open border, new aid strategy of donors or new global policy shifts are additionally analysed to gauge the extent of external effect in shaping or influencing the reforms.

For testing Hypothesis 3, both policies and institutional processes leading to reforms have been thoroughly examined. While analysing the features of reform and sequencing, various forms of reform such as rationalisation of tariff, revision of input and output prices (including the interest and exchange rates), deregulation, privatisation, withdrawal of subsidy, revision and enactment of laws, bylaws and regulations as well as other various market oriented reforms have been examined in detail. This is followed by a closer examination of decision taking processes in which involvement of political institutions, various stakeholders including entrepreneurs, trade unions, civil society organisations and international institutions are examined to test Hypothesis 4.

To test Hypothesis 5 available secondary data sources and studies undertaken to examine the performance of the economy or effect of reform have been employed. These sources have been used firstly to critically review the growth performance of various sectors in the light of the reforms pursued. This is followed by an assessment of reforms in terms of competitiveness of major sectors of the economy including their role in developing the private sector and enhancing its capacity. Likewise, similar data and study sources have been employed to gauge and identify probable gainers and losers in the reform process and likely link between growing vulnerability of various socio-economic groups and distributional conflicts.

The research methodology comprises a three-pronged approach. In the beginning a complete review of origin, driving forces, sequence and process of reform is made. Reforms in the legal, institutional and political aspects are reviewed in terms of their adequacy, stability and effectiveness. Likewise, outcome indicators have been used to assess the impact of reforms (Loayza and Soto 2003). Finally, the question of sustainability of outcomes is also dealt with by looking into both the structure and institution related issues. The causal factors or driving forces of reform have been delineated and analysed based on three questions, viz., why the reforms, what did these comprise, and how were they implemented. In the course of analysis, special consideration has been given to find out the reasons of limited spill over and other effects toward enlarging the positive outcomes of the reform programme.

1.5 Scope of the Study

The main components of the study include: (i) agriculture and industrial sector reforms, (ii) fiscal reforms, (iii) external sector reforms, and (iv) financial sector reforms. Although focused on the main components, the study is extended to cover the processes of reforms and their impacts on various classes and socio-economic groups of the society. Furthermore, the study draws lessons from the past experience of reform processes with a view to properly shaping the future course of reforms.

The study covers a period of eighteen years from 1985 to 2003. The study period is divided into two parts: (i) the first phase from 1985 to 1990, and (ii) the second phase covering the period from 1990 until 2003.

1.6 Limitations

The study is primarily based on secondary information and documents published by the government. Government information and statistics are often biased towards painting a rosy picture and it is very difficult to verify those statistics from alternative sources. In many cases, subjective judgement had to be used. Similarly, after 1995 the political instability along with the eruption of conflict in 1996 has had both direct and indirect effect on the speed and sequencing of reforms and their outcomes. Likewise, the external environment especially after the event of 11 September 2001 has had a negative effect on the economy particularly on tourism and external trade in both goods and services. These could not be adequately quantified to differentiate their impact vis-à-vis ongoing reforms. As the study covers the period 1985-2003, it does not cover the findings of the recently published living standard survey (CBS, 2004). As a result, many new information available through this study pertaining to the level of income and consumption by decile or caste and ethnicity group, access to social services and infrastructure facilities and new poverty incidence among various classes could not be used.

Endnotes

1 Birta is the land granted by monarchy to the members of nobility and aristocracy.

2 Some earlier studies on these lines include Maxwell Stamp (1990), Khanal (1992), Dixit (1995), Sharma and Bajracharya (1996), NEFAS (1996), Pyakuryal (1995) and Acharya et al (1998). Some recent studies undertaken on the government and donor's joint initiatives include FNCCI and World Bank (2000), Khan (2002), HMG/UNIDO (2002), UNDP (2003) and HMG (2003). A report prepared by the government on the status of implementation of the reform agenda presented to the Nepal Development Forum (NDF) also provides information on various reform related aspects (HMG, 2002). Similarly, assessment of the implementation status of reforms associated with loan conditions are being regularly undertaken by the World Bank, IMF and ADB. Some agencies like DFID and USAID while preparing their country aid strategy also regularly evaluate the reform programme. UNDP in connection with preparing the Human Development Report has also started evaluating the performance of various sectors. The Millennium Development Goal now compels the government to evaluate the gaps between the 15-year targets and annual achievements. More recent studies undertaken by individual researchers are also available in the agriculture, industry, and trade, fiscal and financial sectors. Such studies include Karmacharya (2001), IIDS (2002) and Acharya (2003). Despite existence of a

large body of studies and research these broadly follow a traditional approach and are at the same time confined to one area or the other. Similarly, many donor initiated or supported studies are guided by the specific aim of either examining the credit worthiness of the country or comparing the reforms with their broader globalisation or liberalisation agenda set in their headquarters without reference to specific political, socio-economic and cultural conditions of Nepal.

3 The ten elements popularly known as Washington Conesus are: (i) Fiscal discipline, (ii) reorienting of public expenditure priorities, (iii) tax reform, (iv) liberalising interest rates, (v) a competitive exchange rate, (vi) trade liberalisation, (vii) liberalisation of inward foreign direct investment, (viii) privatisation, (ix) deregulation, and (x) property rights.

4 The ten areas include: (i) Rule based fiscal discipline, (ii) smoothening booms and busts, (iii) social safety nets that trigger automatically, (iv) schools for the poor, (v) taxing the rich and spreading more on the rest, (vi) giving small business a chance, (vii) protecting worker's rights, (viii) dealing openly with discrimination, (ix) repairing land markets, and (x) consumer driven public services.

chapter two

Driving Forces of Reforms

The nature and characteristics of the political regime and governing institutions in the course of reform drives were quite different in the first and second phases. Unlike an autocratic regime during the first phase, a democratic governance was in place during the second phase of reforms. Similarly, the compelling or motivating factors of reform were also distinctly different . For these reasons, two phase have been analysed separately.

A. The First Phase (1985-90)

2.1 Internal Factors

2.1.1 Trade, Exchange Rate and Industrial Policies Leading to Economic Crisis

Prior to 1985, macro policies were guided by the state-led inward looking protectionist strategies. The state machinery was always preoccupied with the exigency of revenue maximisation. This resulted into frequent changes in policies and programmes on an ad-hoc basis, which eventually led to ever worsening policy distortions. Until 1983 there was virtually no trade policy in a documented form. Agreements with trading partners including India, and discrete government announcements formed the basis for external trade. For almost fourteen years beginning from 1960, an Exporters' Exchange Entitlement Scheme (so called bonus voucher) was practised which linked imports to export performance. One should admit that this mechanism helped to diversify the country's international trade flows. Nevertheless, it also encouraged smuggling of third country-imported goods to India, which in turn culminated into frequent trade disputes with India. This scheme also discouraged sustainable industrialisation in the country. Therefore, Nepal was compelled to modify this scheme. With the announcement of the first ever Trade Policy in 1983, some alternative schemes of promoting exports were introduced. Among them most noticeable was the de-licensing of exports, except for those items that were either banned or put under quantitative restriction. Furthermore, the new policy waived income tax on export earnings, and introduced a duty draw back system on those imports, which were used as inputs for export. Other salient features of the new trade policy included bonded warehouse facility, procedural simplification, and establishment of a high powered National Export Trade Development Council. However, there was some ambiguity in the proposed policies as they were aimed at achieving the goal of both inward and outward oriented industrialisation simultaneously. Furthermore, in the absence of appropriate institutional mechanisms, the duty draw back system remained non-operational.

On the exchange rate front a dual exchange rate system was introduced in 1977, which was modified in 1978. The modification was required to mitigate various distortions. Again in 1981, a cash subsidy programme was introduced as an alternative measure aiming at boosting exports. However, as this scheme resulted into a heavy burden on the national budget and also suffered from the problem of delayed distribution of subsidies due to bureaucratic hassles, it was again terminated.

Industrial policies were also introduced and amended from time to time. The first Industrial Policy was formulated in 1962. As it encountered some distortions, the policy was first revised in 1965 and again in 1967. In 1974, the government again came out with a new Industrial Policy aimed at promoting both import substituting and export oriented industries. However, adherence to an unrealistic exchange rate and quantitative restrictions greatly constrained export growth. In 1981 a revised Industrial Policy was announced with some specific provisions relating to rationalisation of the incentive system and simplification of procedures. Unfortunately, administrative hurdles and various distortionary practices prevented industries from enjoying such incentives. Thus, because of lack of appropriate policies and industrial environment in the country, a broad based and sustained industrial development could not take any momentum.

Furthermore, direct controls and attempts to guide the market proved highly inefficient. Import licensing, high import tariffs, overvaluation of the domestic currency and direct control of prices and quantities prevented industries from making a technological advance. Because of the restrictive trade regime, resources were wasted on unproductive activities such as smuggling, lobbying, evasion of tariffs and building of plants with excess capacity in order to obtain import licenses (Sharma and Bajracharya, 1996). By discouraging high value addition the overall industrial development process in Nepal failed to harness its comparative advantages (Maxwell Stamp, 1990). More damaging were the interventionist policies with anti-export biases. This resulted in distortions that included trade deflection for revenue mobilisation and political expediency. Such interventionist policies hindered genuine development of trade and industries in the country. This is corroborated by the available facts and figures.

During the period 1965 to 1985, the average rate of growth in value added in the manufacturing sector was low and was highly fluctuating. During the period 1970 to 1975 it went down by 14 percent. Even though it was positive during the period 1970 to 1985, it never exceeded 5 percent. For the period 1970 to 1985 almost a similar trend is observed in the trade sector (NPC, 1965 to 85). As a result the entire industrial structure stagnated during the whole period under consideration. Primary products including jute, rice and timber constituted major items exported to India. Despite some shifts in exports to third countries from primary to manufactured goods, it was confined to carpets and garments, which resulted into high volatility and risk. This constrained increased labor absorption by the industrial sector (DSC, 1990).

2.1.2 *Financial Chaos, Burgeoning Resource Gap and Foreign Exchange Crisis*

The structural rigidity, slow economic growth and state led policy distortions gradually deepened the crisis on both fiscal and foreign trade and payments fronts, especially since the late 1970s. Despite high tariff rates in general, selected low rates were applied on those import items that could be re-exported to India for revenue and arbitrage purposes. This represented a classic manifestation of a monetary approach to the balance of payments (MABP) hypothesis. This meant fiscal deficits translated into external sector deficits. Understandably, this not only led to absorption of more and more hard currency for such imports but also increased the revenue risk depending upon the behaviour of the Indian authorities in dealing with the smuggling business. This also had negative effects on efforts at internal resource mobilisation. At a time when the crisis was picking up, it took a dramatic turn in the aftermath of the 1979 referendum. Because of the apprehension the regime harboured about the future of the Panchayat system, ruling elites concentrated on misusing power in extracting the country's resources for personal benefits by any means. Also, the new direct election system compelling candidates to make commitments in front of voters toward fulfilling their demands also gave certain latitude to the rulers in massively expanding the government expenditure. Interestingly, this was done without simultaneous efforts at revenue mobilisation and maintenance of macroeconomic stability (Panday et al, 1988). Financial indiscipline and anarchism heightened year after year which ultimately resulted into an unprecedented rise in internal borrowing. As imports swamped the domestic consumer markets, such fiscal anarchy and irresponsibility militated against the authorities' pledge to ISI. This in turn fuelled excess liquidity in the economy, which in turn induced imports in a big way. In a situation of meagre foreign exchange earnings from exports, Nepal for the first time recorded a deficit in its balance of payments to the extent of Rs. 675 million in 1983. This trend continued up to the period prior to the implementation of austerity measures introduced through the IMF induced Economic Stabilisation programme in 1985 (MOF, 1998).

Available data indicate that the total government expenditure surged from 14.9 percent of GDP in 1979/80 to 20.7 percent in 1982/83. This happened without a commensurate growth in revenue as its share in GDP increased marginally to 8.4 percent from 8.1 percent until a few years ago. As a result, the amount of revenue surplus as a share in the total development expenditure drastically dropped from 38.7 percent in 1980/81 to 17 percent in 1982/83. This naturally resulted in a menacing deficit financing. In addition to 41.7 percent of the development expenditure being funded by foreign aid, still about 20 percent of the development budget had to be supported by internal borrowing. The share of internal borrowing jumped further in 1983/84 and 1984/85 to reach 4 percent of GDP (Table 2.1). This phenomenon had serious implications on three fronts. First, the total outstanding public debt skyrocketed to 40.5 percent of GDP in 1984/85, comprising 18.5 percent internal and 22.0 percent external debt, from just 4.6 percent in 1974/75. Second, debt-servicing burden correspondingly rose to 12.5 percent of the total revenue from just 3.5 percent a few years ago. Third, the accumulated public debt crowded out the private sector debt as little loanable funds were left with the commercial banks to lend to the private sector. All these fiscal imbroglios were reflected in the increasing rate of inflation for both food and non-food items (Panday et al, 1988).

Table 2.1 Government Expenditure and Sources of Financing (in percent of GDP)

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Expenditure	14.9	15.0	17.3	20.7	18.9	18.0
• Regular	5.0	5.0	5.3	5.9	5.8	6.2
• Development	9.9	10.0	12.0	14.8	13.1	11.8
Revenue	8.1	8.9	8.6	8.4	8.7	8.4
• Overall deficit	6.8	6.1	8.7	12.3	10.2	9.6
• Revenue surplus	3.1	3.9	3.4	2.5	2.9	2.2
• Foreign grants	3.4	3.2	3.2	3.2	2.2	2.0
• Foreign loan	2.3	2.5	2.4	2.9	4.2	3.8
• Internal loan	0.8	0.9	1.6	3.0	4.0	3.9
a) Banking system	0.0	0.0	0.0	0.0	2.7	2.8
b) Non-banking system	0.0	0.0	0.0	0.0	1.3	1.1
Cash balance surplus (-)	0.3	-0.5	1.5	3.1	-0.2	0.0

Source: Ministry of Finance. Economic Survey (various issues).

Table 2.2 Share of Various Funding Sources in Total Development Expenditure (in percent)

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Revenue surplus	31.1	38.7	28.0	17.0	22.0	18.4
Foreign grants	34.9	31.8	26.7	21.9	17.0	16.8
Foreign loan	23.2	25.4	19.6	19.8	32.4	32.0
Internal loan	7.8	9.2	13.4	20.1	30.5	32.8
a) Banking system	0.0	0.0	0.0	0.0	0.2	0.2
b) Non-banking system	0.0	0.0	0.0	0.0	9.7	9.1
Cash balance surplus (-)	3.0	-5.1	12.3	21.3	-1.9	0.0
Total	**100**	**100**	**100**	**100**	**100**	**100**

Source: Ministry of Finance. Economic Survey (various issues).

The deficit financing had a much more devastating effect on external trade and payments (Table 2.3).

Table 2.3 National Accounts Summary (Share in GDP) (in percent)

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Import of goods and Nfs.+	18.7	19.6	18.8	21.3	19.4	20.0
Export of goods and Nfs.	11.5	12.9	11.6	10.2	10.7	11.5
Net factor income	2.1	2.1	2.0	2.1	1.6	1.4
Net current transfer	3.6	3.5	4.0	4.1	3.8	0.2
Current A/C balance	-1.5	-1.1	-1.3	-4.9	-3.4	-6.8
Total consumption	88.9	89.1	90.1	91.4	90.1	86.6
Private consumption	82.2	82.1	81.6	81.3	80.9	77.2
Public consumption	6.7	7.0	8.5	10.1	9.3	9.4
Total investment	18.3	17.6	17.1	19.6	18.7	21.9
Gross fixed capital formation.	15.8	15.7	17.6	19.5	17.5	20.1
Public sector	6.3	6.7	8.0	8.7	8.0	7.8
Private sector	9.5	9.1	9.6	10.8	9.6	12.4
Change in stock	2.5	1.9	-0.5	0.2	1.1	1.7
Gross domestic saving	11.1	10.9	10.0	8.6	9.9	13.4
Gross national saving	16.8	16.5	15.9	14.7	15.3	15.0
GNP at current prices	102.1	102.2	102.0	102.1	101.6	101.4

Source: Ministry of Finance. Economic Survey (various issues).

The share of imports of goods increased from 18.7 percent in 1979/80 to 21.3 percent of GDP in 1982/83, in contrast to reduction in the export share from 11.5 percent to 10.2 percent during the same period. Despite a short rise in transfer incomes the current account deficit reached 4.9 percent of the GDP in 1982/83. At the same time, there was a corresponding decline in domestic savings as a result of mounting negative savings of the government (Panday et al, 1988). All these had severe adverse impacts on foreign exchange reserves. The disproportional foreign trade imbalances and lowest level of foreign exchange reserve ultimately spilled over into the balance of payment crisis of the mid-1980s. At the end of fiscal year 1984/85, foreign exchange reserve stood at the lowest level sustaining only 4.4 months worth of merchandise imports (NRB, 2002). This compelled the government to negotiate first with the IMF for stand-by credit arrangements under the Economic Stabilisation programme (ESP) and subsequently with IMF/ World Bank for loan under the Structural Adjustment Programme (SAP) in which various conditions for reforming the policies were included. Thus, internal factors primarily provided the groundwork for implementing economic reforms from the beginning of 1985/86. The first phase of reform under the standby and SAP lasted up to 1989/90.

2.1.3 *Failures in Agrarian Reforms*

Part of the reason behind the economic crisis was the failure in bringing about required reforms in the agrarian structure. Such reforms were essential also for augmenting industrial development. Obviously, agriculture-led reforms help in enlarging the purchasing capacity of the people and thereby expanding the internal market. Although the land reform programme was initiated in 1964, it was neither scientifically designed nor implemented sincerely. First, the ceiling on land holding was completely arbitrary and regressive. Hesitation toward land reform emanated from the grip of feudal institutions, which provided the major support base to the king led party-less system. Whatever ceilings were imposed were never enforced effectively. At a time when land reform was implemented through the Lands Act 1964, 65 percent of the poor peasants had 15 percent of the land as opposed to 39.7 percent of land possessed by 3.7 percent richer and feudal farm households (CBS, 1962). After the land reform, the number of affected landlords was only 9,136 with 50,580 hectares of land recorded as above the ceilings. Out of this, 32,331 hectares was confiscated of which only 64 percent was redistributed (Zaman, 1973). As a result, even after implementation of the land reform act, out of the total cultivated area, 9.9 percent of the total farm households owned 60.8 percent of the land (CBS, 1972). This means that the landowners' rights in the land were almost unaltered (Regmi, 1976). The land reform initiative had a more damaging effect on production and productivity because after reform 31.2 percent of the farmers were found to be mere tenants (Zaman, 1973). Furthermore, even after two to three decades of tenancy rights granted by the government, almost 28 percent of the households were found to be unregistered tenants especially in Tarai (IDS, 1986 and Khanal, 1994). Even though organisations related to research, horticulture, livestock, fisheries and agricultural extension were gradually created since 1960 at both the central and district levels, they, remained ineffective. In addition, in 1968 the Agricultural Development Bank was established by replacing the Cooperative Bank, which was in operation since 1963. However, owing to the inability of the farmers to pledge the required collateral and lack of appropriate mechanism, knowledge and access to the banking system, majority of the poor and small farmers were unable to reap benefits from it. The credit facility was extensively misused by the big farmers and others having connections with the ruling elites. Similar was the situation in the area of subsidised fertilizer distribution, which was monopolised by the public sector. In irrigation also, huge irrigation projects were launched without properly verifying their viability or sustainability. Ignoring local conditions and farmer's involvement further compounded the problem. On the whole, due primarily to lack of firm political commitment and sincerity initiatives to bring about changes in the traditional feudal structure of the society and enhance agricultural productivity through land reform and other programmes went in vain (Regmi, 1976, Khanal, 1994). As available data indicate, despite substantial investment in the agriculture sector the average yield rate of paddy, a major food crop of Nepal, went down from 1999 kg per hectare in 1964/65 to 1978 kg per hectare in 1974/75 (MOA, 1983). Likewise, taking 1974//75 as the base index, average yields of major food crops including paddy, maize, wheat and barley dropped to 90.1 in 1984/85. The national account estimates show that agricultural GDP during the period 1965 to 1980 grew by less than 2 percent on the average, which was far below the population growth rate. Agriculture grew at an encouraging rate of 5.1 percent during the period 1980 to 1985. However, this was an outcome of massive expansion in the cultivated area in the post-referendum period (MOF, 1998) rather than due to productivity gain. The declining farm income especially of marginal and small farmers and reduction in per capita food availability severely aggravated the poverty conditions in rural areas. The poverty ratio in rural areas increased from 37.2 percent in 1976/77 to 43.1 percent in 1984/85 (NPC, 1997 and 1985). Over a long period, there was a drastic fall in the GDP share of agriculture without a consequent fall in the sector's share in employment. Whatever expansion that occurred in the modern sector economic activities utterly failed to absorb the surplus labor force that depended on agriculture for employment and livelihood. On the whole, the farm sector languished in deepening poverty, misery, destitution and deprivation. This helped to fuel further crisis in the economy.

2.2 External Factors

2.2.1 Trade and Transit Arrangements with India

The trade and transit problems with India were instrumental in triggering the crisis in the Nepali economy in general and in trade and balance of payments in particular. Transit costs compounded by high transportation costs, delays in clearance and delivery at seaports as well as cumbersome procedures at various customs transit points in India escalate the cost of imported raw materials to the extent of 50 to 100 percent. Such additional costs deteriorated trade competitiveness and constrained export potentials. This was happening in a situation where trade clauses requiring raw material and labor component of Nepali or Indian origin even to the extent of 90 percent were invariably preventing easy access to Nepali manufactured goods in the Indian market. Conversely, the special trade relationship was providing a captive market to the Indian manufactured goods into Nepal despite Nepal's terms of trade being highly unfavourable (Islam et al, 1982). The cumulative effect was experienced in both trade and BOP deficits.

2.2.2 Changing Global Policy Environment

Changes in the global policy environment especially in the aftermath of the second oil shock in the 1980s necessitated a review of the existing policy regime. This was a period when most of the third world countries were suffering from balance of payments and fiscal deficit problems. These crises, in turn, were massive and exacerbating the inflationary and debt related problems. Such crises were demanding immediate attention through policy and institutional reforms on both macro and micro fronts (World Bank, 1988). At the same time, success achieved by the East Asian countries in accomplishing higher growth and driving exports through more liberal market policies were gradually inducing multilateral donor agencies to come forward with similar policy prescriptions to those developing countries which had chosen an inward looking state interventionist policies. These were also the motivating factors for undertaking reform initiatives in the mid-1980s.

B. Second Phase (1990-2003)

2.3 Internal Factors

2.3.1 Regime Change and New Political-Institutional Structure

In Nepal democracy that was hijacked in 1961 was restored in 1990 after overthrowing the autocratic Panchayat system through a people's movement launched jointly by the Nepali Congress, a liberal party, and the Left parties. An immediate aftermath of the change in the political system was the recognition of the need for building new democratic institutions and major reforms in the old ones. This process was started and intensified after the formulation of the new democratic constitution (HMG, 1990). For the first time in Nepal's history the new constitution bestowed sovereign right upon the people. However, unlike many revolutions elsewhere that completely overhaul the existing superstructure and auxiliary institutions, Nepal has tried to introduce reforms and changes without causing too much disturbance in the preexisting establishments, power and social relations. It was manifested in the abrupt withdrawal of the popular movement following a negotiated understanding between the palace and political parties. This understanding served as the principal guidepost for formulating the constitution, which adopted a more balanced approach in safeguarding the interests of all constituencies, especially the institution of monarchy. This middle-of-the-road approach generated certain differences among the major political parties about certain provisions in the constitution. Nonetheless, majority of the drafters of the constitution yielded to intense lobbying and pressure from the old power groups and preferred to come up with a compromise document. Obviously, proposals from certain constituencies for inclusion of more drastic reform provisions were not entertained.

As a compromise document, the constitution accepts constitutional monarchy and embraces a multiparty parliamentary system. It recognizes the political parties as pillars of democracy and governance. It envisages a welfare oriented social system. It proposes several governing institutions. For ensuring checks and balances it clearly delineates the power and responsibility between the executive, judicial and legislative bodies. It also guarantees the basic human rights to every citizen of Nepal including press and publication rights, cultural and educational rights, right to information and right to constitutional remedy.

The new constitution establishes a two-tier parliamentary system. It grants executive power to the Council of Ministers, which is made accountable to the parliament. The Supreme Court, the apex level court in the three-tier judicial system, is entrusted with important powers including the power to interpret the constitutional provisions and protect the fundamental rights of citizens. The Auditor General's Office, Election Commission, Public Service Commission and Commission for Investigation of Abuse of Authority (CIAA) have been especially provisioned in the Constitution. The main rationale behind building these institutions has been to maintain financial discipline in the government-funded organisations, conduct free and fair elections and control the misuse of authority by improper or corrupt means by any person holding public office. The constitution has also made provision for a Constitutional Council. It has been entrusted with the responsibility of making recommendations for appointments in the constitutional bodies. Similarly, the constitution embodies the concept of Civilian Control over Military and thus proposes a National Defence Council.

The Constitution prohibits discrimination in any form be it in the name of religion, caste, race or sex. It also upholds the principle of equal pay for equal work. It requires all the national political parties to reserve five percent of the parliamentary seats to women candidates. Similarly, it declares Nepal a multi-ethnic and multi-lingual kingdom despite declaring it a Hindu Kingdom. In Directive Principles it assigns some special roles for the state in terms of promoting conditions appropriate for a welfare state. For this it advocates the need for a just system in all aspects of national life. Protection of life and property comes within the responsibility of the state. Transformation of the national economy into an independent and self-reliant one also comes within the added responsibility of the state. One added feature of the constitution is that it emphasizes a decentralised system of governance with a view to creating conditions for the maximum participation of the people in governance. Thus, the various provisions made in the constitution require far-reaching changes and reforms in institutions, policies, and programmes.

2.3.2 Removal of Distortions and Inefficiency for Better Economic Performance

The reform initiated in the mid-1980s was neither adequate nor effective in promoting market orientation and enhancing efficiency. Much of the focus was on simplification of rules and regulations for undertaking business and trade. Ample discretionary powers still existed in decision-making, which resulted in favouritism and corruption (Cohen, 1995). Getting a business registered took a time of almost six months. The legal system was too archaic, unpredictable and unreliable. Even in cases where rules and regulations existed, the administrative structure was highly inefficient, fragile and rent seeking was excessive (Dixit, 1995).

Despite the emphasis on tax rationalisation and deregulation in trade through structural adjustment, a discriminatory incentive structure and quantitative restrictions created substantial distortions in the economy whether in specified form or in the form of licensing and other regulatory mechanisms. A study examining the effect of SAP in general and industrial policy of 1987 in particular has estimated that distortions to the extent of 6.74 percent in export-oriented to 34.33 percent in electronics assembly industries continued to persist. The average rate of distortions was estimated at 17.6 percent. Import license fee and auctioning premium added 2.4 percent to the total input price. Price and cost distortions amounted to another 1.6 percent, and import tariffs added the remaining 13.5 percent. Similarly, nominal rates of protection to imports from India and third countries varied from 10.97 to 39.46 percent. In addition, the effective rate of protection (ERP) varied from a negative 44.94 percent for *bidis* (smoking tobacco rolled in leaves) to 761.18 percent for alcohol. Tariffs and non-tariff barriers including quantitative restrictions were contributing to the anti-export biases (Maxwell Stamp, 1990). All these factors affected efficiency, competitiveness and overall performance of the economy and added pressure on the newly elected governments to pursue more drastic reforms.

2.3.3 Higher Growth and Poverty Reduction for Fulfilling People's Expectations

The success of the 1990 people's movement in restoring democracy was instrumental in generating high expectations among the Nepali people. The new democratic environment inspired and motivated people to express their accumulated grievances and legitimate demands through different channels and processes. This process got momentum immediately after the restoration of democracy because during the Panchayati regime people were never allowed to publicly express their dissatisfaction despite perpetuation of underdevelopment and their burgeoning livelihood problems (Blaikie et al, 2001). With the freedom to open and establish parties, dozens of political parties instantly came into existence with their organisational structure extending from the grass-roots to the national level. Democracy also created a favourable environment for the various contending classes, socio-economic groups and people of different walks of life in establishing NGOs and civil society institutions for the purpose of advocacy and protection of their political, economic, business and social rights. The democratic system, by guaranteeing freedom of expression, induced a mechanism, which provided enough space to people in utilising their talent and capability in new ventures and activities. This had a far reaching effect on the development of the private sector and promotion of market institutions. It appeared but natural that voices and demands of various societal groups were articulated in an intensified manner in the new open environment. People were confident that unlike in the previous regime, democracy would be a panacea for the country's entire ills through appropriate interventions toward economic development that were long pending (Brown, 1996). Also, the mushrooming of media networks helped to gradually awaken people in securing their social and economic rights.

Different segments of the society anticipated that the democratic governments, unlike in the past, will concentrate on better outcomes and delivery by fulfilling the cherished goal of people's prosperity and well-being within a short span of time. It was hoped that elected governments would succeed in developing a vibrant economy by means of modernisation of agriculture and rapid development of other key sectors. It was expected that governments will focus on commodities and service areas in which the country has competitive advantage. It was also believed that it was legitimate for people to aspire for accessing modern facilities such as roads, electricity and communication. Provision of schools, health posts, water supply and housing facilities as well as guaranteeing of employment were other expectations of the people. In a democratic polity it was natural to expect better representation of women, deprived and other socially excluded people in decision-making processes through adequate representation in elected bodies and various wings of the state apparatus. All these pointed to the need for embarking on policies and programmes that could facilitate in realising the rising expectations of the people.

Equally important was the kind of political coalition that had been formed for overthrowing the autocratic regime and drafting a new constitution. This coalition contributed to prioritising policies and programmes that could help promote higher growth, reduce poverty and eliminate all types of discrimination perpetuating in the society. Despite divergent views on the form, content and processes of the parliamentary democratic system, the political programmes of these coalition forces were committed at least to the abolition of the feudalistic mode of production and speeding up of the capital accumulation process for rapid socio-economic development. The Nepali Congress Party was claiming to be following the principle of democratic socialism embraced by it since its inception. Likewise, the Communist Party of Nepal (Unified Marxist-Leninist), the main force within the left coalition, was of the view that more drastic reforms and changes are needed for democratisation and new socio-economic transformation of the society. Going through the first manifesto of Nepali Congress, which formed the government after winning the first general election, one gets the impression that within fifteen years time the livelihood and poverty problems of the people would be completely solved (NC, 1992). There were also commitments that no one would be deprived of basic services including health and education facilities. The manifesto of the main opposition party CPN (UML) made special commitments to the abolition of all types of external and internal exploitation. It stated that without this dynamic transformation of the society and nation is not possible (CPN-UML, 1992).

The Eighth Plan (1992-97) formulated after the restoration of democracy laid down the objectives of achieving sustainable growth, alleviating poverty and reducing regional imbalances. An ambitious target of generating employment to more than 1.4 million in the labor force was set in this plan (NPC, 1992). Although there was a big discrepancy between the commitments made in the election manifesto of the ruling party and the plan, still it had followed broadly similar orientation as embodied in the election manifesto. Nevertheless, commitments made by the major political parties through their election manifestoes along with the periodic development plans and annual budgets implied pursuance of much more drastic reforms on the economic front in order to realistically accomplish higher growth and reduce poverty in a time bound manner.

2.4 External Factors

2.4.1 Donors Led Liberalisation Worldwide

In the aftermath of the continuous crisis in the developing countries in the form of hyperinflation, burgeoning fiscal deficits, or deteriorating balance of payments position, the Bretton Wood Institutions started persuading countries to embark on more drastic economic reforms from the beginning of 1990s. This was the period when the time frame of the SAP implemented in Nepal from mid-1980s had already elapsed. As more and more third world countries ran into greater difficulties servicing the huge loans, these institutions insisted on the debtor countries to commit to market-oriented economic reforms for obtaining assistance. Debt rescheduling was made conditional on reform (Miller, 1991).

Conversely, that was a period when the newly industrialising countries were achieving economic miracles apparently through market-led export oriented polices. This also gave sufficient ground to the World Bank and IMF to convince developing countries to follow a broadly similar model. For this purpose, the IMF had already evolved the Enhanced Structural Adjustment Facility (ESAF) loan programme. Liberalisation and privatisation had steadily become a worldwide buzzword. This was the time when the Communist system in the then Soviet Union and Eastern Europe had collapsed resulting into worldwide unpopularity of state led interventionist policies. China's successes after the introduction of socialist market system provided enough impetus to the donor community to encourage or pressurize developing countries to go for liberalisation and hasty doses of reforms.

So far as the second phase of reform is concerned, in Nepal's context, it was influenced by the donors through conditions laid down in the ESAF apart from the compulsion of synchronising its policies with the neighbouring countries. At the practical level when the second phase of reform was initiated, Nepal was not facing any serious macroeconomic problems as in the early 1980s. The growth rate was reasonably satisfactory. It was 4.6 percent in 1991/92 as compared to 6.3 percent the previous year. Foreign exchange reserve was also comfortable with 9.9 months worth of merchandise imports at the end of fiscal year 1991/92.

2.4.2 Open Border and Compulsion to Synchronize Policies with India's Reforms

As already mentioned, close economic linkages with India in terms of rate of inflation, merchandise trade, tourism, labor, foreign exchange and financial markets, compel Nepal to be responsive to the policy changes in India. Close economic and financial ties forces Nepal, to a greater extent, to synchronize her economic policies with that of India (Khatiwada, 2003).

At a time when internal and external factors were pushing Nepal to carry out reforms, India shifted its policy towards market orientation in early 1990s. Given the open border, landlockedness and very small size of the Nepali economy vis-à-vis India, it is extremely difficult for Nepal to pursue policies that are at variance from the policies followed in India. Recognition of this reality led to fasten the pace of economic liberalisation in Nepal. After initiating drastic economic reforms in June 1991, India devalued its currency against the U. S. dollar by 20 percent. Nepal followed suit by devaluing the Nepali currency against the same by 20.9 percent in the first week of July 1991. In March 1992 the Nepali currency was made partially convertible in the current account in which foreign exchange earners were allowed to exchange 65 percent of their earnings at the free market rate. India followed suit quickly by providing such facility. In a situation of fixed exchange rate with India and free and unlimited convertibility of Nepali currency into the Indian currency, Nepal had no option other than to harmonize the domestic interest rate structure with that of India.

For discouraging deflection of trade the tariff structure also needs synchronisation. To maintain the level of competitiveness of domestic industries against imports from India, even sales tax and excise duties in Nepal are to be set in line with those prevailing in India because open border and smuggling nullify the protection made through tariff structure under the condition of over dependence on India and a fully convertible currency against the Indian Rupee. Nepal had little choice but keep pace with its southern neighbour. Thus, the India factor required Nepal to expedite its liberalisation process.

chapter three

Features, Sequencing and Process of Reforms

A. First Phase (1985-90)

3.1 Initial Conditions

3.1.1 Political Structure and Governing Institutions During Panchayat

Before unification by King Prithivi Narayan Shah in 1769, Nepal was divided into principalities and small kingdoms. Since 1769 the country was governed by absolute Shah dynasty until it was reduced to the status of a figurehead by the family autocracy of Ranas in 1846. The Rana rulers remained in power for 104 years and consolidated the feudal system in the country by imposing landlordism and other feudal practices in all spheres. Their whole attention was to accumulate the nation's wealth for their family privileges. They were dethroned in 1951 after people launched a democratic movement in coalition with the titular king.

With the political change in 1951, Nepal entered a new era of a pluralistic society. Political parties though growing rapidly, were hopelessly divided and confronting each other. Taking advantage of such a situation, the king seised all powers and delayed holding the general parliamentary election that he had committed earlier. The coalition between the king and the people for establishing democracy proved to be incompatible. However, as a result of strong agitation of the people, the first general election was held in 1959. The Nepali Congress formed the government with over two-thirds majority in the parliament and initiated some reforms.

However, the traditional power holders not only resisted reforms, they rather hatched conspiracy against the democratic parliamentary system. After a short period of 18 months, King Mahendra dismissed through the royal coup de tat of 16 December 1960 the popularly elected government led by B. P. Koirala, dissolved the parliament and banned all the political parties and subsequently replaced democracy by the autocratic party-less panchayat system.

After the imposition of the party-less panchayat system, a new constitution was introduced in 1962 in which some commitments were made toward economic progress and social justice. For this, abolition of various forms of exploitation and ushering in of participatory development through decentralisation and mobilisation of class organisations were provisioned in the constitution. Although many of the progressive clauses were meant for political propaganda, a political and administrative structure was envisaged to ensure participation of the people in the panchayat polity at various tiers and levels even on a non-political basis. For this a three-tier political structure was instituted starting from village/ municipal panchayats at the lowest level, district panchyat at the middle and national panchayat at the national level. The same structure was followed in the case of various class organisations such as labor, women, youth, farmers, ex-servicemen and old (senior) citizens. The stated aim of such an institutional set up was mobilisation of various occupational groups in the country's overall development and at the same time in broadening the support base for the Panchayat polity.

Despite the fact that sovereign power rested with the king, the national panchayat, the highest legislative body, was constituted in which there was a provision for 140 members comprising 112 coming from indirect election in the beginning and direct election after 1979, and remaining 28 being appointed by the king. A nomination system was introduced in 1974, under which only those nominated by the so-called Back-to-the-Village National Campaign could be candidates in elections for all three tires of the political structure. The council of ministers used to be appointed by the king from amongst the members of the national panchayat. Similarly, judicial matters used to be handled by the Supreme Court and its subsidiary regional and district courts. Despite these provisions, the King had absolute right and authority to appoint judges including the chief justice. The king also had the right to review the verdicts of the Supreme Court.

Various political tiers were created to attract people to participate in political and other processes. It was believed that this would enable to pacify the discontent and ensure political stability. It was also hoped that various political structures and their channels working as surrogates of democratic processes would enable to fulfil demands and expectations of the people. However, popular participation of the common people became increasingly impossible because of the power remaining within the bureaucracy and concentrating at the top among those who retained the king's favour (Blaikei, 2001). The higher echelon of the bureaucracy was composed of influential elite groups who enjoyed a monopoly over educational opportunities in a situation where the literacy rate was very low and no job was available outside the government (Pradhan, 1973). The political climate worsened especially after the introduction of the nomination system in 1974 as it isolated the common people from the top-down hard-core panchayati patrons. Thus, by the year 1979 the king had become the pivot around which the traditional interest groups, sacred elite and the landowning aristocrats revolved. The palace secretariat had become the nerve center of administration and political structure. As a result, the elected legislative body just served as a rubberstamp, the judiciary became subservient, and a series of arbitrary laws were enacted that could be called "lawless" (Panday, 1999). As a corollary, since everything was handled by the king or through his small caucus, institution building for good governance and development became impossible. As will be explained later, such a political-cum-governing structure had direct implications on economic policy making and reforms.

By the middle of the 1970s Nepal had transitioned into the category of a very poor country. Over population relative to employment opportunities, ecological collapse in the densely populated and highly vulnerable hill areas together with increasing inability to pay for imported commodities and growing food shortages forced Nepal to face a crisis prone situation (Blaikie et al, 1980). Widespread frustration from the system's political impotence increased the potential for opposition from bureaucrats at lower echelons, small-scale businessmen, industrial labourers, teachers, students and unemployed graduates (Haige, 1975). The unrest outburst in 1979 induced with the backing of the banned political parties and the disgruntlement mass. Almost all sections of the society including students, workers, peasants and teachers actively participated. The king declared a referendum granting people the right to choose between the improved party- less Panchayat versus the multiparty system. The party-less panchayat was declared victorious. This was followed by the introduction of a direct election system together with more decentralised authority to the local bodies aimed at containing the growing mass resentment. Hence, despite that absolute power still remained with the king, individuals fighting the election had to a certain extent be accountable to the voters. However, this had some devastating impact on maintaining economic discipline and promoting socio-economic development through cost effective and better governing procedures. At the same time, freedom to participate in the elections without political rights did not help to extend the support base for panchayat. The political system also became detrimental toward initiating a broad based socio-economic reform that could ensure benefits to the masses (Seddon, 1994).

3.1.2 Socio-Economic Structure

Prior to 1951 the feudal system had reached its zenith. A handful of landlords possessed as much as 36 percent of the total cultivated land. This was in addition to 14 percent of such land being occupied by individuals and communities in the form of Guthi, Kipat, Jagir and Rakam. Only 50 percent of the land was in the hands of tenants (Zaman, 1973). Hence, the socio-economic structure of the pre-democracy period was predominantly governed and dictated by the feudal mode of production and distribution. One additional feature of the societal structure then was the keeping intact the rigid caste hierarchical order, which was arbitrarily determined and enforced since centuries. This legitimised extreme exploitation of the low caste people by the upper privileged class. Various steps were initiated immediately after the change of 1951 to abolish landlordism and secure tenancy rights to the tenants. The budget and planning system were introduced in the country in 1952 and 1956, respectively. The central bank and Public Service Commission were also established in 1956. Launching new institutions replacing the old ones was intensified in the aftermath of the Nepali Congress government, which came to power in 1959. The Nepali Congress, a party of liberal democrats, attempted to abolish landlordism in the same year. Similarly, it had initiated some reforms on the socio-economic front. In addition to establishing a Corruption Control Commission and three courts outside the capital city, some welfare programmes from the grass-root level were also initiated. Similarly, some road projects were started to link the capital with outer towns and villages (Yadav and Kumar, 1982). Thus, despite political instability during the post democracy period, some new steps were taken during the period 1951 to 1960 having some long-term implications on the socio-economic structure of the country (Regmi, 1976 and Khanal, 1994 and 1997).

So far as socio-economic development is concerned the panchayat system followed a two-pronged strategy. On the one hand, some piecemeal reform measures were initiated with the aim of appeasing people so as to preempt likely revolt. On the other, the ruling elites also tried to maintain the status quo by preventing weakening of feudal institutions for maintaining their power base intact. This was the reason that thwarted reform in the agrarian structure. Instead, the ruling class sought support from the tiny entrepreneurial class by encouraging rent seeking practices and institutionalising the commission system.

In principle, a mixed economic system was followed in which the state remained at the forefront in developing socio-economic infrastructures. All development initiatives were undertaken through medium term development plans. For some important sectors, master plans were framed with support from donors, which aimed at linking periodic and master plans from long-term development perspectives. From the mid-1970s, a regional development concept was introduced in planning with new institutional arrangements at the regional headquarters. However, despite the emphasis on regional development and decentralisation, essentially a top-down development approach was followed. Consequently, the institutional set up created at various levels was able to provide only limited access to education, health, infrastructure, and other essential services and facilities to the common people.

Notwithstanding the introduction of the land reform programme, neither the ceilings were progressively determined nor was it sincerely implemented. It did not therefore make a perceptible dent on the life of the tenants and landless people. Likewise, the state followed inward-looking industrial and business development policies, which reached to their climax in the mid-1980s. Accordingly, with the donors' technical and financial support many enterprises were established in the public sector. Likewise, policies of distributing licenses in trade and industry, provisions of quota and high tariffs in imports as well as overvalued exchange rate were pursued broadly in line with the inward looking import substitution development strategy. Policies of subsidising agricultural inputs, essential commodities and tax concessions and rebates to industries were also simultaneously undertaken. However, one clear distinction in Nepal's context was that, given the open border and special trade relations with India, a more open and liberal policy with the neighbouring country was initiated. Because of this, in addition to virtually free trade in primary goods between the two countries, tariff rates applicable to manufacturing goods imported from India were kept substantially lower vis-à-vis other trading partners. Such a preferential arrangement is still in practice, despite some cosmetic changes in the extent and magnitude from time to time. However, despite a liberal trade with India, dominant protectionist policies especially in trade, industry and exchange rate together with burgeoning bureaucratic institutions in the midst of a top-down development process triggered the economic crisis, which worsened people's hardship (Seddon, 1994; Panday, 1999; and Blaikei et al, 2001).

The low level of social development and pervasive discrimination continued. At the time of initiating reforms, adult literacy rate was just 28.3 percent. As a reflection of limited access to health facilities coupled with low level and quality of nutrition and sanitation, life expectancy at birth was as low as 50 years in 1981. On an average, a doctor had to attend 28 thousand people. Only 22.4 percent of the people enjoyed access to safe drinking water by the end of 1985.

Gender-wise, women had a much lower social status than men. In 1981, female literacy rate was only 12 percent compared to male literacy rate of 34 percent. Legal discrimination against women was also continuously perpetuating. Women had no legal claim over the parental property except some loose provision of such a right to the girl remaining unmarried until the age of 35. Cultural discrimination was more acute. In the midst of more than hundred languages spoken in the country, the panchayat regime adopted the policy of lingual exclusion by declaring "one language one country". Some high caste people and a few other privileged groups were predominant in the bureaucracy. Owing to continuous marginalisation and exclusion from the development process, the dalits and majority of the indigenous people constituting a big share in the total population were passing through miseries and deprivation at the time of reform (IIDS, 2002 and NDC, 2003).

3.2 Features, Sequencing and Direction of Reform

In order to cope with the severe foreign exchange crisis, the economic stabilisation programme (ESP) was implemented in 1985/86 under the standby credit arrangements with the IMF. This was followed by implementation of the Structural Adjustment Programme (SAP) in 1986/87. The latter was aimed at initiating some market-oriented reforms by limiting the proactive or interventionist role of the government. The broad reform frameworks thus adopted were guided by the conditions laid down in these programmes, based again on the mutually agreed agenda between these multilateral agencies and the government.

3.2.1 *Economic Stabilisation*

The economic stabilisation programme implemented in 1985/86 was aimed at correcting the deteriorating balance of payment problem and reducing fiscal deficit to a manageable level. Containment of inflation was the other facet of this programme (IMF, 1985). The major ingredients of this programme were as follows:

i. Devaluation of the Nepalese Currency against all currencies including the Indian rupee,
ii. Restraining public expenditures,
iii. Mobilisation of additional resources,
iv. Restriction on commercial bank credits,
v. Liberalisation in industrial licensing,
vi. Drive towards export promotion, and
vii. Control over imports.

This programme was short term in nature. The programme package covered trade, fiscal and financial sectors. Some relaxation was also proposed in industrial licensing. In terms of sequencing, it was the same as pursued in a number of other countries. The reform started with devaluation of the Nepali currency against all major trading partner countries by about 14.7 percent. Understandably, this is regarded as essential in any market oriented reform initiative to curb imports and provide certain incentives to exports. This was followed by announcement of some austerity measures in curbing the burgeoning government expenditure and reducing government deficit. Certain restrictions were also imposed on commercial bank loan to the government. Therefore, the overall objective of this programme was to resolve the foreign exchange crisis emanating from fiscal anarchism as manifested in the interventionist policies of the government such as misuse of government regulated subsidies and other concessions. The reform was also geared to gradually creating an environment favourable for market oriented reforms by bringing macroeconomic stability in the economy.

3.2.2 Structural Adjustment Programme

The Structural Adjustment Programme (SAP) was launched taking into account a medium term time frame (World Bank /IMF, 1986). The WB agreed to provide funds in the form of a Structural Adjustment Loan (SAL) and the IMF agreed to provide a Structural Adjustment Facility (SAF) under the mutually agreed conditions that major policy reforms included in the loan programme are implemented by Nepal within the stipulated time frame.

So as to expedite and smoothen the deregulation process, the programme focused on adjustments and changes in the relative price structure in a number of areas. The reform measures were aimed at creating better incentives in the economy with a view to promoting exports, and raising efficiency in industry and financial system. The programme emphasised reduction in fiscal imbalances by containing the level of government expenditure and mobilising resources. A combined policy of granting autonomy in fixing prices and privatising the enterprises were also proposed in the public sector reform programme. It thus included both macro and micro level policy and institutional reforms.

In the SAP, macro targets were fixed within a certain macroeconomic framework. Although growth targets were set in the programme, the overriding emphasis was on the macro economic stability and demand management. The GDP growth rate for the period 1986/87 to 1990/91 was targeted at 4.2 percent per annum. Taking 1990/91 as a terminal year, it was targeted that fiscal deficit should not exceed 1.1 percent of GDP. Within this, more specific goals were set in which foreign aid was targeted at 10 percent of GDP and internal borrowing at 1.5 percent of GDP. Similarly, the target for government revenue was set at 12 percent of GDP. On the expenditure front, development spending was to be raised to 16 percent of GDP by containing the size of regular expenditure at 7 percent. In this framework, it was assumed that the overall revenue surplus of the government would amount to about 5 percent of GDP.

The specific policy reform areas set by the WB and the IMF were slightly different. The WB concentrated on five main policy areas in the first SAL (1986/87-1987/88), viz., macroeconomic management, agriculture, industry and trade, and public enterprises. In the second SAL (1988/89-1989/90) financial sector was also included. On the other hand, the IMF SAF loan programme mainly focused on areas of government expenditure, revenue, finance and trade.

The major areas of policy reform and corresponding actions taken after implementation of the SAP are given in Appendix 1 and 2, respectively. When the actual reforms undertaken by Nepal are compared with those proposed in the SAP framework, it can be seen that the major policy reforms made in the period 1986/87 to 1989/90 were based on the policy packages embodied in the SAP. Even some policies initiated in 1990/91 during the interim period after restoration of democracy were influenced by the policies laid down in the SAP. Apart from controlling the budget deficit, attempts were made to implement other policy measures, which could help in correcting various distortions and creating an enabling environment to the private sector. For better resource mobilisation, substantial reforms were made in the sales tax and tariff structure. Following supply side economics, attempts were made to rationalize the indirect tax structure by simplifying the tax rates and changing the tax assessment criteria. Parallelly, steps were taken to improve the public expenditure management system. Programme budgeting exercises were initiated in major sectors for identification of core projects. Unlike in the past, a system of allocating sufficient funds to the operation and maintenance activities of the core projects was started. In addition to simplifying the cumbersome budget release processes, better monitoring, information and accounting system were also started. Similarly, some reforms were initiated in public enterprises by providing some autonomy to these enterprises in areas of selection of personnel and fixation of prices even in essential commodities. In the agriculture sector, the fertilizer pricing system was completely changed. With the aim of controlling smuggling a system of adjusting Nepali fertilizer prices at parity with the wholesale fertilizer price in the Indian border was introduced. Not only the Agricultural Inputs Corporation (AIC) was given some autonomy regarding changing prices within the limits of 10 percent (at a time) from the existing ones, the fertilizer distribution system was also somewhat decontrolled by providing dealership to the private sector. Some initiations were made to improve the functioning of the Department of Irrigation in line with the suggestions made in the SAP. Some pilot projects were implemented by involving users' groups. This shift was designed to develop a system by which the beneficiaries would be encouraged to regulate the irrigation management system with due care for maintenance, operation and repairs of small canals.

During the 1987-1990 period trade and industries underwent major policy reforms. In keeping with a liberal trade policy and export promotion, the open general licensing system (OGL) was introduced in few commodities in 1986/87, the first year of SAP. Several additional commodities were included in this system in subsequent years. In the year 1986/87, a system of auctioning import licenses to the industries was initiated followed by a passbook system for ensuring availability of foreign exchange and other facilities to the importers of industrial raw materials. In addition, a duty drawback scheme was introduced in readymade garments. This was accompanied by simplification of export procedures. In 1987, an industrial policy was implemented broadly in line with SAP policy prescriptions. Except in defence, the private sector was allowed to establish industries without any restriction. Similarly, various income tax and other rebates applicable to the industries were withdrawn.

Under financial and monetary reforms, commercial banks were given autonomy in fixing interest rates on both deposits and lending. To promote financial market, interest rates on government bonds and treasury bills were raised. In addition, the government paid outstanding loans owed by public enterprises from commercial banks against government guarantee. Likewise, numerous measures were taken with the objective of improving financial performance of the banking system and promoting financial intermediation.

Thus the overall reforms were focused on deregulation and market orientation keeping macroeconomic satiability as the centrepiece. Although institutional reforms were made in some areas including agriculture, they were mainly guided by price related issues. However, SAP failed to address the structural and institutional problems of historical and contemporary nature such as agrarian reform, better access to resources and opportunities to the poor, and the perpetual adverse terms of international trade leading to continual underdevelopment and poverty. In line with the neo-classical approach the underlying assumptions in the adjustment programme was basically freeing of prices from intervention which in turn would augment economic activities and compensate losses suffered by the poor by means of increased income and employment opportunities. Above all, as lenders, the multilateral agencies were also partly guided by the objectives that the creditworthiness of the loan recipient countries is sufficiently enhanced. Precisely because of this, various policy components were apparently pro-rich and provided market access to the outside world rather than breaking the tradition based structural and institutional rigidities existing internally, as well as creating a non-discriminatory international trading environment. One interrelating feature of the SAP was that it had given paramount emphasis on macroeconomic management and stability. This was necessary for raising competitiveness and efficiency in sectors where reforms were concentrated. Failure to accomplish the stability objective could lead to a worse scenario as the experience of many market oriented reforms has shown. In the sphere of public enterprise reform, the donors' primary concern was to recover cost by laying off redundant labor force and increasing per unit price. Enhancement of efficiency by controlling corruption and multiplicity of leakages was not considered, as these were not included in the SAP agenda. It was implicitly expected that implementation of some liberal policies would help contain rent seeking and thereby corruption.

3.3 Institutions' Involvement and Decision Making Processes

The reform packages were essentially developed by IMF and the World Bank for implementation in countries where crises suddenly occur or require structural reforms as postulated by the neo-liberal school of thought. Nonetheless, the final shape of reform and sequencing were determined by mutual agreement between the government and the donors. Hence higher level political and bureaucratic authorities in the government were involved in the whole process. Within the government, the main actors were the central bank and the Ministry of Finance.

Other government ministries and departments were drawn only to the extent of designing certain nitty-gritty of specific policies and programmes as laid down in the SAP. The legislative body was not involved as no prior approval was taken from it. The legislative body was involved only through the budgetary process, as it was a constitutional obligation of the government to announce many of them through the budget for approval of the National Panchyat. Nevertheless, it was merely a formality. The third level of involvement of the government was in respect of implementing the programmes and to some extent monitoring the progress especially from the standpoint of ensuring timely release of loan. Therefore, participation of the National Panchyat took the form of an ex-post endorsement without having any say in designing or changing programme components. Even the National Planning Commission (NPC) charged with the responsibility of designing policies and programmes and implementation and co-ordination was least involved. This meant that the internal feedback system remained ineffective and there was no mechanism for independently evaluating the strengths and weaknesses of a programme.

3.4 Implementation Strategy and Mechanism

As timely implementation of projects was essential for loan release, some specific measures were adopted for that purpose. The programme budgeting exercise was started with a new institutional arrangement within the Ministry of Finance. It facilitated prioritisation of the core projects and compelled ministries to pay attention to specific programme components. To strengthen that process, a better accounting and auditing system was also simultaneously introduced in the Financial Controller General's Office (FCGO). Similarly, to develop professionalism and specialisation in revenue administration, a new revenue cadre was introduced.

The OGL and auctioning of import licenses and government treasury papers introduced under the SAP were substantive steps taken toward promoting liberal practices in the trade and financial markets. The passbook system introduced to facilitate imports of raw materials was also a new institutional measure designed to discourage various distortions inherent in the existing trade regime. Similarly, as a move toward improving their performance, introduction of physical and financial targeting in public sector institutions was made mandatory. The authority granted to the commercial banks to partially fix interest rates was geared toward strengthening institutional capability of the banking system. The Credit Information Bureau established during the SAP implementation period was aimed at improving information flow regarding the credit status of borrowers. A short-term monetary programming system was reintroduced after being suspended temporarily during the SAP period. All these new institutional arrangements were made through government policy pronouncements and ad hoc decisions.

3.5 Factors Behind the Pace of Reform

During the Panchyat regime, reforms were either delayed or postponed despite the SAP commitments. This affected implementation of the programme in its entirety. Only the most compelling actions were taken to ensure loan release within the stipulated time frame. Interestingly, that was the period when the basic needs programme was also being implemented with a high pitch political propaganda. This programme was announced in 1985 with a very ambitious programme of fulfilling the basic needs like education, health, food, drinking water, fuel wood, clothing, and roads within 15 years. The rulers would have considered this essential in view of erosion in their support base as manifested by the 1979 referendum results. On the other hand, in many instances, the reform initiatives conflicted with these ambitious targets, which, among others, demanded some protective measures in selected areas. The basic needs package also demanded huge expenses in the respective sectors supported with adequate institutional arrangements in order to ensure the common people's reach to the programme. Therefore, fearing antagonism of the intelligentsia and people of different walks of life, some reforms might have been deliberately postponed or delayed. Similarly, some policies were slowed down for fear of hurting the interests of the ruling elites.

Similarly, various obstructions were created time and again hampering smooth transition from a protective trade regime to a more liberal one. Administrative reform, which was essential to push ahead with the overall reform framework, was not initiated at all. Contrarily, the size of the bureaucracy was further expanded because that was the area where regime supporters and others having nexus with the ruling class could be offered employment. Because of a host of similar interrelated problems, the privatisation programme was not started at all. The suggestions of the

CBPASS were never sincerely implemented, which among others could help overhaul the banking and financial system suffering from overburdened non-performing assets. Programme budgeting was not extended to the donor-funded projects, thus hindering comprehensive reform in this area. Consequently, reform was speeded up in areas of subsidy withdrawal or deregulation in prices even in essential commodities without ascertaining the likely social cost of adjustment. At that time, some tradeoffs were faced by the rulers. On the one hand, there was a need to contain government expenditure to reduce budgetary deficit. On the other, strong austerity measures accompanied by deregulatory policies could lead to a rise in social costs with adverse effect on the poor and fixed income groups. For political expediency and minimising economic crisis, the social cost issue was largely ignored.

Another factor that badly affected reform was the trade impasse with India that continued for 18 months beginning from January 1989 to June 1990. India not only blocked movement of goods between India and Nepal, it also imposed restrictions on overseas goods imported via Indian ports. This had a devastating effect on the total economy. As a result, people suffered much hardship because of non-availability of even essential commodities.

B. Second Phase (1990-2003)

3.6 Initial Conditions

3.6.1 *Political and Governance Structure*

Despite the democratic constitution of 1990 envisaged transforming the society toward a relatively progressive one and deepening democracy, the preconditions necessary for this were very poor or non-existent. The foremost constraining factor was continuation of the state superstructure that had evolved and deeply embedded during the autocratic regime. The bureaucracy developed and expanded during the autocratic panchayat regime was neither competent nor suitable to cope with the new challenges posed by the new constitution. Instead, inertia was predominant in the bureaucracy. It was nurtured under poor governance practices. Similarly, even in the new democratic set up, the security apparatus was left untouched from democratisation and hence it continued to act as an impeding factor against moves seeking to change the pre-existing power relations essential for deepening democracy. No effective institutional mechanism was put in place to check abuse of power and make the executive accountable. The Judiciary and other constitutional organs were very weak to perform the responsibilities bestowed on them by the democratic constitution. With regard to abolishing discrimination in the society, ensuring equity and guaranteeing equal opportunity to all, irrespective of caste, creed and religion, effective countervailing institutional mechanisms were not put in place.

Despite emergence of many political parties after the dawn of democracy, two political parties, namely, the Nepali Congress, representing the liberal democrats, and the CPN (UML), representing the progressive left-democratic forces, were in the forefront of democratic polity. These were the parties that had played a decisive role in restoring democracy in the country. Nepali Congress, unlike its traditional socialist inclination, was following two opposing development strategies: maintaining the status quo regarding agrarian reform and adopting a very liberal approach regarding the role of the state with regard to the market. On the other hand, the CPN (UML), which claimed to be the vanguard of the downtrodden, preferred a balanced market oriented reform and sweeping changes in the feudal agrarian structure for progressive transformation of the society. Therefore, it advocated complementarity in the roles of the state and the private sector. Nonetheless, this strategic position advanced either through election manifestos or through policy pronouncements while in the government was beset with certain ambiguities especially in matters of economic reforms. Due to different outlook and approach, rivalry and antagonism between these two parties resulted into failures to build a political consensus or develop policy co-ordination mechanisms in dealing with issues of national importance. The authoritarian tendency of the ruling Nepali Congress party and lack of tolerance within the CPN (UML) in the main opposition in many instances constrained any efforts toward strengthening of governing institutions and deepening of democratic practices.

Despite the fact that decentralised governance was the basic tenet of the constitution of 1990, the top-down administrative structure and development practices remained pre-dominant. The district and village level tiers formed during the panchayat period were kept intact. At a time when democracy was demanding fair participation and representation of marginalised people in the governance system, no legal or institutional mechanisms were introduced. So much so that the West Minster type of parliamentary practice envisaged in the constitution did not pay heed to the exigencies of the need to take decisive and far-reaching measures against the perpetuating discriminatory practices. This led to further compounding distributional conflict even in the democracy era. Only a vague provision was made in the constitution in enhancing equity and abolishing all types of discrimination. Consequently, concerted efforts were lacking in the political and governance structure to effectively address outstanding social and political issues rooted in the Nepali society since centuries.

3.6.2 Socio-Economic Structure

When the second phase of reform was implemented traditional subsistence agriculture was predominant in the economy. In 1990 agriculture contributed 50.6 percent to the GDP as against 6 and 9 percent share of industry and trade, respectively. On the employment front, agriculture was absorbing 81.2 percent of the total economically active population in comparison to 2 and 3.5 percent in the manufacturing and trade sectors, respectively. More challengingly, the distribution of land was highly skewed. Out of the total holdings, 43.8 percent of the farmers having less than 0.5 hectare of land were possessing only 9.4 percent of the total cultivated land. On the other hand, top 10 percent owning 3 hectare and more were holding 42 percent of the land. In terms of access to extension services only the big farmers were advantaged (Khanal, 1994 and Sharma, 2003). Life expectancy at birth was just 54 in 1991. Similarly, literacy rate was 39.6 percent in 1991. The size of population per doctor was 16,000 in 1991. The proportion of the population enjoying access to safe drinking water was 54 percent in 1991. Gender and ethnic disparity remained unabated. Life expectancy at birth of female (53.5 years) was lower than that of male (55 years). In terms of ethnicity, upper caste and other privileged people dominated the state and bureaucratic structures (IIDS, 2002 an NDC, 2003). In such a situation, the share of social sector expenditure was declining. The annual average share of total social sector expenditure covering education, health and drinking water had dropped from 23.6 percent during the period 1980–1985 to 21.6 percent during the period 1985-1991. On the whole, the level of poverty was 42 percent in 1989. By assuming $ 150 as the poverty threshold, population below the poverty line could reach as high as 71 percent (UNDP/ World Bank, 1989).

Table 3.1 Some Social Development Indicators

Description	1981	1985	1991
Life expectancy at birth (year)	50.4	–	54.0
Male (year)	50.9	–	55.0
Female (year)	48.1	–	53.5
Literacy (%)	23.3	28.9	39.6
Male (%)	34.0	–	54.5
Female (%)	12.0	–	25.0
Population per doctor	32267.0	27617.0	16000.0
Population per hospital	5515.0	4720.0	4046.0
Population per health post	23419.0	21591.0	22171.0
Population having access to safe drinking water (in %)	10.9	22.4	54.1

Source: NPC, 1980 and 1985; CBS, 1985 and 1996; NSAC, 1988; MOF, 2002.

Table 3.2 Social Sector Expenditure

Fiscal Years	Percent of Total Government Budget
1980/81	19.1
1981/82	24.4
1982/83	26.7
1983/84	25.0
1984/85	22.8
Average	23.6
1985/86	22.3
1986/87	22.0
1987/88	21.3
1988/89	22.0
1989/90	23.8
1990/91	18.3
Average	21.6

Source: Ministry of Finance. Economic Survey (various issues), HMG, Nepal.

The share of export in GDP in 1990 had hardly reached 10.5 percent. Such a ratio for imports was however higher at 21.1 percent. Neither suitable market institutions nor infrastructure existed. As such the private sector was not in a position to come forward instantly in the absence of an enabling business and investment friendly environment. Therefore, the economy was not only characterised by wide diversity, it also remained highly underdeveloped with pervasive poverty among the majority of the people.

3.7 Features, Sequencing and Direction of Reform

In general, the main motivating factors behind the second phase of reforms were restoration of democracy followed by formulation of a new democratic constitution, commitments of main political parties to expediting economic growth and poverty reduction, rising expectations of the people, and pressure from the mushrooming civil society organisations for change. However, the policy framework embodied in the ESAF and sweeping reforms in India were the major influencing factors in shaping the speed and sequencing of reforms. While pursuing reforms, highest priority was given to maintaining macroeconomic stability and thereby enhancing sustainable growth and development. Sweeping reforms were initiated in exchange rate, trade, and industrial, monetary, financial and fiscal policies. This was followed by reforms in the agriculture sector. The main focus was on deregulation of factor and commodity markets and correction in exchange and interest rates through market determined mechanisms. Side by side, open policies were pursued to attract foreign investment. Similarly, privatisation, fiscal consolidation, tax rationalisation and drastic cuts in the tariff structures were other main components of reform. Some institutional reforms were carried out together with programmes expanding social and physical infrastructure to create a better enforcing environment, develop human resources and attract private sector investment in the economy. On the whole, the main purpose was to eliminate distortions, correct misalignment of relative prices affecting resource allocation and efficiency in use, create incentives for the private sector, augment supply through price led incentive mechanism, and enhance efficiency and competitiveness for sustained growth and poverty reduction. The features, sequencing and direction of reforms in the major areas is discussed below.

3.7.1 *Macro Policies*

3.7.1.1 External Sector

Historically, on account of long and open border with India, Nepal's international trade had been confined to India. Furthermore, India is an accessible market for export of primary commodities and import of essential goods. Free and unlimited convertibility of the Nepalese rupee into the Indian currency and low tariff rates for imports from India, in contrast to foreign exchange controls and high tariffs for imports from third countries, has shaped the Nepalese economy as completely open to India and somewhat closed to the rest of the world.

The trade treaty between the two countries has governed international trade flows between Nepal and India. In addition, the bilateral treaty on transit, and agreement for cooperation to control unauthorised trade also have significant bearings on trade flows between the two countries. The first trade and transit treaty was signed in 1950. The treaty was subsequently renewed in 1960, 1971, 1978, 1991, 1996 and 2002. Since 1978, trade and transit treaties have been separated accepting access to sea as an inalienable international right.

The 1996 treaty exerted remarkable positive impact on Nepal's exports to India. However, the Nepal–India Trade Treaty renewed in 2002 has created regressive impacts on Nepal's trade as it reintroduced the concept of value addition and other non-tariff barriers. Quantitative restrictions were imposed on Nepal's export of vegetable ghee, acrylic yarn, copper and zinc oxide. Furthermore, India has channelised its import of vegetable ghee from Nepal through a state trading company. The new treaty also made Nepalese exports to India subject to countervailing duties to make prices of Nepalese exports comparable with Indian prices. Beginning from early 1990s, Nepal has allowed import of raw materials and intermediate and capital goods from India against the payment of convertible currencies. As domestic taxes are waived by India for imports, it was expected to increase competitiveness of Nepali products both in Nepal as well as in India.

During the first phase of reform, trade liberalisation was limited and confined to gradual expansion of open general license (OGL) for imports and some rationalisation of the tariff structure. After announcement of new trade policy, a range of policies aimed at liberalisation of trade were formulated.

In the process of trade liberalisation, the government moved fast towards eliminating the remaining control on imports imposed through the licensing system. In February 1992, there were 31 items subjected to licensing requirements. This was reduced to 12 in July 1992 and to 6 in March 1993. In July 1993, except few prohibited or banned goods such as narcotics and arms, the government brought all imports under OGL. Thus quantitative restrictions through licenses were completely abolished. This had a positive impact on production due to improved supply of raw materials.

Until July 1992, both the systems of import license auctioning and OGL were in parallel operation. Consequently multiple exchange rates emerged, viz., official rate, auction determined rate, and free market rate, leading to distortions in the foreign exchange market and prices. To avoid such distortions it was necessary to make the Nepali rupee fully convertible in current accounts. This was also necessitated by the fact that India was likely to move toward this direction. In February 1993, the Nepali rupee was made fully convertible in the current account. As expected, India did the same a couple of weeks later. Thus Nepal's foreign trade was completely deregulated from quantity and price controls following a step-by-step approach and in tandem with India.

Revision in tariff structure was a remarkable measure taken in the process of trade reform. Despite the fact that tariff had been the major source of revenue, tariff rates on imports were drastically slashed. The peak tariff was cut down to 110 percent from 200 percent. Presently, the maximum rate of basic custom duty remains at 40 percent except for some luxury goods for which the duty stands at 110 percent. Furthermore, 10 percent concession on the basic duty is provided to SAARC countries. Additional duties, which ranged from 25 to 55 percent before the reforms, were reduced to 5 to 20 percent in 1992/93 and finally eliminated since 1993/94.

Along with the lowering of tariff rates, the number of slabs has also been substantially lowered from more than 100 rates (categories) before reform to 13 in 1992/93 and further down to 5 in 2001/2002. The tariff slabs at present are 5 percent, 10 percent, 20 percent, 30 percent and 80 percent.

All these measures for liberalisation and simplification of tariff structure are supposed to facilitate imports. On the export front, there is no custom duty except service charge, which has been reduced from 2 percent in 1993/94 to 0.5 percent at present.

Similarly, the value added tax is levied at zero percent on exports. In order to release duty burdens on exports, the export duty drawback system has been in operation since 1987. However, slow implementation of duty drawback, particularly because of the lack of established procedures and guidelines and inadequate provision of funds, has hampered its effectiveness (RESTUC, 2000).

For imports of textile by ready-made garment industries, the bonded warehouse scheme was introduced in 1988. This has been an alternative to the duty drawback system. A long back, an announcement to establish an export-processing zone was also made . However, it has not yet come into existence.

3.7.1.2 Fiscal Policy and Privatisation

In Nepal the reform process was initiated to correct macroeconomic imbalances stemming from unsustainable fiscal deficit. Management of fiscal deficit has hence been a key component of the reform programme. For reducing the fiscal gap and maintaining macroeconomic stability, various measures were taken during the second phase of reform.

Measures undertaken to enhance revenue mobilisation were: (i) introduction of the value added tax, (ii) expansion of the income tax net, and (iii) revamping of tax administration. In view of the dominant role of indirect tax in revenue collection, the thrust of income tax reform was in broadening the tax base and strengthening the tax administration.

In an attempt to curtail public expenditure by reducing the size of the overly staffed bureaucracy, the government laid off a large number of civil servants without making necessary changes in the laws promulgated during the Panchayat regime.
In 2000, the government constituted a Public Expenditure Review Commission (PERC) under the Chairmanship of a parliamentarian. As recommended by the commission, 5,000 vacant civil service positions were frozen and 1,045 posts were abolished with an estimated savings of USD 2.4 million in fiscal year 2000/01 (MOF, 2002).

The PERC report of 2000 contains 148 recommendations. A PERC Recommendation Implementation Committee was also formed to implement the recommendations.

The committee classified the various recommendations for implementation in three phases. In the process, the concept of a Medium Term Expenditure Framework (MTEF) was brought into effect to reduce the gap between the periodic plan and annual programme budget as well as between the programme budget and actual progress.

In the area of institutional development, a nucleus monitoring unit was created within the Ministry of Finance (MOF) to improve expenditure reporting, provide early warning on fiscal performance, and monitor implementation of core programmes. Similarly, the National Planning Commission (NPC) has set up a nucleus project screening and expenditure programming unit to review the public investment portfolio and improve the quality of investments on a regular basis.

During the pre-liberalisation period, more than five dozen public enterprises had come into operation in various areas under various charters and acts. They catered to both social and commercial needs. During the panchayat regime, the concerned ministry of the government and the Corporation Coordination Division of the Ministry of Finance controlled the PEs. Business autonomy was virtually nonexistent. Price of the products or services of some of the PEs used to be directly fixed by the government. There was a substantial amount of political interference. Some of the PEs were enjoying not only business monopoly but also regulatory powers. For example, according to the Royal Nepal Airlines Corporation (RNAC) Act, no other airlines could be established without consent of RNAC. Some of the PEs were competing with the private sector. Performance of majority of the PEs was not encouraging even though they enjoyed monopoly or were allowed to compete with the private sector with government support,. In 1985, the government floated in the market shares of three PEs, viz., Rastriya Banijya Bank, Nepal Industrial Development Corporation and Rastriya Beema Sansthan. But the public response was very poor. This created a lull in the privatisation programme (Manadhar, 1998). As financial health of most of the PEs was poor, they were a drain on the national treasury. By the year 1990/91, out of 59 PEs, 28 were in loss. The accumulated total loss of PEs over the six-year period (1986–1991) amounted to Rs. 5.02 billion (US $ 117.8 million). Against this backdrop, Nepal abruptly intensified the privatisation process from 1992 without building necessary legal and institutional infrastructure, and without making concrete attempt to reform the PEs. The government also failed to build public confidence in privatisation. The privatisation act came into effect only in 1994.

According to the privatisation act 1994, the following are the major objectives of privatisation:

- To increase productivity of enterprises by enhancing their efficiency,
- To reduce the financial and administrative burden of the government,
- To promote private sector participation in national development, and
- To generate additional revenue for the government.

Interestingly, the objectives do not include promotion of fair competition. Hence the act does not guarantee that a public monopoly does not get transferred into a private monopoly, which is more dangerous. The privatisation act has provision for a privatisation committee, which is headed by the minister of finance, and comprises the minister, members of the House of Representatives and government officials. The main functions of the committee are:

- To recommend programmes and priorities of privatisation to HMG,
- To recommend HMG on the process of privatisation,
- To remove hindrances faced in privatisation programmes, and
- To follow up the decisions and agreements relating to privatisation.

By the end of the Eighth Plan (1992-97), 17 public enterprises were privatised. As the results from privatisation did not turn up as expected, thereafter, the process of privatisation was delayed. Many studies including those done by DFID (1999) and ILO (2002) have indicated a number of weaknesses of privatisation in terms of the process, valuation and transparency. In some cases, the selling prices of PEs were even less than their liquidation prices. The number of employment has decreased in most of the privatised enterprises. As the private sector could not manage the privatised enterprises some of the privatised enterprises like the Agricultural Tools Factory, Bhaktapur Brick Factory, and Biratnagar Jute Mill had to be taken back by the government. If a demand driven privatisation programme is initiated, in which private entrepreneurs of the country themselves demand that some PEs of the government need to be privatised even when they are running in loss, half of the problems associated with privatisation could be solved. However, this is not happening in Nepal (Adhikari and Adhikari, 2000). Nepal's privatisation is supply driven.

Privatisation is a political process operating in the field of economics. Hence a broad political consensus is required to make the privatisation process a success. Less attention was given towards this end. A hasty and across-the-board privatisation policy was followed without considering its social and strategic importance, financial condition, profitability and market position of the concerned PEs. On the other hand, a selective approach to privatisation was followed in 1994/95 complemented by appointment of chief executives on the basis of a free competition among professionals for improving performance of the public enterprises.

In the Ninth Plan (1997–2002), 30 PEs were targeted for privatisation. Job uncertainty among the employees had some negative effect on their productivity leading to further worsening of the financial health of the PEs. On the other hand, the pace of privatisation has faltered since 1997 for reasons discussed above. However, again in 2000, a tea estate was privatised. Now at a time when there is no parliament, the government has again speeded up the process of privatisation taking advantage of its limited accountability.

Apart from the predominant emphasis on privatisation, some measures have been taken to improve the operational efficiency of PEs. More flexible pricing policies have been introduced and prices of fertilizer, petroleum, water, telephone and electricity have been adjusted frequently to bring about some improvement in the financial positions of PEs. Since 1996, PEs have been given full authority to make price adjustments as necessary to respond to changing input costs. In addition, for increased involvement of the private sector in different economic activities, the government has opened health, education, aviation and telecommunication sectors to private investors. Similarly, the private sector was allowed to import and distribute chemical fertilizer and generate electricity to eliminate public monopolies in these activities.

3.7.1.3 Financial Sector

At the time of initiating economic reform in 1985, Nepal's financial system was very repressed as manifested by interest rate controls, selective credit policies and control on entry and exit. Intermediation cost was very high due to lack of competition and efficiency. There were only two commercial banks, and two specialised financial institutions—the Agricultural Development Bank of Nepal

(ADB/N) and the Nepal Industrial Development Corporation (NIDC), all operating in the government sector.

During the first phase of liberalisation, interest rate structure had been a major component of the deregulation policy in Nepal (NRB, 1996). Interest rate control was liberalised in a gradual manner, starting in 1984 with the provision of freedom to the banks and financial institutions to fix deposit rates above the floor rate fixed by the Nepal Rastra Bank (NRB) up to a certain limit to complete decontrol in 1989. Nepal also opened the door for joint venture banks with foreign collaboration in 1984, although establishment of a bank remained subject to license from NRB and approval from His Majesty's Government (HMG). Three joint venture banks were granted license during 1984–1987. Thereafter, no license was granted for six years. Thus on the eve of initiating the second phase of reform, there was an oligopolistic banking market with only five commercial banks in operation. In addition, with the permission of NRB, ADB/N also started carrying out commercial banking activities in urban areas since 1984. Similarly, the Finance Companies Act was brought into effect in 1985 mainly to meet the demand for business and consumer credit of small borrowers. However, as the legal provision allowed holding only 40 percent of the total issued capital it was not attractive to promoters, and only one finance company, that too in the public sector, came into existence before the second phase of reform. Removal of the statutory liquidity ratio and introduction of auctioning of Treasury Bills were other reform measures implemented during the first phase of reform. Since 1989/90, with a view to indirectly controlling the monetary aggregates NRB adopted open market operations (OMOs) as a monetary policy implementation tool.

During the second phase of reform, the financial sector was liberalised to a great extent. In the process, a number of banks and financial institutions both in the public and private sectors came into operation. Amendment to the Finance Company Act 1985 allowed promoters to hold 60 percent of the total issued capital. This consequently resulted in a mushrooming growth of finance companies in the country. The Regional Rural Development Banks were established in five development regions, modelled after the Grameen Bank of Bangladesh. The Development Bank Act 1995, and Financial Intermediary Institutions Act 1998 have provided a basis for the private sector and NGOs to be involved in financing the agriculture and rural sector. In response to the conducive policy initiatives a large number of development banks, some of them as replicas of Grameen Bank, and financial NGOs and cooperatives have come into operation during the post-reform period.

During the second phase of reform, prudential norms have been refined and strengthened continuously. In 1988/89, NRB fixed capital adequacy ratio, defined as ratio of capital fund to total deposit, for commercial banks at 2.5 percent for July 1989, 3.5 percent for July 1990 and 5.5 percent for July 1991. As this target appeared to be not attainable the NRB issued another directive in 1991 redefining the capital adequacy ratio. Accordingly, commercial banks were required to maintain a capital fund of 6 percent of their risk-weighted assets including off balance sheet items by July 1991, and 8 percent by July 1992. For 2001/02 the capital adequacy ratio was fixed at 9.0 percent of capital fund, which has to increase to 12.0 percent by 2004/05.

In order to minimize the risk of over-concentration of loans to a few big borrowers, NRB, for the first time in 1989, set an upper limit on the amount of loan to be provided to a single borrower or group of borrowers by a bank. Accordingly, banks were allowed to provide a maximum of 50 percent of capital fund in respect of funded loan and 100 percent of capital fund in respect of non-fund based loans for a single borrower. The limit was reduced to 35 percent and 50 percent, respectively, in 1995. The 2001 regulation again revised the limit as follows: (i) 25 percent of core capital in case of fund based loans, (ii) 50 percent of core capital in case of non-fund based loan. As the basis was changed from capital fund to core capital, the credit limit has gone down drastically. The NRB has also issued directives to monitor sectoral concentration of credit.

The concept of mandatory priority sector lending was introduced in Nepal in 1974. Paradoxically, it not only continued in the post-liberalisation era, but also increased in terms of its level and forms. In 1984/85, commercial banks were required to advance at least 8 percent of their loans in the priority sector. In 1990, this was raised to 12 percent. From 1991/92 onwards the commercial banks have also to lend a specific percentage of their priority sector lending towards the deprived sector, composed of small borrowers of below specific amount. The priority sector lending, however, is going to be phased out by 2007 on the ground that the programme is not market oriented and hence against the spirit of reform.

Enforcement of the Nepal Rastra Bank Act 2002, Debt Recovery Act 2002 and establishment of the Debt Recovery Tribunal are the notable steps taken in institutional development in the financial sector. While the government dominates the financial system as an owner and operator, NRB has failed to perform adequately as a supervisor and regulator of the system. Poor supervision capacity of the central bank is in part to blame for the severe problems faced by the two largest commercial banks and for the general deterioration in the system (World Bank, 2002). The Nepal Rastra Bank Act 2002 has provided more autonomy to NRB. This act intends to enhance the role of the central bank in maintaining financial discipline and stability as well as making its regulatory and supervisory role effective.

Debt recovery is presently neither effective nor expedient. The court system suffers from inordinate delays and enforcement of judgement is a serious problem for banks in the process of recovery (World Bank, ibid). Enforcement of the Debt Recovery Act 2002 and establishment of the Debt Recovery Tribunal are expected to make loan recovery mechanism effective and to reduce the NPA of the banking system. A process has also been initiated for establishing an Assets Management Company to ease impediments faced in debt recovery.

During the first half of the 1990s, authorities again followed a liberal policy in granting license for opening a new bank. However, they were caught between the issues of restriction on entry vis-à-vis liberal entry of financial institutions. While outright restriction on entry could lead to oligopolistic practices and suppress competition, liberal entry into financial services would generate unhealthy competition (NRB, 1996). The regulatory authorities had therefore adopted a discouraging and delaying policy mainly through the increase in capital base route.

Among the existing banks, the joint venture private banks are making lucrative profit by means of concentrating their business in the urban centres. However, financial health of the two large and partly/fully government owned commercial banks, namely, Rastriya Banijya Bank (RBB) and Nepal Bank Ltd. (NBL), having much wider branch networks all over the country including rural and remote areas, is not sound.

The main component of the second phase of reform is restructuring of these two banks. In the process, the government sold part of its holding in NBL to the private sector. But the condition of the bank further worsened resulting in negative net worth. According to a study made by KPMG, an international consultant, RBB is technically insolvent. In order to address this problem these banks were given to foreign teams of experts on management contract. However, very little improvements have so far been made. The general public is now questioning the rationale behind bringing in expensive management contract with loan funded by the WB.

NBFI's such as finance companies, financial NGOs and development banks are also regulated and supervised by the NRB. The area and method of regulation are generally the same as in the case of commercial banks.

The NRB has recently declared a more stringent bank licensing policy, where it has also committed that decisions will be made within a stipulated timeframe. Thus the sequence of reform measures in the banking sector of Nepal appears as follows:

- Focus on decontrolling price and quantity and easing entry barriers in the first phase, i.e., the period from 1984 to 1991;
- focus on prudential regulation in the 1990s; and
- focus on institutional development since the beginning of the 21st century.

The most common pattern of financial sector reform in developing countries has been, first, radical liberalisation, and second, implementation of prudential norms that moderate the initial liberalisation (Loayza and Soto, 2003). To some extent, this pattern is reflected in the reform process in Nepal also.

On the insurance front, the Nepal Insurance Company, the first insurance company of Nepal, was established in the private sector in 1947. The first foreign branch was established in 1950. No legal restriction is imposed on entry of privately owned domestic, foreign and joint venture insurance companies in the insurance market. However, the Insurance Act 1968 granted discretionary authority to the Insurance Board for licensing. Because of the inward looking and restrictive policies, the insurance sector grew at a very slow pace before initiation of the reform programme. After enactment of the Insurance Act 1968, only two new insurance companies came into existence during the period of more than two decades, one in 1974, and another in 1987 with foreign equity of 10 percent. In the reform process, a policy shift towards liberalisation of the insurance sector and granting licenses to number of insurance companies has taken place. The total number of insurance companies reached 18 in 2002.

In 1992, a new Insurance Act was brought into effect. The new act has the following main features: (i) it is mandatory for all the insurance companies incorporated in Nepal to offer at least 20 percent of their shares to the general public through public issuance, (ii) foreign investors are allowed to hold up to 80 percent of the total issued shares, and (iii) a single company cannot indulge in both life and non-life insurance.

The Insurance Board formed under the Insurance Act 1992 regulates the insurance market. It has issued several prudential norms related to capital base, and investment. Insurance companies are required to invest their fund in the portfolio specified by the board. The Insurance Board also fixes the price of insurance as per the recommendations of the Insurance Tariff Advisory Committee. Thus there is control on both price and allocation of fund.

Regarding the capital market, the most important measure undertaken during the second phase of reform was conversion of the Securities Exchange Center into the Nepal Stock Exchange (NEPSE) in June 1993. NEPSE opened its floor for stock trading through brokers in January 1994. The secondary market thus created for securities has been an incentive factor to the investors. In the beginning NEPSE activity grew rapidly, which did not last for long. Trading started to concentrate on few companies. Establishment of the Securities Board (SEBO) in 1993 was another important feature of capital market reform in the 1990s. To promote and protect the interest of investors both the primary and secondary market are regulated, supervised and monitored by SEBO. To institutionalize the securities business and to open the market for foreign investors, the Securities Exchange Act 1983 was amended in 1993 and again in 1997. Regulations were also implemented to check insider trading and develop good corporate governance in securities trading.

3.7.1.4 Labour Policy and Labour Market

Labour market in Nepal is characterised by a growing labour force. Labour force during 1991-2001 grew at a high rate of 3.8 percent compared to 2.9 percent during 1981–1991. During the inter-census period 1991–2001, growth in female labour force (4.3%) outpaced that for male labour force (3.2%) by a wide margin

(Mainali et al, 2002). Although female labour force participation is still lower than male participation, women's entrance to workforce is rising.

Nepal's labour market is dominated by the informal sector. The formal sector encompasses only 5 to 6 percent of active labour force and absorbs only semi-skilled and skilled labourers.

There is a strong pressure in the job market as the labour force is growing at a high rate. Free inflow of Indian labourers and their employment by big enterprises operating as joint ventures with Indian companies has further aggravated the problem. In the reform process, the number of government employees has been reduced through compulsory retirement. This has also created pressure on the job market. Similarly, voluntary retirement or golden handshake in PEs has also exerted same effect in the process of privatisation.

A national labour policy was announced in 1999. This focuses on training, social security, promotion of self-employment, abolition of bonded and child labour, and facilitation in foreign employment. It also aims to make industrial relations cordial and complementary to the market oriented liberal economic policies. However, the Labour Act 1991 does not match with these aims. The act stipulates that workers need to be given permanent employment status after six months of employment. This makes it difficult for employers to layoff workers when forced to do so by economic conditions (HMG/UNDP/UNIDO, 2002).

The Minimum Remuneration Fixation Committee, constituted with representatives from the government, employers and employees, fixes the minimum wages. Thus in general wage rates are fixed based on a tripartite agreement. Attempts are made to ensure that the minimum wage rates remain above the per capita income required to meet the basic needs.

The Labour Act 1992 has provisions of various institutional arrangements based on tripartite representation. The Central Labour Advisory Committee (CLAC) is headed by the Minister of Labour and includes secretary level representation from various government agencies, employers associations, trade unions and labour experts. The main tasks of the CLAC are: (i) formulation of policies and laws related to labour; and (ii) coordination of labour related activities. Such a tripartite consultative mechanism helps reduce disputes between the employer and employees and establish smooth industrial relations. The Labour Relations Committee and Labour Courts are also there to resolve labour disputes. However, there are problems in effectively implementing the provisions of the labour law (GEFONT, 2000). This has created a situation in which the labour workers do not appear to be protected while the investors consider it investment unfriendly (HMG/UNIDO, 2002).

In the area of public employment, the government has reduced the retirement age from 60 to 58 years to downsize the government. Similarly, voluntary retirement schemes were introduced in PEs.

As mentioned above, the informal sector dominates the Nepali labour market. Provisions in the labour act including minimum wage is practically not applicable in the informal sector. Labourers in the informal sector are paid much less than the minimum wage. Gender discrimination is reflected in the form of females being paid less than males for the same job.

There was a tradition of keeping bonded labour in the informal sector. The government brought into effect the Bonded Labour Act in 2001 and declared the practice of bonded labour as illegal.

3.7.2 Some Sector Specific Reforms

3.7.2.1 Agriculture

Being the largest sector in terms of both output and employment, agriculture has been playing a key role in the Nepalese economy. Growth in the Nepalese economy is therefore largely determined by growth in its agriculture sector. However, Agriculture in Nepal has been characterised by low rates of productivity, very low level of technology absorption and low level of commercialisation (Sharma and Deraniyagala, 2003). Agricultural growth has been constrained by inadequate infrastructure and lack of irrigation and other complementary inputs (World Bank, 2002). The main component of reform in the agriculture sector has been to improve the supply of inputs.

Crop production accounting for about 60 percent of agricultural GDP is the major activity in the agriculture sector. Irrigation plays a vital role in enhancing crop yields. According to the Agriculture Sector Performance Review 2002, rice yield under irrigated condition is 42 percent higher than under non-irrigated condition. Similarly, the yield of irrigated wheat is 32 percent higher. However, as of 2000, only one-fifth of the cultivated land in Nepal was irrigated.

Since 1980, the government had been providing subsidies to shallow tube-wells to enhance the level of farmer-managed irrigation. Fertilizer is another critical input. Despite the fact that the government had been providing price subsidy on fertilizer, the level of its application in Nepal has been quite low. In the process of reform, the fertilizer market was liberalised with the objective of improving supply conditions. The main components of reform include: (i) elimination of price control, (ii) phasing out of subsidies, and (iii) promotion of private sector participation in import and distribution of fertilizer.

The level of subsidy had been gradually reduced since 1992 and ultimately eliminated in 1998 for the following reasons: first, the subsidy together with distribution monopoly had caused supply bottlenecks leading to pent-up demand, second, the subsidy was biased in favour of the better-off farmers with larger landholdings, third, the subsidy put excessive pressure on the treasury, and fourth, subsidised fertilizer spilled over to India through the porous border.

Credit is one of the major determinants of productive capacity in agriculture. A number of credit programmes including Small Farmers Development Programme (SFDP), Intensive Banking Programme (IBP), and Production Credit for Rural Women (PCRW) are under implementation since long.

The private sector is dominant in Nepal's agriculture sector as most of the activities are in private hands. However, a few agriculture farms have been established in the government sector mainly for research purposes and production of seeds and planting materials. During the second phase of reform, the government adopted a policy of handing some of them over to the private sector. Out of about 50 government farms, six were leased out after introduction of the liberalisation programme in 1990/91. All privatised farms are horticultural farms except one livestock farm. A large tea estate was also privatised in 1999.

3.7.2.2 Manufacturing

Reform in the manufacturing sector plays a vital role in transforming the economic structure, which is heavily dependant on agriculture. The industrial policy of 1986 opened the economy for foreign investment not only to import foreign capital but also to transfer technology. It also declared that the private sector would be allowed to establish any industry except the ones related to defence. In the very beginning of the second phase of reform, industrial policy, foreign investment and one window policy were announced. Similarly, the Industrial Enterprises Act 1992 and Foreign Investment and Technology Transfer Act 1992 were brought into effect. These policies have encouraged private sector investment by easing the process of establishment of industrial enterprise in the country. No license is required for establishment of industrial enterprises except those related to defence, public health and environment. Similarly, the scope of foreign investment has been widened and repatriation of foreign investment has been made easier. Foreign investment was permitted even up to the extent of 100 percent of issued capital in large and medium industries with a floor of Rs. 20 million reserved for Nepali investors alone. Even this floor was later eliminated in 1995 to attract more foreign investment. Similarly, any amount received by sale of equity can be repatriated.

The following are the other major features of the policy introduced in 1992:

- It is guaranteed that no private sector industries will be nationalised. (It is notable here that Nepal has been a member of the Multilateral Investment Guarantee Agency (MIGA).)
- It is also committed that the government will not interfere in fixing the price of industrial products.

To advance into an era of market based industrialisation the government adopted the policy of eliminating all forms of subsidies given to industries with a time bound schedule. The facility of tax holiday given to industries has been withdrawn since 1997. Other facilities, however, continue to remain. In order to improve institutional arrangements for industrial development, a "one window" system was introduced to provide all government services to domestic and foreign investors through a single institution.

Foreign investment is allowed not only in the form of direct investment but also in the form of portfolio investment. However, portfolio investment made through the Nepal Stock Exchange Ltd. must not exceed 25 percent of the total issued capital of a company.

3.7.2.3 Infrastructure

Infrastructures like road, communication and electricity have been recognised as prerequisites for a country's socio-economic development. Lack of basic infrastructures—particularly road transportation, electricity and drinking water—have been found as defining characteristics of poverty in a number of countries (Narayan et al, 2000; and Narayan and Putsch, 2002). Investment in infrastructure services contributes to sustainable growth and poverty reduction in a number of ways. At first, these services contribute to initiating and augmenting the modernisation process in a society and help people gain access to information and knowledge. At the same time, they induce economic activities through promoting trade and encouraging production for marketing. They do so by reducing transaction costs as well as by providing new opportunities to the economic actors resulting in market creation and expansion. Hence people are gradually encouraged to shift to entrepreneurship and business activities. This results in a series of backward and forward linkages. The communication network enhances that course by means of new connections and information flow about prices and marketing prospects of various products. Labor-intensive technologies for infrastructure development may massively help generate employment opportunities. In other words, in a competitive system the reform remains incomplete and unsustainable unless efficiency and better accessibility of infrastructure services is enhanced.

However, it has been very difficult to achieve this in practice. Benefits have often been less than anticipated, especially because of inadequate attention being paid to the issues of governance and institutional framework. High levels of personal and political corruption have distorted public investment choices. Emphasis only on hardware; negligence of social conditions; growing capital intensity of technology; unviable routes, places or modes of service facilities; lack of identification and involvement of beneficiaries; and failure to seek complementarily have been detrimental in augmenting markets and promoting economic activities that benefit the poor (DFID, 2002). This underscores the necessity of various reforms in areas of infrastructure development and services in tandem with other reforms. Therefore, public-private partnership, beneficiary group participation, decentralised decision-making, and competitive bidding have been emphasised in recent years. Access and affordability issues have also come to the forefront in the area of infrastructure services.

In Nepal, infrastructure has received topmost priority in successive plans. In the beginning the emphasis was on the construction of roads. The priority gradually shifted and now electricity generation and distribution has received high priority compared to road and communication (NPC, 2003).

Being a land-locked country, Nepal has given predominant emphasis on the construction of roads and extension of transport services. This has greatly helped to expand road facilities. In 1962, the total length of roads in the country was around 1,198 km comprising of 339 km blacktopped and 859 km fair-weather road (NPC, 1992). This coverage extended to 15,905 km by the end of mid-March 2000, comprising of 4,617 blacktopped, 3,958 gravel, and 7,330 km fair-weather roads. Further addition and expansion has been made during the remaining two years of the Ninth Plan (NPC, 2003). Likewise, domestic and international air services have gradually expanded. However, wherever road facilities are available, these are suffering from huge cost and poor quality (World Bank, 2000) resulting in weak linkages between road building and expansion of economic activities through market creation in a permanent way. The poor linkages have hindered the development of business and enterprises (World Bank and FNCCI, 2000).

Better service delivery and efficiency in resource use through alternative institutional arrangements has not been explored on the same footing as many countries are recently trying in this area. Still, the government's Roads Department undertakes major road works through a bidding process. Although there are divisional offices in different parts of the country, the whole project selection and bidding process is a top down affair with full authority resting at the center. At the same time there have been frequent changes in institutional arrangements for undertaking such works. Absence of accountability and physical auditing system, compounded by frequent transfer of project managers based on their connection with the power centres, have been instrumental in escalating per unit cost overtime. Recent policy thrusts have been on concepts such as BOT, BOOT and public-private partnership, but without much success due again to political and bureaucratic hurdles. Recently, a road fund has been created by involving the private sector with the aim of minimising maintenance problems and improving cost recovery. This remains to be operationalised.

Agricultural and other local roads have been put under the domain of newly created Department of Local Infrastructure Development and Agricultural Roads (DOLIDAR) under the Ministry of Local Development (MLD). In most of the cases, local roads are constructed through the involvement of local beneficiary groups. In this case also, resource misuse due to weak institutional capacity at the local level has been the major problem (Khanal, 1998 and IPRAD, 2000). Furthermore, for market expansion and increased production in the agriculture sector, construction of agricultural roads in a time bound manner was one of the strategies put forward by the Agriculture Perspectives Plan (APP). This objective has miserably failed owing to weak planning and institutional problems at the local level (NPC, 2003).

Problems encountered in the air transportation sector are even more serious. Notwithstanding the entry of many private airlines in the aftermath of the open sky policy, their services continue to be urban and tourist centred.

In the communication sector, rapid expansion has taken place in privately owned print, radio and TV media networks after the restoration of democracy. In telecommunication gradual extension has taken place in telephone services. Internet facility has gradually expanded in most of the urban areas. This success story is an outcome of many private companies providing such services to the customers. Expansion in modern communication facilities is essential for technology diffusion as well as product and trade diversification. A Regulatory Authority has also been established in this area. To provide mobile and telephone services, permission has been granted to private companies with possibilities of extension of services at competitive prices.

Market extension and enhancement of competitiveness cannot take place without cost effectiveness and better access to electricity services. Nepal being one of the richest countries in terms of water resources potential, very little has been harvested so far. The potential is such that it can be harnessed concurrently for household consumption, industrial uses and export. However, Nepal now faces serious problems in the way of speeding up generation and distribution of hydropower due to very high per unit cost.

In the past, the Nepal Electricity Authority (NEA) has had a monopoly in generation, transmission and distribution of electricity. Several experimentations and institutional changes have subsequently been undertaken. The Department of Electricity was re-established recently after being dismantled earlier. Similarly, the Water Resource and Energy Development Commission (WECS) under the Water Resources Ministry works in areas of promoting water resource development. All producers, including joint venture private companies such as Butwal Power Company started with foreign collaboration have to sell electricity to the NEA. This also constrained the development of companies in the private sector. Now a big shift has occurred in this pattern with more and more joint venture companies in the private sector, including those owned by local indigenous entrepreneurs, coming into operation. This has been possible due to adoption of liberal policies in this area through the Foreign Investment and Technology Transfer Act and Electricity Act of 1992. The government has recently announced a new electricity development strategy. However, monopoly distribution right still rests with the NEA. Although some policy pronouncements have been made for involving local communities in this area through cooperatives, many issues are yet to be addressed through new rules and regulations.

NEA monopoly in the midst of excessive mismanagement has had a very damaging effect on the cost effectiveness necessary for exporting electricity at competitive prices. There are serious problems in this area needing further clarification. In the past, the NEA had made agreements with the private sector for purchasing electricity in terms of US dollar along with additional adjustment in prices at par with some fixed rate of inflation. This has pushed up prices every year automatically owing to depreciation of the Nepali currency and rise in the inflation rate every year. As a result, per unit purchase prices of electricity supplied by the private sector have always been higher than the prices fixed by the NEA. Such a gap is widening every year. Consequently, NEA has been incurring losses worth billions of rupees. The role of donors was equally instrumental for such a state of affairs because funding for foreign private companies was made by the ADB and IFC. Technical losses and high levels of leakages, inefficiency in resource use, and very poor management have all contributed to push up the per unit cost of electricity. The practice of frequent hiking of the tariff rate often with donors' advice, justified on grounds of garnering funds for big power projects and rural electrification, has also undermined cost reduction and efficiency. The wide mismatch between small and large projects has also compounded the price and efficiency issue. All these factors demonstrate that reforms in these areas did not go in tandem with reforms in other macroeconomic fronts.

3.8 Institutions' Involvement, Reform Processes and Policy Co-ordination

In a democratic system, processes adopted in formulating rules and attitude of the state in accommodating aspirations and voices of all stakeholders are critically important in sharing of benefits and opportunities amongst the majority of the people. This is essential for resolving contradictions and managing distributional conflicts. This is why adaptation of democratic processes has been increasingly emphasised in the reform process for accommodating the interests of various contending classes and socio-economic groups. These practices ensure that even if some are net losers they are compensated for to avoid distributional conflicts (Bardhan, 2000). In its absence, institutional power loses balance resulting in hijacking of opportunities and state resources by a small number of elites. Prioritised programmes tend to widen gender and class inequalities, which create obstructions to reforms. In this context, the role of processes and policy co-ordination come into the forefront. It is an institutional process that seeks to bring about consensus among different contending classes and groups. Studies indicate that violent conflicts have erupted and intensified in countries where state institutions have failed to address acute horizontal inequality between social groups in the distribution of assets, state jobs, and social services (Verstegen, 2001). As a corollary, studies also indicate that growth and poverty outcomes in many countries of Asia, Latin America, and Africa have depended upon the quality of institutions and their capacity to manage conflicts of interest among divergent classes and groups. Divided societies such as those with ethnic fragmentation or high inequality, low-quality institutions for managing conflict—including low quality government institutions—and inadequate social safety nets have magnified external shocks, triggered distributional conflicts and delayed policy responses resulting into prolonged uncertainty in the economic environment and reduction in economic growth (World Bank, 2002).

Several channels exist in democratic societies through which interests of various contending classes and groups can be accommodated or addressed. In principle at least, various stakeholders and socio-economic groups must be involved in the reform process besides the executive organ, political parties, legislative body, and judiciary. The exigency prevailing in Nepal demanded a concerted move to mobilize all these channels simultaneously. In Nepal as in other Westminster type of parliamentary democracies, an act becomes operational only after ratification by the parliament and subsequent granting of seal of assent by the king. Not only the government but also individual members of the parliament can table a bill in either of the houses of Parliament, except finance bills and bills concerning the Royal Nepal Army or Armed Police Force. There are nine Parliamentary Committees in the Parliament, which discuss, amend and pass bills and forward those for adoption by the full house. The same mandatory procedures were followed while enforcing reforms through rules and regulations.

Immediately after implementation of ESAF, the Industrial Enterprises Act (1992), Foreign Investment and Technology Transfer Act (1992), and Privatisation Act (1994) were introduced. These bills were either revised or newly enacted. They were all passed through the parliamentary processes. However, most of such bills were primarily drafted by the expatriate experts hired by some of the donors. The New Income Tax Act (2002) is still criticised simply because even the language used by the expatriate experts was not properly translated into the Nepali language. Administrative reform that started in 1992 by downsizing the bureaucracy was widely opposed by civil servants and the main opposition parties because no opportunity was given for involving the concerned stakeholders in the reform process. Moreover, there was no legal provision governing the mechanism of such downsizing. That is why the Supreme Court blocked the government's move. In the process of formulating the privatisation act, the employees were not taken into confidence. As a result, this still remains as a major bone of contention between the government and the employee's unions. Regarding labor policy, it has been a universally established practice to pursue a tripartite approach involving labor unions, employers and the government for any move toward policy changes including wages rates.

As a matter of practice, bills have been presented to the parliamentary committees in an ex-post manner. These committees have always attempted to approve or block changes in the bills through majority votes. However, tabling bills after making major decisions outside the parliament continued as a customary practice and it unduly compelled parliamentarians to endorse already made decisions. Therefore, despite attempts to bring consensus in the committees, the government proposed bills with minimum revisions have often been passed in the committees. The bills considered sensitive by the government have always been approved through majority vote and whips of the party. Other than bills, even policies and programmes of the government included in the budget were not discussed with due priory in the parliament. In the absence of binding the government to take approval of those policies announced outside the parliament, major policy decisions were made without policy co-ordination or involvement of the concerned stakeholders. To make the matter worse, valuable suggestions made by the people's representatives were never accommodated in the budgetary proposals. Such insensitivity on the part of the ruling party steadily fomented authoritarian tendencies and adhocism in the functioning of the government. This spoiled institutional development in the country (Baral, 2000). As one study concludes "Because of the pro-elite or pro-upper social strata outlook of those in power, public preferences are not fairly reflected in the policy-making processes" (Dhungel, 2002).

In democratic societies, various stakeholders and socio-economic groups put pressure on the governments for accommodating their interest in acts, policies and programmes. Under these circumstances, the only lobby that ultimately prevails is that enjoying uninterrupted access to the power centres. Big business houses fearing healthy competition fall under this category. It has been observed in Nepal that the same houses or groups are involved in business, industry, banking, finance, insurance, real estate, and other services. Predominance of non-performing assets in the government-owned commercial banks has persisted as a result of accumulation of debt by big houses obtained either by using unethical means or by violating the rules. This practice has obstructed the kind of reform that is required in the whole banking and financial system. Inability to develop business and entrepreneurial culture is partly a reflection of undue advantages taken through lobbying and pressure tactics. Such practices are deeply entrenched and further reinforced as a result of patronage and client based system nurtured through excessive politicisation of the bureaucracy, police and even constitutional bodies. The consequent wide spread nepotism and favouritism has led to creation of anarchism and total lack of accountability in the overall system (International IDEA, 1997 and Panday, 1999).

The voices and demands as well as interests of the downtrodden are seldom heard in the reform process. They are hardly involved in the decision making process. Withdrawal of subsidies and intensification of deregulation in public utility services are best examples of this. Fertilizer and irrigation subsidies were withdrawn abruptly without taking into confidence the poor farmers who constitute the most vulnerable group in the society. Indeed, these subsidies were abolished under the conditions imposed by the Asian Development Bank (ADB) while agreeing to offer the Second Agriculture Programme Loan in January 1998.

External influences together with authoritarian tendencies in the functioning of the executive branch undermined the role of the opposition. It is needless to emphasize that the role of the opposition in a democracy is vital both in safeguarding the interests of various stakeholders and also in channelling their demands to the government. In the case of Nepal, non-responsiveness and non-enforcement of commitments were simultaneously magnified. On many occasions, governments were compelled to announce or enter into written agreements with the opposition in implementing certain policies and programmes. However, those were also never implemented sincerely.

Such a tendency to blatantly evade or push forward with unilateral actions had begun from the very beginning of formation of the interim government. The Mallik Commission was constituted to investigate the excesses of those who had accumulated wealth by misusing power during the panchayati regime, but its recommendations were fully ignored. This indeed worked in disguise toward blocking reforms that were necessary in a new democratic structure. Recommendations of the Administrative Reform Commission also met the same fate. Some of the demands put forward by forces opposing the constitution which could be accommodated were completely discarded. This could probably give some political space to them to remain in the mainstream democratic process. Similarly, no steps were taken to implement the recommendations of the Land Reform Commission of 1994 which had pleaded for a comprehensive agrarian reform necessary for productivity enhancement in agriculture and thereby alleviate rural poverty. Many pro-people policies and programmes initiated in 1994/95 were discontinued after the change of the government leading to practices of confrontation among the major democratic forces in matters of policy and programme. Even the suggestions made by the joint Parliamentary Committee constituted in 1998 to investigate revenue leakages were never implemented even though these were unanimously passed by the joint session of the parliament. Negligence in enforcing the declared policies and programmes in any area whether in poverty alleviation or fulfilling the basic needs of the people remained a common feature in the government.

Starting in 2000, some broader reform initiatives as suggested by the opposition parties and civil society organisations were made amidst the deepening economic crisis and distributional conflicts. The conflict was putting pressure on the government to do something so as to contain the influence of the CPN (Maoist). Some of the agenda agreed between the main opposition party and representatives of the then government included reforms in the election system, corruption control, de-politicisation of bureaucracy, implementation of land reform based on the recommendations of the Land Reform Commission (HMG, 1995), enactment of a law guaranteeing property rights to women, implementation of concrete policies addressing caste and social discrimination issues, promotion of industry and tourism, and effective implementation of the poverty alleviation programme. These agenda however remained only on paper. The next government of the same ruling party had reached an understanding with the main opposition almost along the same lines as above. Accordingly, it declared an eight-point programme in the parliament in August 2001. The programmes so agreed upon were land reform, property right to women, promotion of the language and culture of indigenous people, elimination of discrimination against dalits, strong anti-corruption steps, and land and housing facilities for the emancipated bonded labourers. Subsequently, some new acts were passed in the parliament dealing with property rights for women (although this materialised in a distorted form) and providing more power to the CIAA. In the mean time, the peace process that had started with CPN (Maoist) after declaring a ceasefire came to an abrupt end. In hindsight, one would consider it predictable because the government lacked preparation and failed to consult other political parties and the civil society with respect to tactics to be adopted in responding to the demands of the CPN (Maoist). General election for a constituent assembly was the principal demand of CPN (Maoist) at that time. The Property Investigation Committee formed in 2002 was also the result of the mounting pressure for curbing corruption. The new land ceiling, which was still high, was an outcome of the above understanding, although it received a jolt due to a Supreme Court decision. Other necessary reforms were not pursued at all.

Despite knowing very well that it was impossible to hold election for the local bodies in a situation of insecurity and violent conflict, the government did not extend the tenure of these bodies, which had ended in mid-July 2002. There is legal provision to do so. This widened the rift among the main political parties in institutionalising policy co-ordination. All these circumscribed the scope for effectively implementing the declared programmes. A more worrying part is that, the political crisis deepened and the government was unable to conduct the declared general election. This created a constitutional crisis leading to a unilateral move by the king to install his own council of ministers in October, 2002 by replacing the democratically elected government. After that, some initiatives were taken to restart dialogue with the CPN (Maoist). In this process, CPN (Maoist) forwarded some drastic reform agenda in political, social, economic and cultural spheres[1]. The government responded by making some proposals aiming at gradual reforms in certain political, economic and social areas[2]. Likewise, all major political parties opposing the king's October move issued an 18-point reform agenda aimed at the socio-economic transformation of the Nepali society[3]. Rapid unfolding of these events indicates that there was a need for political consensus or policy coordination in matters related to reforms to address the demands or voices of various constituents. Nevertheless, confrontation among the various political coalitions still continues as a constraining factor. The king's cool response to the demand of the mainstream political parties to reinstate the parliament in realisation of the fact that there is little possibility for holding general elections in the near future has further exacerbated the situation and made the process of national reconciliation and consensus building more difficult and challenging. Recent practices of enacting bills and even budgets through ordinances have completely blocked the formalities of consultations. Now in the aftermath of WTO membership, dozens of new acts have been promulgated or existing ones revised through the same process of ordinance. This has distinctly bypassed policy coordination or institutional involvement of the concerned stakeholders.

The problem associated with the involvement of various institutions and policy coordination was aggravated due to some of the donor driven acts, policies and programmes without adequate attention to initial conditions, content, sequencing and modality of reforms. Stakeholders other than the government were always sidelined. Almost all acts relating to economic reforms were formulated under the guidance or involvement of some of the donors. This stands true in the case of trade, industry, foreign investment and technology transfer, insurance, privatisation and tax related acts including VAT and income tax. Outside experts were involved in all bank and financial institution related acts. Truly, technical support of the donors was not harmful in itself. But, because of the absence of a wider internal consultation and discussion, interests and concerns of various vulnerable groups and other stakeholders were ignored and bypassed. This also had a discouraging effect on internalising ownership of policies and programmes. This tendency not only discouraged a system of institutionalising internal policy co-ordination, but also hindered a process of enhancing internal capacity building in policy related areas.

Nepal's experience so far suggests that, even in a democratic system, people may seek alternative modes of expressing their frustration and anger if proper responses channelled through opposition parties and various stakeholders are systematically ignored. Hence democratic processes are critically important in framing or reforming policies and acts, ensuring policy co-ordination among various stakeholders, and enforcing contracts and agreed agenda while pursuing reforms in the desired direction. In a highly discriminatory society with majority of the people are deprived of their rights and opportunities, this is the only process through which to strengthen or deepen the democratic system. Even after initiation of the PRSP that emphasised consultation among the concerned stakeholders, the tendency to impose conditions has continued because of the lack of a prior assessment of the likely implications of conditional policies on various socio- economic groups in general and vulnerable people in particular.

3.9 Implementation Strategy and Mechanism

At the time of the second phase of reform initiatives, the initial conditions were highly unfavourable as pointed out earlier. State institutions were very weak. Political institutions, which are the backbone of democracy, were also passing through certain transition and new experiments. The governance structure and institutional set up at the grass-root level were not strong enough to cope with the new development challenges. The market institutions as well as regulatory mechanisms were either non-existent or were underdeveloped and ineffective to facilitate the reform process.

3.9.1 State Institutions/Constitutional Bodies

The bureaucracy that had developed and expanded during the autocratic culture of the Panchayat regime before 1990 was neither competent nor suitable to cope with the new challenges as bestowed by the Constitution to the democratically elected governments. Therefore, the immediate task initiated by the first elected government was to reform the civil service in order to make it efficient and result oriented. Without this, success in economic reform programmes could be jeopardised. A High Level Administration Reform Commission was formed in 1992. The Commission had made a number of recommendations. Most notable among them were redefining the state's role in the context of a liberal market economy, decreasing the number of ministries from 21 to 18, reducing the number of districts based on a review by a special Commission, curtailing the size of the bureaucracy by 25 percent, lowering the bureaucratic hierarchy at both gazetted and non-gazetted levels, introducing a system of different service cadres in bureaucracy, pursuing stiff corruption controlling measures, and enhancing bureaucratic efficiency through a system of performance based reward and punishment. It had also cautioned on the needs for protecting bureaucratic institutions from over-politicisation.

In the beginning, attempts were made to implement some of the recommendations including curtailment the size of the bureaucracy. However, it met with a setback as the Supreme Court ordered to reverse the decision in the absence of a law authorising such a power. Nevertheless, the issue of administrative reform has got prominence in the government agenda (HMG, 2002). Accordingly, some specific attempts have been made to abolish temporary hiring and stop frequent transfers practised through politicisation of bureaucracy. Further initiatives have been made to introduce a contract system at lower level positions based on the recommendations of the Public Expenditure Review Commission (HMG, 2001). Some civil service positions have either been frozen or abolished. The number of ministries has been reduced to 21 from 26. Some reforms have been initiated in the pension scheme. The medium term expenditure framework has been introduced in programme planning and budgeting with a view to rationalising expenses and prioritising development expenditure. In line with the PRSP, attempts have also been made to ensure government expenditure more pro-poor (NPC, 2003). However, despite some of these initiatives there are still many areas, which have been least reformed resulting into burgeoning unproductive expenses and worsening governance and delivery system (IMF, 2002).

Since 2001, some concrete steps were taken to address the problems of corruption and bad governance posing major hurdles to improved performance of the government. One of the major steps taken was to make the CIAA more powerful and effective. For this, a new law was enacted in 2002, which granted the Commission authority to investigate the abuse of power and violation of rules and regulations by anyone holding a public position. Indeed, such a law was felt urgent since long in view of the growing nexus among the ruling elites, politicians, politicised bureaucracy, and some unethical stakeholders engaged in institutionalising corruption and rent seeking. As a corollary, the patron-client system encouraged by the ruling elites had facilitated siphoning off major chunks of resources away from the development process. This law for the first time granted CIAA the power to investigate the abuse of authority of the ministers without any prior permission. To expedite that process, a special court has also been established. After enactment of the new law, some politicians and civil servants have been jailed and further investigation is going on. To contain the spread of corruption in a more systematic manner, a Property Investigation Commission was constituted in 2002 with full authority to scrutinize the sources of income and accumulated property of those who had occupied public position after the restoration of democracy. The report of the Commission has been handed over to the CIAA by the government for follow up action.

At about the same time, parliamentary committees were acting proactively to expose and contain the rising corruption especially during the period 1999 to 2001. A number of suspected corruption cases were investigated and recommendations were made by the Public Accounts Committee (PAC, 1999, 2000 and 2001) for the CIAA to further investigate and take necessary action. Similarly, a bill was also passed in 2002 requiring transparency in the activities of political parties. This was felt necessary in view of political parties mobilising funds through different means without transparency on sources. Such a practice was continuing since long in a situation where political parties were left out of the orbit of audit. Attempts were also made to reform the Election Commission without much success. Attempts were made to improve financial discipline in government offices through the Office of the Auditor General (OAG) as outstanding dues and irregularities mounted year after year (OAG, 2001 and 2002).

One of the state institutions that had hardly reformed was the judiciary. It has been very weak and controversial. The courts have faced several problems including corruption and politicisation. Judicial activism in political matters and delay in dispensing verdict characterize the major features of the Nepalese courts. Questions have frequently been raised on the efficiency of the courts and their pace of delivering justice. In year 2000, out of 4,564 cases registered with the Supreme Court, only 1,884 cases (41.28% of the total) were settled (Supreme Court, 2001). Similarly, in 2001, of the 4,131 registered cases, verdicts were given in 1,398 cases only. This indicates that thousands of cases of the past still remain piled up in different courts without any verdict and clearance. The judiciary has failed to hold the executive and legislative bodies accountable for their misdeeds. All these have had immense detrimental impacts on overall reforms.

In a democracy, the role of an elected body like the parliament, which is the supreme policy making body, is very important. It is the only body to which the executive has to be accountable, and the judiciary has to act in accordance with the bills passed by this body. Therefore, the role of the legislature in a parliamentary democracy is very vital and decisive. But in Nepal, the parliament has also fumbled in playing a decisive role. At first, no democratic processes were adopted in the course of parliamentary proceedings. Similarly, most of the parliamentarians did not show their abilities as policy makers. It was an enigma that only a few qualified people could get elected for the parliament from their respective areas. A study indicates that fewer than a dozen of Nepal's 205 members of parliament have any training in economics (Mahbub ul Haq H. D. C., 1999). As a result, the parliament could not be effective in terms of formulating public policies (Dahal et al, 2002) and undertaking the responsibility of a watchdog by forcing the government to improve its performance and enhancing better delivery. Most of the parliamentary committees also could not properly monitor and supervise the works and functions of the executive organs of the state.

In the late 1990s initiatives were taken by the state to form some watchdog institutions targeting the deprived sections of the society. To promote human rights and also advocate the necessity of pursuing a right-based approach to development, the National Human Rights Commission was established after enactment of a related act in 1999. Similarly, separate Commissions were formed at the national level to promote and protect the rights of Dalit, indigenous people, and women. But, they all lacked constitutional right and hence have been ineffective to play effective countervailing roles.

3.9.2 Political Institutions

Political parties are the backbone of democratic institutions. One cannot conceive of a functioning democracy in the absence of political parties. At the same time a well functioning democracy and effective governance pre-suppose the existence of well functioning political parties, which are sensitive and responsive to the people. If there is no internal democracy, parties become individual fiefdoms (UNDP, 2002). Democratic experiences of 1990 to 2003 show that political parties made certain epoch-making contribution in terms of strengthening democratic culture and practices in Nepal. Because of their instrumental role sovereign power could be vested upon the people. People enjoyed the right to express and organize themselves. Thousands of vibrant civil society organisations came into existence. They activated people to exercise their legal and constitutional rights by creating awareness or mobilising them for civil liberties. The decentralised system of governance would not have been possible in Nepal had there not been political institutions that were not committed to fulfilling legitimate demands of the people. The people's expectation rose because of democratic freedom which got further fostered by dissemination of information by the free and vibrant media.

Nevertheless, experience shows that major political parities, despite their full commitment to democratic principles failed to nurture democratic culture and practices within and across their organisational structure and in their functioning. Democratic forces that worked hand in hand to restore democracy became archrivals immediately after the restoration of democracy and often forged alliances with those political forces against whom they had jointly struggled for decades. They forgot and ignored the possibility of a revolution thwarted by a counter-revolution. Instead, in many instances democratic forces directly or indirectly worked to make political grounds for regressive forces. Amidst intensified rivalry, the culture of appreciating the good works done by the government of the ruling party or the opposition, never come to public knowledge. Some form of authoritarian tendencies became paramount across the ruling governments. At the same time, the main opposition and others generally imbibed a culture of intolerance and impatience. Such practices provided enough space for the extremist forces of the left and right to defame the multi-party democratic system.

The main political parties like the Nepali Congress (NC) and CPN (UML), which emerged as beacons of democratic forces in the aftermath of the popular movement of 1990, had remained underground for 30 years. They thus lacked the intricacies of open politics. These parties had no sufficient idea about the ways and means that could enhance democratic governance in both the governments and the parties. They did not try to adjust their organisational structure and functioning of party machinery to be compatible with democratic polity in the changed context. Instead, even after restoration of democracy, the party organisational setup remained largely the same as it was during the underground period. They largely remained top-heavy and employed imposing means even in selecting leadership during party congresses or conventions. Hanging on to the party's top positions became an overriding concern for the leadership. This resulted in the entrenched practice of buying favour and formation of leader specific coteries across the party hierarchy. This further resulted in erosion of inner party democracy. As an offshoot of this, within the party a permanent type opposition also became always active often disobeying the party's formal decisions, thus creating confusion among the rank and file of the party cadres, and to the detriment of democratic practices.

Thus lack of inner party democracy characterised by a centralised decision-making system, and hierarchical and sometimes bureaucratic organisational structure were major factors contributing to political parties' failure in institutionalising and strengthening democratic culture. No uniform standards and transparent criteria were developed and followed in the selection of candidates' for the parliamentary elections. Lack of financial transparency amidst power grabbing behaviour of political leaders hindered the process of strengthening governance in party functioning. The problem of inner-party democracy especially from the standpoint of managing conflict of interest among contending groups and coalitions led to the extent of splits in major political parties. This jeopardised a process of strengthening the nascent democratic institutions.

Not enough attention was given to ensure adequate representation of women and other disadvantaged groups at various levels of party leadership. This epitomised nonchalance on the part of political parties in pioneering assertive actions against a discriminatory and feudal society. Leadership was always trapped into certain controversies as a result of absence of wider consultation and discussion at various levels of party or leadership circles. Weaknesses in party functioning were directly reflected their performance whether in the government, or in the parliament, or outside. A system of non-accountability at the highest level of government amidst strengthening of the patron-client relationship through political penetration in bureaucracy and other spheres of society further encouraged the opportunistic tendencies and groupism in the parties for grabbing power, sometimes with malafide intentions. This eventually led to institutionalising permanent hostility among various groups within the political parties that climaxed with a ruling party's MPs playing a vital role in toppling own government. Because of such practices, political instability intensified especially from mid-1995 leading to more than 13 governments in a twelve-year period of democratic practices.

Many unfair practices and unethical means were embraced both in political parties and in the governments that were at variance with democratic norms, values and culture. This resulted in defaming of the democratic system by undemocratic forces. Parties did not adhere to the spirit of inter-party democracy by holding detailed discussions within their organisations in matters related to economic reform or other issues of national importance. This encouraged the behaviour of expressing different views by different leaders on the same policy matter creating confusion within the party rank and file. Such a trend reached its climax when an issue of a far-reaching and very sensitive national interest was taken to voting overlooking the dire consequences in the absence of a broader inter-party consensus. This ultimately resulted in the split of the main opposition party. Although the party was re-united, the split however created some ground for CPN (Maoist) to expand their organisational networking and weaken the democratic system. Likewise, the ruling party was also divided later in 2002 at a time when it was in the government enjoying absolute majority in the parliament.

Unhealthy rivalries within major groups of the ruling party were used to inspire the then prime minister to dissolve the parliament at a time when holding the mid-term election was almost impossible due to intensification of conflict throughout the country and fragile security situation. In the absence of sufficient precaution on the part of political parties on the possibilities of smashing democratic institutions in the pretext of constitutional crisis, the elected government was dissolved on 4 October 2002. It is especially noteworthy that after the Royal Massacre of 1 June 2001, deliberate attempts were made to weaken democratic institutions and downplay the unity and consensus of political parties on broader national issues. Political instability amidst poor governance emanating from the tendency of grabbing power by any means had a pervasive impact on the features, pattern and sequencing of the reforms as well. The Nepali experience thus reaffirms that inner party democracy and better governance in the functioning accompanied by due respect to democratic norms on major political issues is essential if one is to forestall resurgence of the extreme right which is not conducive to reform.

3.9.3 Local Bodies and Civil Society Institutions

Strengthening of local body organisations was part of the two-pronged development strategy. In order to augment participatory development and ensure sharing of benefits among the people, priority was given to decentralisation and devolution of power to the local institutions. To expedite that process, three separate acts were formulated for the VDC, Municipality and DDC, complemented by the Local Bodies Election Act 1992. The first election for local bodies was held under these acts in 1993. Along with implementation of these acts, measures were initiated for actual devolution of power and development from below. In 1994, the Build-Our-Village-by-Ourselves (BOVO) programme was started in order to further accelerate this process. It helped to speed up local development through the utilisation of locally available labor and financial resources. It also facilitated developing local body institutions in an independent way without intervention by the central government. Above all, it promoted self-reliant development at the local level (Dahal et al, 2002).

To enhance that process the Local Self-Governance Act was enacted in 1999 by replacing the above separate acts. This was followed by implementation of the Local Self-Governance Rules in the same year. The act is regarded as a milestone in terms of augmenting the decentralisation process in Nepal. To a certain extent it provides authority to the local bodies in collecting taxes, selecting and implementing local level programmes, and preparing periodic plans for the district. Another important aspect of the act is that it postulates the concept of some reservations to women in local bodies, be it the ward, village development committee, municipality, or District Development Committee. This provision enabled women to get elected in various bodies. Recently, a Local Service Commission has also been proposed. Similarly, to enhance the decentralisation process the process of handing over of schools and health-posts to local communities has been started.

Naturally, one of the effective ways to reform is to ensure that majority of the people reap benefits through decentralised, participatory and people-centred development. However, despite continuous efforts, a full-fledged decentralisation is still awaited. The Local Self-Governance Act 1999 has serious flaws and loopholes. Problems associated with fiscal decentralisation are equally serious (HMG, 2000, and Khanal, 2003). Experience indicates that decentralisation still remains a top-down affair and means of political propaganda for different ruling coalitions to claim championing the cause of the poor and disadvantaged. Local governments have no legal power in coordinating and supervising the programmes launched at the local level. In the absence of a built-in mechanism for full-fledged participation, local elites have taken most of the benefits of decentralisation. Above all, there is no consensus among the major actors on the process of decentralisation because some focus on devolution of power to the elected units, others on the market, and still others on civil society, CBOs, NGOs, ethnicity, and territorial federalism. Thus the diverse views on a vital issue have created ambiguities about the decentralisation process at all levels (Dahal et al, 2002).

During the autocratic Panchayat regime, no role was accorded to the civil society institutions. It is only after the restoration of democracy in 1990 that democratic space has encouraged promotion of these organisations. Today, there are more than 35,000 civil society organisations in the country. They have also begun to expand their area of work. These civil society institutions are working either at the local level or are networking at the local, district and national levels. These organisations are quite diverse not only in structure, but also in functional character. Many of them are involved in awareness raising, social mobilisation, local infrastructure building, and implementation of basic service delivery programmes in education, health, and drinking water. On the other hand, the co-operative and sajha societies are mainly engaged in carrying out saving and credit mobilisation activities.

Apart from these, there is a large number of other civil society institutions of various stakeholders operating at the national, district and local levels dedicated to protecting the interests of their members or occupational groups. Human rights groups are engaged in protecting the civil liberties of the people. Procedural flexibility and integrated approach in functioning of these organisations has resulted in enhanced efficacy in social mobilisation or identification and execution of small scale projects, organising user groups to facilitate service delivery, accomplishing the programmes in a cost-effective manner both in terms of time, personnel and finance, and building local capacity for local self-governance (Dahal et al, 2002).

More importantly, civil society organisations can be the driving force in terms of changing a dominant social structure and bringing about new configuration in the society in which the marginalised will have a major say in the decision-making processes. Intensification of such a course becomes possible in a situation where many organisations established with the aim of serving own constituents can become proactive for the common cause. Such a phenomenon has been manifested quite visibly in recent years. But still, there are several problems in this area. Many NGOs are elite driven and hence elites quite often use them for simply personal resource mobilisation purposes. Experience suggests that voices of the more vocal and wealthy class-based civil society organisations are heard more and hence they are unduly benefiting at the cost of other stakeholders. Transparency of funds and funding sources, co-ordination and monitoring are also becoming serious problems in this area. Therefore, many deficiencies are still inherent among many civil society organisations.

3.9.4 Market Institutions

It is increasingly being recognised that market institutions formed through legislations, rules, regulations, and other formal and informal means are critically important for enhancing economic performance of a country (Bossert, 1994; Rodrik, 1999; 2002; and World Bank, 2002). Guarantee of property rights and enforcement of contracts through various legal and other means are equally necessary for reducing transaction costs and promotion of a market-based competitive system. For the same purpose, after implementation of the Enhanced Structural Adjustment Facility (ESAF) programme with support from the International Monetary Fund (IMF) in 1992, more than 140 acts comprising new and revised ones have come into existence along with new institutional arrangements set up in a number of areas. This stands true in areas of industry, trade, foreign investment and technology transfer, privatisation, taxation, and money and finance. Initially, the Industrial Enterprises Act (1992), Foreign Investment and Technology Transfer Act (1992), and Privatisation Act (1994) paved the way for creating various market based institutions to enhance the role of the private sector in the economy. The acts have provisioned a 'One Window System' to provide all the incentives, facilities and concessions to both domestic and foreign enterprises in a quicker way without imposing too many and cumbersome procedures here and there. Institutional arrangements have now been changed with one high level committee chaired by the Prime Minister. The Investment Promotion Board is working in the Ministry of Industry. Similarly, to avoid delays in decisions, the Department of Industry has the authority of approving joint-venture projects of up to one billion rupees. In order to ensure private property rights and induce market institutions, the Privatisation Act gives authority to the government for privatising public enterprises based on codified norms, procedures and modalities. For this, a high-level privatisation committee is envisaged to be chaired by the finance minister and comprising parliament members and secretaries from various ministries. In addition, there is a permanent privatisation cell in the finance ministry. New VAT and Income Tax acts have been introduced. In the process, various tax related departments have been restructured. Similarly, a permanent revenue board has been constituted involving the private sector and taxation experts. The ASYCUDA has been introduced at all major customs points for better tax compliance and transparency. Legal reform through changes in the Company, Contract and Consumer Protection Law are already in place. Some reforms in the labor law were also made with the provision of tripartite agreements among the government, employers and employee's associations while bringing changes in the labor policy. The rigidity clause in the above in relation to hiring and firing of employees has been a matter of contention between employers and employees' associations.

The constitution of Nepal guarantees property right to its citizens. The company and contract law also make provisions of ownership and contractual rights in the respective areas. The Foreign Investment and Technology Transfer Act provides ownership of investment and right to transfer earnings to the foreigners. Though very old, the Patent Design and Trademark Act is also in existence. The Copyright

Act 2002 has also been enacted. Tenancy right has also been guaranteed by the act of 1997. But still, enforcement issues remain debatable. The major controversy still lies in relation to the right of inheritance of property by women. Although the Civil Code of 1962 and the revised provision of 2002 provide property right to women in principle, they all are still discriminatory.

New initiatives like market based compensation in the case of acquisition of land by the government, amendment of the Contract Act, BOT, BOOT and information technology policies and establishment of regulatory institutions like the Nepal Tourism Board, Civil Aviation Authority, Nepal Electricity Authority and Nepal Telecommunication Authority have also been set up. All these have contributed positively to private sector development and extension of private-public sector partnership.

For enhancing deregulation of the economy and involving private sector institutions in agricultural extension services and input distribution, all types of subsidies including fertilizer, irrigation and interest subsidy given to the farmers have been abolished. In this process, the state owned Agricultural Inputs Corporation has been bifurcated into two separate companies after allowing the private sector to purchase and distribute fertilizer. The government owned companies now work on a competitive basis. The Small Farmers Development Programme of the Agricultural Development Bank is also being gradually converted into Small Farmers' Credit Co-operatives to be fully managed by its members. Government policy announcements indicate that entities dealing in technical products are also being handed over to the private sector.

The Federation of Nepalese Chambers of Commerce and Industry (FNCCI), Nepal Chamber of Commerce (NCC) and the Confederation of Nepali Industries (CNI) are very active in the private sector. They play a catalytic role in pressurising the government for policy changes and facilitating entrepreneurial development and business promotion. Likewise, many commodity business specific associations in the areas of carpet, garments, overseas trade, handicrafts, and cottage and small-scale industries are working in the private sector. The Agro-Enterprise Center is also working under the FNCCI. With donor support, various projects are in operation promoting small businesses and micro enterprises (ILO, 2002).

However, despite the various acts and institutional arrangements, numerous problems still remain to be resolved. The reforms implemented abruptly had constrained institution building since the process adopted did not take into account local conditions. Because of many loopholes in the midst of weak enforcement capacity or willingness, policy led distortions have come to the forefront constantly (HMG/UNIDO, 2002, and FNCCI and World Bank, 2000). Host of acts, and institutional and enforcement related problems were perpetuating at a time when Nepal was in the process of getting WTO membership and hence in opening up its agriculture and service sectors as well. This may create more problems to the already decaying small and medium enterprises.

In obtaining WTO membership, Nepal has committed to open up the banking and insurance sectors by allowing as much as 80 percent of foreign direct investment in all major services sectors. The government has also committed to opening the agriculture sector for business promotion purposes. To fulfil the WTO conditions or requirements, more than three dozen acts need to be either revised or newly enacted within two years of time. Among them, most noticeable from the viewpoint of future reforms will be export-import, plant resources, customs, industrial enterprises, labor, company, insurance, bank and financial institutions, foreign investment and technology transfer, competition, access to genetic resources, anti-dumping, seed, bankruptcy/insolvency, industrial property, copyright, cyber, and pharmaceutical acts. Thus, Nepal confronts a big challenge in developing rule based new institutions and fully opening the economy with high uncertainty and risks. This is more so in the absence of favourable initial conditions, including political ones.

3.10 Regulatory Mechanism

As market forces are often distorted by economic powers gained by market participants through cartel, syndication, acquisition and merger, a strong market oriented regulatory mechanism is required to ensure that competition as well as economic performance increases and economic as well as social well being of the people is promoted. In the absence of proper regulation, public monopoly could be transformed into private monopoly, which is even more dangerous. A sensible government needs to appoint a regulator immediately after allowing the private sector to enter into any sector of the economy. Thus developing a regulatory mechanism becomes an integral part of the reform process.

In Nepal, after opening virgin avenues for private entrepreneurs, a number of regulatory authorities were formed in different sectors. For example, after allowing entry of the private sector in the aviation business under the open sky policy of 1993, the Civil Aviation Authority of Nepal (CAAN) was established in 1996 to regulate this sector. Similarly, the Nepal Telecommunication Authority (NTA) was established in 1997, when the telecommunication sector was opened to the private sector. However, there is still no regulatory authority in health and education sectors, where it is more urgent as these comprise the basic needs.

These regulatory authorities formulate sectoral regulations and issue directives to enterprises running under licenses issued by them. Although the Industrial Enterprises Act does not require a license, in several cases license has to be obtained from the concerned regulatory authority. For instance, a license must be taken from NTA to run a business for providing Internet service. Similarly, there are restrictions on foreign investment in some cases. For example, foreign investment to the extent of only 80 percent of total equity is allowed in telecom business. The Industrial Enterprises Act and Foreign Investment and Technology Transfer Act are general in nature and applicable only in activities not governed by special acts like the Telecommunication Act, and Security Exchange Act.

Regulatory reform is the other side of policy reforms. They should move in tandem and protect the interest of all stakeholders. Regulatory mechanisms should be built in such a way that it ensures competition, quality, safety and protection from health hazards and environmental pollution. This is one of the weakest aspects of economic reform in Nepal, resulting into perpetuation of anomalies and distortions.

3.11 Pace of Reforms

From the above it is clear that in Nepal only a partial reform approach was followed. In that also institutional aspects and preconditions necessary for equitable and sustained outcomes were hardly considered. Rather, an unbalanced tactics was followed under the influence of multilateral donors. Hence no rigorous homework was made on the likely consequences of reform. As a result, a big bang approach in some areas and a piecemeal approach in others was followed. The big bang approach in some areas led to making Nepal's pace of reform faster compared to most of the other South Asian countries (IMF, 2002 and HMG, 2003). The tariff rate averaging 13.8 percent stands lowest in this region (HMG, 2003). Reforms in insurance and some other service sectors have been very fast despite these being very sensitive and risky. This is the reason why many countries, including Nepal's neighbours, are still hesitating to fully open up these sectors for foreign investors. Similarly, reforms were speeded up in areas of subsidy withdrawal and deregulation. In addition, in areas like public utility services policies centring on price hikes were enforced even undermining the management and efficiency issues. While in others it was slow or less effective. The main virtue of reforms was such that no serious consideration was given to the adverse initial conditions that could either circumscribe the scope of equitable benefit to various socio-economic groups or perpetuate distortions and anomalies undermining effectiveness of reforms. This was true regarding issues related to institutional capacity and adequacy. It was not realised that the path of dependency gaining strength in the Nepali society was responsible for perpetuating misery and deprivation, and issues of equal opportunities could not be properly addressed without first reforming the state, local and other formal/informal institutions in tandem. Similarly, despite the long development experience of many countries that in a highly inequitable society with top-down development and reform processes, some bold policy and institutional reforms are required was almost overlooked. Therefore, the reforms were more cosmetic lacking a societal transformation approach despite the new democratic milieu demanding such a course. By pursuing externally directed reforms, main attention was given to acquiring external resources in the belief that this will help the political expediency of the ruling party. Internally, the growing nexus between the rulers at the highest political level and unethical segments in the business community, on one hand, and expanding nexus between the rulers and politicised bureaucracy, on the other, guided the direction or sequencing of reforms to a greater extent. This was the reason behind delays in those reforms which would hurt the interest of the vested interests including certain ruling elites. Hence only those reforms were expedited where no immediate resistance was expected because there was no organised voice from the weaker sections of the society. Such a tactics succeeded due to lack of willingness to forge political consensus and policy coordination. As explained earlier the practice of making major decisions outside the parliament encouraged such a course toward reform. This partly explains the reason for reform confronting resistance from political parties and civil society from the very beginning. At the same time, no concerted efforts were made to first strengthen constitutional bodies like the judiciary. This resulted in reluctance toward enforcement of contracts or rules. The delay or sometimes controversial judicial decisions had detrimental impacts in augmenting reforms and enforcing rules and regulations.

The privatisation programme was controversial from the very beginning. The modalities that were adopted have continuously been questioned resulting into delays in the programme. Prudential rules and regulation were not evolved, nor was a transparent system followed in the bidding process. Similarly, financial sector reforms were delayed despite many pronouncements made to this effect by the government. This was partly due to the growing nexus between the people at the highest level of government and few business houses for delaying repayment of bank loans or taking undue benefits. Only in the late 1990s some of the declared policies were implemented as a result of a deep crisis in the financial system in general and banking system in particular. Reforms in certain areas were expedited at a time when credibility of the government was at its lowest ebb. This was due to negligence of the programmes and policies that were critically important from the standpoint of meeting people's livelihood and augmenting overall development. The agriculture sector is worth mentioning in this respect. No attention was given to pursuing agrarian reform as an integral part of overall reform. Although the APP was declared adopted, it has never been implemented in its entirety. In agriculture, only deregulation was pursued. In that also, for optimising outcomes, Nepal always needs to synchronize its reform agenda with India's. Under donor pressure Nepal deviated from aligning the sequencing of reform in agriculture with that of India. Indian farms still enjoy much higher levels of subsidy and infrastructure support and realize higher returns vis-à-vis Nepal. Yet, India continues to subsidize farm loans, chemical fertilizer, electricity and diesel for irrigation and cold storage. Moreover, India effectively continues with the practice of minimum support and procurement prices whereas Nepal has already abandoned such practices long ago. Given the porous border Indian farm products have virtually swamped the Nepali market since the last few years.

From a politico-economic perspective, any reform package must promote political legitimacy and stability of the reigning authority. Therefore, reforms become possible especially when democratic governments with full mandate of the people are in the power. In Nepal's context, when the second phase of reforms was started this was exactly the case. The democratic government had both authority as well as duty to expedite policy or programme reforms that could help in fulfilling the rising expectations of the people which had remained suppressed during the thirty years of panchayat regime. Actually, the first election manifesto of the Nepali Congress contained many welfare oriented programmes which helped the party to secure absolute majority in the first parliamentary elections. But the development strategy adopted after assuming power was much deviated from the manifesto. Had reforms been more comprehensive covering the agriculture sector, small scale cottage industries, small businesses and services backed by social safety nets and adequate social security related programmes to compensate the loser, the Nepali economy by now would have already attained a sustained high growth trajectory.

The trade-offs were not explored while designing and pursuing reforms. A number of reasons come to the fore. As already noted, the foremost consideration has had always been in obtaining donor support with a view to winning election and stick to power. Similarly, it might have also been thought that despite the poor comprising a larger voter base, the rich would play a decisive role in the elections through financial support for campaigning and information dissemination. Similarly, because of the authoritarian tendencies in the name of majority and right to conduct election while in power, it might have been believed that manipulation in elections would ensure victory to the ruling party's candidates. All these factors could have influenced the reform process. Above all, frequent changes in the government amidst internal rivalry within various coalitions in the party accompanied by institutionalisation of patronage and client based system might have constrained well thought reforms and encouraged a course that could provide immediate benefits to the ruling elites, and at the same time ensure external resources as a result of the big bang approach to reforms in some critical areas.

Even though the minority government of CPN (UML) had tried to pursue a relatively balanced approach with more focus on local participatory development, many programmes were launched without due attention on implementation capacity. At the same time, the governance aspect was less focused. This provided enough space for unified opposition from various parliamentary parties. The slow pace of economic reforms and unilateral move to pursue many programmes by the CPN (UML) government abruptly motivated successive governments to discontinue some of the popular programmes. As a result, a judicious approach followed during the nine-month period through some broad-based reforms got subsequently discontinued. As noted above, the behaviour of the political institutions played a key role in this. The political instability since mid-1995 further constrained that course or direction of reforms leading to intensification of distributional conflict. This in turn gave fertile breeding grounds for both the ultra leftist and extreme rightist forces to weaken democratic institutions and processes by defaming some credible reforms that were undertaken by the popularly elected governments.

Endnotes

1 Among the major agenda forwarded by CPN (Maoist) are: constitutional assembly for drafting new constitution; self-determination rights and regional autonomy to the oppressed nationality/indigenous people, madheshi community and other oppressed regions; declaration of secular sate; free and accessible education and health care facilities to each individual; "land to the tillers"; and abrogation of all unequal treaties including the 1950 treaty of friendship with India.

2 Some of the reforms and changes proposed by the Thapa government are: redrafting of constitution development of a political system enabling participation of all Nepali; opportunities for self-promotion; elimination of all forms of discrimination and exploitation; proportional election system in few areas; adequate representation of indigenous people, dalits and other marginalised people in the National Assembly; 25 percent share of women in representation in all elected bodies including the House of Representatives; further empowerment of local bodies; reservation for women, dalits, minority communities and indigenous people in education, employment, elected bodies and health care facilities for a certain period of time; and strengthening of a liberal, market oriented economic system.

3 Some of the reform agenda proposed by five major parties are: consolidation of people's sovereign and executive power; amendment in the constitution incorporating the provision of referendum on major issues; making the election free, fair and impartial; increasing representation of women up to 33 percent gradually in all elected bodies; more transparency and democratic practices in political parties; a system of parliamentary hearing for constitutional appointees; national consensus to resolve the CPN (Maoist) problem; restructuring of the national assembly to ensure adequate representation of

dalits and indigenous people; empowerment of the local governing bodies; elimination of discrimination in economic, social and political spheres; introduction of a special programme for those who are under the poverty level including programmes addressing landless people's problems; and upliftment of the economic, social and cultural condition of the kamaiya (bonded labor), agricultural and industrial labourers and other economically marginalised people.

chapter four

Outcome and Impact of Reforms

Outcomes and impacts of reforms are assessed based on secondary data sources and findings of earlier studies. For such an analysis, comparable primary data sources would have been more useful and instructive. At the same time, these data sources provide limited idea about the extent of political instability and conflict and the underlying mechanisms. Therefore, interpretation of secondary data sources warrants caution. Nonetheless, the study tries to examine the outcomes and impacts of reforms in terms of losses and gains suffered by or accrued to the main classes and socio-economic groups.

4.1 Sources and Pattern of Growth

Generally, economic reforms are aimed at promoting efficiency in resource allocation and use, which in turn are expected to help augment both savings and investment in an economy. Reforms also accord parallel priority to macroeconomic stability and in minimising uncertainty and risks to the investors. Price deregulation is expected to accelerate output and enlarge supplies. It is ultimately anticipated that reforms will create spill-over effects in income and employment opportunities.

The repressed financial system and low exports due to the trade impasse with India as well as continued negative savings by the government were the main factors contributing to the initiation of reform (Panday et al, 1988). A low level of saving and the need for austerity compressed the investment ratio from 21.9 percent in 1985 to 18.4 percent in 1990. Thanks to remittances and upsurge in excise refunds, the national saving ratio nearly doubled in 1994/95. Consequently, the savings-investment gap slightly narrowed down in the mid-1990s.

The second phase of reform resulted in some positive effect on both savings and investment. In the first phase, the domestic saving ratio dropped sharply from 13.4 percent 1985 to 7.9 percent in 1990 (Table 4.1). Domestic and national savings reached 14.8 and 17.4 percent of GDP, respectively, in 1995. The domestic saving rate further rose to 15.2 percent in 2000. The national savings rate extended still faster to 19.2 percent following a big jump in remittance income, improvement in government savings, low level of internal borrowing by the government, as well as rise in private saving through high exports and financial deepening. These in turn helped to augment both investment and output. However, such a healthy situation did not sustain for long. In fiscal year 2003, both domestic and national saving rates fell to 11.3 and 16.9 percent, respectively. Almost a similar pattern is observed in the case of gross fixed investment. After 2000, all major macroeconomic indicators show a worsening trend. This was an outcome of worsening conflict and external environment. Many policy distortions also contributed to suppressing the saving as well as investment ratios.

Table 4.1 Macro Economic Indicators (in percent of GDP)

	1984/85	1989/90	1994/95	1999/00	2000/01	2001/02	2002/03
Import of goods and Nfs.	20.00	21.10	34.61	32.43	31.47	28.84	29.34
Export of goods and Nfs.	11.53	10.53	24.22	23.28	22.38	16.07	14.62
Net factor income	1.42	1.87	2.20	3.46	3.94	4.36	5.10
Net current transfer	0.22	0.17	0.37	0.35	0.35	0.40	0.51
Current A/C balance	-6.83	-8.54	-7.82	-5.34	-4.79	-8.01	-9.11
Total consumption	86.61	92.13	85.19	84.83	85.13	88.18	88.66
Private consumption	77.23	83.46	75.94	75.88	75.34	78.13	78.17
Public consumption	9.38	8.66	9.25	8.95	9.79	10.05	10.49
Total investment	21.86	18.45	25.20	24.31	23.96	24.59	26.06
Gross fixed capital formation	20.15	16.44	22.07	19.32	19.02	19.29	19.16
Public sector	7.79	7.70	6.88	6.97	7.62	7.61	7.05
Private sector	12.36	8.74	15.19	12.36	11.40	11.68	12.11
Change in stock	1.71	2.01	3.13	4.99	4.94	5.31	6.89
Gross domestic saving	13.39	7.87	14.81	15.17	14.87	11.82	11.34
Gross national saving	15.03	9.91	17.38	18.98	19.17	16.59	16.95

Source: MOF. Economic Survey (various issues).

From the beginning of reforms, paramount emphasis was placed on fiscal balance and macroeconomic stability. In both phases, Nepal was successful in this regard to a great extent. However, in the reform process predominant emphasis was given on macro balance without commensurate efforts at broadening the revenue base and enhancing sustained growth. This has led to a low-level equilibrium trap (Table 4.1).

In 1985, revenue surplus contributed 18.4 percent in total development expenditure. Similarly, internal borrowing contributed another 32.8 percent. In 1995, the share of revenue surplus to development expenditure increased to 26.8 percent. In that year the ratio of internal borrowing to total development budget dropped down very encouragingly to 9.6 percent (below one percent of GDP). The falling share of internal borrowing was offset by growing inflow of foreign aid. In recent years, the share of foreign aid in total development expenditure has remained in the range of 50 to 60 percent. Overall, the budgetary situation started worsening again especially since 2002. For the first time in Nepal's history, the amount of total government revenue in 2003 fell short of regular expenses, a symptom of internal borrowing crossing the limits. Despite various reforms on the taxation front including introduction of VAT, actual revenue realisation targets always fell short of the SAP and ESAF conditions. In both of these programmes, the incremental growth in revenue was projected to rise annually by 0.5 percent of GDP. This never materialised. As already noted above, even the recommendations of the joint committee of the parliament to curb revenue leakages were never implemented. Leakages are so rampant that even VAT and the new Income Tax Act have failed to make any dent. There is no perceptible structural shift in taxation (MOF, 2000 and 2003).

Table 4.2 Government Budgetary Trends (in percent of total development expenditure)

Cash Balance Surplus (-)	**1984/85**	**1989/90**	**1994/95**	**1999/00**	**2000/01**	**2001/02**	**2002/03**
Revenue surplus	18.4	20.1	26.1	26.4	16.5	5.9	-4.7
Foreign grants	16.8	15.2	19.9	18.0	18.2	21.2	29.9
Foreign loan	32.0	45.9	36.9	37.2	32.5	24.5	31.9
Internal loan	32.8	16.5	9.6	17.3	18.9	25.4	42.8
a) Banking system	0.2	0.1	0.1	0.1	0.0	0.0	0.0
b) Non-banking system	9.1	5.4	3.0	6.9	0.0	0.0	0.0
Cash balance surplus (-)	0.0	2.3	6.7	1.1	13.9	23.0	0.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Ministry of Finance. Budget Speech and Economic Survey (various issues).

The consistently poor performance of the public sector enterprises further compounded fiscal imbalance. Except public utilities and finance, all enterprises are in huge and growing losses, adding up the liability of the government (MOF, ibid). Withdrawal of subsidy and suspension of guarantee on loan to public enterprises has had some positive effect in containing the magnitude of transfers from the government to public enterprises. Yet, the accumulated losses pose a great burden on the treasury. Government's negligence in the management of non-privatised enterprises and rumours of impending privatisation have resulted in further deterioration of fiscal burden for the government. The government encouraged frequent hikes in the prices of public utility services, which further encouraged mismanagement and misuse of resources. Price hike was the only reason behind the somewhat improved financial position of public utility related enterprises. To make the privatisation programme completely incredible, not even a single penny has been utilised for development purposes and payment of arrears out of the proceeds from privatising two dozen or so enterprises. Modalities of privatisation including selection of enterprises, asset valuation and management in the private sector have been very controversial in Nepal[1]. The privatisation process was started with profitable enterprises. Out of them, some have been already dismantled. The worsening financial condition of public enterprises further aggravated the financial crisis of the government. The other problem is the overburdened bureaucracy. With about one hundred thousand personnel, it has a pyramidical structure in which more than 90 percent belong to the support staff category (MOPA, 2002). This has not only increased the wage bill, it has also added liability against long-term pensions. This is persisting in a situation where rampant corruption, leakages and rent seeking are pushing unproductive and recurring expenses in an unprecedented way. Despite several attempts made toward reforms in the public resource management and expenditure control, enforcement has always remained an insurmountable problem[2].

All these tendencies have adversely affected the level and quality of development expenditure. Alarming jumps in the size of the military and police related expenditure has crowded out the size of development expenditure by almost one-third in the last two years, i.e., 2002 and 2003. No sincere effort has ever been made at containing unproductive expenses. Notwithstanding the pattern of development expenditure being broadly consistent with the PRSP and medium-term expenditure framework, the level has drastically decreased affecting both social and economic sectors. In 1985, the size of development expenditure accounted for 11.8 percent of the GDP. This increased to 12.6 percent of GDP in 1990. This was partly due to new practices of shifting regular expenses toward development expenditure because of SAP conditions (Khanal, 1992). Conversely, in the aftermath of the second phase of reforms, most of the recurrent type expenses including the salaries of teachers were shifted to the regular expenditure category. This has had some dampening effect on the level of development expenditure. Along with the continued thrust on macroeconomic stability, the emphasis was on containing the development expenditure rather than regular expenses. The development expenditure was 9 percent of GDP in 1995 which was somehow maintained up to 2001. But within two years, its share in GDP has drastically fallen to 6.3 percent in 2003. On the contrary, the share of regular expenditure has nearly doubled from 6.5 percent of GDP in 1990 to 12.7 percent of GDP in 2003 (Table 4.3). This trend is neither compatible with fiscal reforms nor PRSP priority. Hence the claim that fiscal policy is recognised to be a critical instrument for enhancing short-term stability as well as long-term growth is nothing more than a myth.

Although the share of the service sector in development expenditure has steadily increased following broadly the long-term public expenditure pattern, the level shows a different pattern. This has been possible at the cost of sectors like agriculture, which are main sources of people's livelihood. The share of agriculture in total development expenditure was 12.8 percent in 1985. This ratio reached to 13.3 percent in 1995. Then it went down drastically to 6.3 percent in 2001.

Despite some jumps in its share, the level of social services has decreased in recent years. For instance, in 2000, actual spending on social services amounted to Rs. 12.4 billion. This level fell to Rs. 12.3 billion in 2003 (Table 4.6). Therefore, the macroeconomic stability achieved in recent years was primarily at the cost of socio-economic development. This is perpetuating at a time when the outstanding external debt is on the rise in a massive way. It increased from Rs 9.2 billion in 1985 to Rs 37 billion in 1990. In 1995 it reached Rs. 113 billion. In 2002 it stood at Rs 220 billion. In this way, outstanding external debt accounted for 54.4 percent of the GDP in 2002. Similarly, debt servicing has gone up to almost one-fifth of merchandise exports. Debt servicing alone (both internal and external combined together) represents almost one-fifth of government revenue. In a situation of bleak development prospects, this may further exacerbate vulnerability of the Nepali economy. Thus fiscal reforms were partial and hence less effective to promote sustainable growth and development. This is exemplified by the average and sectoral growth trends.

Table 4.3 Government Budgetary Position (Share of GDP in percent)

	1984/85	1989/90	1994/95	1999/00	2000/01	2001/02	2002/03
Expenditure	18.0	19.0	17.8	17.5	19.5	19.0	19.0
Regular	6.2	6.5	8.8	9.1	10.4	11.5	12.7
Development	11.8	12.6	9.0	8.4	9.0	7.5	6.3
Revenue	8.4	9.0	11.2	11.3	11.9	12.0	12.4
Overall deficit	9.6	10.0	6.6	6.2	7.5	7.0	6.6
Revenue surplus	2.2	2.5	2.4	2.2	1.5	0.4	-0.3
Foreign grants	2.0	1.9	1.8	1.5	1.6	1.6	1.9
Foreign loan	3.8	5.8	3.3	3.1	2.9	1.8	2.0
Internal loan	3.9	2.1	0.9	1.4	1.7	1.9	2.7
a) Banking system	2.8	1.4	0.6	0.9	-	-	-
b) Non-banking system	1.1	0.7	0.3	0.6	-	-	-
Cash balance surplus (-)	-	0.3	0.6	0.1	1.3	1.7	0.0

Source: Ministry of Finance. Budget Speech and Economic Survey (various issues).

Table 4.4 Sectoral Decomposition of Development Expenditure (Rs. In Million at Current Prices)

Heading	1984/85	Share (%)	1989/90	Share (%)	1994/95	Share (%)	1999/00	Share (%)	2000/01	Share (%)	2001/02	Share (%)	2002/03	Share (%)
Social services	1501.2	27.4	3973.2	30.6	6224.7	31.4	12406.2	39.1	12872.7	34.7	11299.3	35.9	12344.4	44.1
Education	644.2	11.7	1479.8	11.4	1453.6	7.3	2573.7	8.1	2783.9	7.5	2755.1	8.8	2272.0	8.1
Health	254.8	4.6	393.8	3.0	858.5	4.3	2126.7	6.7	1972.4	5.3	1876.7	6.0	1971.6	7.0
Drinking water	201.6	3.7	617.4	4.8	1102.2	5.6	2423.0	7.6	2407.2	6.5	1904.4	6.0	2408.5	8.6
Local development	339.3	6.2	454.1	3.5	2416.1	12.2	4136.7	13.0	4626.2	12.5	3684.9	11.7	4908.4	17.5
Other social services	61.3	1.1	1028.1	7.9	394.3	2.0	1146.1	3.6	1083.0	2.9	1078.2	3.4	783.9	2.8
Economic services	2051.8	37.4	4087.8	31.5	5825.9	29.4	6750.8	21.3	21114.3	57.0	15043.5	47.8	5906.1	21.1
Agriculture	703.6	12.8	1183.5	9.1	2639.4	13.3	2089.5	6.6	2329.3	6.3	2636.1	8.4	1820.1	6.5
Irrigation	652.2	11.9	1204.8	9.3	2550.8	12.9	3044.6	9.6	3953.3	10.7	3141.5	10.0	2263.5	8.1
Land reform	17.9	0.3	38.8	0.3	1.4	0.0	63.6	0.2	90.0	0.2	354.8	1.1	197.9	0.7
Survey	40.7	0.7	64.5	0.5	198.7	1.0	200.2	0.6	251.8	0.7	0.0	0.0	0.0	0.0
Forestry	290.4	5.3	547.2	4.2	408.4	2.1	519.0	1.6	478.9	1.3	632.9	2.0	557.0	2.0
Industry & mining	347.0	6.3	1049.0	8.1	27.2	0.1	833.9	2.6	366.8	1.0	659.1	2.1	542.4	1.9
Communication	90.4	1.6	128.4	1.0	1517.8	7.7	282.5	0.9	244.0	0.7	194.7	0.6	525.2	1.9
a) Post office	5.3	0.1	1.8	0.0	-	-	17.2	0.1	54.4	0.1	-	-	-	-
b) Telecommunication	85.1	1.6	126.6	1.0	1517.8	7.7	265.3	0.8	189.6	0.5	-	-	-	-
Transportation	923.0	16.8	1590.1	12.2	3010.5	15.2	4695.4	14.8	5354.9	14.4	4748.3	15.1	3663.4	13.1
a) Roads	519.5	9.5	1090.6	8.4	2277.1	11.5	3613.0	11.4	4106.6	11.1	4553.4	14.5	3453.5	12.3
b) Bridge	53.5	1.0	81.4	0.6	383.2	1.9	663.8	2.1	671.0	1.8	0.0	0.0	0.0	0.0
c) Aviation	347.1	6.3	410.3	3.2	316.8	1.6	417.8	1.3	508.9	1.4	194.9	0.6	209.9	0.7
d) Others	2.9	0.1	7.8	0.1	33.4	0.2	0.8	0.0	68.4	0.2	0.0	0.0	0.0	0.0

Electricity	504.9	9.2	2087.6	16.1	1764.9	8.9	5537.9	17.4	6813.7	18.4	4395.3	14.0	4204.2	15.0
Other eco. services	46.7	0.9	306.7	2.4	488.8	2.5	1382.0	4.4	1231.6	3.3	920.1	2.9	1078.2	3.8
a) Commerce	26.9	0.5	57.3	0.4	10.0	0.1	359.8	1.1	356.2	1.0	68.5	0.2	78.4	0.3
b) Labor	3.6	0.1	8.3	0.1	47.8	0.2	60.9	0.2	73.8	0.2	93.1	0.3	107.9	0.4
c) Tourism	6.1	0.1	18.4	0.1	147.4	0.7	221.5	0.7	383.7	1.0	253.9	0.8	154.2	0.6
d) Meteorology & hydrology	9.0	0.2	16.2	0.1	20.3	0.1	235.1	0.7	164.4	0.4	145.7	0.5	95.0	0.3
e) Supply & others	1.1	0.0	206.5	1.6	263.3	1.3	504.7	1.6	253.5	0.7	226.2	0.7	188.0	0.7
(f) Other											132.7	0.4	454.7	1.6
Miscellaneous	370.6	6.8	823.8	6.3	962.2	4.9	694.4	2.2	2742.8	7.4	2499.9	7.9	819.8	2.9
Miscellaneous	17.3	0.3	25.1	0.2	309.9	1.6	163.3	0.5	48.2	0.1	419.9	1.3	248.8	0.9
Contingency	353.3	6.4	798.7	6.1	652.3	3.3	531.1	1.7	2694.6	7.3	2080.0	6.6	571.0	2.0
Total	**5488.6**	**100.0**	**12997.6**	**100.0**	**19794.8**	**100.0**	**31749.2**	**100.0**	**37065.9**	**100.0**	**31482.0**	**100.0**	**28016.1**	**100.0**

Source: Ministry of Finance. Economic Survey (Various Issues).

Historically, growth performance of the Nepali economy has remained low. The GDP growth rate averaged less than 4 percent during the last three-and-a-half decades. The agriculture sector, which supports the livelihoods of the majority of the population, grew by 2.2 percent. This stands below the population growth rate of 2.3 percent. During the same period, the non-agricultural sector grew by around 5 percent per annum (Khatiwada, 2003). A closer examination of the growth performance of the two phases of reforms shows a mixed and unpredictable trend. In the first phase of reform, the growth rate was relatively high. In the second, growth was robust in the initial period of economic reforms. The growth rate eventually started deteriorating in major sectors of the economy resulting into a negative growth rate in 2002 (Table 4.5).

During the second half of 1980s when the structural adjustment programme was implemented, GDP grew at a rate of 4.8 percent on the average, comprising of 4.1 percent in agriculture and 5.5 percent in non-agricultural sectors. Due to good monsoon and steady expansion in cultivated area, growth in the agriculture sector was relatively satisfactory (MOF, 2000). Among the non-agriculture sectors, electricity enjoyed a much higher growth of 10.3 percent. This was followed by construction (6.5 percent) and manufacturing (6.4 percent) sectors.

Table 4.5 Total and Sectoral Growth Rate (1985-2003) (In percent)

Descriptions	(1985-90) 7th Plan	(1993-97) 8th Plan	(1997-002) 9th Plan	(1990-003) 13 Year	2001	2002	2003
Agriculture	4.1	2.9	3.2	2.6	5.5	2.2	2.1
Mining	6.0	4.9	1.8	5.1	1.4	3.0	3.3
Manufacturing	6.4	5.5	1.0	6.3	1.2	-10.8	-0.5
Electricity	10.3	19.4	5.6	15.3	12.8	1.4	11.6
Construction	6.5	6.0	2.8	5.3	1.3	3.0	1.9
Trade	5.8	4.5	1.1	3.6	-0.6	-12.3	1.8
Transport	4.2	8.8	7.4	7.4	8.6	0.7	3.4
Financial and real estate	6.0	6.8	5.2	5.4	7.9	1.7	3.5
Commercial social services	3.5	6.4	6.5	6.1	12.1	0.9	3.0
Non-agriculture GDP	5.5	6.4	3.9	5.7	4.9	-2.7	2.6
Total GDP (at factor cost)	4.8	4.9	3.6	4.3	5.1	-0.8	2.4

Source: Central Bureau of Statistics. Various Plan Documents and Economic Survey.

In the initial phase of reform, which coincides with the Eighth Plan (1993-97), the overall growth performance was very good with a 4.9 percent growth rate on the average. Growth performance in the agriculture sector was however low at 2.9 percent. Hence the higher growth was the outcome of the non-agriculture sector. The non-agriculture sector grew by 6.4 percent on the average. Among the non-agriculture sectors electricity grew at the fastest pace of 19.4 percent. This was primarily due to completion of medium sized hydropower projects. This was followed by the transport, and finance and real estate sectors. The high growth in these two sectors was due to rapid expansion in private sector activities in transport, finance and real estate sectors after implementation of market-oriented reforms in these areas. Viewed in terms of growth rate, reforms yielded some extent of positive effect on trade and manufacturing sectors as well. But, during the period 1997 to 2002 growth rate started decelerating partly due to poor performance in manufacturing (1.0 percent) and trade (1.1 percent) sectors. As a result, notwithstanding some improvements in the agricultural growth rate (3.2 percent) due to favourable weather conditions, the non-agriculture sector grew at a much lower rate of 3.9 percent during the same period. More worryingly, in the year 2002 the growth rate in these sectors declined by as much as 10.8 and 12.3 percent, respectively.

Between 1990 and 2003, when various reforms were accelerated GDP grew by an average of 4.3 percent. In this growth rate, contribution of the agriculture sector was 2.6 percent, which is slightly higher than the population growth rate. During the same period, the non-agriculture sector expanded by 5.7 percent. This was due partly to higher growth in electricity (15.3 percent) and transportation (7.4 percent) sectors. Interestingly, these are the most capital intensives sectors (NPC, 1992 and 2003). On the whole, the limited growth momentum brought about by economic liberalisation in the early 1990s did not sustain for long. Understandably, the low performance in the recent past was due partly to the internal security and adverse external environments faced by the country. But as will be explained later, the policy shortcomings or anomalies coupled with institution related problems were to a greater extent instrumental in dampening the growth rates, particularly from the mid-1990s.

As exhibited by the growth pattern (Table 4.6) the economic structure also shows a similar trend. During the first phase of reform, there was virtually no change. For instance, the contribution of agriculture in the total GDP fell marginally to 50.6 percent in 1989/90 from 51.2 percent in 1984/85. Correspondingly, a minor change occurred within the non-agriculture sector. The manufacturing sector's contribution increased to 6 percent from 5.7 percent during the same period. Almost a similar pattern is observed in the trade and construction sectors.

During the second phase of reform, structural shifts were rapid for some time. The share of agriculture in total GDP dropped by almost ten percentage points during the period 1990 to 2003. Interestingly, the shifts was very sharp during the period 1990-1995 when contribution of agricultural GDP slipped to 40.8 percent within just five years. There was a big surge in the contribution of the manufacturing sector as its ratio reached 9.3 percent from 6 percent in 1990. Some increase in the contribution of construction, trade, transport, community and personal services sectors also took place during this period. Better export opportunities enjoyed by the export-oriented industries until the mid-1990s had very positive effects on the structural shift. This momentum could not however be maintained for long. After 1995, the shift away from agriculture toward non-agriculture was not only negligible, even the shift within the non-agriculture sector was not as expected. The share of the manufacturing sector continuously dropped reaching 7.9 percent in 2003. Almost a similar pattern persisted in the trade sector. Conversely, growth in some major non-agricultural sectors including electricity, construction, transport, finance, community and personal services registered some increment.

On the whole, the agriculture sector stagnated as a result of low growth rate. Likewise, performance in the non-agriculture sector sharply deteriorated in recent years due particularly to dismal performance of sub-sectors like trade and industry, which are regarded to be most dynamic sectors in the liberalised economic environment. Both the growth and pattern additionally reveal that sectors with urban biases have expanded steadily with the exclusion of sectors that could enhance or broaden growth and augment employment. This also means that in the reform process no concerted efforts were made at the policy or other levels to reverse the trend so that benefits could be shared by the poor and low income earning socio-economic groups. Unlike the presumption of the liberal policies, why is such an unwarranted phenomenon persisting or even aggravating needs further diagnosis.

Table 4.6 Contribution of Major Sectors in GDP and Their Trends (In percent)

Sectors	1984/85	1989/90	1994/95	1999/00	2000/01	2001/02	2002/03
Agriculture	51.2	50.6	40.8	39.6	38.4	39.6	39.6
Non-agriculture sector	48.8	49.4	59.2	60.4	61.6	60.4	60.4
– Mining	0.4	0.5	0.5	0.5	0.5	0.5	0.5
– Manufacturing	5.7	6	9.3	9.2	9.0	8.1	7.9
– Electricity	0.4	0.5	1.4	1.6	1.8	1.8	2.0
– Construction	8.5	9	11.0	10.2	10.1	10.4	10.4
– Trade	10.3	10.5	11.6	11.7	11.3	10.0	9.9
– Transport	6.0	5.7	6.7	8.0	8.5	8.6	8.7
– Financial and real estate	9.0	9.3	9.8	10.1	10.6	10.8	10.9
– Community and social services	8.6	7.9	9.0	9.1	9.9	10.1	10.1

Source: Ministry of Finance. Economic Survey (various issues).

4.2 Productivity, Competitiveness, and Gainers and Losers

4.2.1 *Agriculture*

Generally, policies providing price incentives help agricultural producers to diversify production for the market. This is the major channel through which both production and farm incomes are boosted. An examination of the weight of various food and commercial crops reveals a very slow production shift in the Nepali agriculture. As per national accounts estimates, in 1984/85 food grain accounted for 37.3 percent in total agricultural production. This has come down to 33.7 percent in 2002/2003 (CBS, 2000 and 2003). Between these two intervening periods, the weight of livestock has decreased considerably, which was replaced by other crops. The share of livestock has dropped from 32.5 percent to 27.7 percent, whereas the share of other crops has gone up from 14.5 percent to 21.6 percent during the same period. Empirical evidences from Nepal thus indicate a very slow pace of product diversification.

When the yields of major farm produces are examined, some improvement is found in the productivity of major crops. Between 1990 to 1995, there was a decline in the yield rate of paddy. Improvements in the yield of other food crops like maize and wheat were also very marginal. This was true in the case of cash crops also. Since then, however, improvements have been significant. The yield rate of paddy reached 2.75 MT per hectare in 2003 from 2.06 MT in 1995. The average yield of wheat has gone up from 1.44 to 1.89 ton/ha during the same period. Almost a similar trend is observed in cash crops (MOAC, 1995 and 2002). Apparently, this shows that despite withdrawal of subsidy, abundant supply together with price incentives to the producers exerted a positive impact on growth and productivity in agriculture. But, these trends conceal many unique features of the Nepali agriculture, which make it extremely difficult to link them with policy parameters. First of all, in comparison to the historical trends observed in other South Asian countries, Nepal exhibits an opposite trend. For instance, during 1961 to 1963 the yield rate of paddy and wheat in Nepal were higher by 29 and 46 percent in comparison to their yield rates in India. During 1997 to 1999, however, the yield rates of all other South Asian countries have surpassed Nepal's yield rates (Sharma, 2003).

A recent empirical study, which examined the major determinants of yield, provides many interesting results having far-reaching policy implications (IMF, 2002). In the regression runs and iterations, fertilizer, irrigation, credit and rainfall were considered as major arguments. Fertilizer was found significant only in the case of paddy crop. In all major crops, no close link was observed between irrigation and yield rate. The rainfall index indeed swamped the effect of irrigation. The study clearly indicated that the recent rise in yield rate was primarily due to better weather conditions. This means that for raising productivity in a sustainable manner as well as increasing income of the poor farmers, massive expansion is called for in irrigation facilities. From the near term policy perspective, only the credit variable was found significant in all major crops depicting its important role in the Nepali agriculture. These findings reconfirm that fertilizer use is limited in paddy and its use needs to expand rapidly for productivity enhancement. When these findings are compared with recent policy changes, no proper compatibility is found.

In 1985, the sales price of urea was Rs 3.5 per kg. Before the withdrawal of subsidy, the price had reached Rs 8 per kg. It rose 2.28-fold in fourteen years. With the complete abolition of subsidy, the sales price of urea instantly went up 1.74 times to Rs 14. With a slight fall in 2001, urea sales price further increased to Rs 14.1 per kg in 2002 (Table 4.7). When the pattern of fertilizer use is observed, the price effect is clearly pronounced. The use was at its peak in 1994, and it has fallen steadily thereafter. Urea consumption drastically fell to a total of 19,713 MT in 2001 from a peak of 90,263 MT in 1994. After deregulation, most of the distribution of chemical fertilizer is done by the private sector. This component is not reflected in the government's published data. But even the Agriculture Sector Performance Review done for ADB concludes that "the official figures would seem to lend some support to the criticism of the reform of the fertilizer sector, in so far as they point to a disappointing performance. When measured in terms of nutrient per hectare of cropped area, the situation is similarly gloomy. The nutrient application seems to have declined from a low level of 21.9 kg/ha during the first five year period of the 1990s to an even lower level of 16.4 kg/ha in the second part of the 1990s" (ANZDEC, 2002). Furthermore, the same study reveals that after the deregulation and subsidy withdrawal despite some improvements in timely availability, supply and quality have emerged major problems at both the aggregate as well as the farm levels. In 1997/98, three percent of the 1st quintile of farmers had quality problems. In 2001, 12.5 percent of this category reported such a problem (ANZDEC, Ibid).

More alarmingly, after the abolition of subsidy on shallow tube wells (STWs), their installation has completely halted due to cost escalation and poor affordability. In 1988/89, about 6,800 STWs were installed. In 2000, actual STW installation numbered only 2000 against the target of 8,800. After the complete removal of subsidy there is no reporting of any further installation of STWs by farmers (ANZDEC, ibid). This simply means that the subsidy removal has had a very distressing effect on the poor farmers.

The situation in the credit market is not so different from that for other inputs. Rural credit surveys of the Nepal Rastra Bank together with the National Living Standard Measurement Survey (NLSS) of CBS provide information on access to credit among various farmer categories and expenditure quintiles. The trends indicate that there is not much change in the role of formal and informal sources of rural credit supply from 1969/70 (Table 4.8). The proportionate share of informal supply of credit has remained above 80 percent throughout the period with the only exception of 1976/77. Between 1969/70 and 1976/77, the coverage of institutional credit had increased by more than six percentage points due to the concerted efforts at branch expansion of ADB/N and commercial banks. On the other hand, by this time, the compulsory savings schemes were suspended and their assets and liabilities were taken over by the Sajhas (cooperatives). Expansion in the supply of credit to rural areas by commercial banks continued through 1991/92. It started declining in the aftermath of financial sector liberalisation. Another point observed in 1991/92 was borrowings, particularly by smaller households, from both informal and formal sources. About 2.26 percent of the sample households had reported doing so (Acharya, 2003).

Table 4.7 Sales Prices of Commonly Used Fertilizers (in Rs per Kg)

	Urea		DAP		Potash	
Year	*Index*	*Price*	*Index*	*Price*	*Index*	*Price*
1984/85	3.50	100.0	4.50	100.0	1.57	100.0
1985/86	4.20	120.0	5.62	124.9	2.10	133.8
1986/87	3.99	114.0	5.34	118.7	2.00	127.4
1987/88	3.92	112.0	5.34	118.7	2.00	127.4
1988/89	3.99	114.0	6.02	133.8	2.19	139.5
1989/90	4.07	116.3	6.32	140.4	2.32	147.8
1990/91	4.07	116.3	6.32	140.4	2.32	147.8
1991/92	5.71	163.1	8.36	185.8	3.21	204.5
1992/93	5.14	146.9	12.50	277.8	2.90	184.7
1993/94	5.60	160.0	12.50	277.8	8.50	541.4
1994/95	5.60	160.0	12.50	277.8	8.50	541.4
1995/96	6.70	191.4	16.88	375.1	8.50	541.4
1996/97	6.70	191.4	16.88	375.1	8.50	541.4
1997/98	7.40	214.4	18.60	408.9	9.40	598.7
1998/99	8.00	228.6	20.40	455.3	13.90	885.4
1999/00	13.80	399.4	19.50	433.3	13.90	885.4
2000/01	13.50	385.7	19.00	422.2	13.60	866.2
2001/02	14.10	402.9	19.30	428.9	14.30	910.8

Source: Ministry of Finance. Economic Survey (various issues).

Table 4.8 Source of Rural Credit Supply (Outstanding as of Mid-July 2000)

Institutions	Rs. in million	Percent
Agricultural Development Bank	12883.1	53.25
Commercial banks (agriculture only)	8863.7	36.64
Regional Rural Development Banks	733.2	3.03
All cooperatives	1276.0	5.27
NRB registered NGOs	10.5	0.04
PDDP	412.2	1.70
LGP	15.8	0.07
Total	22918.5**	100.00

Source: Acharya (2003).

Table 4.9 Borrowing from Formal and Informal Sources in Nepal (in percent)

Items	Rural Credit Surveys of NRB			NLSS, 1995/96		
	1969/70	1976/77	1991/92	Rural	Urban	Nepal
Percent of borrowing households	38.28	51.26	38.89	63.18	37.59	61.32
Formal sources of credit	18.01	24.03	20.30	16.19	25.40	16.28
Agricultural Development Bank and Land Reform Savings Corporation	0.34	4.99	9.4	9.90	9.61	9.89
Commercial banks	2.45	4.12	8.6	2.55	10.90	2.88
Grameen type banks	-	-	-	1.24	0.76	1.22
Ward/village committees	12.35	-	-	-	-	-
Others (including cooperatives, NGO/INGOs and local groups)	2.95	14.91	2.3	2.50	4.13	2.29
Sources of credit: informal	81.92	75.98	82.46	83.78	74.67	83.43
Friends and relatives	30.90	24.24		40.40	50.70	40.80
Moneylenders	43.42	36.36		31.6	16.00	31.00
Landlords/employer	2.78	3.74		4.07	2.19	3.99
Merchants/agricultural traders	3.27	11.16		4.76	3.91	4.73
Others	1.55	0.48		2.95*	1.87*	2.91*
Total	100	100	102.76	100	100	100

Source: Acharya (2003).

Access to credit from the organised sector is disproportionately large for urban households. Generally, female-headed households had lesser access to institutional sources (Acharya, 2003). A slightly lower proportion of small and marginal farmers has access to formal sources of borrowing compared to the average rural households. However, figures from the NLSS of 1995/96 disaggregated by quintile show that a much lower proportion of households in the lowest 20 percent income quintile had access to formal sources of credit compared even to the second quintile. On the other hand, the difference between the average rural households and households in the second quintile in accessing formal sources of credit was not large (Acharya, 2003).

Table 4.10 Access to Sources of Borrowings of Small and Marginal Households

Sources	Small and Marginal Farmers (Rural Credit Surveys of NRB)			Consumption Quintiles (NLSS 1995/96)	
	1969/70	*1976/77*	*1991/92*	*Lowest*	*2nd Lowest*
Formal	15.23	16.86	16.43	8.28	15.06
Banks	1.72	4.79	na	8.28	15.06
Cooperatives, ward committees, etc.	13.51	12.07	-	-	-
Informal	82.94	82.57	88.21	91.72	84.94
Relatives and friends	31.07	26.53	na	38.46	36.53
Moneylenders/landlords/traders	51.87	56.04	na	49.61	45.90
Others	1.82	0.56	na	3.72*	2.51*
Total	100	100	104.64	100	100
Percent borrowing	76.30	64.45	39.0	na	na

Source: Acharya (2003).

Further, in 1995/96, households in the mountain areas had much lower access to formal sources of credit, although a larger proportion of households in this ecological region borrowed compared to households in the hill or Tarai areas (Table 4.11)

The greatest impact formal credit institutions have made in the credit market is probably in interest rates. Interest rates, especially for the small and marginal farmers, had shot up to astronomical proportions by the end of seventies. Comparable figures for various farmer or income groups are not available for the nineties. But, the level and range have declined sharply in the mid-nineties compared to the early nineties. This is probably due to the proliferation of mutual lending activities by community and self-help organisations. Another phenomenon is that majority of the targeted credit programmes have failed to cater to the needs of the bottom 20 percent of the households as they lack other resources and knowledge to benefit from the savings and credit programmes. Micro credit programmes leave the bottom 20 percent of the income ladder completely untouched.

Table 4.11 Access to Formal Credit Institutions by Ecological Region, Rural Only
(percent of the total sample households)

	Borrower Households, Overall				From Formal Sources	
Regions	*NRB – Rural Credit Surveys*			*NLSS*	*NRB*	*NLSS*
	*1969/70**	*1976/77**	*1991/92*	*1995/96*	*1991/92*	*1995/96*
Mountain	na	na	35.68	67.25	4.00	5.18
Hill	36.52	42.37	38.07	58.97	8.00	13.86
Tarai	39.13	54.87	41.05	61.31	9.00	14.32
All Nepal	38.28	51.26	38.89	63.18	7.13	10.23

Source: Acharya (2003).

Thus reform policies have had little effect on raising access of the poor farmers to productive assets. Instead, with intensification of deregulation policies, the pace of proletarisation had also hastened. In 2001, the share of landless population had reached as high as 23 percent (CBS, 2002). A complementary policy option to nullify the near to medium term negative effect of market oriented reform is through better-targeted programmes. In addition to neutralising the social cost of adjustment, targeted programmes help the poor and disadvantaged in enhancing their productive capacity and in creating assets. Studies indicate that in 1999/00, despite higher budgetary allocations to local development, education, and health, the share of spending directly related to the poor stood at less than one-third of total spending (UNDP, 2002). These numbers are based on the assumptions that expenses made in some sectors or areas are fully spent for benefiting the poor. For instance, about 95 percent of the spending in water resources and 80 percent of local development spending is treated as pro-poor (Table 4.12). This is refuted by the recent Agriculture Census, which shows that extension services and irrigation facilities are predominantly enjoyed by the big farmers (CBS, 2003).

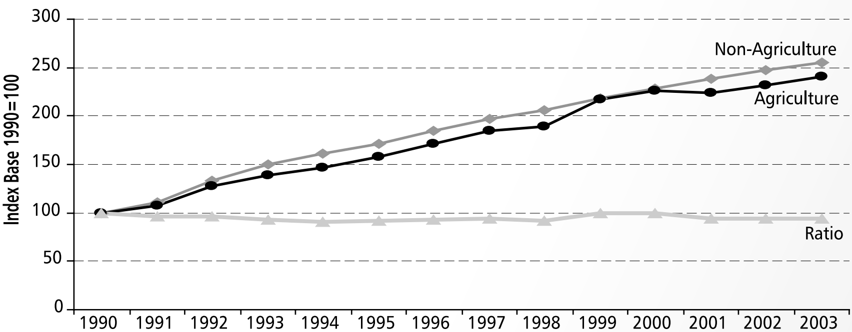
Table 4.12 Expenditure Directly Related to the Poor 1999/00 **(Rs. million)**

	Total Expenditure (a)	Targeted Expenditure (b)	Share of (b) in (a)
A. Ministries			
Finance (including investment on PEs)	7893.2	614.3	7.7
Industry, Commerce and Supply	1147.3	163.5	14.2
Agriculture and Cooperative	2224.4	624.5	27.1
Population and Environment	34.2	14.2	41.5
Water Resources	3034.0	2871.0	94.6
Physical Planning and Construction	6832.6	2359.8	34.5
Land Reform	520.2	44.8	8.6
Women, Children and Social Welfare	206.5	145.2	70.3
Forest and Social Conservation	1304.6	383.6	29.4
Education and Sports	9606.6	7134.0	74.3
Local Development	4849.3	3880.4	80.0
Health	3371.8	2425.3	71.9
Labour and Transportation	94.6	36.9	39.0
Subtotal	41209.0	20697.2	50.2
B. National total expenditure	66272.5	20697.2	31.2
Targeted expenditure as percent of total expenditure		**31.24**	

Source: UNDP (2002).

The combined effects of market driven price policies in both factor and product markets, currency devaluation and uniform tariff structures are transmitted to agriculture through changes in relative prices and terms of trade. To assess the effect of all these policies, the ratio of agricultural to non-agricultural GDP deflators was first calculated for the period 1990-2003. This is presented in the graph below (Figure 1). Both converging and diverging trends in the ratio portray interesting results with some policy implications.

Figure 1 Ratio of Agricultural to Non-Agricultural GDP Deflators

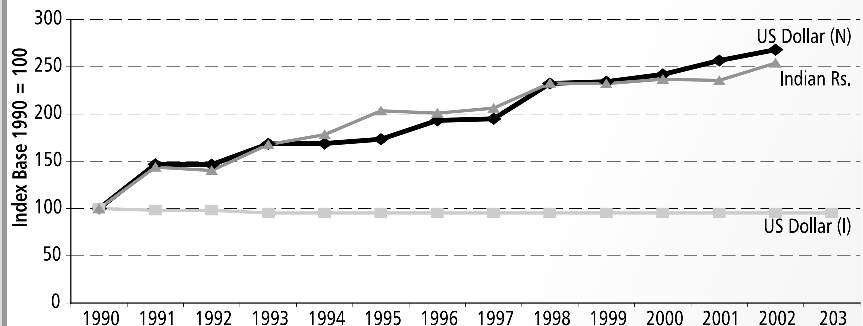


Source: Khanal and Kanel (2005).

As the graph indicates, increment in the index of agricultural deflator has been lower than the non-agricultural deflator in most of the years under consideration. Interestingly, when the currency was devalued, there was almost a convergence of prices. Likewise, the near term effect of deregulation in inputs and outputs has had some positive effect. But after 2001, the terms of trade in agriculture is deteriorating quite adversely. This trend reconfirms that highly subsidised agricultural products from India dampened prices of Nepali products that too at a time when input prices were rising sharply after deregulation. In that way Nepali farmers, whether they be marginal and small or medium and large, have been victimised by high input and low output prices. In a situation of predominance of subsistence farmers, the hike in input prices has made them highly vulnerable. Similarly, the latter categories have suffered due to dampening of output prices owing to inflow of subsidised agricultural commodities from across the border. This indicates that under the open border and free trading arrangements of primary products between Nepal and India, the rising asymmetry between the agriculture pricing policies between the two countries will have a very detrimental impact on Nepali agriculture. Because of this, any price-induced policies that are different from India will be self-defeating under the existing trading arrangements.

The problem is compounded when the exchange rate policy is additionally examined. Despite a pegged exchange rate system with India, Nepal has tried to correct the mismatch through adjustment of hard currency exchange rate based on the cross-rate between the Indian currency and hard currencies. The cross-rate is widening after the deregulation. This is adversely hitting both the input and output prices. As shown in the graph, despite some fluctuations and gaps, there was almost a convergence in the cross exchange rate with the dollar in 1998. However, the difference in the cross-rate has gone up especially after 2000.

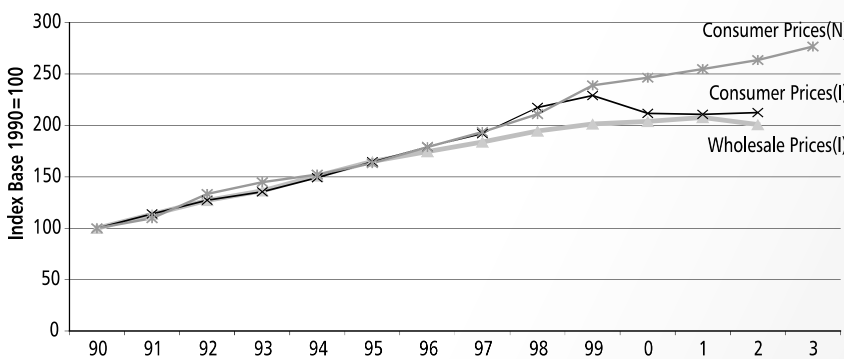
Figure 2 **Exchange Rate Movement**



Source: Khanal and Kanel (2005).

At a time when Nepali farmers are confronting a host of problems, the rate of inflation in Nepal has remained higher than in India in recent years. For comparison, India's wholesale and consumer prices as well as Nepal's consumer prices are plotted on a graph (Figure 3). There is sharp downward trend in both wholesale and consumer prices in India whereas in Nepal the reverse trend is manifesting especially after 1999.

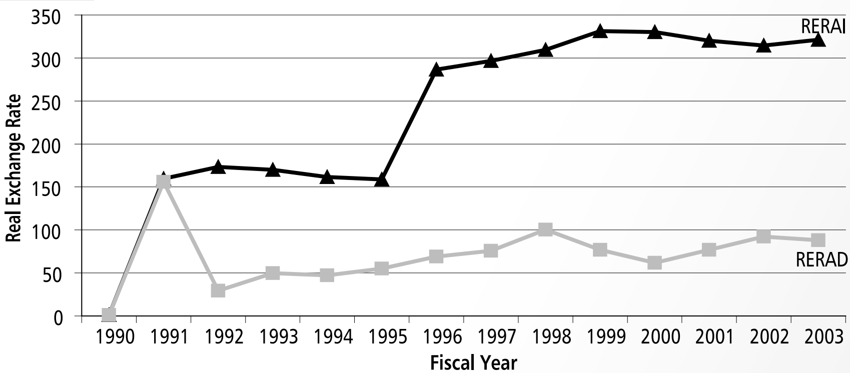
Figure 3 **Price Movement/Nepal and India**



Source: Khanal and Kanel (2005).

Under a pegged exchange rate arrangement, this means that by preventing depreciation of the Nepali currency Nepal is subsidising imports from India and discouraging exports as a result of decreasing competitiveness of Nepali products vis-à-vis Indian commodities. Quick estimates of the real exchange rate (graph) show that during the period 1990 to 2003, the Nepali currency appreciated by more than 3 folds. This simply means that misalignment in prices through a pegged exchange rate policy has additionally dampened competitiveness of Nepal's agriculture sector. Therefore, the foregoing analysis clearly indicates that, from the perspectives of sustained growth and broader distribution of the benefits among the larger population, a review of recent agriculture related policies including the exchange rate policy would be essential. Both industrial and trade sector performances also indicate the need for such a review.

Figure 4 **Real Exchange Rate with India**



Source: Khanal and Kanel (2005).

The above findings broadly corroborate the findings observed in many Asian agricultural economies that have undergone deregulation and market-oriented liberalisation policies (Vyas, 2002). In many cases, price induced liberal policies have failed to generate supply responses either due to very low price elasticity or due to the predominant role of non-price factors. Besides demand conditions, non-price factors such as fixed land supply, lower initial input intensity, and agro-climatic conditions governing crop patterns have been found to be decisive and important (Desai, 2002). Even the empirical relation between the barter terms of trade and aggregate supply response has been found to be ambiguous. In many instances, income and wealth effects of relative prices have worked in the opposite direction (ibid, 2002). Apart from showing a negative net aggregate impact on food grains and allied farm product, empirical studies show that there is a negative correlation between the total factor productivity and terms of trade (Desai and Namboodiris, 2002). The weakening of production base, weaker linkages between agricultural and non-agricultural growth, growing incongruence between the agrarian structure and supply systems, weak research base, and confusion about the role of the state have been found to be working adversely. The effectiveness of the new market oriented policies in promoting growth and reducing poverty is therefore questioned by many countries (Vayas, 2002). This is especially true in the Nepali context.

4.2.2 *Manufacturing Sector*

The role of the manufacturing sector in a country's development hardly needs justification. Its role can be enhanced only when the drive for industrialisation is efficient and competitive. This is essential both for export oriented and import competitive domestic resource based industries. Priority on higher forward and backward linkages helps broadening the benefits across the majority of the population. Continuous technology upgrading, institutional efficacy, better enforcement mechanism, low transaction costs, well developed infrastructures, skilful human resources, and policies aimed at internal market expansion through broad-based reforms are needed in the process. Experience shows that all these are possible in a private sector induced liberal policy environment. But many studies suggest that the liberal policies themselves are not enough. Some countries with the same liberal policies and timing have lagged far behind and some have advanced impressively. In Nepal, despite some encouraging signs up to the mid-1990s, adverse trends have reemerged despite continued emphasis on reforms. This has added the urgency of assessing outcomes more objectively.

A closer look at the performance of industries and their pattern reveal many interesting features. In 1986, the total number of manufacturing establishments in the country was 3,633. This number increased to 4,271 in 1991. Thereafter, the number started declining. In 2001, the number of such establishments fell to 3,213. The reduction was particularly high in the cottage and small-scale industries. This is happening in a situation where such industries constitute 90 percent of the total manufacturing establishments (Table 4.13). Their contribution in total manufacturing employment has been even higher (Khatiwada, 2001). This has had an effect on the growth and contribution of this sector to the country's value added, employment and export promotion. By location the Eastern, Central and Western regions of the country claim the major share in the total manufacturing establishments.

Table 4.13 Total Number of Manufacturing Establishments

Description	1986/87	1991/92	1996/97	2001/02
Number of establishments	3633	4271	3557	3213
Industry classification				
• Cottage and small	3436	4083	3203	
• Medium	111	136	282	
• Large	67	52	72	
• Others	19			
Legal status				
• Government owned	62			
• Private owned	3517			
• Foreign owned	1			
• Jointly owned	35			
• Personal		2957	2403	
• Partnership		600	324	
• Public limited		83	63	
• Private limited		604	743	
• Others	18	27	24	
Location				
• Eastern Region	648	749	704	
• Central Region (excluding Kathmandu Valley)	777	1313	681	
• Western Region	679	439	519	
• Mid-Western Region	196	177	182	
• Far-Western Region	146	159	133	
• Kathmandu Valley	1186	1434	1338	

Source: CBS. Census of Manufacturing Establishments, 1985/86, 1991/92, 1996/97 and 2001/2002.

One additional feature is that within the establishments, the proportion of private limited companies has increased in place of personal ones. Up to 1989 only 59 joint venture companies were registered in Nepal. The number has reached 835 in 2003. Of the 835 establishments, 340 are operating under foreign investment. Foreign investment amounted to Rs 8 billion out of Rs. 40.6 billion worth of total investments. They provide employment to about 46 thousand people (Dahal and Aryal, 2003). This magnitude of foreign direct investment is essentially the outcome of liberal policies. Establishment of joint venture industries in areas of toilet soap, toothpaste and the like has contributed to enlarge exports to India, a country with which nearly two-thirds of international trade takes place (NRB, 2005).

After the reforms, marked changes have taken place in the industrial structure. In 1985, the share of manufacturing products in total exports was about 43.6 percent. This share reached 79.4 percent in 1991. Now they account for about 80 percent. In 1995, their share had gone further up to 87 percent (MOF, 2000 and 2003). However, despite the shift in the structure, concentration is very high (Table 4.14). During 1991/92, the share of carpet in total manufactured products was highest at 63.4 percent. This has dropped to 29.1 percent during the period 1998-2001. Export of readymade garments, vegetable ghee, toothpaste, toilet soap, acrylic yarn and copper rod surged during the same period. There was a phenomenal growth in woollen pashmina for a while. More recently, slowdown in the economy, renewed trade treaty with India in 2001 and quota problems with the USA regarding garments have led to a slowdown in the export of these commodities, which had surged up during the period 1998-2001 (NRB, 2003). As a result, both the risk and volatility in export-oriented industries has increased further.

A recent study shows that Nepal enjoys a comparative advantage in sectors like dried leguminous vegetables, spices, seeds, leather and leather products, fibres, yarn and textiles, articles of apparel and clothing, and non-apparel textile articles. Other commodities having a competitive edge are lentil (leguminous pulse), large cardamom and ginger (spices), niger seed, hides and skins, wet blue chromes (leather and leather products), hand knotted woollen carpets, jute and jute products, polyester yarn (fibres, yarn and textiles), readymade garments, knitwear, Pashmina muffler, shawls, sacks and bags, and linen (HMG and UNIDO, 2002).

Certain shifts have also taken place in the comparative structure. Agricultural raw materials used to be the only source of Nepal's comparative advantage until 1980. Labor-intensive manufacturing products have taken that place by the mid-eighties (HMG and UNIDO, Ibid). Nevertheless, the study findings clearly suggest that Nepal enjoys a comparative advantage in only few products.

Table 4.14 Share of Major Products in Total Manufactured Exports and Their Growth

Description	Share of Major Products in *Total Manufacturing Products (%)*			Average Growth of Major *Manufacturing Products (%)*		
	1991-92	*1993-97*	*1998-2001*	*1991-92*	*1993-97*	*1998-2001*
Readymade garment	26.1	32.8	32.3	58.2	8.2	16.3
Carpet	63.4	55.1	29.1	42.2	-0.5	-5.9
Vegetable ghee			8.2			25.4
Toothpaste		1.0	4.6		4.3	49.1
Toilet soap			2			13
Acrylic yarn		1.0	2.8		4.1	43.2
Cooper rod			1.5			1422.0
Zinc oxide			0.4			24.4
MS pipe			0.6			30.9
Gold and silver Jewellery		0.6	0.7		-0.8	-0.4
Wooden handicrafts		0.1	0.1		-0.6	26.1
Nepalese paper		0.2	0.4		4.7	24.7
Tea		0.3	0.5		9.4	108.2
Leather goods		0.2	0.1		4.0	19.9
Hazmola			0.2			194.8
Chyawanprash			0.4			-4.8
Noodles		0.3	0.3		30.7	-0.5
Biscuits			0.3		19.5	-12.9
Hides and skins	3.6	3.0	1.7	-0.3	7.1	13.9
Handicrafts	0.8	1.0	0.6	47.2	14.4	

Source: MOI and UNIDO (2002). Long Term Industrial Plan.

Therefore, the low level and declining trends in industrial development associated with over-concentration in few manufactured products clearly indicate that the reform policies have failed to promote and diversify industrialisation accompanied by effective backward and forward linkages. This means that very little success has been achieved in promoting domestic resource based industries. Studies conclude that entrepreneurial environment is inadequate in the country (FNCCI and World Bank, 2000). The high transit cost, poor and costly infrastructures and absence of enabling environment have particularly been cited in this context.

Despite Nepal being very rich in water resources, per unit electricity generation cost is one of the highest in the world. Available information reveal that per unit prices of electricity in Nepal is the highest in South Asia. In Nepal it is 8.73 US cents compared to 4.3 cents in India and 8.53 cents in Sri Lanka (Table 4.15).

Table 4.15 Average Electricity Tariff in Selected Countries

Countries	Average Tariff US c/kWh
Nepal	8.73*
Sri Lanka	7.90**
Bangladesh	8.53**
Pakistan	6.5**
India	4.30**

Sources: * *Nepal Electricity Authority (2002). Annual Report.*
** *ADB (1997). Electric Utilities Handbook.*

Comparative indicators show that except in paved roads and telephone per worker, Nepal is far behind in terms of internet users, electricity consumption, radio facility, road density, and per unit energy use in South Asia (Table 4.16). As shown in Table 4.17, electricity followed by road and water are most burning problems being faced by industries and firms. Whatever services are provided, their timely availability constitutes another serious problem.

Table 4.16 Poor Infrastructure: Comparative Indicators

Indicator	Year	Nepal	Bangladesh	India	Pakistan	Sri-Lanka
Paved roads (%of total)	1999	30.8	9.5	45.7	43.0	95.0
Internet users (thousand)	2000	50.0	100.0	5000.0	133.9	121.5
Electricity consumption (kWh per capita)	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
Radio (Per 1000 people)	1997	39.2	49.4	120.5	105.1	207.5
Road density (km per 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

Source: HMG (2003).

Table 4.17 Problems in Infrastructure Services

Service	Firms with Problems %	Firms with Severe Problems %	Firms Providing own Services %
Electricity	71	42	57
Water	31	19	71
Roads	35	20	12
Telecommunication	17	8	-

Source: FNCCI and World Bank (2000).

These are some of the reasons that explain failures in attracting foreign investors to Nepal (IFC and World Bank, 1998, Dahal and Aryal, 2003). Although Nepal's lower wage costs provide an important competitive advantage, this is offset by its lower productivity (Tables 4.18, 4.19 and 4.20). Similarly, aggregate productivity is also low in the economy, and performance varies widely among firms, indicating that the economy tolerates high level of inefficiency. In addition, Nepal's productivity and competitiveness, which had increased over the 1990s, tapered off toward the end of the decade. On the whole, the problem of productivity and price competitiveness in the midst of rising transactions cost has severely constrained the industrialisation drive in Nepal (HMG, 2003).

Table 4.18 Index of Cost competitiveness Indicators of Nine Asian countries

Country	Labor cost per worker (A)	Value added per worker (B)	Unit labor cost (C)
Nepal	100	100	100
India	130	205	81
China	180	271	72
Bangladesh	110	130	90
Indonesia	120	276	87
Thailand	480	390	94
Sri Lanka	160	195	105
Malaysia	960	909	93
Philippines	600	742	93

Source: FNCCI and World Bank Survey 2000 and ILO (2001).

Table 4.19 Annual Percentage Change of Labor Cost and Labor Productivity of Eight Asian Countries

Country	Labor Cost	Labor Productivity
Nepal	0.5	4.2
India	2.1	4.4
China	9.0	10.1
Indonesia	8.1	8.2
Thailand	8.4	10.7
Sri Lanka	5.3	0.8
Malaysia	9.1	9.2
Philippines	7.4	10.1

Source: UNIDO (2001) and ILO (2001).

Table 4.20 Average Productivity in Manufacturing Size and Sectors

Manufacturing Industry	Average	Large Firms	Small Firms
Garment and textiles	53	56	42
Wood and furniture	53	58	52
Food processing	52	55	51
Chemical	46	50	36
Non-metal fabrication	53	63	49
Metal processing	44	53	41
Pharmaceuticals	60	67	55
Carpets	56	58	41

Source: FNCCI and World Bank Survey 2000.

Despite the far reaching reforms already made in the tariff structure the cascading tariff system still continues to exist. This has had certain biases in favour of low value-added activities, whether they be assembly industries or producing intermediate goods. Several rates or bands and relative rates are still practised corresponding to the stages of production or degree of fabrication. This is some sort of effective rate of protection (EPR). Obviously, the EPR for each good depends on a combination of its nominal tariff, tariffs on its inputs and the ratio of value added in production to the border (price) value of the commodity. The simple assembly activities are often characterised by quite low value-added ratios in the range of 1 to 2 percent. Manufacturing of most of the consumer goods typically exhibits value-added ratios in the range of 5-30 percent. Manufacturing of intermediate goods and processing of raw materials usually have somewhat higher value added ratios, commonly 20-60 percent, and agricultural production is usually characterised by high value-added ratios of more than 80 percent. Assuming 25 percent tariffs on outputs and 10 percent on inputs in Nepal, effective rates of protection would vary from 28 percent in agriculture up to 927 percent in some assembly activities. Thus the major drawback of this type of bias in incentives is not so much that it disproportionately rewards low-value activities, but that it distorts advantage. This is one of the major policy deficiencies still persisting in Nepal (HMG, 2003). Because of this, firms are either protected from cheaper imports in the home market or export to India based upon tariff differentials in critical inputs without any appreciable value addition (HMG and UNIDO, 2002). This is especially true in sectors where economies of scale matter, such as textiles, pharmaceuticals and soap. This tendency emerged as a major hurdle in 2001 while renewing the most liberal 1996 trade treaty with India. The non-reciprocity facility provided by India without any value added restrictions could have been used to promote genuine industrialisation in the country. This did not happen. Absence of corporate governance was partly responsible for this. As a result, in the new treaty of 2001, the non-reciprocity clause was replaced by value added and quantity restriction clauses. Although a more conservative outlook and intention of obstructing Nepal's exports to Indian market, were also responsible for this, absence of corporate governance is nevertheless jeopardising the industrialisation drive in Nepal. This shows liberal policies if not properly enforced could be simply used for usurping immediate personal benefits. This indicates the lacuna in developing entrepreneurship culture in the country despite reforms since almost three decades.

On the whole, whatever gains accrued during the reform process were mainly overtaken by the trading and commercial class at the cost of emerging manufacturing class. In this respect also, in view of many big houses operating in industry, business and service activities simultaneously (GFONT, 2000), the net losers were the genuine entrepreneurs mostly operating in cottage and small-scale industries. At the same time, because of the prominence of industries based on imported raw materials, no linkages could be established which would simultaneously transmit the benefits to the peasantry.

4.2.3 Trade

Advocacy for free trade or trade openness is based on a number of arguments. As the argument goes, by inducing higher specialisation trade allows countries to exploit areas of comparative advantages for gains in total factor productivity. Similarly, it is advocated that by expanding potential markets trade allows domestic firms to take advantage of scale of economies for further gains in total factor productivity. It is also added that in the process of diffusing technological innovation and improving managerial practices through stronger interaction with foreign firms and markets, trade helps economic modernisation of a country. A more forceful argument often made in favour of trade openness is that freer trade discourages allocation of resources in unproductive firms and activities by lessening anti-competitive and rent-seeking practices leading to efficiency gains and competitive strength (Srinivasan and Bhagawati, 1999 and Rodriguez and Rodrik (2002). Such premises are assessed in the Nepalese context based on similar foundations.

Similar to the pattern exhibited by the manufacturing sector, Nepal's foreign trade is also characterised by many unique features. Internal policy reforms, external trade and transit treaties, and international environment have considerable influence over the trade pattern.

As shown in Table 4.22, total exports of goods rose to 8.0 percent of GDP in 1995 from 5.0 percent in 1990. It was 5.9 percent in 1985. Exports were affected by the trade impasse with India in 1990. Thus, the rise in exports in the period 1990 to 2000 was quite impressive. Since 2001, there has been a deceleration in exports. In 2003, it again dropped down to 11 percent of GDP as compared to 13.6 percent in 2001. However, trade gap shows significant improvement after 1995. Almost a similar pattern is observed in imports. When export was picking up in 1990-1995 import was also surging up. Resultantly, the gap between exports and imports was as high as 21 percent of GDP in 1995. Nepal's service export is quite high. For instance, when the total exports of goods and services accounted for 23.3 percent of GDP in 2000, the share of commodity export was 13.1 percent. This also means that in Nepal's context, service trade is extremely important with direct bearings on the current account as well as the overall balance of payment situation.

In terms of volume, the value of total imports was Rs 7.7 billion in 1985 (Table 4.21). Since then it increased many folds to reach Rs. 115.7 billion in 2001. Conversely, exports rose to Rs 55.7 billion during the same period from the level of Rs 2.7 billion in 1985. Within the major commodity groups, import of manufactured goods constitutes the biggest share ranging from 47 to 56 percent. This is followed by capital goods. On the other hand, export of food items, which used to constitute the largest share, has decreased considerably, ranging between 8.7 and 12 percent. This has been overtaken by export of manufactures goods. The overall balance by commodity group shows that a larger deficit is found in capital goods. Manufactured goods and fuel follow this. Except in 2002, there has been a continuous decline in exports of intermediate goods since 1985. After 1985, Nepal has steadily emerged as a net importer of food items. Thus, despite some structural change in exports there is excessive concentration in few products. On imports, however, no such shift is observed indicating no upsurge in import competing industries with diversified structure.

Another phenomenon is that the country concentration is also extremely high (Table 4.22). Except during the trade impasse, the trade share with India has been very high. It constituted 47.5 percent of the total in 2003. One significant change is that now the export share to India has considerably increased especially after the more liberal trade treaty with India in 1996. The export share in total was 17.7 percent in 1995. It rose to 59.6 percent in 2002. But because of inclusion of more regressive clauses in the renewed trade treaty of 2001, export has already started decelerating. More stringent rules of origin with 30 percent value added in the beginning which was latter lowered down to 25 percent during the rest of the treaty period, quotas in few commodities, clear specification of safeguard clauses, and provision of the need for submitting information regarding the basis of calculating rule of origin to the Indian government by Nepal on an annual basis are some of the new clauses imposed in the renewed treaty. The Indo-Nepal Treaty also designates 22 border crossings that may occur through preferential trade. This change in policy, from virtual free trade to one with a number of restrictions, has had immediate to long-term negative effect on Nepal's export performance with India. Similarly, the Africa Growth and Opportunity Act (AGOA) and the Caribbean Basin Trade Partnership (CBPTA), which grants Sub-Saharan African and the Caribbean producers preferential access to the US market, may have negatively affected Nepal's garment exports.

Nepal's exports are also highly volatile. A recent study indicates that compared to other South Asian countries, Nepal's exports are least correlated with overall change in imports by the US and market shares also vary with yearly export performance (IMF, 2002). At the same time, informal trade between Nepal and India is very high. Survey-based estimates show that informal trade from India to Nepal amounts US$ 180 million, while that from Nepal to India is equivalent to US$ 156 million (Karmacharya, 2002). Studies also show that despite more liberal trade flows between Nepal and India, institutional factors like quick realisation of payments, no paper work, no procedural delays, and lower transportation cost are instrumental in motivating traders toward informal channels. The majority of informal traders bear a transaction cost of less than 10 percent whereas formal traders have to bear more than 30 percent on their turnover (Taneja and Pohit, 2000). Transit problems escalate the prices of both import competing and exports promoting industries by 50 to 100 percent.

Table 4.21 Exports and Imports by Major Commodity Groups (Rs in Million)

	Import						Export					
Description	*1984/85*	*1989/90*	*1994/95*	*1999/2000*	*2000/2001*	*2001/2002*	*1984/85*	*1989/90*	*1994/95*	*1999/2000*	*2000/2001*	*2001/2002*
Food items	862.3	1834.3	4964.9	11745.5	6900.5	7902.4	997.1	620.1	1574	4357.6	4852.2	5571.5
Intermediate goods	547.2	2047.4	5403.9	11458.4	13148.8	14778.1	543.9	258.7	699.6	3791	4855.1	8422.1
Fuel	918.8	1515.5	4717.1	9097.9	11269.2	15231.3	1	0	0	2.2	1.3	0.9
Manufactures durable goods	3742.3	9137.3	35565.8	55655.2	61340.9	49984.3	1164.9	4277.3	15328.5	41281.1	45601.9	33181.5
Capital goods	1671.4	3790.4	13027.6	20547.9	23027.8	18835.2	33.7	0.1	37.1	390.8	343.6	364.4
Total	7742	18324.9	63679.3	108504.9	115687.2	106731.3	2740.6	5156.2	17639.2	49822.7	55654.1	47540.4
Share in percent												
Food Items	11.1	10.0	7.8	10.8	6.0	7.4	36.4	12.0	8.9	8.7	8.7	11.7
Intermediate goods	7.1	11.2	8.5	10.6	11.4	13.8	19.8	5.0	4.0	7.6	8.7	17.7
Fuel	11.9	8.3	7.4	8.4	9.7	14.3	0.0	0.0	0.0	0.0	0.0	0.0
Manufactures durable Goods	48.3	49.9	55.9	51.3	53.0	46.8	42.5	83.0	86.9	82.9	81.9	69.8
Capital goods	21.6	20.7	20.5	18.9	19.9	17.6	1.2	0.0	0.2	0.8	0.6	0.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.00	100.0

Source: Nepal Rastra Bank (2002). Quarterly Economic Report.

Table 4.22 Direction of Foreign Trade (At current Prices, Rs. in million)

Description	1984/85	1989/90	1994/95	1999/2000	2000/01	2001/02	2002/03
Export FOB	2740.6	5156.2	17639.2	49822.7	55654.1	46878.8	49245.4
India	1601.7	602.5	3124.3	21220.7	26030.2	27956.2	26913.0
Other countries	1138.9	4553.7	14514.9	28602	29623.9	18922.6	22332.4
Import C.I.F	7742.1	18324.9	63679.5	108504.9	115687.2	107388.9	125553.8
India	3895.8	4674.5	19615.9	39660.1	45211.0	44117.1	56118.1
Other countries	3846.3	13650.4	44063.6	68844.8	70476.2	63271.8	69435.7
Trade balance	-5001.5	-13168.7	-46040.3	-58682.2	-60033.1	-60444.1	-76308.4
India	-2294.1	-4072.0	-16491.6	-18439.4	-19180.8	-16160.9	-29205.1
Other countries	-2707.4	-9096.7	-29548.7	-40242.8	-40852.3	-44283.2	-47103.3
Total trade volume	10482.7	23481.1	81318.7	158327.6	171341.3	154267.7	174799.2
India's share in total	52.4	22.5	28	38.5	41.6	46.7	47.5
Share of exports and imports							
Export to India	58.4	11.7	17.7	42.6	46.8	59.6	54.7
Export to other countries	41.6	88.3	82.3	57.4	53.2	40.4	45.3
Import from India	50.3	25.5	30.8	36.6	39.1	41.1	44.7
Import from other countries	49.7	74.5	69.2	63.4	60.9	58.9	55.3
Export share in GDP	5.9	5.0	8	13.1	13.6	11.1	11.0
Import share in GDP	16.6	17.7	29.1	28.6	28.2	25.5	28.1

Source: Nepal Rastra Bank.

The open border with India, preferential market access to India, free convertibility between the Nepalese and Indian rupees at a fixed nominal exchange rate, differential tariff structures with 13.8 percent average tariff rate, duty drawback and bonded warehouse facilities broadly govern Nepal's trade regime. All these however have failed to diversify and promote trade in a sustainable manner. In view of trade being the engine of growth in the liberalised economic framework, the present pattern is detrimental from every perspective. The kind of export structure induced through various policy incentives benefits only a small trading class. This class has been able to influence policies and distort them for reaping quick benefits by means of the strong nexus with the ruling elites of both Nepal and India. This practice has obstructed widening of urban-rural linkages for ensuring that benefits of trade flow to the peasantry and the working class. The findings are quite similar to the experience of not only the least developed countries, but also of even the relatively developed ones. A recent OECD study shows that even after the openness and WTO membership, many African countries continue to suffer a lot due to structural rigidity on the trade front and declining prices of primary products (OECD, 2003).

Although the balance of payment position has remained comfortable after the crisis of the mid-1980s, decline in current account surplus in recent years indicate growing vulnerability in this area. If foreign grant is adjusted, current account deficit widens further. As already pointed out above, the debt-servicing burden has also increased considerably. Under these conditions the remittance income, which now accounts for about 5 percent of GDP, together with external grant may not be enough to keep current account in surplus. Therefore, without drastic policy reforms, no meaningful restructuring will take place. This is sure to fail in reversing the present benefit sharing tendencies.

In the process of WTO membership, Nepal has been engaged in the formulation and revision of acts with a view to making special institutional arrangements for more open, free and rule based trading practices. These new initiatives will to some extent help to eliminate existing distortions or tariff biases in trade. A compulsion to shift toward industries with competitive advantage will also benefit the agriculture sector because of its tremendous potential in terms of both agro- and forestry-based industries in the country. However, there are more challenges and risks emanating from the given adverse initial conditions in terms of productivity and competitiveness as pointed out above. Prospects of agriculture or forestry based industries are contingent on the extent of Nepal's capacity to preserve patent rights of its rich biodiversity within the stipulated timeframe, which under the given situation is most unlikely. At the same time, the binding tariff rates committed by Nepal in a number of areas are low compared to those of India (RIS, 2003). This may compel Nepal to pursue similar tariff policies under the bilateral trade arrangements at a time when free trading of primary products added by growing asymmetry in the agriculture and exchange rate policy is hurting the agriculture sector very badly. Also, the agreement on subsidy limit may prevent Nepal from providing required incentives to the medium and small industries. More dangerously, agreement on trade related investment measures prevents the possibilities of putting conditions on foreign investors to use local raw materials. Under such circumstances, the hardest hit losers will be the farmers and small enterprises. How the possible losses could be compensated or countervailed through safeguarding or incentive measures will be a major challenge in the days to come. This additionally underscores the necessity for taking enough care in the process of changing rules and reforming or building institutions.

4.3 Financial Deepening, Efficiency and Beneficiaries

It is well known that only a healthy and competitive financial system enables mobilisation and utilisation of resources, reduce cost and risks, expand and diversify opportunities, and increase allocative efficiency of resources. For these reasons, the financial reform gives priority on financial development and deepening. A developed financial system, in turn, enhances the role of the monetary policy by helping to maintain macroeconomic stability by means of enabling economic transactions through the banking system and other intermediaries. The exchange rate policy, as part of an overall financial policy, further enhances that process by maintaining stability in domestic prices and external balance of payments by correcting misalignment of domestic vis-à-vis international prices.

Liberalisation of the financial system and other reform measures have succeeded in expanding banking and financial institutions to a great extent. By the end of 2003, the number of commercial banks, development banks and regional rural development banks (RRDBs) had reached 17, 18 and 5, respectively. Likewise, there are 116 postal saving banks, 58 finance companies, 34 saving and credit cooperative societies involved in limited banking activities, 44 non-government micro-credit institutions, one stock exchange with the network of brokers and security dealers, 17 insurance companies, one employees' provident fund, one Credit Guarantee and Deposit Insurance Corporation, one Citizen Investment Trust, and nearly 20 insurance companies operating in the country.

Consequently, financial deepening has intensified during the post liberalisation period of 1990s. The ratio of all financial assets has increased from 32 percent of GDP in 1990 to 76 percent in mid-July 2000. This ratio was about 29 percent in 1985. These figures thus clearly indicate that the role of the financial sector in the economy has increased a lot. Likewise, deposit/GDP ratio rose to 44.1 percent in mid-April 2002 from 10 percent in 1980 and 22 percent in 1990. Growth in credit/GDP ratio, which was slower during the 1980s, began to increase subsequently. This ratio increased from 12 percent in 1980 and 15 percent in 1990 to 27.8 percent in mid-April 2002. Unlike the 1980s when the government alone absorbed one-third of the total bank credit, the private sector credit has accounted for the biggest share of such credit in the 1990s. The lending pattern of commercial banks by purpose also shows some shifts. The biggest borrowers now are industries followed by trade and businesses. One typical phenomenon is that the relative share of credit to the agriculture sector has decreased along with the initiation of the second phase of reforms (Table 4.23).

Table 4.23 Rural/Urban Credit Operations of Commercial Banks* (Rs. in million)

	Deposit				Credit & Investment			
Mid-July	***Rural***	***Urban***	***Total***	***Rural* %**	***Rural***	***Urban***	***Total***	***Rural* %**
1977	341.2	1727.8	2069.0	16.5	217.4	1423.9	1641.3	
1980	634.3	2627.2	3261.5	19.4	491.6	2689.6	3181.2	
1985	1474.2	6617.3	8091.5	18.2	1534.0	4930.4	6464.4	
1990	3213.2	18193.6	21406.8	15.0	2740.0	13269.5	16009.5	
1995			61193.3				48412.9	
2000			154943.0				114292.1	

Note: *Includes ADB/Ns commercial banking activities

Source: NRB (2001).

Table 4.24 Outstanding Loans of Commercial Banks by Purpose (Mid-July) (percent of total)

Sector	**1975**	**1980**	**1985**	**1990**	**1995**	**2000**
Agriculture	0.1	0.9	3.2	13.0	12.1	8.9
Industry	5.1	12.0	18.8	32.4	39.1	45.1
Commerce	45.5	62.2	44.1	28.6	32.8	32.9
General users & social	48.0	21.0	30.0	23.6	11.8	7.3
Others	1.4	4.0	3.9	2.5	4.2	5.7
Total	**100**	**100**	**100**	**100**	**100**	**100**

Source: Acharya and Khatiwada (2003).

Table 4.25 Targeted Credit Programmes (Mid-July 2000)

Programmes/ Institutions	Cumulative Coverage Districts/VDCs	No of Groups Borrowers	Cumulative (Rs in 000) *Disbursement*	*Savings*
SFDP (ADB/N) 1999	75/587	21606/152595	5379664	66981
PCRQ/MCPW, 1999	67/624	22346/113606	662974	53473
MCPW/NGOs, 1999	17**/96	5872/19215	139273	51382
Grameen Bank Replicates				
RRDBs	38/819	25989*/127107	4230305	220712
CSD+Nirdhan	17/405	14798/61786	1237283	89401
SFCL	31/105	8827/60626	380340	102046
PDDP/VDP	30/313	7311/198474	272000	130500
LGP/VDP	28/206	5509/39440	153900	410000

Note: * 1999 figures. ** Twelve districts and 5 urban centres.

Source: Agricultural Development Bank (2000), Women Development Programme, Progress Report; NRB, Women Development Division (2001) Non-Bank Financial Statistics, January 2001; LGP (2000). Annual Report 2000; PDDP (2000). the Year in Review 2000; MOF (2001). Economic Survey, 2000/01.

Table 4.26 Selected Financial Indicators of Credit Cooperatives, 2000 (Rs. in million)

Indicators	NRB Registered	NRB not Registered	Overall Average
Capital fund	38.6	49.3	44
Deposits	270.0	264	267
Credit	221.7	268.3	245
Profit on capital Fund (%)	18.7	13.7	-

Source: NRB (2002), projected from 10% Survey.

Notwithstanding some positive developments, banks and financial institutions have however concentrated their activities in the urban areas in general and metropolitan Kathmandu in particular. They thus far continue to cater to the credit needs of the urban middle class. Thus financial deepening has almost bypassed the needs of the agriculture sector. This is happening at a time when none of the non-bank financial institutions is undertaking activities in the rural areas. Contrary to expectations, the magnitude of institutional credit has considerably been reduced in the rural areas. This is due partly to the introduction of the so-called wholesale banking policy without assessing the overall ramifications on the coverage and outreach.

Also, the number of commercial bank branches has shrunk in 2000 as compared to 1995 (Acharya, 2003). All these have again compelled the rural populace to depend more on moneylenders to meet their credit requirements at very high interest rates, ranging from 36 to 60 percent. On one hand, the financial sector with its international connections and quick money transfer abilities is overflowing with public funds. On the other, the productive sectors are starved for credit. A recent decision to completely phase out the priority sector-lending programme by 2007 is sure to further aggravate the rural-urban divide.

Similarly, liberalisation has failed to fully streamline the banking system in the country. The problem of non-performing assets and system inefficiency has further worsened in the post-liberalisation period of 1990s. The problem faced by two state biggest commercial banks has been very serious. This has compelled the banks to bear high risk. The negative net worth of the two largest commercial banks amounted to Rs. 32.22 billion in mid-July 2003. This has additionally threatened sustainability of the banking system. Weak legislative arrangements and poor governance have prevented punitive actions against defaulters. Besides, customers have been denied quick and quality service. This is one of the reasons for the continued wide gap between lending and borrowing rates. This undermines the entire reform. As a result of persistence or expansion in inefficient banking activities, intermediation function has been overburdened with non-core activities in the system. At the same time, in the face of bank-wide rural networks, these two banks have to compete with entirely urban based joint venture banks. Recent evidences are indicating that the newer banks also have window dressed their balance sheets so as to show better performance. Overdues have been reduced to a substantial extent by means of rescheduling. Moreover, the commercial banks, whether domestic or joint venture, have shown little innovation and positive attitude in identifying new instruments of saving and investment opportunities. They have rather preferred to cater to the traditional larger urban savers and invest in safe and gilt-edged government securities and treasury bills. This kind of investment involves no additional administrative cost and is easily convertible into ready cash in the secondary window operated by the central bank (Acharya, 2003). The development banks, finance companies and co-operatives are also not performing well. It is becoming increasingly clear that inefficiencies of the commercial banks are attributable more to the political intervention and oligopolisitic tendencies in the financial sector, rather than their involvement in the priority sector or rural branches. The joint venture banks with practically no rural operations are also suffering from bad quality of their investment and credit. It is becoming public that their balance sheets are widely window-dressed.

Urban households enjoy a disproportionately larger access to organised sources of credit. Generally, female-headed households have a narrow access to institutional sources (Acharya, 2000). A comparison of figures shows slightly lower proportion of small and marginal farmers had access to formal sources of borrowing than the average rural households. But, the quintile-wise figures derived from the NLSS 1995/96 shows that much lower proportions of households in the lowest 20 percent income quintile had access to formal sources of credit. On the other hand, the difference in access between the average rural households and the second quintile households to formal sources of credit was not that large (Acharya, ibid).

Probably the greatest impact the formal credit institutions have made in the credit market is in the interest rates. Interest rates applicable to the small and marginal farmers had shot up to astronomical proportions by the end of the seventies. Separate figures for various farmer or income groups are not available for the nineties. This is probably due to proliferation of mutual lending activities by community and self-help organisations (Acharya, 2003). Another phenomenon is that majority of the targeted credit programmes have failed to serve the needs of the bottom 20 percent households as they lack collateral and knowledge to benefit from the saving credit programmes. Micro credit programmes have thus bypassed these households lying at the bottom of the income ladder. With financial policies focusing more on monetary stability, availability of alternative banking systems in the rural areas, financial deepening, and credit outreach have emerged as major policy issues. Despite continuous reduction in the deposit rates, lending rates have not gone down commensurately. The likely negative effect of pegging the exchange rate with the Indian currency the terms of trade and competitiveness of Nepali exportable products may gradually aggravate the balance of payment problem. Along with the emergence and expansion of various forms of financial institutions, unethical practices have become more widespread. Unless a prudential regulatory and supervision system is put in place, such risks may trigger further disparity in the days to come.

Many deficiencies thus still persist in the financial system. The insurance companies have not been able to function efficiently and in a transparent manner. Similarly, their lack of confidence and acceptability among the general public has resulted into very limited coverage. At the same time, the capital market is least developed and continues to face a host of problems. Unless the capital market is properly developed, neither internal nor external capital can be mobilised in a substantial way for using the funds for the country's development. A well-developed capital market is essential for the development of industries or services. As obvious, money and capital markets are mutually inclusive in the context of an overall development of the financial system. Reforms undertaken so far have been unable to fulfil the intended objectives. Therefore, the success of the entire reform process demands deeper and wide-ranging reforms in the financial sector.

4.4 Prices, Wages and Their Effects on Living Conditions

Both price stability and increased labor productivity are key to the success and sustainability of reforms. High inflation not only taxes the poor, it also contributes to further deterioration of business and entrepreneurial confidence. It is an established fact that deregulation policies pursued in the course of structural adjustments brought about changes in the relative prices in both factor and product markets with immediate to long term income distribution implications. Similarly, high inflation instantly hinders growth in exports by weakening the competitive strength of the economy. In addition, if real wages do not correspond with productivity it is sure to retard development. A big mismatch between domestic and international prices compresses domestic markets for the tradable goods.

In the beginning of both phases of reforms, price rise was very high because these were initiated through currency devaluation (Table 4.27). In 1986 the price rise was 15.8 percent. The price increase in food items was sharper at 18.4 percent. In the subsequent two years the average inflation rate remained above 12 percent although some improvement was noticeable. Thereafter, it fell down to one digit level. In the first year of the second phase of reform, inflation rate was the highest at 21.5 percent. Subsequently, there was a decline in the inflation rate. It stood at below 3 percent in 2002 with a slight rebound in 2003. More recently, 1999 was the only exceptional year when the rate of inflation registered a high of 13.3 percent, with food prices registering a much higher rise of 18.8 percent. However, some price advantages enjoyed by food items as against non-food items in 1985-91 was lost in 1991-2001, as both commodity groups registered identical rates of inflation. What is observed is that despite some inflationary surge following devaluation, the price rise has not been generally that serious in Nepal as in many developing countries including Latin America. However, the toiling masses suffered most due to escalation in the cost of living. This was more so due to the existence of a very small trading class including the ruling elites overtaking benefits of growing investment and expanding economic activities. Depressed prices of agricultural products have had a more adverse effect on the farmers' living conditions.

Table 4.27 National Urban Consumer Price Index (1984/85 = 100) (in percent)

Year	Overall Index	Food and Beverages	Non-food and Services	Growth Rate in %		
				Overall	*Food*	*Non-Food*
1984/85	100.0	100.0	100.0	0.0	0.00	0.0
1985/96	115.8	118.4	110.1	15.8	18.4	10.1
1986/97	130.1	135.1	119.6	12.3	14.2	8.6
1987/88	146.2	152.5	132.1	12.4	12.9	10.5
1988/89	157.1	159.8	150.8	7.5	4.8	14.2
1989/90	169.9	172.5	163.7	8.1	7.9	8.5
1990/91	186.3	190.8	176.8	9.7	10.6	8.0
1991/92	226.4	240.8	199.4	21.5	26.2	12.8
1992/93	245.9	262.3	224.9	8.6	8.9	12.7
1993/94	258.7	266.5	242.2	5.2	1.6	7.7
1994/95	277.5	286.4	259.5	7.3	7.5	7.2
1995/96	304.0	316.5	279.3	9.5	10.5	7.6
1996/97	328.9	342.7	301.7	8.2	8.3	8.0
1997/98	358.4	369.6	333.2	9.0	7.8	10.5
1998/99	406.1	438.9	355.6	13.3	18.8	6.7
1999/00	418.5	437.0	383.0	3.1	-0.4	7.7
2000/01	432.8	440.1	409.4	3.4	0.7	6.9
2001/02	445.3	456.4	418.0	2.9	3.7	2.1
2002/03	466.7	476.4	438.9	4.8	4.4	5.0
1985-91				10.9	11.4	10.0
1991-2001				8.8	8.7	8.8
1985-2003				8.9	9.1	8.6

Source: Nepal Rastra Bank.

Inflation in Nepal is primarily a structural problem. The supply side constraints are often more pronounced than the demand side variables including the monetary ones. Monetary policy has a limited role in controlling inflation in a situation of production and supply shocks and continued depreciation of the domestic currency. Besides, the fixed exchange rate weakens potency of the monetary policy. As consumption goods account for more than 50 percent of the consumption basket, prices prevailing across the border have a significant bearing on Nepalese prices. Thus low food prices in India have resulted into depressed food prices in Nepal in recent years. This, together with depressed domestic demand for non-food items has resulted in low inflation since 2000. At the same time, in the long run Nepal's monetary policy acts on the inflation rate, largely through the Indian Rupee reserve and exchange rate of NRs vis-à-vis the Indian currency. In the short run, the exchange rate with the Indian Rupee is fixed. Because of the openness of the economy towards the Indian market and full convertibility provided to Indian Rupees in Nepal, the first impact of the monetary policy falls on the holding of Indian currency reserves. For the same reason, fiscal and pricing policies are also partially responsible for inflationary tendencies. On the whole, the supply side variables are stronger than the demand side ones in influencing the rate of inflation in Nepal (Khatiwada, 1981 and 2003). Therefore, in the Nepali context characterised by high priority on policies affecting output and supplies, undue emphasis on fiscal balance or monetary targeting may not be that effective. No doubt, the liberal policies have ensured supplies by minimising artificial or other kinds of scarcities as used to happen during the controlled regime. Still, cartelling, oligopoly and monopolistic practices are persisting. Also, supply in the remote areas is a big problem in Nepal leading to persistence of large price differentials between the accessible and non-accessible areas. On the whole, the price rise emanating from domestic supply bottlenecks is still a big problem.

Generally, wage rates in the formal sectors are determined on the basis of tripartite agreements held amongst the government, employers and employees. Therefore, attempts are made to ensure that minimum wage rates remain above the per capita income. Wage rates vary across the unskilled, semiskilled and highly skilled categories (Table 4.28). Nevertheless, the rate fixed for 1985 was based on the criterion of meeting minimum basics needs. The basic needs programme of NPC had determined Rs 1,971 per person per year as the minimum amount to fulfil the basic needs requirements. Interestingly, it is observed that the nominal wage rate increased faster than the rate of inflation during the first phase of reform. In the second phase, the pace of price rise exceeded the rise in wages resulting into a decline in the real wages. For instance, during 1985-91 wages of the highly skilled category rose by almost two times as opposed to 1.86 times increase in prices (Table 4.27 and 4.28). On the other hand, during the 1991-2001 period the price rise was 2.46 times the rise in wages. A similar pattern is observed in other categories as well. This simply means that the reforms have had some negative impact on the life of the wage earners. As noted above productivity of the workers is obviously low in Nepal. But part of the problem lies in the inability in skill enhancement of the workers. A typical Todaro effect is in place in Nepal where in the absence of gainful work, rural workers migrate to urban areas in search of employment. The increased labor supply dampens the urban wage rate.

Table 4.28 Monthly Minimum Wage Rate* (in Rs)

Year	Unskilled	Semiskilled	Skilled	Highly Skilled
1985	475.0	535.0	602.0	748.0
1987	582.0	632.0	740.0	923.0
1989	850.0	900.0	1008.0	1191.0
1992	1150.0	1200.0	1310.0	1500.0
1997	1800.0	1850.0	1960.0	2150.0
2000	1616.0	1666.0	1776.0	1966.0
2001	2116.0	2166.0	2276.0	2466.0
1985-92	242.1	224.3	217.6	200.5
1992-2001	184.0	180.5	173.7	164.4
1985-2001	445.5	404.9	378.1	329.7

Note: * Including allowance

Source: Compiled from various sources including GFONT and Economic Updates of the World Bank.

Similarly, there are severe structural problems in Nepal in the labor market and on the wage front. At first, the average dependency ratio is extremely high (CBS, 1996). Similarly, labor force engaged in agriculture is very high at 76.1 percent with virtually no wage policy in this area (CBS, 1999). This has contributed to persistence of very low wage rate in rural areas. One recent study shows that about 70 percent of the informal sector workers work 12 hours a day and earn in the range of Rs. 1,000 to 3,000 per month. Encroachment of labor market by non-Nepali workers is equally serious (Mainali et al, 2002). Wage workers neither enjoy any job security nor do they have a strong bargaining power in fixing wage rates. At the same time, wage differences between men and women are equally high. Currently, wage rates of women are 75 and 87 percent of male wage rates in rural and urban areas, respectively (ILO, 2002). Therefore, the present wage level itself is detrimental from the point of view of enhancing productivity and raising the living standard of the work force.

4.5 Access to Social Services

Access to social services and affordability are of critical importance in the overall reform process. Experience from many countries including that of South Korea indicates that education is the key to high growth associated with more equitable development. Literacy enables people to gain knowledge and skills required for diversifying occupations and income sources and thus making them less vulnerable to income risks. Likewise, literacy of mothers affects the nutritional status of children positively and child mortality negatively.

Nepal has accorded high priority to education and literacy. Accordingly, the literacy rate increased from 24 percent in 1981 to 40 percent in 1991 and further up to 53.8 percent in 2001 (CBS, 1981, 1991 and 2001). However, these trends conceal many discriminatory distributional patterns inherent in the existing education system. First, the literacy rate among females is very low compared to males. As of 2001, it was 42.5 percent among females against 65.1 percent among males. Similarly, the literacy rate across various regions and castes is very uneven and biased. Among the ecological belts, literacy is highest in the hills and lowest in the mountains. In all the development regions and ecological belts, female literacy is far below male literacy. It is worst in the mid-western and far-western development regions. Among the caste groups, the literacy level among the Tarai Dalits (deprived and socially excluded) is the lowest. According to the 2001 Census, literacy among the most deprived castes like Mushahar, Kamar, Dom and Kushwadia is 7.28, 15.15, 9.39, 13.22 percent, respectively (Table 4.29). Even though enrolment in primary school education is more than 90 percent today, the ratio of girls to boys in primary and secondary school enrolment is only 78 and 71 percent, respectively. Likewise, the dropout rate is very high and share of pupils starting grade 1 who reach to grade 5 is only 41.6 percent of the total enrolment (MOPE, 2002).

Table 4.29 Literacy Rate in Nepal by Region, Sex and Ethnic/Caste Group

Region/Sex	Literacy Rate
Nepal	53.80
Male	65.10
Female	42.50
Region	
Mountain	
Hill	
Tarai	
Development Region	
Eastern	55.43
Central	52.64
Western	59.04
Midwestern	49.00
Far western	48.22
Ethnic/caste groups	
Five highly literate groups	
Jain	93.94
Marwadi	89.31
Kayastha	82.05
Thakali	75.66
Hill Brahmin	74.90
Five lowly literate groups	
Mushahar	7.28
Dom	9.39
Kushwadia/Patharkata	13.22
Bing/binda	14.80
Kamar	15.15
Region	
Urban	71.55
Male	80.90
Female	61.60
Rural	50.66
Male	62.24
Female	39.32

Source: CBS, Nepal (2001).

A detailed survey carried out in 1996 shows that out of the total sample population of six years and above, about 56 percent had never attended school. In all, the educational status of females was far behind males. The reason for the 6-24 year age group not attending school was lack of parents' interest (about 30 percent). This was followed by the need to work at home (about 21 percent). Problems associated with affordability contributed to less interest. This is further corroborated by the same survey findings. Out of every Rs. 100 spent by the government up to the tertiary level, only Rs. 17, (primary) 5 (secondary) and 0.4 (tertiary) was spent among the lowest 20 percent income brackets (CBS, 1996). As a result of the decrease in the level of development expenditure, the situation has further worsened in recent years. At the same time, unit costs have risen markedly overtime at all these levels. In 1997 the average cost of primary level education per student stood at Rs. 1,270, a real increase of 65 percent over 1991. Similarly, the cost of secondary level education was Rs. 1,644, representing 54 percent real increase over as compared to 1991 (World Bank, 2000). Whatever gains made in literacy resulted in a very skewed disparity across the classes, regions and gender categories. Nonaffordability of qualitatively better private sector provisions of education and widespread deterioration in the quality of government provided education have further marginalised the masses.

The health services demonstrate a similar pattern as education. There has been a steady improvement in the life expectancy of the people. The average life expectancy has reached 61.9 years in 2001, comprising 61.8 among males and 62.2 among females. However, a worse form of discrimination persists in terms of health facilities. There are only 89 hospitals, 5,415 certified medical doctors, 3,921 nurses and 5,310 hospital beds (CBS, 2001). In Nepal, better health services are mostly confined in the Katmandu Valley and urban areas. Several studies show that the rural people of Nepal have the least access to health services and drinking water facilities. The proportion of the population below the minimum level of dietary energy consumption stood at 47 percent. Likewise, the proportion of underweight under-five children is 48 percent. The proportion of the population without access to drinking water is 20 percent (MOPE, 2002). Protein-energy malnutrition, iodine deficiency disorders, and iron and vitamin deficiencies are most common in Nepal. Similarly, more than a quarter of the Nepalese women suffer from protein-energy malnutrition. In addition, the sanitation situation in Nepal as a whole is very poor. The overall coverage of households with latrines was 19.8 percent in 1991, which increased moderately to 22.5 percent in 1996/97. Of the total reported cases of diseases in 74 government hospitals between July 1997 and April 1998, 32 percent of the cases were "water and sanitation related diseases" (Nepal State of Sanitation Report, 1999/2000).

Table 4.30 Health Indicators by Sex and Region

Region/Sex	Life Expectancy at Birth, 2001	Infant Mortality Rate, 2001	Under-Five Mortality Rate 2001	Percentage of People Below Minimum Level of Dietary Consumption, 2000
Nepal	61.9	64.0	91.2	47.0
Sex				
Male	61.8	79.2	104.8	
Female	62.2	75.2	112.4	
Residence	NA			
Urban		50.1	65.0	
Rural		79.3	111.9	
Eco–regions	NA			
Mountain		112.0	157.4	
Hill		66.2	93.9	
Tarai		80.8	112.8	

Source: CBS (2001). Nepal Demographic Health Survey 2001.

A recent study examined the link between income poverty and access to health services using the data from the 1996 survey. It shows that health conditions are closely linked to income levels. In terms of travelling time, the poorest 20 percent of the population have less access to a health post than the non-poor. Furthermore, data on immunisation also shows that it gets better as income increases. The percentage of children with no immunisation decreases rapidly as the income level increases and the percentage of children with full immunisation increases rapidly as income increases (Pyakuryal, 2002). Similarly, household expenditure spent on gaining access to publicly provided health services varies substantially by income group—from Rs. 470 for the poorest quartile to Rs. 5,016 for the wealthiest quartile annually. These expenditures constitute more than half of the total income of the poorest income bracket. Service orientation to the poor is also very low and discriminatory. This is one of the principal reasons for the poor not seeking health services (CBS, 1996). Poor levels of health services are reflected in reproductive health and safe motherhood, early marriage, early motherhood, more pregnant women with anaemia, low percentages of births attended by trained health workers, lack of access to professional ante-natal care, and high mortality of children due to lack of proper immunisation (NESAC, 1998). Like in education, there is a stark disparity in the price and quality of health services provided by the private and public sector. The poor have virtually zero access to private health care.

It is evident in the huge gap in the infant and under-five mortality rates across the rural-urban and mountain-hill divides.

4.6 Access to Assets, Opportunities and Poverty Situation

Access to assets and opportunities in terms of occupancy in positions in the government's bureaucratic hierarchy and representation at various elected bodies play an important role in enlarging the benefits of reforms among various segments of the society and safeguarding the interests of different classes and socio-economic groups.

In a traditional agrarian society, access to land is crucial in enhancing the social status and improving living conditions of the people. To a greater extent, the power relations are also governed by these patterns. The agriculture census data show that during 1981 to 2001, a considerable change has occurred in the land holding pattern. In 1981 households holding less than 0.5 hectare of land constituted 50.49 percent of the total. This ratio dropped to 43.8 percent in 2001. However, this is not reflective of an upward movement of marginal farmers toward higher farm categories. It was rather an outcome of the growing proletarisation of marginal farmers to a greater extent, and even small farmers to some extent. The incidence of landlessness increased from about 15 percent in 1996 (NESAC, 1996) to 23 percent in 2001 (CBS, 2001). Similarly in 1981, 16.2 percent of the farmers had land holding in the range of 0.51 to 2 hectare. Farmers falling in this category rose to as much as 45.4 percent in 2001 (Table 4.31). The land distribution pattern also shows that the lowest farm category of 0.5 hectare held only 6.58 percent of total cultivated land in 1981. This pattern has hardly changed. Within the most deprived dalit community constituting about 13 percent of the total population, the situation is highly alarming. About 48.7 percent of this community holds less than 5 ropani (ropani is a local land area unit and approximately equals 0.05 hectare) of land. Similarly, the number of the landless population in hudke, dum, gaine, badi, and dhobi is 100, 88.2, 41.2, 39.1 and 33.3 percent, respectively (National Dalit Commission, 2003). This simply means that in the reform process, proleterisation of marginal and near landless farmers has intensified. In a situation where productivity in the agriculture sector has remained stagnant and is grappling with the problem of rising input and falling output prices, vulnerability of majority of the farmers in the post-reform period has risen markedly. Obviously, this has had a very adverse effect on poverty conditions leading to widening of distributional conflict in the society.

Table 4.31 Land Holding and Distribution

Census Period	Range	0.51 Ha. & less	0.51-2 Ha	2.0-5.1 Ha	5.1-10.2 Ha	10.2-20.3 Ha	20.3-50.9 Ha	50.9 Ha & Above	
1981/82	% of land	6.58	10.75	35.31	18.5	15.78	13.07		
	% of holding	50.49	16.2	24.4	5.45	2.74	0.68		
	Range	<0.5 ha	<1 ha	<2 ha	< 3 ha	<4 ha	<5 ha	<10 ha	>10 ha
1991/92	% of land	9.4	19.2	27.6	15.4	7.8	4.8	8.1	5.8
	% of holding	43.8	26.0	19.4	6.2	2.2	1.0	1.2	0.3
	Range	<0.5 ha	0.5-2 ha	2 ha & above					
2001/002	% of land								
	% of holding	43.8	45.4	10.8					

Source: CBS (various years). National Sample Census of Agriculture.

Another factor affecting the access of various socioeconomic groups over assets and opportunities is the government expenditure pattern. Targeted programmes normally tend to neutralize the social cost of adjustment and facilitate the poor and the disadvantaged to enhance their productive capacity and create further assets. Studies indicate that in 1999/2000, despite higher budget amounts allocated to local development, education and health, the share of spending that were directly related to the poor stood at less than one-third of total spending (UNDP, 2002). These numbers are based on the assumptions that expenses made in some sectors or areas are fully spent for benefiting the poor. For instance, about 95 percent of the spending in water resources and 80 percent of local development spending is treated as pro-poor, which may not be necessarily so (Table 4.32).

From the standpoint of pro-poor budget allocation, the existing Nepali budgetary system encounters three additional problems. First, despite the substantial increase in the share of social sector expenses the level of development budget is itself shrinking. This is very adversely affecting enhancement of the productive capacity of the poor. Second, efficiency of expenditure has dwindled. Third, the gap between the budgeted and actual expenditure is widening particularly among the various pro-poor programmes (Table 4.33). The actual expenditure on the nutrition and women health programme is the best example. Despite poverty alleviation being the sole target of the 9th plan (1997-2002), the government could not utilize the fund allocated for this purpose. Therefore, in addition to shifting the budgetary allocation toward targeted programmes it is also necessary to use funds efficiently and effectively by involving the beneficiary groups themselves through bottom-up processes. This will require overhauling of the present resource management and budgetary system.

Table 4.32 Expenditure Directly Related to the Poor 1999/00 (Rs. in million)

	Total Expenditure (a)	Targeted Expenditure (b)	Share of (b) to (a)
A. Name of Ministries			
Finance (including investment on PEs)	7893.2	614.3	7.7
Industry, commerce and supply	1147.3	163.5	14.2
Agriculture and cooperative	2224.4	624.5	27.1
Population and environment	34.2	14.2	41.5
Water resources	3034	2871.0	94.6
Physical planning and construction	6832.6	2359.8	34.5
Land reform	520.2	44.8	8.6
Women, children and social welfare	206.5	145.2	70.3
Forest and social conservation	1304.6	383.6	29.4
Education and sports	9606.6	7134.0	74.3
Local development	4849.3	3880.4	80.0
Health	3371.8	2425.3	71.9
Labor and transportation	94.6	36.9	39.0
Subtotal	*41209.0*	*20697.2*	*50.2*
B. National total expenditure	**66272.5**	**20697.2**	**31.2**
Targeted expenditure as percent of total expenditure		31.24	

Source: UNDP (2002).

Table 4.33 Allocated and Actual Spending in Selected Pro Poor Programmes (Rs. in million)

Programmes	1999/00			2000/01		
	Allocated Budget (a)	*Actual Expenditure (b)*	*Actual to Estimated, %*	*Allocated Budget (a)*	*Actual Expenditure (b)*	Actual to Estimated, %
Basic and primary education	4368.1	2839.5	65.0	9911.6	6877.5	69.4
Women health volunteers	70.5	29.8	42.3	80.2	8.7	10.8
Nutrition programme (center)	380.9	214.7	56.4	404.6	57.7	14.3
Nutrition programme (district)	46.7	37.7	80.7	56.6	20.0	35.3
Rural agricultural road	1500.0	685.4	45.7	2000.0	530.0	26.5
Second irrigation sector project	5443.0	2553.4	46.9	6893.4	3977.4	57.7
Nepal irrigation sector project	8920.5	6350.5	71.2	10763.7	7684.6	71.4
Groundwater project	1000.0	207.2	20.7	1153.0	756.2	65.6
Groundwater shallow tube well	1200.0	223.8	18.7	150.0	80.0	53.3
Hill leasehold forestry and pasture development	350.0	0.0	0.0	350.0	262.5	75.0
Third livestock project	8000.0	-	-	1500.0	1080.0	72.0
Groundwater water irrigation	140.0	-	-	140.0	100.8	72.0
Poverty alleviation fund	100.0	4.80	4.8	100.0	20.0	20.0

Source: UNDP (2002).

When access to government jobs among the various socio-economic caste and community groups is observed, a very disappointing picture emerges. In 1984, 2.8 percent of the ethnic communities, constituting more than 37 percent of the total population, were occupying higher positions in the government bureaucracy. No one was represented the dalit caste. Even 15 years later, in 1999, there was no major structural shift in this aspect. Of the total number of government employees, ethnic communities accounted for 8.4 percent and dalits much lower at 0.17 percent. This means that the civil service still remains a monopoly of the privileged classes and higher castes. In terms of representation in the parliament also, the situation is quite similar. In the parliamentary election of 1991, only 12 percent of the 205 elected MPs belonged to the ethnic communities. No one could get elected from the dalit community. This was partly due to the dominance of the privileged upper castes in the highest echelon of the party hierarchy (National Dalit Commission, 2003). Of the 205 MPs, women numbered only 12. In the district and village councils 1.5 and 2.1 percent women were elected in the last local body elections held in 1998 (Election Commission, 1998 and 1999). This again is a reflection of especial provisions influencing allotment of seats to the women. On the whole, this type of very uneven and discriminatory system in all spheres of life has led to intensification of the distributional conflict and contradictions in the Nepali society. Both the democratic processes and reform programmes contributed very little to altering this privileged class dominant political, economic and social structure.

Table 4.34 Elite Capturing in Governance

	1984		1999	
Social groups	**No.**	**%**	**No.**	**%**
High caste (hill)	166	78.30	763	66.23
High caste (hill)	32	15.09	152	13.19
High caste (hill)	2	0.94	138	11.98
Ethnic groups	6	2.83	97	8.42
Dalit caste			2	0.17
Others (caste unidentifiable)	6	2.83		
Total	**212**		**1152**	

Source: Neupane, G. (2000). Nepalma Jatiya Parichaya, p. 82.

The reform process failed to make any dent in the existing discriminatory employment opportunities. According to the Population Census of 2001, out of the total population of 23.15 million, 9.9 million are economically active. This number was 6.85 million two decades ago. This indicates a rapid growth in the economically active population. Apparently, a structural shift has also taken place in the population engaged in various activities during this period. In 1981 about 91.1 percent of the active population was engaged in agriculture and related activities. This ratio gradually decreased to 81.2 percent in 1991 and further down to 65.7 percent in 2001. Thus in the period when liberalisation was intensively pursued a certain shift took place during the period. This has been possible due to high rates of absorption of the economically active population by the manufacturing, trade and growing informal sectors. These sectors had absorbed very limited number of people in 1981. These two sectors had engaged 2.1 and 3.5 percent of the total economically active population in 1991, respectively. These ratios increased to 9 and 9.9 percent in 2001 (Table 4.35). But, these statistics neither show the actual employment phenomenon nor reveal the severity of problems in the labor market in terms of obtaining gainful employment opportunities.

Table 4.35 Economically Active Population 10 Years of Age and Over, by Major Industry

Industrial Group/Year	1981	Share in Total	1991	Share in Total	2001	Share in Total
Total	6,850,886	100.0	7339586	100.0	9900198	100.0
Agriculture forestry & fishery	6,244,289	91.1	5961788	81.2	6504689	65.7
Mining and manufacturing	971	0.0	152418	2.1	888301	9.0
Electricity, gas and water	33029	0.5	11734	0.2	148218	1.5
Construction	3013	0.0	35658	0.5	286418	2.9
Commerce	2022	0.0	256012	3.5	984662	9.9
Transport and communication	109446	1.6	50808	0.7	161638	1.6
Finance and business services	7424	0.1	20847	0.3	76687	0.8
Personal & comm. services	9850	0.1	752019	10.2	663737	6.7
Others	313570	4.6	28004	0.4	163412	1.7
Industry not stated	127272	1.9	70298	1.0	22395	0.2

Source: CBS. Various Population Censuses.

First of all, out of the total economically active population, the ratio of self-employed is still very high. In 1981, this ratio was 85.5 percent. In 1991 it fell down to 75.25 percent. It further dropped to 67.2 percent in 2001. This was offset by a jump in the share of 'employees' which expanded from 9.1 percent in 1981 to 21.41 percent in 1991 and further up to 24.63 percent in 2001 (Table 4.36). However, these numbers still conceal various dimensions of the structural problems perpetuating in this area. First of all, out of the total self-employed, 78 percent are engaged in agriculture related works. Among them 43.3 percent are engaged in own-family works without any pay. This is persisting at a time when underemployment in the agriculture sector is still very high at about 32.3 percent (CBS, 1999). This is based on the new definition in which the concept of gainful employment is not followed. The studies made on those lines show the incidence of underemployment in the range of 43 to 47 percent (NPC, 1977, 1985).

Table 4.36 Economically Active Population 10 Years of Age and Over, by Employment Status

Age, Sex & Age Groups	Total Economic Active	Employer	Employee	Self Employed	Unpaid Family Workers	Not Stated
1981	6850886	46968	621432	5860419	172789	149278
Share in total		0.7	9.1	85.5	2.5	2.2
1991	7339586	41455	1571300	5522827	171631	32373
Share in total		0.56	21.41	75.25	2.34	0.44
2001	9900198	376349	2438328	6210841	874678	
Share in total		3.80	24.63	62.73	8.83	0.00

Source: CBS. Various Population Censuses.

The labor force survey of 1998/99, despite some definitional problems in identifying gainfully employed, reveals serious structural problems persisting in Nepal's labor market (CBS, 1999). First of all, according to this latest survey, the ratio of labor force engaged in agriculture is still very high as opposed to the lower ratio revealed by the economically active population figures in the population census. Accordingly, 76.1 percent of the labor force is still engaged in the agriculture sector. On the other hand, out of the 23.9 percent of the labor force employed in the non-agriculture sector, 73.3 percent is engaged in the informal sector. More distressingly, assuming the entire agriculture sector as informal sector, job ratio in the formal sector works out at a mere 6.4 percent. In the informal non-agriculture sector, the ratio of engagement of rural labor force is as high as

77.4 percent (Table 4.37). One recent study shows a terrifying situation in the informal labor market of Nepal. About two-thirds of the workers in the informal sector did not receive any kind of training whatsoever from any organisation. The ownership pattern of informal sector is dominated by male proprietorship (87 percent). About 70 percent of the informal sector workers work 12 hours a day and earn in the range of Rs. 1,000 to 3,000 per month (Mainali et al, 2002). This sector neither guarantees job security nor allows any collective bargaining power to the workers in fixing wage rates. At the same time, wage differentials between the male and female workers are equally high (ILO, 2002).

Table 4.37 Persons Aged 15 Years and Over Currently Employed in Agriculture and Non-agricultural Sectors (Both Formal and Informal)

Occupational Groups	Total	Agri.	Non-agri sector	Share in Non-Agri Sec	Formal	Share in Non-Agri	Informal Sector Jobs	Percent Informal	Urban	Urban (%)	Rural	Rural (%)
Total	**9463**	**7203 (76.1%)**	**2260 (23.9%)**	**100.0**	**603**	**26.7**	**1657**	**73.3**	**375**	**22.6**	**1282**	**77.4**
Legislator, senior officials			12	0.5	7	0.3	5	44.7	4	80.0	1	20.0
Professionals			37	1.6	33	1.5	4	10.8	3	75.0	1	25.0
Technicians			203	9.0	163	7.2	40	19.9	16	40.0	24	60.0
Clerks			106	4.7	102	4.5	4	3.9	3	75.0	2	50.0
Service workers			487	21.5	30	1.3	457	93.7	0	0.0	4	0.9
Agricultural workers			13	0.6	2	0.1	11	86.3	1	9.1	5	45.5
Craft & related trade workers			556	24.6	59	2.6	497	89.3	103	20.7	394	79.3
Plant & machine operators			102	4.5	42	1.9	60	59.5	14	23.3	46	76.7
Elementary occupations			739	32.7	161	7.1	578	78.2	72	12.5	506	87.5
Armed forces			5	0.2	5	0.2	0	0	0	0.0	0	0.0

Source: CBS. Nepal Labor Force Survey 1998/99.

Assuming that the incidence of unemployment and underemployment is 5 and 32.3 percent, respectively, an adjusted unemployment rate is estimated at 17.4 percent (NPC, 2003). This estimate additionally corroborates the view that the unemployment problem is quite serious in Nepal. The recent economic downturns in a situation of severe structural problems in the labor market have further worsened this scenario. Slowdown in the non-agriculture sector and very low productivity and commodity diversification in rural agriculture is generating very adverse effects on the level and pattern of employment (Sharma, 2003). Trends in the manufacturing sector, for which data are readily available, indicate that employment in this sector has decreased in recent years. In 1986 about 137 thousand persons were employed in the manufacturing sector. This number increased to 213 thousand in 1991. It further went up to 230 thousand in 1995. Since then, the number is declining year after year and reached about 180 thousand in 2001 (CBS, 1987, 1992, 1995 and 2002). Likewise, employment in public enterprises has gone down from 60 thousand in 1989/90 to 47 thousand in 2001 as a result of, among others, privatisation. Closure of cottage and small enterprises day by day together with extinction of traditional occupations in rural areas have exacerbated vulnerability among the most disadvantaged (Blaikei et al, 2001). Although various initiatives have been taken through institution building with a view to promoting vocational educational, upgrading of skill as well as enhancing medium-sized and micro enterprises, most of these programmes have very limited coverage and they are deficient and ineffective (ILO, 2002). Investment on infrastructures is getting more capital-intensive. The labor market suffers from encroachment by outsiders. Allocation of resources and services has failed to address the problems of the most vulnerable socio-economic groups of the society. All these have further perpetuated the precarious living condition of the poor. Despite some structural shift, compulsion to work mostly seasonally in low productivity and income sectors of the economy such as small-scale agriculture, rural non-farm trade and other activities as well as urban informal sector services have compelled poor workers to remain poor despite engagement in a job. Gender biases, very low wage rates and concentration of limited opportunities in few accessible areas have further compounded the magnitude of such problems. On the whole, unlike the expectation, the liberalisation programmes have been unable to address the problem of unemployment especially after 1995. Rigidity in labor laws has encouraged not only capital-intensive mode of production but also informalisation of the labor market. Similarly, in the absence of well thought out programme for human resource development, despite the existence of skill formation and upgrading programmes for employees or job seekers, the problem of unemployment has intensified. This has resulted in the displacement of Nepali workers from the job market. The pegged exchange rate system has also indirectly attracted workers from the neighbouring country.

All of the above factors coupled with very low level of per capita income and increasing income concentration has generated very adverse effects on the poverty situation. Moreover, excessive concentration of benefits among few trading and commercial classes in the midst of deterioration in general economic activities has further compressed employment opportunities. All these have further worsened income and consumption levels of the poor, deprived and socio-economically marginalised groups. At $ 230, Nepal's per capita income is one of the lowest in the world (World Bank, 2002). This itself is indicative of the poor income and consumption levels of the majority of the people. Indeed, the per capita income had increased from $ 150 in 1986 to $ 230 in 2002.

The NLSS survey of 1995 (CBS, 1996) reported that in 1995, the average household income was Rs. 43.7 thousand (Table 4.38), which varied by ecological belt as well as rural and urban areas. Among the three ecological belts, household income was the highest in the hills (Rs 45,000) followed by the Tarai (Rs 44,500), and the mountains (Rs 32,300). Average household income in urban areas (Rs 86,800) was more than double that in rural areas (Rs. 40,400).

In terms of income sources, farm income at 61 percent of the total constituted the largest share. Among the ecological belts, the highest share was found in the Tarai (64%) followed by the mountain (62%). Among the quintile groups, both the first and second quintile groups had the highest earning of 69 percent from farm income. As expected, farm income constituted the lowest share of the total household income in urban areas (Table 4.39).

Table 4.38 Nominal Household and Per Capita Income by Geographical Group

	Average Household Income	Average Household Size	Average Per-Capital Income
Development Region			
Eastern	40892	5.5	7434
Central	52408	5.6	9366
Western	39213	5.6	7011
Mid-west	36435	6	6038
Far-west	37307	6.3	5928
Ecological Belt			
Mountain	32343	5.4	5938
Hill	44998	5.3	8433
Tarai	44518	6.1	7322
Urban	48797	5.4	16118
Kathmandu	118939	4.9	24084
Other Urban	65363	5.7	11502
Rural	40400	5.7	7075
Eastern Hill/Mountain	41084	5.4	7609
Western Hill/Mountain	35053	5.4	6534
Eastern Tarai	45284	5.7	7876
Western Tarai	39308	6.8	5772
Nepal	43732	5.7	7690

Source: CBS (1997). Nepal Living Standards Survey Report 1996.

Table 4.39 Shares of Farm, Non-Farm, and Other Incomes in Nominal Household Income

	Share of Farm Income	Share of Non-Farm Income	Share of Other Income
Development Region			
Eastern	66	22	12
Central	56	26	18
Western	59	19	22
Midwest	71	20	9
Far-west	62	19	19
Ecological Belt			
Mountain	62	18	20
Hill	58	24	18
Tarai	64	22	14
Urban	16	54	31
Kathmandu	3	63	34
Other Urban	25	47	28
Rural	65	20	15
Eastern Hill/Mountain	66	20	14
Western Hill/Mountain	60	20	20
Eastern Tarai	64	22	14
Western Tarai	73	15	11
Consumption Group			
First Quintile	69	19	12
Second Quintile	69	21	10
Third Quintile	64	20	16
Fourth Quintile	63	20	17
Fifth Quintile	47	18	25
Nepal	61	22	16

Source: CBS (1997). Nepal Living Standards Survey Report 1996.

Similarly, in terms of employment status, self-employment generated about 54 percent of the total income. This was followed by wage income (28%) (Table 4.40).

Table 4.40 Nominal Household Income by Source

	Share of Wage Income	Share of Self-Employment Income	Share of Other Income
Development Region			
Eastern	33	58	9
Central	30	50	20
Western	25	52	23
Mid-west	20	65	16
Far-west	26	54	19
Ecological Belt			
Mountain	34	54	12
Hill	22	59	20
Tarai	33	50	17
Urban	36	33	31
Kathmandu	42	24	34
Other Urban	32	39	29
Rural	27	56	17
Eastern Hill/Mountain	25	64	11
Western Hill/Mountain	20	57	23
Eastern Tarai	35	48	17
Western Tarai	29	57	14
Consumption Group			
First Quintile	35	54	12
Second Quintile	34	52	14
Third Quintile	29	55	16
Fourth Quintile	23	60	17
Fifth Quintile	23	51	26
Nepal	28	54	18

Source: CBS (1997). Nepal Living Standards Survey Report 1996.

Among the quintile groups, the first quintile with a mean per capita income of Rs. 2,020 had the lowest income share of 5.3 percent. The second quintile with an income of Rs. 3,848 per capita enjoyed a share of 10 percent in the total. Among the consumption quintiles, the situation was slightly better with the first and second quintiles together accounting for 19 percent of the total per capita consumption

(CBS, 1996). Nevertheless, trends in income distribution show that concentration is increasing in an unprecedented way. In 1985, the first 40 percent of the households had a share of 23 percent in the total income. On the other extreme, the top 10 percent of the highest income group possessed 23 percent of the total income. By 1996 this scenario had completely changed in which the share of the first group fell to 11 percent whereas that of the upper income bracket rose to 52 percent. The Gini-coefficient also corroborates this phenomenon (Table 4.41). Although these coefficients show a slight improvement in income distribution in rural areas between the period 1985-1996, if recent trends are any guide as discussed in the previous sections, they clearly indicate a worsening income disparity.

Table 4.41 Household Income and Distribution Pattern

Reference Year	Household Income Share of			Gini Coefficient		
	First 40 %	Next 50 %	Last 10 %	Rural	Urban	Nepal
1985	23.0	54.0	23.0	0.55	0.85	0.57
1996	11.0	37.1	52.0	0.51	0.55	0.57

Source: NPC (1985) and CBS (1996).

All these data indicate that incidence of poverty is on the rise. Based on the same criteria as used in 1985 and 1996, the incidence of poverty increased from 41.4 percent to 45 percent. The reduced calorie requirement criteria showed poverty remaining at 42 percent. Likewise, as in the previous surveys, the latter survey also found huge variations across ecological belts as well as rural and urban areas. For the rural areas poverty was calculated at 46.6 percent as against 17.8 percent in urban areas. In terms of ecological belt, the highest poverty level was found in the mountain (62.4%) followed by the hills (52.7%).

Poverty, which is worsening, is much more pronounced when the income level is evaluated in terms of landless and marginal, small, and medium/large land holding categories (Table 4.42). First, in the hills and mountain regions, the incidence of poverty is markedly higher among the landless/marginal households and small farms. These regions characterize higher incidences of landlessness or smaller holding sizes, which very significantly increases the probability of being poor. Thus, among the landless in the hills, 70 percent are poor and 30 percent non-poor. The situation in the mountains is much the same, with the corresponding figures being 77 percent and 23 percent. In contrast, only 24 percent of the medium/ large landowners in the mountains are poor. Second, poverty is not limited to landless/marginal and small landholders. Forty-three percent of the medium and large holders of the hills, 24 percent in the mountains and 18 percent in the Tarai fall under the below poverty line income category. In addition, 60 percent of the small holders in the hills, 58 percent in the mountain and 30 percent in the Tarai have incomes below the poverty line (Sharma, 2003).

Table 4.42 Distribution of the Poor and Non-poor Farm Households by Farm Category

	Landless/Marginal	Small	Medium/Large	Total
Tarai region				
Poor	476 (40%)	320 (30%)	97 (18%)	893 (32%)
Non poor	723 (60%)	759	441	1923
Hill region				
Poor	877 (70%)	1138 (60%)	162 (43%)	2177 (62%)
Non poor	371 (30%)	766	211	1348
Mountain region				
Poor	296 (77%)	300 (58%)	24 (24%)	620 (62%)
Non poor	87 (23%)	214	74	375

Source: Sharma (2003).

The above findings suggest that it is not the size of holding, but returns from it that supports households to graduate away from poverty. The calculated average land productivity among the poor and non-poor groups by land size class corroborates these arguments (Table 4.43). Land productivity corresponding to the non-poor group is almost twice as high as the corresponding figure of the poor groups in each region.

When the poverty condition among the various socio-economic and caste groups is evaluated, a very distressing phenomenon is observed. Among the most deprived communities, incidences of poverty falling on the Kami, Damai and Sarki are the highest at 68, 67 and 65 percent, respectively (Table 4.44). Among the ethnic communities, poverty among the Limbu is widespread (71%), followed by Tamang (59%), Magar (58%), and Rai (56%).

Table 4.43 Average Land Productivity by Poor and Non-Poor Groups of Households and Farm Category

	Small	Medium/Large
Tarai region		
Poor	8014	4824
Non poor	15786	10654
Hill region		
Poor	11161	6046
Non poor	21115	11929
Mountain region		
Poor	11199	5811
Non poor	26058	10864

Source: Sharma (2003).

Table 4.44 Poverty Among Cast/Ethnic Groups

Caste/Ethnicity	Poverty Proportion
Brahmin	34
Chhetri	50
Newar	25
Kami	68
Sarki	65
Damai	67
Muslim	38
Rai	56
Gurung	45
Tamang	59
Limbu	71
Magar	58
Tharu	48
Others	40

Source: NHDR (1998).

Many of these are survey findings of the periods when the economy was performing by and large satisfactorily. Since the economy is performing dismally on every front after the mid-1990s, one may safely conclude that recent trends in the Nepali economy have had very detrimental effects on the income distribution pattern and living conditions of the poor, including those deprived of access to assets and opportunities. This also means that the way the reforms were carried out in Nepal have failed to contribute to sustained and broad-based development and in augmenting the living conditions of the toiling masses. Instead, the open and liberal environment worked in disguise favoured a small privileged class and enabled it to capture the benefits, which ultimately contributed to further aggravating the political, social and economic crises in the country.

chapter five

Major Findings, Conclusions and Policy Implications

1 Nepal was one of the early initiators of economic reform in the South Asian region. The reforms were initiated in the mid 1980s through economic stabilisation and structural adjustment programmes. However, more intensive and wide-ranging reforms were introduced only in the early 1990s. This period also coincided with restoration of democracy in the country. Now the state led and controlled system has largely been replaced by a broadly liberal, open and market based economic regime. Hence the role of the state has been considerably squeezed. In the realm of macroeconomic policy the exchange rate, trade, financial, monetary and fiscal policies have been mostly liberalised. The privatisation programme has also been pursued simultaneously. With the aim of making agricultural policies compatible with macroeconomic policies, both input and output markets have been almost fully liberalised. Except some limited amount of subsidy in the area of food supply, no other form of subsidy is provided to the agriculture sector. The priority sector lending is being phased out. Apart from finance, insurance, trade and industry, social and economic infrastructure related areas have also been opened up to domestic as well as foreign private investors. Nepal is in the process of further opening up its economy in a way to fulfilling the WTO obligations. The SAFTA agreement introducing a free trading system within the SAARC region by 2006 is bound to further accelerate this process.

2 The present study, instead of assessing the outcomes in a fully technical or mechanistic manner, tries to analyse the whole spectrum of reforms broadly following a politico-economic and institutional approach. It essentially examines through analytical lenses three key aspects of the reforms, namely, what forces led

to initiation of reforms, what were the basic ingredients of the reform package, and how well were the reforms carried forward. The major focus of the study is on the forces compelling reforms, initial conditions at the time of initiating reforms, processes followed in carrying those out, their features and sequencing, as well as strategies adopted to ensure successful implementation of the reforms. It also assesses the major outcomes of reforms from the political economy perspective.

3 A quick look at the reforms reveals that outcomes of liberalisation and opening up have been far from satisfactory. Neither was the growth momentum of the mid-1990s sustained nor could the most disadvantaged people reap benefits from the reform. On the contrary, along with the deterioration in macro economic performance, the inherent contradictions and gaps between the haves and have-nots escalated further providing a fertile ground for widespread discontent. In contrast to the general belief, the democratic polity could not embrace and strengthen self-correcting mechanisms to address the weaknesses and inadequacies in policies and institutions. So much so that the country precipitated into a situation where democratic institutions increasingly became threatened by both the extreme rightist and leftist tendencies through increased curbs in political, social and economic arenas. The present study tries, among others, to find out some of the underlying reasons for such tendencies from political economy and institutional perspectives treating various aspects of economic reforms as the basis of analysis.

4 The foreign exchange crisis emanating from financial chaos and burgeoning resource gap during and in the aftermath of the referendum in 1979 were the compelling factors leading to initiation of the first phase of reforms (1985-90). As a result of inefficiency in resource allocation and utilisation and failure to bring about agrarian changes, economic crisis had deepened from the early 1980s. Widespread distortions in the economy were yet another reason for this. Since the reform was directed primarily to addressing the problem of deepening foreign exchange crisis, the initial conditions and likely effects of reforms on various contending socio-economic classes were hardly considered.

5 In the first phase, conditions embodied in the economic stabilisation programme and the Structural Adjustment Programme (SAP) were the major factors determining the features, pattern and sequencing of reforms. These programmes comprised various market related agenda and forced Nepal to change the stance of its economic policy from a largely state regulated to market-oriented one. Interestingly, this was the period which coincided with the 15-year basic needs programme (1985-2000). It had set, among others, some ambitious targets which called for an active role of the state in many areas of national economic management. Hence, despite some ambiguity and contradictions, the devaluation and other deregulatory measures were hastily implemented.

6 Despite the IMF and the World Bank being instrumental in bringing changes in the policies, internally, only the higher authorities in the government—that too only at the political and bureaucratic level—were taken into confidence. Within the government, mainly two organisations, namely, the Nepal Rastra Bank and the Ministry of Finance, were involved. Other government ministries and departments were drawn to the fray only to the extent of designing policies specific to their domain. Neither the stakeholders nor the legislative body were involved in the process. No new act was passed. Policies embodied in the ESP and SAP were presented to the legislative body through the budget on an ex-post basis. Even the NPC was not involved. This was the principal reason behind the unresolved contradiction between economic reform and the Basic Needs Programme.

7 From the political economy perspective, reform was a compulsion emanating from the financial chaos and anarchism induced during and in the aftermath of the referendum. Therefore, it was implemented with some speed in few areas and with reluctance and inertia in others. Reluctance in fully adopting the agreed agenda was to ensure that the loan comes in time as per the agreement and that the interests of the ruling elites are duly safeguarded. Reform in agricultural taxation was not pursued as per the conditions, because it would antagonize big proprietors and ruling elites. Administrative reform, an integral part of the overall reform, was not initiated at all. Contrarily, the size of the bureaucracy was further expanded because that was the area where regime supporters and others having

nexus with the ruling class could be offered a premium by guaranteeing employment in the public sector. Because of a host of similar interrelated problems, the privatisation programme did not start at all. As its implementation would compel the defaulters having a strong nexus with the ruling elites to pay back the loan to the banks and financial institutions, the suggestions of the CBPASS were never sincerely implemented. Programme budgeting was either lopsided or confined to few areas and sectors. Protective or regulatory systems were eased only to certain limits so that the ruling elites and the trading class could continue to usurp the benefits accruing from discretionary practices. The reforms were directed only in areas of subsidy withdrawal or deregulation in prices of even the most essential commodities without ascertaining the likely social cost of adjustment. This was the area where no strong opposition was expected from the unorganised, voiceless and politically suppressed people.

8 At a time when the second phase of reform was launched starting in 1990, the context was slightly different. The economy was free of crisis. The growth rate was robust. The macroeconomic fundamentals by and large were sound enough. However, at that time the wave of liberalisation and globalisation had gained momentum universally forcing competition among countries to move ahead of others in pursuing the new 'paradigm' of economic policy. At the same time, India was moving fast with sweeping reforms in macroeconomic policies. Under such a situation, it was imperative for Nepal to follow suit. Moreover, the ongoing protectionist measures were far from optimal in facing the challenges of competition in the areas of industry and trade. On the other hand, after the restoration of democracy, the political-institutional structure had changed. This was accompanied by a dramatic surge in people's expectations compelling democratic governments to pursue policies that would trigger higher growth and reduce poverty at a much faster pace. Both internal and external factors called for intensive and wide-ranging reforms. However, one important feature of this phase is that the ESAF programme of IMF was instrumental in the overall framework and sequencing of reform. Notwithstanding the fact that such a programme is launched only with mutual agreement between the government and the IMF, the conditions embodied in the release of loan were instrumental in initial shaping and expediting the reform. As a result, adequate attention was not given to ascertaining whether or not the required preconditions for reform existed, nor was there an attempt

to internally analyse the broad ramifications of reforms before the reform was actually implemented.

9 At the time of initiating the second phase of reform, the initial conditions were very different than in the first phase. The pre-existing power and social relations perpetuating since centuries were major inhibiting factors on the way to drastic reforms. Similarly, the state institutions including the bureaucracy and its structure developed in an autocratic environment were equally constraining factors for ensuring better outcomes and delivery. The political institutions had no experience in democratically running party organisations, particularly in nurturing intra-party democracy. Market institutions were not properly developed. This posed major challenges to enforcing the reforms. Despite numerous constraints, the first elected government expedited the second phase of reforms. It is worth noting that the policy framework embodied in the ESAF and sweeping reforms in India were the major influencing factors in shaping the speed and sequencing of reforms. Therefore, no adequate attention was paid to creating an enabling environment or improving adverse initial conditions. Similarly, no attempt was made whatsoever to examine a prior ramifications of the reforms among various socio-economic groups. Even the commitments made during the election time through the election manifesto were hardly considered while implementing reforms.

10 When the reform process in the democratic era is examined, a very typical and unexpected phenomenon is observed. In democratic societies several channels exist to accommodate and address the interest of various contending classes and groups. In principle at least, in addition to the executive organ of the state, political parties, legislative body, judiciary, various stakeholders and socio-economic groups could be involved in the reform process. Formally, all these channels have been used in Nepal one way or the other. In some it is mandatory also. But in practice, apart from the bureaucracy, that too limited to NRB and MOF, no other stakeholders were ever seriously involved. In the name of a majority hold in the parliament, even the most regressive bills used to be passed by completely bulldosing the voices of opposition parties. Even the agreements made with the donors with their stringent conditions having long-term implications on the economy in general and people's livelihood in particular were never discussed in the parliament on a priory basis. This was true in the case of ESAF as well, which was the major framework of sweeping reforms in Nepal. Despite having no legal or other bindings, a system evolved whereby a single proposal embodied in the government budget could not be changed. This means that people's representatives had virtually no influence in the policy reform processes. There was no system in which the parliamentarians could voice their concern in the medium to long-term plans of the country. Downsizing of the bureaucracy was attempted without any legal authority vested on the government. This means that even sensitive decisions used to be made in an ad hoc basis. In the reform process, mainly the interests of certain resourceful and vocal business communities as well as few others having a nexus with the ruling elites were safeguarded. Hence the voices and demands as well as interests of the downtrodden were seldom heard. Withdrawal of subsidies and acceleration of the process of deregulation in public utility services are the best examples. Fertilizer and irrigation subsidies were withdrawn abruptly without taking into confidence the poor farmers, the most vulnerable group in the society. In the privatisation process labor unions were not duly consulted. Under external dictation and authoritarian functioning of the executive, a system evolved which completely undermined the role of the opposition, a role vital for safeguarding the interests as well as channelling the demands of various stakeholders to the government and the state. Along with the burgeoning economic crisis amidst distributional conflicts, some broader reform initiatives, especially due to pressure from the opposition parties and civil society organisations were made from 2000. But it was already too late by then. After the political crisis and the King's undemocratic steps of 4 October 2002, even the limited scope of consultation or policy coordination completely collapsed. Now even the budgets are enforced through ordinances.

Nepal's experience thus suggests that even in a democratic system, if there are no proper responses channelled through opposition parties and various stakeholders, people seek alternative channels to express their frustration and anger. This is partly happening in Nepal. Similarly, it has also been experienced that without operationalising a genuine democratic system, trivial weaknesses provide regressive elements alibi for hatching conspiracies against the democratic system. Therefore, while formulating or reforming policies and acts, policy co-ordination among various stakeholders and enforcement of contracts and agreed agenda are critically important if reforms are to deliver the desired results. This leads to the conclusion that although the frequency of consultation has increased after PRSP, the basic modalities of reforms have changed very little. The major problem in such a reform process is that, only limited groups of people are awarded benefits at the cost of the majority have-nots. Such a reform process also lacks comprehensiveness, and bypasses important areas that actually require drastic reforms. Besides, safeguarding the interest of a few necessarily resulted in the wrong pattern, speed and sequencing of reform. That was the reason for deepening the economic crisis and exacerbating the distributional conflict. Although external conditions and internal security problems have had an influence, the above has provided a breeding ground for deepening of these problems. Examination of the outcomes of reform corroborates this.

11 Growth performance in the first phase was somewhat satisfactory principally because of good monsoon. In the second phase, the performance was satisfactory up to the mid-1990s because of high growth in the non-agriculture sector. Expansion was rapid in industry, trade, transport, finance and other services due to the liberal policy environment. Growth in export was also robust. Revenue mobilisation was picking up with sufficient scope for expanding developmental works, at the same time enabling the fiscal balance and macroeconomic stability. Liberalisation also enabled smooth supply of goods and services easing price pressures over time. However, such a momentum could not be sustained for long. Especially from the late 1990s, performance of the non-agriculture sector started deteriorating eventually resulting into a negative growth rate in 2002. Interestingly, during the same period growth performance of the agriculture sector was gradually improving. This also exemplifies presence of very poor linkages between the agriculture and non-agriculture sectors. The economic structure also shows an oscillatory trend with some big shifts in the beginning of the second phase of reform. During the first phase of reform, there was virtually no change. During the first half of the 1990s, the share of agricultural GDP declined by almost ten-percentage points. There was a big surge in the contribution of sectors like manufacturing, trade, transport and services. During this period, export-oriented industries expanded very rapidly. This pattern however did not sustain for long. After 1995, not only has there been a negligible shift from agriculture to the non-agriculture sector, the latter sector has defied the liberal policy environment. The share of both the industrial and trade sectors have decreased sharply. A similar phenomenon is observed in other countries also where the reforms are confined to limited areas and benefits are captured by a limited number of people due to their preexisting power base and social relations. An in-depth analysis of productivity and competitiveness in agriculture, trade and industrial sector reveals the major underlying reasons.

12 Generally, policies providing price incentives to the producers are expected to help diversify production in the agriculture sector away from subsistence. This is the major channel, which simultaneously boosts producers' income. Nepal, on the other hand, experienced a very slow production shift in agriculture. Although the yield rates of both food and cash crops have increased from the late 1990s, this is principally due to weather conditions. Moreover, compared to other South Asian countries, yield rates in Nepal were very high in the early 1960s. Now these have come down to the lowest among its South Asian neighbours. Empirical analysis indicates that except credit neither fertilizer nor irrigation facilities determine the yield rate of major crops in Nepal. Fertilizer has some influence only in paddy. The rainfall factor is so strong that others are either outweighed or displaced by it. The findings suggest that, apart from easy access to credit, irrigation facilities and access to fertilizer are critical for productivity enhancement. Contrarily, in the post-deregulation years, as a response to increased input and falling output prices, farmers have stopped installing shallow tube wells. At the same time, despite increased access to fertilizer, its quality has become a major problem. Likewise, credit outreach for the farmers has also gradually decreased. Amidst this, majority of the targeted credit programmes have failed to cater to the needs of the bottom 20 percent of the households as they lack other resources and knowledge to benefit from the saving and credit programmes. Micro credit programmes leave the bottom twenty percent of the income ladder almost untouched.

13 The terms of trade in agriculture has worsened after the deregulation of input and output prices. This is a reflection of massive inflow of highly subsidised agricultural products from India. These findings confirm the arguments that under the open border and free trading arrangements of primary products, on one hand, and rising asymmetry in agriculture related policies between the two countries, on the other, results into pervasively negative impacts on the Nepali agriculture. In this context, the pegged exchange rate system with India was found to be equally harmful. After 1999, there has been a downward trend in both wholesale and consumer prices in India whereas an opposite trend is manifesed in Nepal. Under a pegged exchange rate arrangement, this means that by preventing depreciation of the Nepali currency, Nepal is subsidising import from India and discouraging exports. This is naturally a reflection of decreasing competitiveness of Nepali products vis-à-vis Indian commodities. Misalignment in prices through the pegged exchange rate policy has additionally weakened competitiveness of the Nepali economy in general and the agriculture sector in particular. Therefore, from the perspective of sustained growth and broadening the benefits to the large segment of population, review of recent agriculture related policies including the exchange rate are essential. Experience from industrial and trade sectors lend support to this need.

14 Closely looking at trade and industry, it was found that despite many agro-based and other industries having comparative advantages, they could not come up in the absence of incentives. On the contrary, a large number of agro-based cottage and small-scale industries collapsed in the last one decade. Over-concentration in few-imported raw material based manufactured products has constrained Nepal's industrial diversification. This inhibited backward linkages and discouraged promotion of domestic resource based industries. The advantage of lower wages is more than offset by high transaction costs as well as poor and costly infrastructures. This means that reform in the infrastructure sector was concentrated at hiking prices. This exerted a detrimental impact on Nepalese industries and trade. In addition, the cascading tariff structure has hampered growth in industries and exports. It is due to biases in favour of low value-added activities, whether they be assembly industries or producing intermediate goods. Because of this, in sectors where economies of scale matter, such as textiles, pharmaceuticals and soap, firms are either protected from cheaper imports in the home market or export to India taking advantage of the tariff differentials in critical inputs. This kind of export structure induced through various policy incentives benefits only a small trading class. For fulfilling WTO obligations, new acts are being implemented with some special institutional arrangements for ensuring rule based trading practices. In addition to helping predictability of policy changes, these will also enable elimination of distortions to some extent. A compulsion to shift toward industries with competitive advantages would also help to tap the tremendous potentials of both agro- and forestry-based industries. However, there are more challenges and risks emanating from the given adverse initial conditions in terms of productivity and competitiveness. Prospects of resource based industries will depend very much on the extent of Nepal's capacity to preserve patent rights on its rich biodiversity within the stipulated timeframe, which under the given situation is most unlikely. At the same time, the binding tariff rates committed by Nepal in number of areas are low compared to those of India. This may compel Nepal to pursue similar tariff policies under the bilateral trade arrangements at a time when free trading of primary products added by the growing asymmetry in agriculture and exchange rate policy is hurting the economy in general and trade competitiveness in particular. Also, the agreement on subsidy limit may prevent Nepal from providing required levels of incentives to the medium and small industries. More dangerously, agreement on trade related investment measures prevents the possibility of putting conditions to foreign investors to use local raw materials. Under such circumstances, the losers will obviously be the farmers, domestic small entrepreneurs and business community.

15 Despite financial deepening, banking and financial services are mainly concentrated in urban areas. Contrary to expectations, the coverage of institutional credit has considerably fallen in the rural areas. The number of commercial bank branches has shrunk after 1995. The problem of non-performing assets and inefficiencies has aggravated. Problems faced by the state owned commercial banks are onerous. Even after contracting out of commercial banks to foreigners, the problem has not eased very much. As a result of persistently inefficient banking activities, the intermediation function has been overburdened with non-core activities. This has prevented narrowing down of the gap between the deposit and lending rates, which is the major yardstick of successful reform in this sector. Inefficiencies in the financial system are reflective of the delay in reform and prevalence of oligopolisitic tendencies in this sector. Therefore, financial sector reform demands a prudential regulatory and supervision system as well as correction in the structural weaknesses. Similarly, without alternative mechanisms to ensure access of the poor people and farmers to credit through appropriate outreach, phasing out of priority lending, withdrawal of bank branches and abolition of concessionary credit facilities will have very detrimental effects from the point of view of ensuring benefits of reforms to the poor.

16 Devaluation hit the common people very hard. Similarly, deregulation and market-oriented reforms bringing changes in relative prices created adverse effects on the poor and fixed income groups. Although prices have gradually stabilized at lower levels, relative changes in food and non-food prices are still problematic especially at a time when the purchasing capacity of the people is sharply deteriorating. In the course of the second phase of reforms, the rise in prices was high compared to the nominal wage increment. This indicates that special considerations will be required toward supply inducing policies, on one hand, and the wage policy has to be linked with the price level and productivity of labour while considering labour policy reform, on the other.

17 Access to assets and opportunities in terms of holding positions in government bureaucracy and representation in various elected bodies play an important role in enlarging the benefits of reforms among various segments of the society. Opportunities for increasing overall income and in getting employment affect the poverty situation in general and living condition of the poor in particular. In traditional agrarian societies, access to land or land ownership is crucial in enhancing the social status and improving the living condition of the people. The power relations are also governed by these patterns. The agriculture census data show that during the period 1981 to 2001, considerable changes occurred in the land holding pattern. This resulted in growing proletarisation of the marginal and poor farmers. In a situation where productivity in the agriculture sector has remained stagnant along with rising input and falling output prices, vulnerability of majority of the farmers in the post-reform period has risen markedly.

18 Another factor affecting access over assets and opportunities is the pattern of fiscal policy reform and accompanying government resource allocation trends. Targeted programmes help the poor and disadvantaged in enhancing their productive capacity and in creating assets in addition to neutralising the social cost of adjustment. Studies indicate that in 1999/00, despite higher budgetary allocations to local development, education and health, the share of spending directly related to the poor stood at less than one-third of the total. These numbers are still based on the assumption that expenses made in some sectors or areas are fully spent for benefiting the poor. Moreover, the existing budgetary system has three additional problems. First, the level of development budget is shrinking and the regular expenditure is rising in an unprecedented way. Second, one of the complementary measures to nullify the immediate adverse effect of deregulation could be a faster expansion of extension services and building of infrastructure facilities for market creation in the rural areas. Available information indicate that recent budgetary priorities have completely ignored this also. During the Ninth Plan period, only 19 percent of the development budget was spent in agriculture as against the plan target of 27 percent. The agricultural road programme has been a failure. The small irrigation and local development programmes have been badly affected. Contrary to the expectation that deregulation policies will have some positive spill over effects on private investment, private investment in agriculture has gone down considerably. This has even cast doubts about the government's sincerity in addressing poverty and fulfilling MDG commitments. The problem has been compounded due to rising inefficiency in government programmes. Third, the gap between the budgeted and actual expenditure is widening in the development programmes.

19 The policy mismatch and inconsistency has had an adverse effect on employment opportunities for the growing labor force. Although a considerable shift has occurred in the employment pattern in Nepal, especially during the last decade of market-oriented reforms, many serious structural problems still persist in the labor market. On one hand, most of the employment opportunities were available in the urban areas mainly in the informal sector. Contrary to expectations, liberalisation programmes did not address the unemployment problem especially after 1995. The pegged exchange rate system has also indirectly attracted workers from the neighbouring country. In the midst of such a phenomenon, cottage and small-scale industries collapsed causing very detrimental impact on rural non-farm employment. Recent surveys reveal that only a small fraction of the rural population is engaged in non-farm employment, that too on a casual work basis. No spillover effect of the new policy shifts could be traced out in this area. Improvement in rural poverty has further been constrained by continued decline in the real wages. Additionally, the pattern in which various castes, ethnic communities and socio-economic groups have accessed government jobs presents a very dismal picture. Job and other opportunities are still monopolised by the privileged higher castes.

20 Over-concentration of benefits with few trading and commercial classes in the midst of deterioration in general economic activities has compressed employment and other opportunities. Both the growth and pattern reveal that sectors with urban biases have expanded steadily while sectors that could enhance or broaden growth and augment employment shrank. Since the economy is performing poorly on every front after the mid-1990s, one may safely conclude that recent trends in the Nepali economy have had a very detrimental effect on the income distribution pattern and living conditions of the poor, including those deprived of access to assets and opportunities. Increased income inequalities, rising rural and urban income gaps and perpetual poverty in the backward regions indicate that reforms aggravated rather than alleviating distributional conflicts.

21 Summarising the policy implications, some important lessons can be drawn from the standpoint of future reforms and their processes. First, Nepal's reforms are mainly donor driven. Although the PRSP approach emphasizes internal ownership, donor driven tactics are quite evident, manifested in more stringent conditions in areas like privatisation and deregulation. The PRSP approach, which demands a prior poverty impact assessment of macroeconomic policies, was fully overlooked while preparing it. This simply means that the serious adverse impacts of some conditions or policy prescriptions have not been foreseen. During the process of internalising ownership, accountability and good governance must constitute the cornerstone of the policy reform agenda. Second, the reforms have so far been partial leaving the large agriculture sector outside the ambit of structural reforms. In this particular context, land related policies come to the forefront. Despite continuous attempts, land reform has never been a success in Nepal. On the other hand, the policy shift of 1998 demands a market-based approach in land policy, which in turn could facilitate consolidation of land holdings. The simple assumptions of a big supply response to deregulation have not been practicable and effective due to numerous reasons as indicated above. Under such circumstances, land policy ensuring land to the landless and marginal farmers along with effective tenancy rights is extremely important. This is more so in view of small farms being more productive and efficient. This means that land distribution to the landless or marginal farmers will result in equitable growth. Land reform integrated with the APP will be the key to Nepal's future development. Similarly, unlike in the past there is a need to consider efficiency and management enhancement issues in infrastructure sector reforms. This in turn will require reforms in state institutions in general and bureaucratic institutions in particular. Third, the mismatch within the macro policies has to be completely eliminated through their harmonisation. It becomes imperative in this context to conduct an ex-ante analysis of poverty impacts of economic policies applying appropriate quantitative techniques. Such an analysis would then allow decision makers to identify the likely gainers and losers of the proposed policies. This would then serve a basis for formulating complementary policies and programmes to compensate the potential losers, particularly the most vulnerable ones. The asymmetry persisting across macro, sectoral and micro policies vis-à-vis the development approaches being followed has to be corrected and rationalised to make those coherent and consistent with sustained growth and poverty reduction. The present pegged exchange rate with India needs reconsideration to ensure elimination of misalignment in relative prices for reversing the worsening competitiveness of Nepal's agriculture, industry and trade. This will be essential especially under the WTO trading arrangements in order to reap the benefits from the new opportunities and minimize the risk of very adverse initial conditions. Likewise, in the financial sector, the gap between deposit and lending rates has to be narrowed substantially by augmenting structural and institutional reforms in the entire financial sector, while at the same time guaranteeing credit access in the rural areas. In addition, drastic reforms will be required on the industrial and trade fronts. In this respect, special incentives will be essential for small industries and trade through legal and other means. This will strengthen macro-micro linkages by enhancing backward linkages between industry and trade. Corporate governance likewise needs special reforms together with substantial reduction in transaction costs. This calls for comprehensive reforms in state and market institutions. On the fiscal front, many asymmetries have been perpetuated over time. The cascading tariff and revenue structure has to be corrected. The development budget needs a big push for enhancing the productive capacity of the economy. Unless infrastructures are substantially developed, the reform will neither be sustainable nor could the private investors operate with adequate level playing field. Likewise, the labor policy needs balanced reforms aimed at enhancing the labor productivity. This has to be supplemented by skill development or upgrading programmes on a massive scale. Above all, unlike in the past, the future reform has to be employment inclusive making it as part and parcel of a comprehensive reform. Apart from these macro and sectoral reforms, it is critical to ensure that there is a paradigm shift in terms of enforcement of participatory grass-root development approach. This will require, among others, introduction of the concept of local governance in which elected local bodies have full control of the budget and can independently implement development activities. This would require complete devolution of power and fiscal decentralisation. In Nepal's context, complete restructuring of the present administrative structure will be required. All these demand comprehensive and far-reaching institutional reforms.

22 When the role of institutions is stressed, people-centred governance and process of democratic strengthening hold a paramount importance. Indeed, they are mutually complementary. Besides, an authoritarian rule, which by its very nature is centralised would be totally incompatible with a people-centred, decentralised and democratic polity. Hence overthrowing such a rule is a prerequisite. An authoritarian rule that follows a regressive course is bound to aggravate social contradictions and distributional conflicts by reversing the process of progressive transformation of the society. Similarly, if a democratic system is limited to people's role in voting then it will contribute very little in deepening the democratic system essential for addressing structural conflicts. For this participatory and inclusive democratic practices will be required which could enhance people's role in decision-making processes. It is therefore necessary that a fair and proportional representation system is developed and strengthened that could ensure equitable distribution of outcomes and opportunities. This is particularly necessary in a society like Nepal, which is characterised by feudal structure, traditional values, and highly discriminatory practices. This is possible only when various components of the state apparatus and state institutions are democratised by following an inclusive approach that replaces pre-existing power relations dominant in state, semi-state and political institutions. This would call for a bold and serious vision and commitment among the key actors capable of moulding the nation's super-structure consistent with the broader societal interest.

23 The analytical narratives presented in this study have demonstrated that genuine democracy and improved governance is possible only in a system where the political institutions follow democratic practices and develop mechanisms through which voices of the people including civil society organisations are heard and responded to. Nepal's experience clearly demonstrates that even some progressive clauses embodied in the country's constitution could be meaningless unless political institutions are made inclusive, transparent and forward looking for making them compatible with the required changes in the state's governing structures aimed at economic and social transformation. Due attention and continual efforts toward ensuring this could have weakened both the extreme leftist and rightist tendencies. Therefore, institutional reforms should constitute an integral component of new policy initiatives, both among political parties that serve as the key harbingers of people's voices and the rest of the state apparatus. In the absence of proper institutional practices, aspirations and voices of the people are hardly accommodated in the process of formulating legislations and policies. This could not happen in the absence of a built-in mechanism in which the concerned stakeholders and various contending classes are included in the policy-making process. Hence, political consensus and policy co-ordination on major issues of national importance are critically important in making the reform broad-based, sustainable and pro-people. This is particularly essential for resolving the contradictions and managing the distributional conflicts witnessed in a highly discriminatory society like Nepal. This will also enable strengthening the country's bargaining power with the donors who in the past were guided largely by neo-classical assumptions and emphasised deregulation and price raising policies without addressing politico-economic and institutional issues.

A system that institutionalizes and strengthens policy-coordination through democratic processes facilitates accommodation of the interests of various contending classes and socio-economic groups and eventually helps to deepen the democratic system itself. All these warrant democratisation of the state, local and political institutions in more effective and credible ways and abolition of all forms of discrimination. The challenge lies in chartering a new course toward a more prosperous and socially desirable future. This would not only require that democratic values and processes are imbibed, institutionalised and vigorously practised across all state organs and societal organisations, including political parties, but also that concerted efforts are made in winning the faith, confidence and support of the diverse economic, social, cultural and political classes and groups within the society.

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Appendix Ia SAL I Policy Matrix

Policy Areas and Objective	Achievement and Action Taken		
	1986/87	1987/88	1990/91
A. Macro Economic Policy			
Promote balanced growth by achieving the following targets with respect to GDP by			
1990/91 hold fiscal deficit 11%	8.67	8.78	10.65
Hold domestic financing to 1.5%	2.58	1.47	3.78
Raise development spending to 16%	11.55	12.26	13.28
Raise government revenue to 12%	9.36	9.56	8.91
Hold regular spending to about 7%	6.48	6.08	6.29
Raise government surplus to 5%	2.88	3.48	2.62
Raise foreign aid to 10%	6.25	7.66	7.0
B. Development Expenditure Policy			
Steadily increase the level and quality of investment and O and M expenditures through improvement in project identification, management and resource control, and allow implementation of high priority projects to be expedited through smooth budgetary releases	i. Introduced the programme budgetary system in agriculture, irrigation, power, forestry, transport, education and health sectors ii. Initiated the concept of core project in order to prioritise projects which are viable from economic point of view iii. UNDP/ADB Accounting and Auditing Project started		

C. Industrial and Trade Policy	
Move toward a more liberal policy regime for industry, exports and imports	i. The budget of 1986/87 introduced trade tax, and revised tax rates on imports of raw materials ii. OGL system introduced iii. Initiated a system of auctioning import licenses on imports iv. Introduced a passbook system for import of industrial raw materials
D. Agricultural Policy	
Increase supply and timely availability of fertilizers to increase agricultural production, liberalize the fertilizer distribution system, allow automatic adjustment in fertilizer price to reduce price induced smuggling to India, implement a new strategy emphasising greater collaboration between HMG and farmers in irrigation development and O and M, and improve the role of local bodies in developing, managing and using forestry resources	i. Allowed private dealers where Sajhas were not functioning ii. Nepalese fertilizer prices increased to maintain parity with Indian prices iii. AIC given authority to change fertilizer prices up to 10% at a time iv. Implemented policies relating to increase of dealer charges by 2 percentage points v. An irrigation policy package implemented and a task force established to study appropriate cost recovery methods in irrigation vi. No successes in modification of forestry legislation for ensuring retention of collected revenues by local bodies from protected forest products
E. Public Enterprises Policy	
Limit the scope of public enterprise activities and improve efficiency of remaining PE's	i. Started fixing physical and financial targets and evaluating performance ii. Increased prices of some commodities like sugar and fertilizer to reduce subsidy iii. Borrowing by PEs controlled iv. The divesture programme not initiated
F. Development Administration	No major reform programmes undertaken in the area of development administration
G. Financial Sector Reform	

Appendix Ib SAL II Policy Matrix

Area Covered	SAL II Actions to be taken before Tranche III Release	Action Taken
Macro Economic Management	i. Achieve in fiscal year 1990 at least NRs 300 million additional revenue from new measures, and limit the budgetary deficit to NRs 1400 million ii. Include O and M expenditures satisfactory to IDA for irrigation, transport, power and education sectors iii. Adopt an action plan satisfactory to IDA for phasing out tax holidays for new industries	i. Budget of fiscal year 1990 included Rs. 500 million to be mobilised through new revenue measures ii. Budgetary deficit kept below SAL conditions iii. O and M expenditures increased iv. Tax holiday provisions eliminated
Trade	i. Increase items allowed for third country imports under OGL/ annual passbook for fiscal year 1990 ii. Announce and implement duty drawback system in all exports iii. Streamline import license system	i. Simplified the duty drawback system ii. In February 1990 two additional items included in the OGL system iii. New import licensing system started based on marginal bids
Agriculture	i. Increase fertilizer import by 50%, decontrol number of dealers per zone, allow private dealers to operate even in areas where Sajhas are active, maintain retail prices at least as high as relevant Indian border prices, and also monitor Indian wholesale prices ii. Prepare an action plan to formally establish an irrigation management division, implement a cost recovery plan, provide adequate O and M budget allocation, and increase farmers participation	i. Action taken on fertilizer policy ii. A system management branch established in irrigation development iii. Initiated pilot projects to involve farmers

Financial Sector	i. Take satisfactory action to strengthen and improve the financial and economic performance of the Rastriya Banijya Bank and Nepal Bank Ltd. including action on bad debt, re-capitalisation and debt recovery targets satisfactory to IDA ii. Prepare an action plan to make payments of all guaranteed loans in three years iii. Implement satisfactory provisions and interest supervision policy upon completion of CBPASS iv. Bring NIDC under NRB supervision v. Targets for lending be phased out and eliminated	i. Payment of guaranteed loans started as scheduled, but progress on other reform measures slow ii. Commercial banks authorised to fix interest rates, and priority lending policy continued

Source: Khanal, (1992)

Appendix II IMF Structural Adjustment Facility

Measures	Status
Macro Management	
SAF First Annual Programme (1987/88)	
Introduction of revenue measures estimated to yield additional NRs. 500 million (0.8 percent of GDP) in revenue	In 1987/88, import duties were adjusted, excise and sales taxes were raised on selected items and land registration fees were increased. Total revenue increased by 0.6 percentage points to 10.4 percent of GDP in 1987/88. In 1988/89, an advance income tax on imports of commercial goods was introduced and import tariffs increased. Excise and sales taxes were raised on non-essential goods in 1989/90. In 1990/91, wealth tax was introduced and customs and excise taxes rationalised.
Improvement in tax administration through the establishment of a closed and unified revenue service for senior revenue officials and establishment of specialised units to concentrate on important revenue sources.	Specialised units were set up in 1987/88 concentrating in Kathmandu area, covering major companies and small taxpayers. In 1989/90, academic qualifications were established for revenue officials and MOF authorised to select its recruitment.
Restraint on regular expenditure through freezes on the number of civil servants and on expenditures for materials and supplies. No general salary increase granted to civil servants.	Regular employees of the government increased from about 90,000 in 1986/87 to 100,000 in 1988/89. The interim government froze the number of civil servants.
Improvement in project implementation through adaptation of a core investment programme with IBRD assistance, improved financial accountability, streamlined auditing procedures.	The programme and budgeting department of MOF undertook a systematic identification of core projects with assistance from IBRD.

Measures	Status
SAF Second Annual Programme (1988/89)	
Establish a closed and unified revenue service (January 1989)	As above
SAF Third Annual Programme	
Review of land evaluation and agricultural tax	Land and agricultural taxes not changed. Land registration tax rate increased.
Phase out the five year income tax holiday to new enterprises	The five year income tax holiday to new enterprises abolished.
Public investment programme	To improve efficiency of the public investment programme, non-productive investment was cut back and O and M expenditure increased.
Accounting and Auditing	A UNDP funded programme undertaken to improve accounting and auditing of the Financial Controller General's office and AIC
Expand programme budgeting to line ministries and improve the project monitoring system	The programme budgeting and monitoring project started in 1988/89, and training conducted for project officials of line ministries
Shift toward multi-year rolling budget	Project budgeting improved, but problems still faced in foreign aided projects
Public Enterprises Reform	
SAF First Annual Programme (1987/88)	
Elimination of subsidised sales of food grains in Kathmandu Valley, subsidies to be financed through explicit budgetary provisions rather than bank credit	Only transportation costs in the hills subsidised. All subsidies to public enterprises financed through explicit budgetary provision rather than bank credit except for cross-subsidies such as in the case of petroleum products.
Reduction of fertilizer subsidies and promotion of fertilizer distribution by the private sector	Fertilizers sold to farmers at prices 20-40 percent lower than import costs. Private traders participated in the distribution of fertilizers at the district level in competition with cooperatives

Measures	Status
Sale of government held shares of four public enterprises	A government tasks force formed in December 1989 completed a report on the procedures for selling the shares of public enterprises. The sale of stocks of a sugar factory and a paper mill started in November 1990 as model cases.
SAF Third Annual Programme (1989/90)	
Reduce public enterprise arrears to the banking system with payment of NRs. 400 million	See financial reform
Price decontrol on public enterprise products and services	All output prices of manufacturing public enterprises, except sugar decontrolled
Autonomy of public enterprises	Public enterprises instructed to include outside professionals on their board of directors to enhance autonomy in management and to prevent financial irregularities.
Industry and Trade Policy Reforms	
SAF First Annual Programme (1987/88)	
Liberalisation of industrial licensing	A new Industrial Enterprise Act introduced in October 1987, which allowed the private sector to establish industries in any area except those related to defence
Import liberalisation through placing raw materials, intermediate imports, and capital goods on open general license	The industrial OGL covered about 100 items
Tariff reform including rationalisation and simplification of the tariff system and adaptation of a duty drawback/exemption system for all important exporters	Harmonisation of the tariff structure. The duty drawback system for exports implemented for the readymade garment industry

Measures	Status
SAF Second Annual Programme (1988/89)	
Further import liberalisation	Commercial OGL introduced. The number of items under commercial OGL rose from 2 to 30 in mid-1989 to relieve shortages of consumer goods during the Trade and Transit impasse. Due to increasing incidence of abuses, the number of items under the commercial OGL reduced to 12 in March 1990 and then to 5 in May 1990.
SAF Third Annual Programme (1989/90)	
Expansion of the bonded warehouse system	System expanded to cover readymade garments
Modification of import license auction procedures	The marginal bidding system introduced at the beginning of 1989/90. In May 1990, classification of goods in the import license auction further refined, increasing categories from three to five.

Financial Reforms

Reform Measures	Timing	Status
Commence treasury bill auctions	1988/89	Auctions commenced in November 1988, and extended to 182- day bills in July 1989
Develop secondary market for government securities	1989/90	Proposal submitted to the government in July 1990 by the Security Market Center for appointment of dealers
Establish a unit to coordinate bank supervision and inspection and reorient programme toward offsite supervisions, shift supervision of NIDC from Ministry of Finance to NRB	1989	Implemented
Independent financial reviews of RBB and NBL. Identify, design, and implement a strategy to structure banks, if necessary	1989/90	CBPASS study completed in early 1990/91 and implementation of recommendations planned for the same year

Measures		Status
Fund technical assistance to NRB for bank supervision	1990/91	Implemented
Establish and implement appropriate provisioning and no accrual policies, and replenish capital	1989/90	A framework developed for provisioning and no accrual policies
Enact a legal framework to improve regulatory framework	1989/90	A Credit Information Bureau established in May 1989
SAF Third Annual Programme (1989/90)		
Redesign NRB's refinancing facilities	1989/90	Three windows (basic, selective and lender of last resort) established in August 1989, only basic window utilised
Modify procedures for government security auction	1989/90	Not implemented
Develop and implement a system of short item monetary programming	1989/90	Implemented in early 1989/90, but temporarily suspended in second half of fiscal year, reactivated in 1990/91
Limiting tax exempt status for government securities in excess of 182 days	1989/90	Tax exempt status withdrawn
Modify method of calculating reserve requirement for commercial banks	1989/90	Lagged reserve accounting with average maintenance period implemented, penalty rates for non compliance adopted
Strengthen debt recovery efforts	1990/91	CBPASS recommendations considered for gradual implementation.

Source: Khanal (1992)

Continued From FrontFlap

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About IPRAD

Institute for Policy Research and Development (IPRAD) was established in 1995 as a non-profit making non-governmental organization. It focuses on research and studies in economic and social fields of national and international importance for contributing to Nepal's development and promoting regional and international cooperation.

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During its ten years experience, it has undertaken several studies with both national and international importance. Some of them include,

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2. Macro-economic Forecasting Model for Nepal (1996).
3. Application, Issues and Future Prospect of Quantitative Tools in Economic Planning: Nepalese Experience (1997).
4. Implementation of Full Convertibility of the Nepalese Rupee in the Capital Account (1998).
5. Assessment of the Effectiveness of Ongoing Local Level Programs (2000).
6. Evaluation of Impact of Renewable Energy Programme on the Poor People (2002).
7. Monetary Cooperation in South Asia (2004) in collaboration with IPS Sri Lanka.
8. Economic Development and Reform in Nepal with Reference to Reform Process in India (2004).
9. *Macroeconomic Policies, Shocks and Poverty Reduction in Nepal : A Simulation-based Quantitative Analysis* (2005).
10. An Analysis of Ex-ante Poverty Impact Assessment Practices of Macro-economic Policies in Nepal (2005).
11. Understanding Reforms: A Case Study of Nepal (2005).
12. Impact of FDI Policy of Rich Countries on Poverty Reduction of Developing Countries: A Case Study of Manufacturing Sector in Nepal (On going jointly with IIDS).
13. Institutional Building for Controlling Corruption: A Case Study on the Effectiveness of Commission for the Investigation of Abuse of Authority (CIAA) and National Vigilance Centre (NVC) in Nepal (On going).
14. Creation of GTAP Database for Trade Related Policy Analaysis (On going).

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