

Nepal

Systematic Country Diagnostic

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IFC

International
Finance Corporation

MIGA

Multilateral Investment
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Abbreviations

FCHVs	female community health volunteers
FDI	foreign direct investment
GDP	gross domestic product
GLOF	glacial lake outburst flood
ICOR	Incremental Capital-Output Ratio
NEA	Nepal Electricity Authority
SCD	Systematic Country Diagnostic
SMEs	small and medium-sized enterprises
SMS	Short Message Service
SOEs	state-owned enterprises

Preface

This Systematic Country Diagnostic (SCD) examines the key constraints to and opportunities for accelerating poverty reduction and enhancing shared prosperity in Nepal. The SCD builds on a broad body of analytical work conducted in Nepal, but particularly on three World Bank reports published in 2017: “Moving up the Ladder: Poverty Reduction in Nepal,” “Climbing Higher: Toward a Middle-Income Nepal,” and the “Nepal Risk and Resilience Assessment.” It also builds on evidence compiled in six working groups and consultations and surveys in all seven Nepalese provinces with civil society organizations, the private sector, government, development partners, and citizens.

The report was prepared as the first “Agile” SCD, which meant considering the objectives of the SCD upfront and designing a process to efficiently and effectively achieve those goals. In addition to informing the next Country Partnership Framework (the primary objective of all SCDs), two further objectives were highlighted: aligning the World Bank Group around a common understanding of the constraints and opportunities to progress, and contributing to the public debate in Nepal on key development challenges. Clear communication is essential to achieving these objectives, and thus the team focused on developing a short, self-contained report that can easily be read by a wide audience. This means the SCD is a strategic assessment rather than a summary of the evidence, and further resources are referenced throughout. A supplemental annex provides additional evidence.

Broad-based consultations were essential for building the legitimacy of the SCD, and provincial consultations, an online survey, and an SMS survey (with more than 200,000 responses) were conducted to garner inputs from as wide a base as possible. This informed the diagnostic and grounded it in the realities of life in Nepal. There were also several innovations and adjustments made to the internal processes of drafting the SCD to increase the efficiency and quality of engagement. For example, (a) the concept note was prepared as a presentation to focus discussion on the framework being proposed; (b) working groups on key development challenges were used to solicit country team inputs, build consensus, and develop ownership; and (c) more structure was provided for the internal World Bank Group review process to encourage more focused reviews.

The report was prepared by a team led by Damir Cosic, Rafael Dominguez, Ruth Hill, and Ashish Narain. Petal Jean Hackett and Persephone Economou contributed from MIGA. The extended team is listed below and many others in the country team contributed by attending the regional consultations and sharing their observations. Rajib Upadhyaya and Richa Bhattarai led the development of the consultations supported by Gayatri Pathak. The team gratefully acknowledges the guidance of Annette Dixon, Mengistu Alemayehu, Qimiao Fan, Martin Rama, Wendy Werner, Benu Bidani, Manuela Francisco, Takuya Kamata, Sreen Juma, Christian Eigen-Zucchi, Tekabe Belay, Sanjay Srivastava, Volker Treichel, Ambar Narayan, Dhushyanth Raju, Sailesh Tiwari, Trang Nguyen, Bigyan Pradan, John Ikeda, and Juri Oka in preparing the report. The peer reviewers were Luis-Felipe Lopez Calva, Johannes Hoogeveen, Masud Cader, and Sebastian Eckardt. Administrative support was provided by Igor Kecman and Sunita Yadav.

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Part A Motivating a Different Approach

1. Introducing Nepal

1. Nepal is a low-income country, but is rich in natural endowments. Nepal's per capita water availability and forest cover is more than twice the South Asia average. However, Nepal's natural endowments also make development challenging. The topography limits domestic connectivity, and it is exposed to floods, landslides, and drought. The Himalayan mountains are an area of intense seismic activity that results from the tectonic collision of the Indian and Eurasian plates, making Nepal the 11th most earthquake-prone country in the world. Nepal is predominantly an agrarian economy; 67 percent of the workforce is engaged in agriculture, which accounts for 33 percent of value added, on average. Although Nepal's economic history was in trade and the industries that grew up around trade, the industrial base is small (12 percent of value added) and declining.

2. Nepal is a relatively closed economy but is uniquely connected to India and its pace of economic development. Although Nepal is landlocked, it is located between two of the fastest-growing economies in the world, China in the north, and India in the east, west, and the south. India is Nepal's largest trading partner, accounting for 65 percent of Nepal's total trade, and the principal transit route, with more than 85 percent of all imports entering through India irrespective of their country of origin. Nepal and India share 1,750 kilometers of open border, which means that, in addition to formal trade, there is a considerable volume of unrecorded trade in goods, exchange of labor, remittances and, consequently, a close correlation of inflation. The Nepalese rupee is pegged to the Indian rupee, giving the central bank limited scope to undertake independent monetary policy. Nepal's relationship with China is less developed, given the physical barrier the Himalayas present along the border, but the relationship is deepening. However, despite the large and dynamic markets on its border, Nepal's export-import ratio is quite small and it has one of the lowest rates of foreign direct investment (FDI) in the world and entry barriers to many sectors.

3. Nepal's population is ethnically diverse. Nepal is a majority Hindu country with significant ethnic diversity; 123 mother-tongue languages were recorded in the 2011 Census. It is mixed geographically, with few areas where any ethnic group or caste has a majority. Nepal is comprised of three agroecological zones: the Tarai (southern plains), the Hills, and the Mountains. About half of Nepal's 28.5 million people live in the Tarai, which is the breadbasket of the nation. Economic activity is concentrated around Kathmandu and the Tarai.¹ However, power has historically been concentrated in the hands of a small number of high-caste Hindu families from the Hills.

4. Nepal's recent history is marked by a succession of feudal regimes and underinvestment in physical and human capital. After decades of rivalry between the medieval kingdoms, modern-day Nepal was unified in 1768 and led by a series of hereditary leaders for two centuries. However, until 1951, there was no modern administration and little public education, which resulted in very low levels of physical and human capital. Illiteracy rates exceeded 90 percent.² Nepal experimented with democracy in the 1950s, which was ended by a royal coup. A party-less system known as Panchayat was put in place until a peaceful "Peoples Movement" in 1990, which brought in democratic reforms, elections, and a new constitution. From the mid-1990s until 2006, the country was in the throes of a Maoist insurgency. A peace treaty was signed in 2006 and elections were held two years later.

5. Following the end of conflict, Nepal has witnessed a lengthy political transition, as the country embarked on a 10-year process of drafting a new constitution. During this period, the country went from monarchism to a federal republic, with 20 prime ministers and as many governments. The contested political transition has been marked by an absence of political leadership, replaced instead by rotating ownership of political appointments by three major political parties and empowerment of a bureaucratic elite. The transition to federalism that is currently being implemented marks a substantial shift in the locus of power from a Kathmandu-centric bureaucracy to 7 provinces and 753 local governments. This is a response to the inability of the central government to deliver the type of inclusive social contract and progress that Nepal's citizens desire.

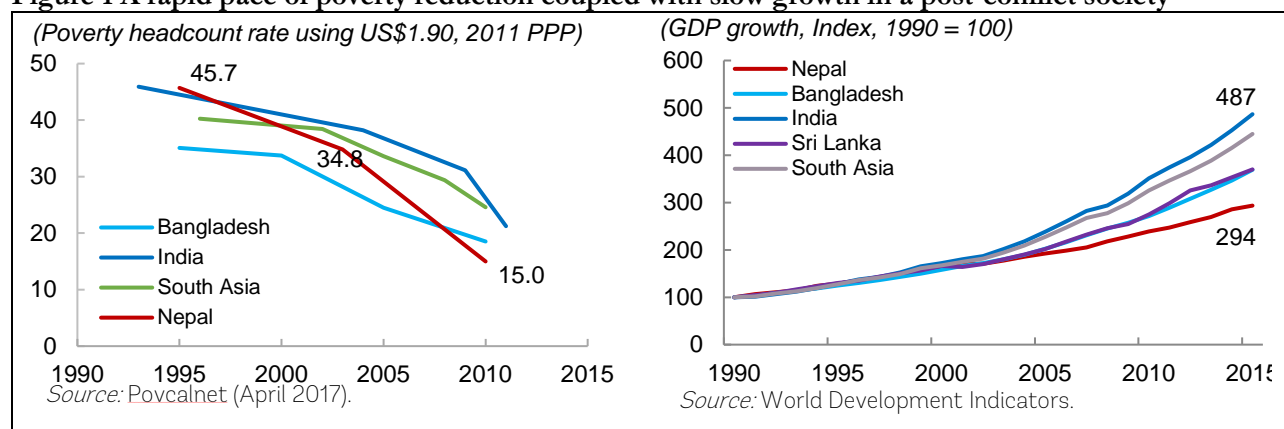
2. Nepal's recent development: surprising progress given low growth and persistent inequity

6. Strong progress has been made over the last two decades on reducing poverty and boosting shared prosperity. The proportion of Nepalese households living in poverty as measured by the international extreme poverty line fell from 46 percent in 1996 to 15 percent in 2011 (figure 1).³ A similarly impressive improvement in well-being is observed when the national poverty line is considered—the national poverty rate was 25 percent in 2011—and gains in other dimensions of welfare are also evident.⁴ Although there is a paucity of official data on

well-being trends and other basic statistics since 2011 (see data annex), estimates undertaken by the Central Bureau of Statistics and the World Bank suggest poverty continued to fall until 2015 (data collected prior to the earthquake and subsequent trade blockade).

7. In contrast, Nepal experienced low GDP growth with minimal productivity growth over the last 20 years. Nepal's growth was much lower than that of the other economies in the region during the last 20 years (figure 1), growing at an average rate of 4 percent annually.⁵ **On the supply side,** the large agricultural sector has performed poorly, accounting for only 1.3 percentage points of growth. The sector now produces only one-third of total value added, although remains the largest employer, accounting for 67 percent of total employment. The service sector accounted for half of total growth such that it now comprises half of gross value added. The services sector is largely informal and is dominated by wholesale and retail trade, with transport and communications, education, and real estate sectors being the fastest-growing subsectors. Industry contributed only 0.5 percentage points of total growth, and declined to 12 percent of total value added, in part as guaranteed quotas for export of garments and carpets to lucrative U.S. markets came to an end. **On the demand side,** consumption was a dominant driver, contributing 3.3 percentage points to average growth. Public investment has been low (table 1), resulting in slow public capital accumulation. Of great concern, productivity growth was broadly flat and did not contribute to growth through this period.⁶

Figure 1 A rapid pace of poverty reduction coupled with slow growth in a post-conflict society



Note: The Nepal 1996 and 2004 poverty rates are adjusted to make them comparable to the 2011 rate, which used a consumption aggregate based on 7-day recall (1996 and 2004 used a 30-day recall). Without this adjustment, the pace of poverty reduction would appear more rapid, as a 30-day recall results in a higher poverty rate than a 7-day recall. PPP = purchasing power parity.

Table 1 Selected macroeconomic indicators

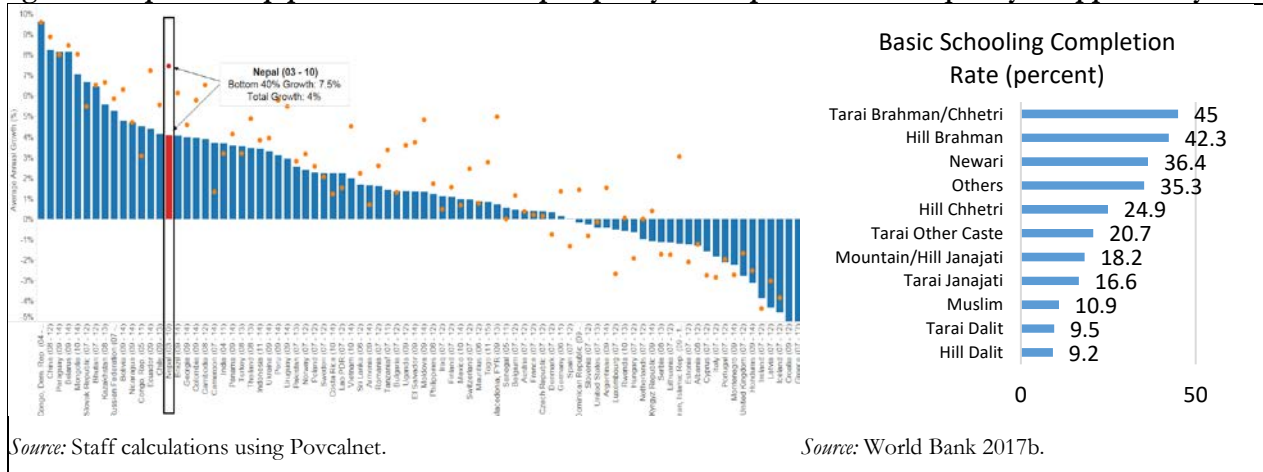
	FY13	FY14	FY15	FY16	FY17 (e)	FY18 (f)	FY19 (f)	FY20 (f)
Real economy	(percentage change, unless otherwise stated)							
Nominal GDP, current prices (NPR, billion)	1,695	1,965	2,130	2,247	2,599	2,884	3,240	3,613
Real GDP growth (at market prices)	4.1	6.0	3.3	0.4	7.5	4.6	4.5	4.2
Consumer prices (period average)	9.9	9.0	7.2	9.9	4.5	5.5	6.5	7.5
Fiscal sector	(as percentage of GDP, unless otherwise indicated)							
Total revenue and grants	19.5	20.6	20.8	23.2	26.1	26.6	26.7	27.0
Expenditures	19.0	20.0	21.9	23.7	29.3	30.9	31.3	31.5
Fiscal balance (including on-lending)	0.5	0.6	-1.1	-0.4	-3.3	-4.3	-4.6	-4.6
Total public debt	32.2	28.2	25.6	28.0	27.6	29.4	31.0	32.6
Monetary sector	(percentage change, unless otherwise indicated)							
Broad money	16.4	19.1	19.9	19.5	15.5	...	...	...
Domestic credit	17.2	12.7	15.6	18.1	20.2	...	...	...
Private sector credit	20.2	18.3	19.4	23.2	18.0	...	...	...
Balance of payments	(as percentage of GDP, unless otherwise indicated)							
Current account balance	3.4	4.6	5.1	6.2	-0.4	-2.0	-2.8	-3.2
Exports of goods and services	10.7	11.5	11.6	9.5	9.2	9.8	9.7	9.6
Imports of goods and services	37.5	40.8	41.5	39.4	43.6	43.9	44.0	44.2
Remittances (as percentage of GDP)	25.6	27.7	29.0	29.6	26.8	26.3	26.5	26.6
Gross reserves (in months of imports)	7.9	8.4	10.1	10.9	9.8	8.6	7.3	6.0
Memorandum items								
Population, million	28.0	28.3	28.7	29.0	...	...	...	...
GDP per capita, US\$ current	689	706	747	729	...	...	...	...

Source: Nepal Rastra Bank, Ministry of Finance and Central Bureau of Statistics for actuals, WB staff for estimates and forecasts.

Note: e = estimate; f = forecast; ... = not available.

8. Nepal also recorded strong progress on shared prosperity, despite persistent inequality of opportunity. From 2004 to 2011, consumption among the bottom 40 percent grew almost twice as fast as consumption among the top 60 percent. This makes Nepal one of the best performers globally on shared prosperity. Yet this was also a period in which historic patterns of spatial and socio-economic exclusion continued to limit the opportunities of disadvantaged groups, as exemplified in adult literacy rates that are almost twice as high in Kathmandu valley as in the mid-Western mountains^[i], and basic schooling completion rates that are four times higher among Brahmins than Dalits (figure 2).

Figure 2 Nepal is a top performer in shared prosperity in the presence of inequality of opportunity



9. Rapidly increasing rates of international migration help explain strong and equitable improvements in welfare. Officially recorded remittances increased from 2 percent of GDP in 2001 to 30 percent in 2015, one of the highest shares in the world (figure 3). Remittances were received by poor and nonpoor households alike, with half of households at all points in the consumption distribution reporting the receipt of remittances by 2011. Remittances directly accounted for 27 percent of all poverty reduction from 1996 to 2011, and high rates of migration also had indirect impacts on poverty—one estimate has the total impact of migration to the Gulf countries at 40 percent.⁷ Migration led to real wage increases, particularly in agricultural wages and nonfarm wages for women.⁸ These real wage gains have resulted in higher labor force participation among households without a migrant. Estimates on labor force participation in households with migrants vary, but overall suggest lower labor force participation as a result of migration.⁹ Remittances also enabled increased investments in health and education, particularly female education.¹⁰

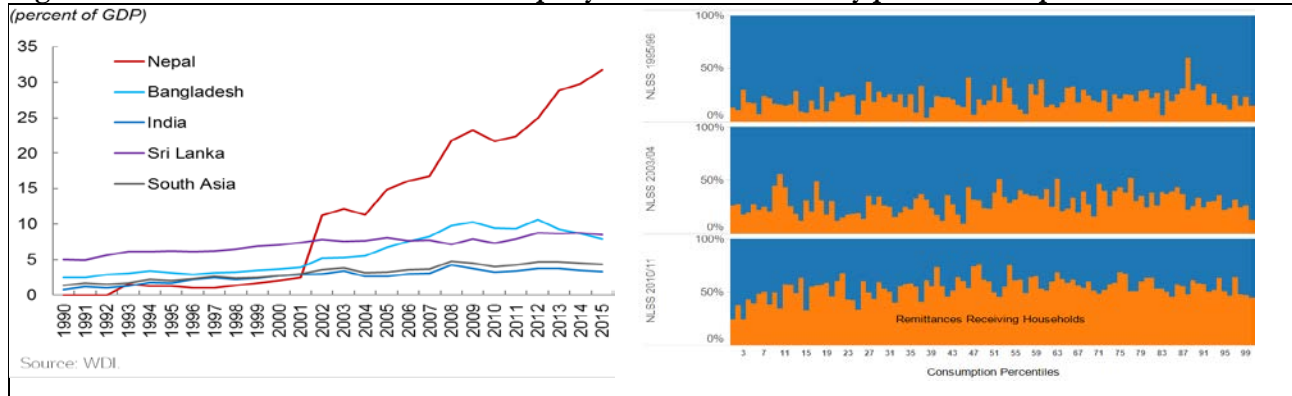
10. Sending a male adult to work abroad has been an optimal strategy for many Nepalese households, but it has not been without cost. First, the type of migration predominating in Nepal is temporary work for young men outside of the country, with workers returning after completing some years abroad. Much of social and domestic life gets put on hold as these young men take on multiple migrant stints, and the social cost of this was repeatedly remarked upon during the regional SCD consultations. Working and living conditions for migrants are often hard, and some migrant workers die while abroad.¹¹ Second, as Nepal has exported workers, the cost of exporting other goods has increased. The gains in real wages, which have been good for the welfare of poor rural households, have raised the relative cost of production in Nepal. Remittances have also led to an appreciation of the real exchange rate and made continued reliance on import tariffs to generate government revenue feasible (section B.2).

11. In addition to migration and remittances, other factors have also aided Nepal’s progress on poverty reduction and shared prosperity. Consensus on macroeconomic policies among political parties, albeit informal, resulted in macroeconomic stability and declining debt ratios. High global food prices at the end of the 2000s were an important driver of rural income growth: 78 percent of agricultural income growth was driven by increased prices. Smaller household sizes and lower dependency ratios were also an important contributor to poverty reduction¹²; Nepal’s fertility rate nearly halved from 5.1 in 1991 to 2.6 in 2011.

12. Strong local communities and private demand for health and education increased access to basic services and allowed service delivery to be maintained during years of conflict. For example, the primary enrollment rate increased from 66 percent in 1999 to 97 percent in 2016,¹³ and 85 percent of primary enrollment is in community schools that receive funding centrally, but are locally managed.¹⁴ Female Community Health Volunteers (FCHVs) were an important part of the expansion in the provision of preventive health services. Private spending on health and education is high, both for services provided in public facilities (for example,

paying for drugs in public health facilities or additional fees charged by community schools) and for private services. Private expenditure accounts for 55 percent of total expenditure in education and 60 percent of total expenditure in health, making private contributions to health and education some of the highest in the world.¹⁵ Community-based groups such as farmer-managed irrigation systems and forest user groups were also important in ensuring progress on natural resource management.¹⁶

Figure 3 Personal remittances increased rapidly and were received by poor and nonpoor alike



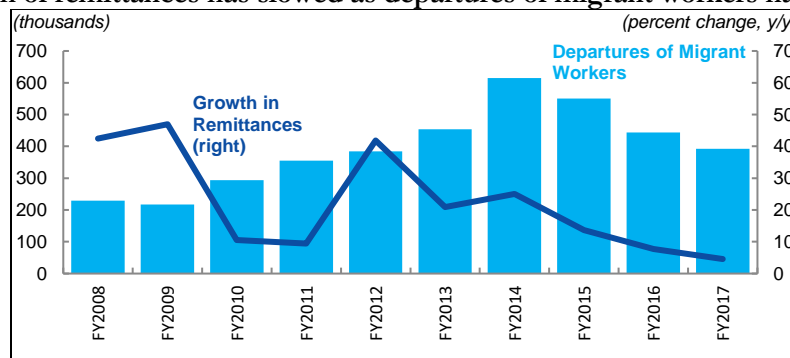
13. Increased government spending on health and education and supportive policies in these sectors (such as support of the system of FCHVs and community-managed schools) also contributed to progress on education and health outcomes. Spending on education and health was maintained during a decade of conflict, and spending on both sectors, particularly health, increased after 2006.¹⁷ These positive policies were encouraged by strong donor involvement in these sectors. This spending allowed user fees to be removed or lowered, which also helped increase access to basic services.¹⁸ Still, government spending on health and education remains much below that of peer countries.¹⁹

3. Why is a different approach needed?

14. Despite the successful and rapid reduction in poverty over the last two decades, this SCD argues that there is an urgent need to change Nepal’s development model, for three main reasons:

- i. **Opportunities for faster growth and poverty reduction are being missed.** Growth rates are low and are driven by remittance-dependent private consumption rather than investment. Yet migration and remittance flows are on a declining trend (figure 4). The structure of employment has remained dominated by agriculture and increasingly informal services. Higher rates of productivity growth and structural transformation require a change of the growth model from one that relies on consumption to one that is fueled by investment in physical capital. Opportunities and financing for investment are present, but public investment has been low and unable to crowd in potential private investment. The rate of FDI is currently one of the lowest in the world. Productivity can also be helped by returnee migrants, who come back with experience in a new sector, cash in their pockets, and a strong desire to be entrepreneurs.

Figure 4 Growth of remittances has slowed as departures of migrant workers have contracted



Source: Nepal Rastra Bank and Department of Foreign Employment.

An examination of growth rates in a business-as-usual scenario highlights that more is needed. Keeping key variables—investment to GDP, growth of human capital, growth of productivity—at recent historical averages and complementing them with United Nations population projections, Nepal’s potential or trend rate of growth would slow to an average of 3 percent per year from 2017 to 2030. At that rate of growth, per capita income would reach only US\$958 in 2030.²⁰ Given that Nepal is a low-income country, it needs faster rates of growth, on the order of 7 to 8 percent, than it is achieving.

- ii. **Sources of fragility remain because of power imbalances and inequality of opportunity.** The Worldwide Governance Indicators ranked Nepal in the bottom 20th percentile for political stability and absence of violence/terrorism, and in the 23rd percentile for rule of law, out of more than 200 countries.²¹ A desire to address entrenched structural inequalities fueled conflict in the past. Measures of inequality, such as the Gini index of consumption, show overall inequality in Nepal to be low and stable over the long term—0.33 in 2011 and almost unchanged since 1996. However, this reflects the fact that Nepal is at the early stages of development, and benefiting from the equalizing force of international remittances, rather than the absence of structural inequalities. As the “Nepal Risk and Resilience Assessment”²² notes, although Nepal has made significant progress over the last 10 years of peace, serious challenges remain. A desire for rights, equity, and inclusion motivates the current move to federalism and features frequently in the constitution, highlighting the importance of this agenda in Nepal today.²³

Business as usual will not address these inequalities quickly enough. The current political system remains highly centralized and exclusionary. Identity has increasingly become a mobilizing political force. The move to federalism offers a historic opportunity to reshape this dynamic if power is moved closer to citizens. However, limited accountability at the local level, given the absence of elected representatives for nearly two decades, has often allowed extractive political elites and patronage to be present at the local level too.²⁴ Inequality of opportunity and access to public services along gender, spatial, and ethnic lines persist, despite substantial improvements. This has impacts on many aspects of society; for example, only 8 percent of Nepal’s lawyers are women, less than 1 percent are Dalit, and about 80 percent are Brahmin and Chhetris.²⁵

- iii. **Welfare gains are vulnerable to natural disasters and other uninsured risks.** The earthquake in April 2015 took 9,000 lives and destroyed or damaged assets worth US\$5.2 billion, approximately one-quarter of the country’s FY2014 GDP.²⁶ Although many households have exited poverty in Nepal, welfare gains have not been large enough to move them into the middle class, and they remain vulnerable to falling back into poverty should an uninsured income shock occur.²⁷ The proportion of households counted as vulnerable to poverty increased from 28 percent in 1996 to 45 percent in 2011.²⁸ The position of these households is particularly precarious given Nepal’s high levels of exposure to natural disasters, which will increase with climate change, and the continued dependence on rain-fed agriculture. Health shocks also push many into poverty.²⁹ Remittance income is also vulnerable, as shown by the recent slowdown in remittance growth, and given that migrants are concentrated in India and four oil-dependent countries. A substantial change in the structure of the economy is needed to reduce vulnerability.

Part B Elements of a New Approach

15. This SCD identifies six areas where action is required to allow Nepal to take advantage of opportunities for growth and poverty reduction, to address sources of fragility, and to reduce vulnerability:³⁰

- i. **Encouraging political inclusion and eliminating clientelism.** Increasing the inclusiveness of the political process and strengthening the rule of law is particularly important to addressing the sources of fragility. The current transition to federalism is a potential game changer if it is accompanied by a meaningful change in the balance of power. This makes this area of action one in which real progress is not only important, but also very possible. Progress in other areas also requires acknowledging the constraints emanating from exclusive and unaccountable institutions. Without that, technical solutions may be proposed and implemented but lead to little lasting change as existing power structures remain intact. For example, poor policy design and ineffective institutions constrain public investment in infrastructure, not lack of financing or technical know-how. And public institutions reinforce the inequalities that persist in nutrition, health, education, and access to good jobs.
- ii. **Promoting private sector investment to create more and better jobs.** This is essential to taking advantage of opportunities for growth and poverty reduction. Nepal’s domestic labor force is predominantly in low-return sectors such as agriculture, and transitions out of agriculture have been into sectors such as urban

services, where productivity is declining.³¹ The low productivity of work and underemployment in Nepal mean individuals are substantially more productive when they migrate. Low income and lack of domestic jobs is cited as the primary reason for seeking foreign employment.³² When youth who stay in Nepal are employed, they are less likely to report being satisfied with their work and more likely to desire a new job than similar youth in Bangladesh, Cambodia, and Vietnam.³³ Lower fertility rates offer the potential for Nepal to reap a demographic dividend through a rise in the working-age share of the population, but this requires adequate jobs for new entrants into the workforce.³⁴ Addressing constraints to private investment is essential for individuals to become more productive employees and entrepreneurs.

- iii. **Harnessing the potential of natural resources.** The constraints to private investment are apparent in natural resource development, the third area for action. Nepal is rich in natural resources—its forest cover, water availability, and hydropower potential are among the highest in South Asia—but they contribute very little to GDP growth, reflecting a lack of both public and private investment in the sector. For example, Nepal’s economically viable hydropower potential is estimated at 43,000 megawatts, but less than 2 percent of this is currently exploited.³⁵ Forests cover about 40 percent of Nepal’s geographic area but Nepal imports both timber and fuelwood. While protections on the development of Nepal’s natural resource base are needed, the current low rates of productivity mean that key opportunities are being missed. Getting more from natural resources will improve employment for the many who are engaged in this sector and have spill-over effects into other sectors by increasing electricity generation and providing inputs to other economic activities.
- iv. **Ensuring all Nepalese are equally able to invest in and use human capital.** While more and better jobs are essential, individuals need good health, skills, and freedom from discrimination to be able to benefit from these opportunities. Increasing human capital increases labor productivity. Addressing spatial and social inequalities in the acquisition and use of human capital is also essential for increasing efficiency. Rates of international migration are higher for groups that are less favored in the domestic job market.³⁶ Inequality in access to jobs reflects inequalities that are present from before birth that impact the acquisition of human capital. In Nepal, a child’s gender, location, and parental education play a dominant role in determining whether a child is well-nourished, has clean water to drink, and starts and finishes primary school on time.³⁷ Improving inclusion in acquisition and use of human capital is not only important for taking advantage of opportunities for growth and poverty reduction, it is fundamental to addressing sources of fragility.³⁸
- v. **Increasing resilience to natural disasters and health shocks.** Too often in Nepal’s history, progress was set back by natural disasters. Although such disasters spotlight the vulnerability of life in Nepal, Nepalese grapple with more mundane shocks, such as ill health, on a regular basis. Resilience is built both by reducing exposure to risk and strengthening coping mechanisms for when shocks do occur.
- vi. **Getting more from migration.** Large-scale international migration will remain an important fact of Nepal’s development trajectory over the medium term. Getting more from migration entails addressing constraints remittance recipients and return migrants face in pursuing entrepreneurial investments. In addition, migration needs to be made as safe and remunerative as possible.

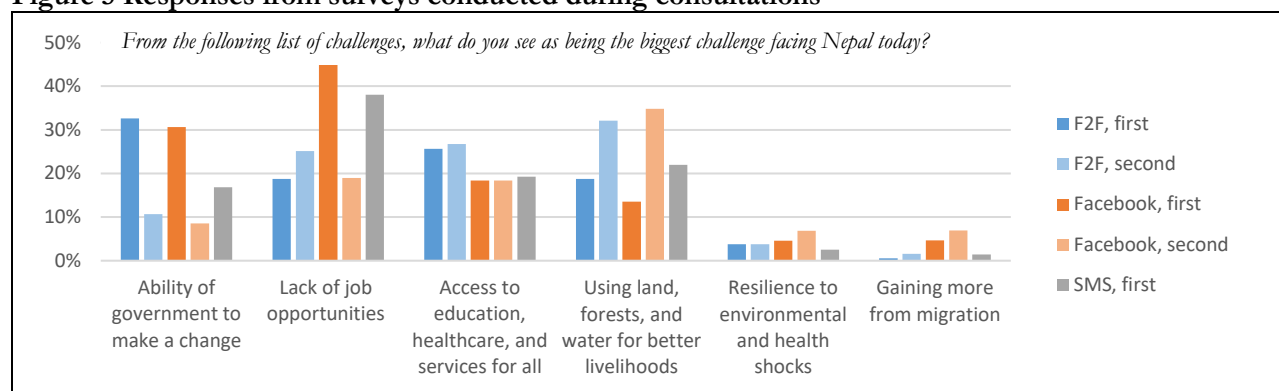
16. These areas of action are interrelated. Lack of inclusive and accountable public institutions is an area of action, but is also the underlying cause of constraints to progress in the other five action areas. Examples of this are highlighted in the following subsections.³⁹ However, finding opportunities for politically feasible progress to overcome the constraints identified in areas 2 to 6 would help Nepal grow and reduce poverty, address fragility, and reduce vulnerability. In addition, many of the actions in areas 2 to 4 would increase resilience: increasing more formal jobs, investing in health and education, and sustainable land management practices. Likewise, addressing the constraints to private sector investment is essential to Nepal getting more from international migration. Migrants often return with experience working in a new sector, cash in their pocket, and a desire to set up their own business (more than two-thirds of those who stay indicate that they would like to be entrepreneurs). Nepal cannot gain from this unless the barriers that constrain private investment are removed.

17. While action in all identified areas is needed, the evidence suggests a prioritization, as indicated in table 2. Constraints were prioritized based on their likely impact on creating more or better jobs, addressing the underlying drivers of fragility, and building resiliency. The evidence base used was (a) benchmarking criteria that indicates Nepal is underperforming compared to a set of structural and regional peers;⁴⁰ (b) empirical evidence that shows removing the constraint will accelerate or sustain progress on the three objectives; and (c) country expertise provided during extensive country consultations that suggests the constraint is binding. In addition, the feasibility of addressing constraints was considered: challenging constraints to address, such as improving public institutions, were prioritized only when it was deemed that even minimal progress would have a large impact.

18. Improving public institutions is considered first, because inefficient and exclusive institutions constrain progress on all fronts, and because the transition to federalism presents a unique opportunity that should not be missed. Increasing private sector investment is essential to taking advantage of the growth and poverty reduction opportunities that Nepal is currently missing. Acquiring and using human capital also contributes to growth and poverty reduction and is fundamental to addressing the sources of fragility still present in Nepal. Thus, both issues are deemed equally important. Natural resource development is considered fourth, because of its important role in creating jobs in a spatially equitable manner and contributing to increased resilience. Additional action to increase resilience against shocks and to get more from migration are fifth and sixth, because much of the action needed in these areas will be addressed by action in other areas.

19. Surveys undertaken as part of country consultations suggest that this prioritization is consistent with the challenges participants identified as most important to Nepal's progress. Surveys were conducted with all participants at the end of face-to-face consultations in each province, as well as online (advertised via Facebook) and via SMS (advertised via local radio in the poorest 20 districts of Nepal). The SMS survey attracted more than 200,000 responses (see the consultations annex for full details). Job creation was by far the biggest priority for younger, less employed, less educated respondents on Facebook and SMS. In the face-to-face consultations, public institutions, human capital, and natural resources were identified as more important (figure 5).

Figure 5 Responses from surveys conducted during consultations



Note: F2F = face to face.

Table 2 Ranking of areas for action

	Taking advantage of growth opportunities	Addressing drivers of fragility	Reducing vulnerability	Aggregate ranking
Improving public institutions	High	High	High	1
Increasing private sector investment for job creation	High	Medium	Medium	2
Acquiring and using human capital	Medium	High	Medium	2
Natural resource development	High	Low	Medium	3
Resilience to natural disasters and health shocks	Low	Low	High	4
Getting more from migration	High	Low	Low	5

20. Within each of the six action areas, key constraints to progress in that area have been identified based on evidence, working group sessions, and consultations. The following subsections describe these constraints.

1. Improving public institutions in a federal Nepal

This will require an effective transition to federalism that gives power to inclusive, accountable, and capable subnational governments, and increased inclusion and accountability in federal institutions.

21. Improving public institutions is fundamental to progress, and an area in which there is room for meaningful change. The World Bank's *World Development Report 2017: Governance and the Law*^{A1} explores the reasons why some policies work and others fail. Policy making takes place in complex political and social settings in which individuals and groups with unequal power interact within changing rules as they pursue conflicting interests. Power is distributed unequally in every society and is, in part, determined by history. The unequal distribution of power is not always harmful, but it may lead to harmful consequences and undermine the core

functions of institutions if it gives rise to exclusion, capture, and clientelism, as it has in Nepal. Improving governance can mitigate, even overcome, power differences. Change happens by shifting the *incentives* of those with power, reshaping *their preferences and beliefs* in favor of positive outcomes, and considering the interests of previously excluded participants, thereby increasing *contestability*. Federalism is changing incentives and contestability in Nepal and could provide an opportunity for positive change.

22. The last two decades have been turbulent in Nepal as society seeks to redefine the very nature of the country. The central tension in Nepal's society was, and continues to be, between the ruling groups and those that continue to feel excluded and marginalized. The post-conflict period (2006–16) has been characterized by intense political fragmentation and a proliferation of new actors, with political parties splitting and new groups competing for space on the national stage, leading to increasing challenges to form a stable and long-lasting governing coalition.

23. During this time, Nepal's ranking on key dimensions of governance has suffered.⁴² It ranked in the bottom 20th percentile on rule of law, government effectiveness, and political stability/absence of violence out of more than 200 countries. Further, it ranked in the 23rd percentile on regulatory quality and control of corruption.⁴³ Except for political stability/absence of violence indicators, Nepal is performing worse in 2016 than it did in 2006 on key measures of governance. One report states: "Much of the government apparatus, even including anti-corruption bodies, might be viewed as being structured around providing financial returns to the elite in the political and bureaucratic class."⁴⁴ There are specific examples of politicians and bureaucrats benefiting themselves and their patronage networks through the implementation of policies and regulations: a minister's home district received compensation for more than three times the number of buildings destroyed in the conflict;⁴⁵ politically connected firms circumvent taxes by having the tax code changed and by government-complicit evasion, resulting in incumbent firms having lower rates of taxation than regional and structural peers;⁴⁶ and the percentage of firms in Nepal expected to give gifts to secure government contracts (51 percent) is more than twice the regional average.⁴⁷ As a result the majority of the public believes that the most important factor in winning procurement contracts is personal connection with government officials (88 percent) or political parties (87 percent).⁴⁸

24. Two key facets of Nepal have contributed to the current quality of institutions: (a) an exclusionary, centralized government present throughout Nepal's history; and (b) the protracted transition in which the influence of political parties strengthened and accountability declined.

25. Nepal's history is characterized by an exclusionary and Kathmandu-centric state. Two hundred years of hereditary, feudal regimes and a party-less system, where participation in the political process was the prerogative of two high-caste groups,⁴⁹ limited the voice of many citizens. The centralized structure of the state, with significant imbalances in power and influence between the largely Kathmandu-based political and bureaucratic class compared with the rest of the country, is central to the political economy of corruption and the capture of resources by this elite class. This culminated in a first people's movement in 1990 followed by a new constitution and the introduction of multiparty democracy. The progress made during this period was not sufficient to prevent a decade-long violent insurgency that started in 1996 that had origins in antifeudal ideology and grievances due to exclusion. In the decade since peace, political and public institutions have become more inclusive, but the influence of historically excluded groups is still limited. For example, Dalits comprised 4 to 7 percent of the central executive committees of the main parties in 2012 (compared to their population share of 14 percent).⁵⁰ Despite a commitment to minority quotas, 70 percent of civil service hires from 2007 to 2014 were from high-caste groups and 13 percent were from historically excluded groups, despite both comprising about 30 percent of the population.⁵¹ Within castes, hiring is often from families with members that are already civil servants.⁵²

26. Nepal's protracted political transition has had implications for accountability and the rule of law. Legitimacy has not come from legality, but rather from consensus among the main parties. The Comprehensive Peace Agreement and the Interim Constitution state that disagreements will be settled through "mutual talks, understanding, consensus and dialogue." The Interim Constitution explains that political consensus means the consensus reached by the main seven political parties present in November 2006. This has had the effect of putting politics above the law, which has had implications for the way society functions.⁵³ Political parties are distinguished less in terms of policies or ideas they represent, and more in terms of the patronage they bestow with the resources they control. At the local level, the power of party has further been strengthened by the lack of accountability resulting from a 20-year gap in local elections. Local elections held in 2017 provide an important opportunity to address the lack of accountability that has been present. Sixty percent of those elected were new to politics, and this offers a genuine opportunity for change.

27. The current transition to federalism provides a considerable opportunity for increasing inclusion by devolving power out of Kathmandu and increasing accountability. The new constitution, adopted in 2015, has defined Nepal as a democratic, federal, and secular republic, and Nepal is embarking on potentially the most radical restructuring of the state in its history. The precise aim of the new constitution is to address the issues that led to marginalization and exclusion. Federalism is not conceived of as decentralization of service delivery, but as a genuine sharing of power between 753 local governments with the power to raise and manage resources, 7 provincial governments, and the center. In theory, federalism brings the government closer to the people and it can lead to a much more inclusive and accountable form of government. These aspects make federalism particularly applicable in Nepal, where domestic connectivity is a challenge, and ethnic and linguistic diversity is high.

28. The benefits of federalism are potentially far-reaching and could encourage the spatial expansion of economic activities. Federalism offers several potential benefits beyond increasing inclusion in the political process. The creation of provinces with their respective seats of power should speed up the creation of urban agglomerations outside of Kathmandu. Competition among more autonomous local governments could foster a more desirable investment climate. More inclusive and fairer representation offers the potential to address geographic and social inequities in access to basic services. Federalism could also make the utilization and allocation of investment in natural resources more efficient and sustainable.

29. However, there is still considerable uncertainty about how federalism will unfold. Transitional arrangements and elections are on track to be completed by the beginning of 2018, as required, but key aspects of the constitution remain contested by certain segments of the population. While plans for the deployment of funds, functions, and functionaries are underway, there is much that remains to be determined. The FY2018 government budget has dedicated budget codes linked to local government accounts and facilitates the disbursement of funds, but only 19.2 percent of the budget is devolved to local governments (less than the 50 percent that was requested by newly elected local council members), and at the time of writing mechanisms for administering the fiscal transfers have yet to be established. The deployment plan for existing civil servants to all tiers of government is ready but is meeting resistance from Kathmandu-based civil officers. Although functions have been allocated across government tiers and approved by the cabinet, the bill that defines local government responsibilities is with parliament.⁵⁴

30. Federalism also poses risks. There is an inherent risk in disrupting the power balance in society, and this will need to be managed. In addition, federalism may increase implementation challenges if responsibilities among different levels of governments in the new structure are unclear, if adequate fiscal resources for delegated services are not provided, or if implementation capacity at the newly created subnational levels is not built. The new responsibilities of planning and financial management in local governments require new skills to ensure service delivery is maintained. This is particularly the case in municipalities that face more complex demands for service provision, and in poorer, more remote local governments where capacity is likely to be lower.

31. However, more fundamentally, governance challenges will still need to be addressed in a newly federalized Nepal. Governance challenges have been just as large at the local level, where capacity is lower than the central government.⁵⁵ The education sector provides an example. Decentralization improved delivery of education services, but the sector has been considered one of the most political service sectors in Nepal, with political interference in large procurements (such as the contribution of school buildings), the hiring of teachers, and the disbursement of scholarships (see section B.3).⁵⁶ Some of the challenges reflect the lack of local elections for 20 years, but in part they also reflect the fact that the risks of capture are just as present at the local level, and can be even larger when the local policy arena is less contested (World Bank 2017c). Increasing inclusion of excluded groups and the contestability of elections and policy making at the local and central level are essential to federalism bringing about a fundamental change.⁵⁷

32. Inclusive, accountable, and transparent subnational governments are essential to addressing Nepal's governance challenges, and the uncertainty and risks surrounding implementation cannot be the excuse for failure. The challenges listed would only be the proximate causes of why federalism might not lead to improved development outcomes. Good policies are often difficult to introduce and implement because certain groups in society that gain from the status quo may be powerful enough to resist the reforms needed to break the political equilibrium. Donor support to provide the necessary funds to subnational governments; building capacity for political leadership, planning, and financial management at the local level; and investing in increased transparency and accountability (such as through publishing understandable budgets and plans, and measuring and publishing comparative indicators on local government performance and service delivery) are essential. There is also still a need to improve the political process at the federal level, which requires investments

in evidence-based decision making, transparency, and inclusion. The following sections detailing the five further action areas will also note where improving institutions at the federal level is particularly important.

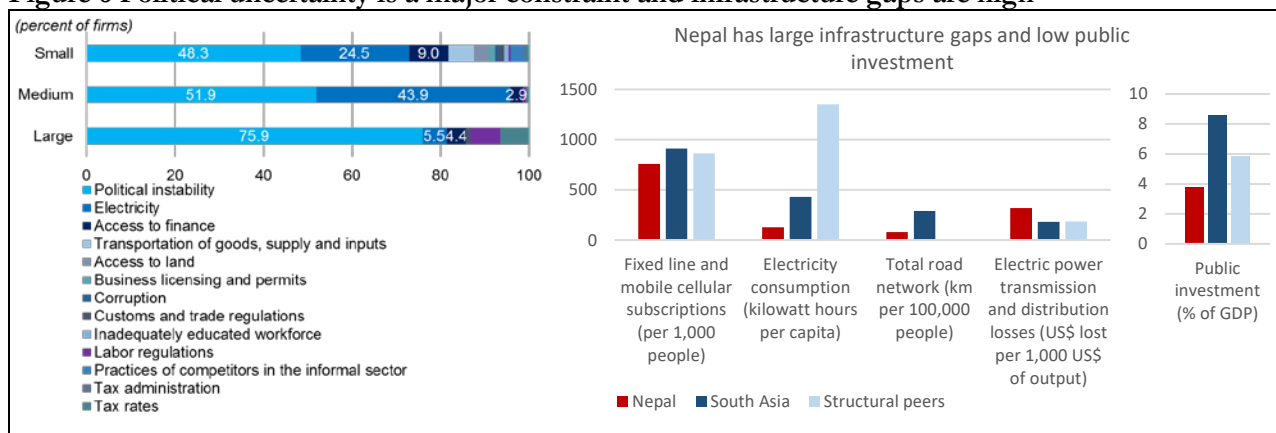
2. Creating more and better jobs for all Nepalese

This will require investment in infrastructure, the removal of barriers to competition that currently constrain private investment, greater openness to external markets, and more equitable access to finance.

33. Raising productivity is key to more and better jobs, and this section looks at what it will take to raise productivity. Sectors in which previous analytical work shows that the country has a strong and unexploited comparative advantage include hydropower, tourism, agribusiness, and cement. Increasing productivity in natural-resource-based sectors is considered in more depth in section B.3. Political instability and weak institutions are identified as the key constraint, discouraging firm investment, limiting infrastructure investment, and encouraging poor governance of markets. In addition, lack of openness limits the degree to which Nepal benefits from the vibrant markets on its border, and from global markets more broadly. Finally, access to credit remains unequal, limiting productivity growth for some firms.

34. Political instability and the weakness of institutions within which individuals, firms, and governments interact are the biggest constraints to business identified by firms. Leadership and good governance have been a common feature of most countries that have experienced rapid and sustained growth. Several cross-country empirical studies also find a statistically significant and inverse relationship between political instability and long-term capital accumulation.⁵⁸ In Nepal, too, numerous studies carried out in recent years in the country have identified political instability as the biggest constraint to private sector investment and growth.⁵⁹ Indeed, firms cite political uncertainty as one of the major obstacles to operations, cutting across location and size (figure 6). Political uncertainty is understood to mean a protracted postconflict period of constitution drafting and rotating leadership among the three parties (along with the regular changes in civil service this implies). Strong institutions can serve to dampen the effects of political instability on policy direction and the regulatory environment. However, economic institutions remain weak in the country.⁶⁰ The result is uncertainty, which discourages investment, particularly for those who are less well-connected and able to navigate uncertainty.

Figure 6 Political uncertainty is a major constraint and infrastructure gaps are high



Source: Enterprise Survey 2013 and World Development Indicators.

35. Poor infrastructure is further constraining private investment and productivity. Nepal ranks 130th out of 190 countries in terms of infrastructure availability, the worst in South Asia. Electricity and roads are particularly large infrastructure constraints compared to regional and structural peers (figure 6). Two-thirds of Nepalese firms identified electricity as a major constraint, much higher than the regional and global average. There are frequent outages, and firms must rely on expensive diesel generators for up to 40 percent of their electricity use. This raises costs and reduces competitiveness.⁶¹ Increasing investment in hydropower would address this constraint, and this is discussed in section B.3. Given the country's geography, most movement of goods and people happens by road. Poor road infrastructure thus has a big impact both on competitiveness and on the spatial concentration of economic activity. Almost 40 percent of services inputs to processed food exports are transport related, as are 30 percent for leather and 25 percent for beverages and tobacco exporters.⁶² Not only is the road network small, it is also poorly maintained. Not surprisingly, transport is the third-most-cited top business environment obstacle.

36. Low public investment rates have led to large infrastructure gaps. Despite ample savings, investment has been lower than comparators (figure 6). Gross public investment in Nepal has averaged less than 5 percent of GDP, below the average not only of South Asia, but also of all low-income countries. Not only is the level low, but public investment is inefficient. One measure of this is the Incremental Capital-Output Ratio (ICOR),⁶³ which averaged 5.7 between 2001 and 2007, the highest among comparator countries.⁶⁴ The inefficiency results from a public investment management process that does not plan, budget, or deliver priority assets on time and in a cost-effective manner. The capital budget is underspent, with spending averaging 70 to 80 percent of the amount budgeted in recent years.⁶⁵ According to the list of projects compiled from the Annual Development Plans of the National Planning Commission, the average life of ongoing projects is more than 11 years, and of “national pride” projects even more, around 13 years. A substantial increase in infrastructure investment, as well as greater efficiency in spending, is required.

37. Addressing Nepal’s infrastructure gap will also require addressing constraints to private investment in infrastructure. The private sector can be supported in investing in infrastructure if the project can be financed on commercial terms while remaining affordable and offering value for money. There are challenges to private infrastructure investment in Nepal that need to be addressed. Public-private partnership models have failed to deliver on a major corridor project, the Fast Track Highway, despite six attempts since 1996.⁶⁶ Constraints to private infrastructure investments are discussed further with respect to hydropower investments in section B.3, and the InfraSAP diagnostic will provide a more in-depth assessment.

38. In addition, poor governance limits competition and impedes private investment in some sectors, including key sectors like transport. Weak competitive structures, regulatory barriers that restrict entry, and prevention of international competition, have led to the prevalence of “insider” firms in some sectors with large market shares and comfortable profit margins, and with little interest in growing their business or breaking into new product areas and markets. This obstructs the development of a vibrant and dynamic private sector capable of generating the kind of growth and good jobs that Nepal needs. Small and medium-sized enterprises find it difficult to enter and survive as evidenced by low rates of entry of new firms and an aging of firms over time.⁶⁷ Larger firms and firms with a larger market share have lower rates of productivity, which is indicative of limited contestability in these markets.⁶⁸ Trucking and public transportation services are a prime example. Trucking and public transporter associations have been accused of price fixing, particularly regarding plying on minor roads, as well as applying high charges on services, using old and worn-out vehicles, and overloading cargo. These are sustained through a plethora of government approvals and quotas that deter free entry and enforcement of laws.⁶⁹ While the impact of limited contestation of markets on prices has been quantified in the trucking and public transportation sector, further evidence on other sectors would help prioritize the sectors in which improving competition and regulation would have the largest welfare impacts.

39. In some sectors the government is directly engaged through state-owned enterprises (SOEs). Some, like the Nepal Electricity Authority (NEA), play a dual role as regulator and market player that gives them significant market control (discussed further in section B4). In some cases, SOEs have preferential access to state subsidies or financing.⁷⁰

40. The evidence points to these two factors: infrastructure gaps (particularly in roads and energy) and limited competition as the two primary constraints to productivity growth. As has been described, both are consequences of political instability and weak institutions. Making politically feasible progress on either of these issues will have large beneficial impacts. However, two further constraints are also important: a lack of openness to world markets and inequitable access to finance for SMEs, women-owned enterprises, and rural businesses.

41. Nepal’s weak links with world markets is a further key constraint. Nepal is a small economy surrounded by vibrant markets. It also has potential to expand trade with the fast-growing economies in East Asia and the Pacific, with which it substantially undertrades.⁷¹ Embracing trade and investment is crucial for growth and development, and yet, Nepal seems to be doing neither. Export shares have fallen, participation in regional and global value chains is low, and attraction of FDI is underwhelming. In 2003, Nepal accounted for 12 out of every 1 million U.S. dollars of worldwide trade in goods and services. But by 2014, this number had fallen by 25 percent to just 9 dollars. Foreign investment has averaged just 0.2 percent of GDP over the last decade.⁷² Integrating further into the region and the world through trade will help domestic firms access an enlarged market, gain exposure to better technologies and more varied intermediate inputs, and become more competitive.

42. On the regulatory side, this is attributable in part to trade policies that either are not supportive enough or impede firms from accessing foreign markets for their output or to source inputs (both goods and services). Nepal has consistently applied higher tariffs on the import of intermediate and capital goods than countries in the region.⁷³ In many cases, this is purely motivated from a revenue point of view, as there are no

domestic industries that need protection. The environment for FDI is also not supportive. FDI has been hurt by unclear policies, complex procedures, and inadequate investment facilitation, in addition to lack of infrastructure and political instability. Entry barriers to foreign investment include foreign ownership limitations, sector caps, a long negative list, and restrictions on nonequity modes of investment. Among the other important restrictions affecting foreign investment in the country are the cumbersome processes on the repatriation of funds and the lengthy processes needed to hire foreign workers. Further, the country has imposed barriers to service trade that have implications for the quality and cost of provision of key backbone services (transport, telecommunications, finance).⁷⁴

43. Although migration has delivered gains, it has accentuated existing challenges for export growth. Remittances are contributing to an appreciation of the real exchange rate by putting upward pressure on the prices of nontradables. In turn, the appreciation of the real exchange rate favors imports and biases against exports by making domestic goods uncompetitive.⁷⁵ The impact is possibly largest on low-value, low-margin manufactured goods, which account for a significant share of Nepal's export bundle. Further, from a political economy perspective, rising imports made possible by remittances, are an attractive taxation base and incentivize increased reliance on import taxes. This adds to the anti-export bias, as domestic exporters rely on imported goods as key inputs for production.

44. Finally, significant gaps in access to finance for smaller firms, and unequal access across gender and geography, are further hampering job creation. Access to finance for firms has shown some progress, but 40 percent of firms still report access to finance as a major constraint. Significant gaps exist for small and medium-sized enterprises (SMEs), startups, women, and rural businesses. These are firms that contribute significantly to job creation but only 9 percent use banks to finance investments, compared to 17 percent on average nationally.⁷⁶ Access is limited by the relatively high cost (for financial institutions) of personal screening and due diligence for typically modest loan amounts, and concerns that borrowers might be accumulating many loans from multiple lenders, potentially resulting in their over-indebtedness. A regulatory cap on the spread on interest rates that financial institutions, domestic and international, can offer above their base rate further reduces the ability of credit providers to accurately price in this risk, thereby limiting their ability to take the risk on or to provide long-term financing. When firms can access credit, financial institutions rely on conventional collateral-based lending approaches given the lack of credit information in the market. Collateral demands in their case can reach almost 400 percent of loan value.⁷⁷ Land and buildings are often used as collateral, so high collateral requirements perpetuate inequities in these asset holdings by restricting access to finance for those who do not have access to these assets. The institutional capacity required to use non-collateral solutions to overcome lack of credit information is lacking.

45. In summary, creating more and better jobs for all Nepalese will require making progress on infrastructure investment and improving competition in key markets. Progress on neither will be easy, but it will have a large impact on job creation and productivity growth. More and better jobs will also require an increase in outward orientation—lower tariffs and barriers to FDI—so that Nepal can benefit more from the vibrant regional market in which it is located. Finally, improving access to finance for SMEs and female entrepreneurs will help this segment of the market grow, a segment that has the potential to create many new jobs.

3. Productive and sustainable livelihoods from Nepal's land, forests, and water

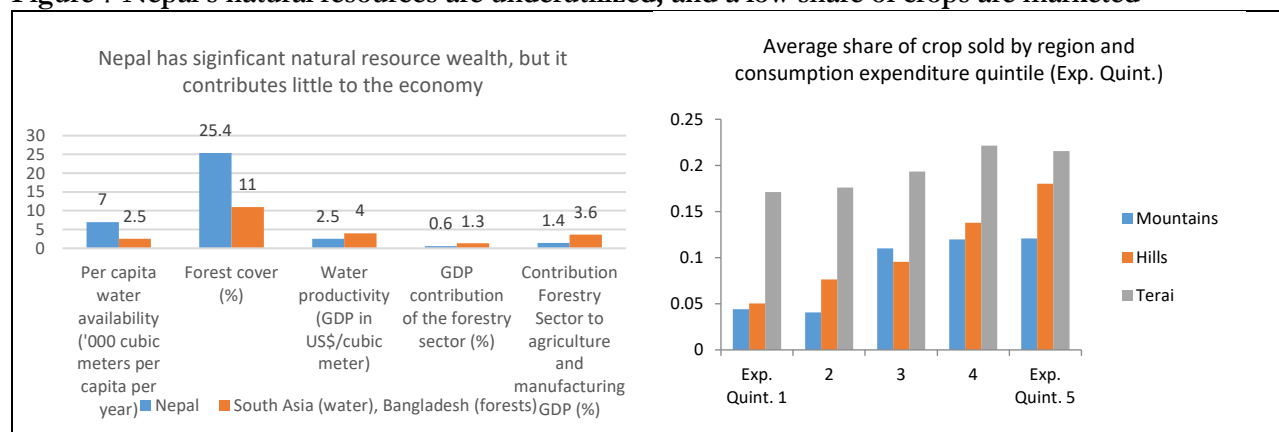
This will require supporting private enterprise, improving planning and interagency coordination, and clarifying rules for sharing the benefits of resource creation.

46. The same constraints that limit private sector investment and growth identified in section B.2 also limit the degree to which Nepal can benefit from its rich natural resources—land, water, and forests. Lack of investments in developing its hydropower potential, roads, and irrigation, and poor regulations and governance of markets, are major constraints.

47. Agriculture remains the primary employer for 86 percent of poor people, making growth in the sector critical for poverty reduction. However, growth in agriculture has been low and volatile, driven by higher relative prices for agricultural commodities and favorable monsoons rather than any growth in productivity.⁷⁸ There are opportunities for growth. Agricultural products have a sizable domestic market (Nepal is a net food importer); and Nepal has untapped comparative advantage in production of nontraditional higher-value crops such as apples and almonds in areas of higher elevation.⁷⁹ Widely varying geography and agroecological conditions pose diverse challenges that call for nuanced strategies. Although land reform was a key demand of the Maoists, most rural households now own land, although rates of landownership are lower among disadvantaged groups.⁸⁰ Land inequality is higher in the Tarai, but it is not higher in the Tarai than in other countries in the region.⁸¹

48. The evidence points to two overarching constraints: (a) underdeveloped markets and limited postproduction value addition, which make prices too low and volatile to encourage investment; and (b) lack of year-round irrigation, particularly in the Tarai. *Enabling the Business of Agriculture* showed that Nepal ranked lowest on transport and water (52nd out of 62 countries).⁸² Cereal yields are low compared to neighboring countries, even when comparing production in lowland Nepal to other lowland neighbors, suggesting that available technologies are not being used.⁸³ Improved extension services, fertilizer distribution, access to land (particularly in the Tarai), mechanization, and credit would increase productivity and diversification, but addressing constraints to market efficiency and agribusiness investment can be just as effective in increasing productivity by incentivizing productive investments.⁸⁴ Efficient markets are essential to enabling households to diversify out of subsistence agriculture. In Nepal, diversification from cereals (rice, maize, wheat, millet, barley, and buckwheat) toward higher-productivity fruits and vegetables has been limited.⁸⁵ The share of crop produced for market is low—averaging about 10 percent in the Hills and Mountains and 20 percent in the Tarai (compared to 30 percent in Nepal’s structural peer, Uganda)—and falls significantly with income (figure 7) and distance.⁸⁶

Figure 7 Nepal’s natural resources are underutilized, and a low share of crops are marketed



Sources: World Development Indicators and Jacoby (2017), using Rural Household Survey 2016.

49. In agriculture, the lack of year-round irrigation, particularly in the Tarai, is one of the biggest constraints to raising agricultural productivity. A 2005 study showed that the incidence of poverty in irrigated areas is half that in rainfed areas and that access to irrigation water mitigates poverty.⁸⁷ The highest return to investment in the Tarai is irrigation.⁸⁸ Some key challenges relate to less than optimal utilization of developed irrigation facilities due to poor maintenance of the existing irrigation systems. Irrigation systems need to be rehabilitated and modernized to make them resilient.

50. Lack of road infrastructure hinders agricultural development, better utilization of forests, and tourism. The costs of transacting among regional, central, and border markets is very high in Nepal, causing farmgate prices to be low and highly volatile.⁸⁹ Half of the spatial and temporal variation in estimated transport costs between regional and local markets is explained by road and bridge infrastructure.⁹⁰ Farms in hill districts that have closer proximity to Nepal’s major North-South road links are more profitable.⁹¹ Better connectivity to markets on the border will be required to take full advantage of export opportunities for nontraditional high-value agricultural products. Poor connectivity also makes it difficult to get forest products to markets. In addition, there are insufficient airports serving hill and mountain areas, and the existing ones are not kept or managed well. Tourism offers significant potential, but reaching many destinations requires devoting multiple days to the journey, making them effectively “off the map” for most tourists.

51. The challenges to market development in agriculture do not come from infrastructure alone. Trucking syndicates also hinder integration by raising transaction costs, which is particularly costly for marketing of low-value added products such as cereals and timber.⁹² Other constraints (as outlined in section B.2) that hinder the development of trade logistics and agroprocessing enterprises also limit market development. In addition, Nepal lags on phytosanitary certification and inspections, which are important for export markets, and on developing farmer organizations, which can prove particularly important in reducing the transaction costs associated with securing a predictable supply chain of adequate quality when producers are geographically dispersed.⁹³ Although limited market development constrains the productivity of natural capital in all of Nepal’s regions, its nature varies: the infrastructure challenges in accessing markets are more severe in the Hills and Mountains, while the strong competition from India (where fertilizer is half the price given larger domestic

subsidies) makes market efficiency even more important in the better connected Tarai. Addressing these different constraints is important to reducing spatial inequality.

52. There are many opportunities for private sector investment in hydropower development. There are currently about 8,500 megawatts of projects under development, with investment costs of about US\$15 billion, or almost 80 percent of GDP. However, progress has been slow, and projects have faced numerous delays. Nepal also needs to develop more off-grid technologies such as micro hydropower and solar and wind energy that may be viable means of providing smaller-scale electrification to rural and remote places, and which have the additional benefit of being more environmentally friendly. In transmission and distribution, there is a need to bring down technical and commercial losses, which are currently high at around 25 percent. Potential public-private partnerships in transmission and distribution could help. These investments can provide not just consumption benefits, but also promote a shift toward greater entrepreneurial activity, and formal employment, though the impact is likely to be smaller than grid connections.⁹⁴

53. The hydropower sector suffers from weak policy, an insufficient regulatory framework, and weak supporting infrastructure. Nepal lacks a long-term comprehensive generation expansion plan that considers electricity imports, and solar, wind, and hydropower, collectively. Though the government has announced plans to add 17,000 megawatts over the next seven years, it is unclear how this will be achieved. Institutional and regulatory frameworks need to be strengthened. Cumbersome processes are required to obtain clearances, get subsidies (in the case of off-grid options), and overcome other regulatory hurdles. There is a lack of a level playing field for independent power producers due to the strong NEA presence in generation and control over transmission and dispatch. The NEA dominates sector operations by generating over half of Nepal's total electricity supply, solely managing transmission of electricity to domestic load centers as well as to and from India, and distributing electricity to consumers across the country. These factors put it at a significant advantage in negotiations with private power producers and create conflicts of interest. As the sole offtaker of all electricity generated, it oversees negotiating Power Purchase Agreements with projects developed by independent power producers, as well as its own subsidiary companies.⁹⁵ The NEA has not developed internationally bankable standard Project Development Agreements or Power Purchase Agreements that can aid private sector investments. Other potential areas for conflict of interest include the time that NEA takes to complete Power Purchase Agreement negotiations, and the priority with which it invests in building the necessary transmission lines for projects developed by independent power producers compared with its subsidiaries.⁹⁶ Complimentary investments of US\$11.6 billion of new transmission lines and upgrades of the distribution system are required for this new capacity to reach consumers. However, these have been delayed in many cases by delays in land acquisition. Overall, there is a need to create a rationalized sector operating model that clarifies the roles of various public institutions regulating and operating in the sector, and standardization of processes and documents. Addressing these constraints will be essential to encouraging private investment in this sector.

54. Development of natural resources is also constrained by lack of planning and interagency coordination, and lack of clarity on rules for sharing the benefits of resource creation. Water resource planning, for example, is fragmented. The management of water resources is spread across five agencies that do not plan or implement activities and investments in a coordinated manner. Although Nepal has adopted a policy of integrated water resource management, implementation remains poor due to the need to coordinate across multiple agencies. Although investments in irrigation infrastructure are needed, they are likely to have modest impact if not combined with improved water distribution and efficient management. This is currently hampered by weak participation of Water Users Associations and weak institutional capacity.⁹⁷ The agriculture sector suffers from weak coordination, planning, and implementation among line ministries, and between local and central government. Similarly, in the forest sector, there is a lack of integrated landscape management. Further, the management of forests is divided between the federal government and local communities, with weak interagency coordination. The fragmentation of institutions also prevents Nepal from responding to the challenge of climate change effectively.

55. Current government processes support this lack of coordination, because financing is activity-based and there are no incentives to collaborate. The complexity of institutional arrangements is a "humanly devised constraint,"⁹⁸ and while it is not clear whether any group benefits from this complexity, it is not benefiting the public good. There is a risk that the new federal structure could lead to a further split of responsibilities, which are already poorly coordinated across agencies.

56. Revenue-sharing arrangements for investments in natural-resource-based goods and services need to ensure local affected communities benefit from such investments. Tax and royalty sharing arrangements are scattered across a variety of laws, regulations, and institutions, making them difficult to monitor and enforce. The new federal structure allows for royalty sharing to the federal, provincial and local governments. While local

governments can benefit from such taxes and royalties, few benefits are legally required to be shared with the local communities affected by, for example, hydropower generation facilities or tourism investments. Similarly, the legal rights to benefit from various forest products are scattered across various laws and institutions, and the process of allocating permits for various forest products is complex and lacks transparency. This has resulted in jurisdictional overlaps, inappropriate assignment of roles, and institutional inefficiencies, as well as some gaps in the permit allocation systems for forest activities and products.⁹⁹ Cumbersome permit procedures are biased in favor of powerful elites.¹⁰⁰

57. In sum, while Nepal's land, forests, and water provide productive and sustainable livelihoods, some of the same constraints that limit private sector investment and growth identified in section B.2 need to be addressed. Specifically, infrastructure in hydropower, roads, and irrigation needs to be built. Better governance of transport services is needed for road investments to contribute to more efficient markets. In addition, better regulations for sharing the benefits from natural resource development and clarity on institutional arrangements to support and protect natural resource management are needed. The ongoing Country Private Sector Diagnostic will further assess constraints and opportunities for private sector investment in agribusiness and tourism, among others.

4. Equitable investments and use of human capital

This will require addressing inequities in basic services based on proximity, affordability, and social norms; more information and competition in domestic job markets; tackling high malnutrition; and developing quality secondary and tertiary health and education services.

58. Nepal has made impressive gains in education and health and performs relatively well compared to its structural peers. Life expectancy, at 70 years at birth, is above the regional average and the average for Nepal's structural peers. The youth literacy rate is 85 percent in Nepal, higher than the South Asia region average of 83 percent. Access to good sanitation and clean water is comparatively high in Nepal.¹⁰¹

59. However, progress has also brought key challenges to light. Progress at the national level belies significant inequity that remains in investments in health and education, and the ability of individuals to use the human capital they acquire. High rates of malnutrition also ensure that inequalities at birth persist into adulthood. In addition, Nepal has struggled to go beyond community-led basic service provision to address more complex challenges, such as provision of curative health services, and high-quality secondary and tertiary education. Making progress on these challenges will be essential to ensuring poor households can invest in and use their human capital.

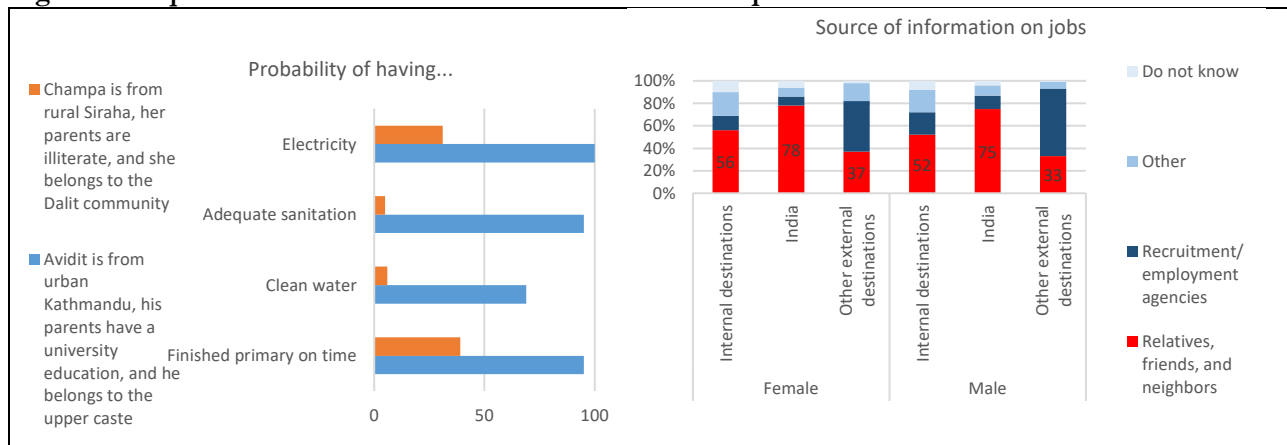
60. Spatial and socioeconomic disparities in health and education investments are considerable. Health and education investments diverge based on a child's location and parental characteristics (figure 8). Starting primary school on time; finishing primary school on time; being well-nourished in early childhood; and having clean water to drink, adequate sanitation, and electricity are in large part determined by a child's gender, parental wealth and education, and location (urban or rural; Mountains, Hills, or Tarai; central, eastern, midwestern, or far western region). An estimated 52 to 79 percent of the variation can be explained by these characteristics.¹⁰² Differences in location, parental wealth, and education often, but not always, reflect differences in ethnicity and caste.¹⁰³ Inequity in the quality of health and education services is also pronounced along these lines. Analysis of performance on national examinations such as the School Leaving Certificate or the National Assessment of Student Achievement administered to eighth graders, show the odds of passing to be skewed in favor of children with favorable birth circumstances.¹⁰⁴

61. The challenges of providing services in remote locations, the reliance on privately financed investments, and variations in social norms underpin these disparities. School quality, proxied by the education of the school principal, falls with remoteness, reflecting the challenge of quality service provision—public or private—in more remote locales.¹⁰⁵ The quality of health services in remote areas is compromised due to lack of infrastructure, frequent absenteeism of service providers, and shortage of drugs and supplies.¹⁰⁶ As a result, human capital outcomes are highly unequal along spatial lines. The predominance of private investments in education and health (on private services and fees in public services) reinforces inequities along wealth lines. Spending on health and education and private school attendance increases with wealth.¹⁰⁷ In addition, regional consultations highlighted that social norms and the expected benefits of education vary across communities and reinforce inequalities along gender and spatial lines.

62. High rates of malnutrition reinforce inequality of opportunity. Lack of adequate nutrition during a child's first 1,000 days (from conception to his or her second birthday) is strongly associated with lower cognition, executive function, and school attainment later in life. Improvements in Nepal's food security,

maternal education, and access to good sanitation, clean water, and basic health services resulted in the fastest recorded decline of stunting rates in the world from 2001 to 2011,¹⁰⁸ but Nepal also started with one of the highest global rates of stunting, and rates of malnutrition and wasting among children under five years of age are still very high (figure 9). Thus, malnutrition rates in Nepal are much higher than in the country's structural peers. The annual economic cost of malnutrition was an estimated 2 to 3 percent of GDP, using data from 2006. Malnutrition rates have fallen since then, but the cost is likely to be of the same order of magnitude.¹⁰⁹ Places with the highest rates of malnutrition have the highest rates of diarrheal disease and aflatoxin exposure, suggesting further progress in good sanitary practices, access to clean water, and food storage are needed in some districts.¹¹⁰ However, other studies highlight the need for more progress on inadequate maternal diets during pregnancy, complementary feeding practices, and dietary diversity (particularly among children).¹¹¹ More evidence on which interventions have the largest impact on reducing malnutrition in different districts would help prioritize local investments.

Figure 8 Inequalities in investments in and use of human capital



Sources: World Bank 2016a; Raju and Rajbhandari 2017.

63. Even when individuals have the skills and good health they need, underdeveloped labor markets and gender norms limit their ability to access jobs that are available.¹¹² Social networks dominate access to jobs, reinforcing inequalities. Only 10 percent of youth who are employed found their job through an advert or job center; most joined the family business or found their job through family and friends (figure 8). Two-thirds of individuals with postsecondary education work in the public sector,¹¹³ and as section B.1 documented, access to these jobs is highly skewed to certain segments of the population. Regional consultations repeatedly pointed to the problem of patronage and nepotism in determining who has access to jobs and government contracts. The one exception is non-Indian migration opportunities, which are largely found through formal means. Gender is also a significant determinant of labor market outcomes, both domestically and internationally, as few women migrate.¹¹⁴ Although female labor force participation is high, the quality of the work women are engaged in is low, largely because of strong gender norms around work. Women are more likely to be engaged in unpaid work.¹¹⁵ When they are in paid work, they are concentrated in informal employment and in agriculture, and when they are employed in wage work, they receive between half and two-thirds the earnings of men.¹¹⁶

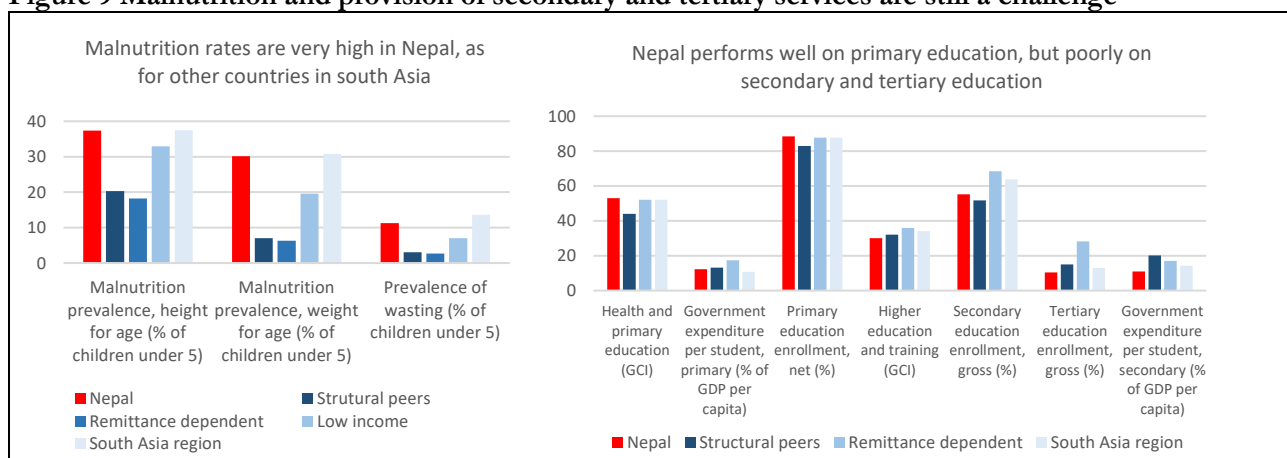
64. Addressing these drivers of inequity in the acquisition and use of human capital is essential to addressing the fundamental drivers of fragility in Nepal. Inequality in the use of human capital is also inefficient, and addressing these inequities will also contribute to growth. Addressing some of the norms that limit educational investments and that shape who gets access to which jobs can be challenging, but recent experiences in behavioral interventions addressing aspirations and gender roles has shown that some progress is possible.¹¹⁷

65. In addition, although Nepal has been able to achieve much through community-led basic service provision, it needs to go beyond that to provide quality secondary and tertiary health and education services. For example, Nepal compares well to peers on the share of women receiving prenatal checks, but poorly on the proportion of births being attended by skilled health workers.¹¹⁸ Less than half of health facilities can offer normal vaginal delivery services (and 5 percent cesareans).¹¹⁹ Similarly, primary enrollment rates are above those of structural and regional peers. Although there is significant room for improving the quality of primary education, the quality is not substantially lower than that of structural and regional peers.¹²⁰ However, secondary and tertiary enrollment rates are lower, in part reflecting lower public spending on secondary and tertiary education (figure 9).¹²¹ There may be room for the private sector to play a stronger role in providing health and education services in Nepal. Constraints to their greater involvement need to be studied and resolved. Firms do not provide much training to employees, perhaps because they are not large enough to benefit from investing in training. Firms that

provide training to their workers tend to be, on average, larger and more open to trade, and have higher foreign ownership and a workforce with more years of formal schooling, and there are few of these in Nepal.¹²² Nepal thus performs poorly on the Global Competitiveness Index on higher education and training, while performing well on primary education and health (figure 9).

As Nepal transitions to a federal structure, the challenge it faces is to protect the gains made in primary service provision, while doing much better in delivering quality secondary and tertiary health and education services. Education and health services were structured differently with different political economy challenges, yet in the absence of inclusive and accountable public institutions, both structures failed to deliver quality secondary and tertiary health and education services. The health sector resisted devolution and has been highly centralized, which has resulted in corruption in procurement in the central government and inadequate planning that does not meet the needs of local populations: 72 percent of primary health centers, 69 percent of health posts, 87 percent of sub-health posts, and 50 percent of hospitals surveyed had experienced stock-outs of one or more essential drug, ranging from one to nine weeks.¹²³ Devolution of education services in the early 2000s was much more complete. However, in the absence of local elections, devolution resulted in ample room for collusion and patronage politics at the local level.¹²⁴

Figure 9 Malnutrition and provision of secondary and tertiary services are still a challenge



Sources: Worldwide Governance Indicators and World Development Indicators using Find my Friends.

In sum, Nepal has made tremendous progress in improving human capital, but important inequities in health and in the acquisition and use of education, need to be addressed. Action is needed to address inequities based on proximity and affordability of services, and to modernize the domestic labor market and equalize access to jobs. In addition, the delivery of quality secondary and tertiary health services in a federal Nepal need to be improved.

5. Strengthening resilience to natural disasters and health shocks

This will require reducing environmental risk by addressing deforestation and improving watershed management, improving targeting and coverage of social protection, and enabling the development of insurance markets, particularly in health.

66. The degree and nature of vulnerability to natural disasters and health risk varies across Nepal. The eastern part of the country is wetter and the western part is more arid and exposed to greater climate risk. Rainfall levels are on average higher in the Tarai, but drought has the largest monetary and welfare impact there.¹²⁵ Drought also has a larger impact on welfare in places with lower access to markets (local production shocks have a larger effect on local food prices in remote areas, highlighting the potential impact of infrastructure investment on reducing vulnerability).¹²⁶ Health risk is larger in more remote regions because access to health services is more challenging. Thus, the most important constraints to reducing vulnerability vary across the country.

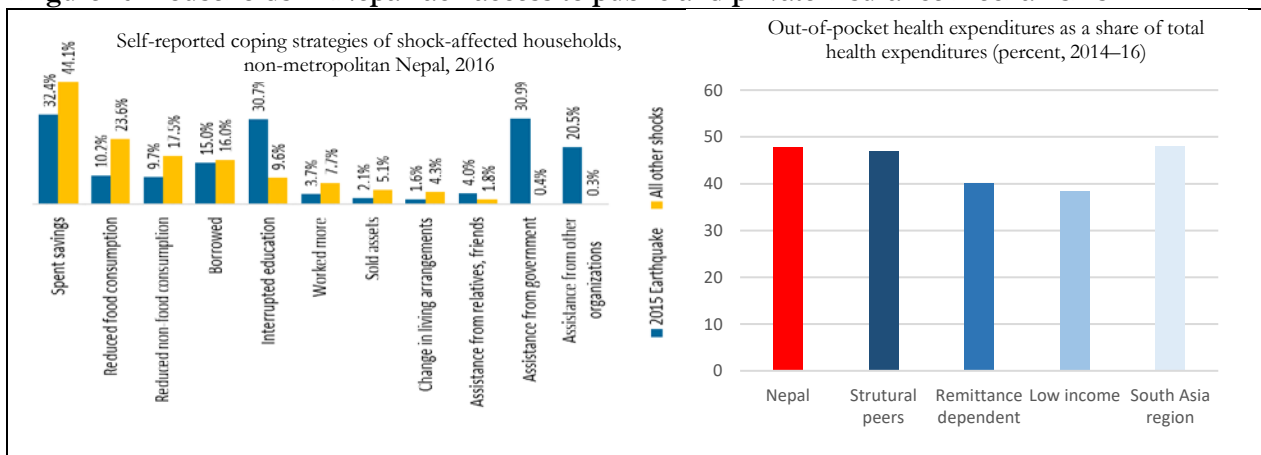
67. Some of the sources of environmental risk facing Nepal are beyond human control, but not all, and much more action needs to be taken to reduce exposure to risk. For example, glacial lake outburst floods (GLOFs) and landslides pose a significant national and regional risk that is increasing due to climate-change-induced glacier thinning and retreat in the Himalayas. Nepal has recently experienced 24 GLOF events, several of which have caused considerable damage and loss of life.¹²⁷ In the non-Himalayan region, climate change projections indicate that the risk of flooding will increase considerably in Nepalese river basins because of higher monsoon precipitation (a projected increase of 14 to 40 percent by the 2030s and 52 to 135 percent by the 2090s).

68. While action can be taken to reduce exposure to environmental risk, there has been limited action to do so, particularly to flooding. Flood risk is increased by deforestation and poor catchment management, and can be reduced by environmental stewardship through implementation of watershed management practices (such as groundcover, gully control, contour bunding, and afforestation). Addressing the drivers of deforestation (increased demand for forestland and products, lack of access to improved technology, absence of an inclusive forest policy process, weak rule of law, and social inequality) is also an important part of Nepal meeting its Nationally Determined Contribution.¹²⁸ Nepal aims to enhance its forest carbon stock by at least 5 percent from its 2015 level by 2025, and to decrease the mean annual deforestation rate by 0.05 percent.¹²⁹ Evidence on how much the risk of flooding can be reduced by addressing deforestation and improving watershed management practices would be useful. Similarly, investments in infrastructure and housing need to be made to make them more resilient to floods and earthquakes.

69. When shocks occur, they have a big impact on welfare in part because public safety nets are not ready to scale in the event of a disaster. Households have few safety net or other risk-pooling mechanisms such as insurance (public or private), which they can use to manage the impacts. Except for support received after the earthquake, public safety nets are infrequently relied upon by poor households to cope with disasters (figure 10). Transfers are poorly targeted to poor households (the same proportion of households in the bottom 40 percent and top 60 percent received government transfers in 2014), are small, and do not scale in the event of a disaster.¹³⁰ Therefore, the impact of social protection programs on poverty or inequality is more limited than it could be with better targeting and scalability.¹³¹ Disasters need to be tackled with increased preparedness, strengthened capacities for relief work during disaster, and institutionalized capacity for post-disaster rebuilding and recovery efforts. In the newly established federal political structure, this will require strengthening the capacity of local governments to respond.

70. Public health care does not insure households from the costs of care. Health care services that are offered for free or at a subsidized rate are limited to primary and some basic secondary health care services and to certain diseases or conditions, and increasingly this will not meet most health needs, with the changing pattern of disease. In more developed areas, private providers are more readily available and perceived as providing better quality than the public health system, causing households to invest in private care. Out-of-pocket expenditures comprise 48 percent of total spending on health care, which is comparatively high (figure 10). They comprise more than 4 percent of the total consumption of households in the bottom 40 percent, pushing many of these households into poverty.¹³² A social health insurance system has been initiated, but its coverage is very low.

Figure 10 Households in Nepal lack access to public and private insurance mechanisms



Sources: Nepal Household Risk and Vulnerability Survey, 2016 (sample frame excludes metropolitan areas as defined in 2010 Census), and Find My Friends using Health Nutrition and Population Statistics.

71. Private insurance markets are weak. No households report using private insurance. Transfers from family and friends are the most common source of cash in the face of emergencies, followed by savings.¹³³ The proportion of households that save, and save in formal institutions, is on par with or higher than in comparator countries, suggesting that financial inclusion per se is not a major constraint to addressing vulnerability.¹³⁴ However, savings are inadequate for larger or repeated shocks, and access to credit and insurance is limited. Some households reported borrowing to cope with shocks (figure 10), but this is primarily from nonformal sources with high average annual interest rates of 25 percent, and 5 percent higher for poorer households.¹³⁵

6. Getting more from international migration and remittances

This will require addressing constraints to private sector growth so that Nepal benefits more from the skills, entrepreneurial desire, and cash of returning migrants; providing training and information for migrants; and diversifying destinations.

72. In the medium term, large-scale international migration will remain an important fact of life in Nepal. The SCD has highlighted key constraints to the availability of and access to jobs in Nepal. If these constraints can be overcome, the benefits of staying in Nepal will increase and international migration will fall. However, progress will take time. Is there more that Nepal can get from migration in the meantime?

73. Remittances and returnee migrants represent opportunities for Nepal—opportunities for investment and entrepreneurship. Addressing the constraints to investment and entrepreneurship highlighted in sections B.2 and B.3 are essential to Nepal getting more from migration. The constraints to the use of remittances for productive investment are no different from the constraints highlighted, and there is little evidence to suggest that the cost of remitting is high. There is also little evidence that there are specific labor market constraints faced by returnees, just because they are returnees. However, rates of employment are lower among returnee migrants than among those who have never migrated.¹³⁶ This could be explained by the fact that they are about to migrate again, or by the fact that their employment aspirations have changed. Most migrants were in agriculture before they migrated and gained experience in nonagricultural sectors while abroad.¹³⁷ Although some wish to go back into agriculture, many (68 percent of those who plan to stay) wish to become entrepreneurs.¹³⁸ However, banking lending practices impose a serious constraint on some of Nepal's most innovative and technically-skilled returnees. Most do not own land, which partly explains why they had gone abroad, and so are unable to meet the collateral requirements of banks. Consequently, even though migrants generally have good access to financial services because of their need to remit income and so have established relationships with the banking system, and despite having generally high income levels, only 8 percent can access bank credit¹³⁹.

74. Ensuring safe and remunerative international migration and remittances is also important for welfare in the immediate term. The evidence points to two key constraints in this regard:

- i. **Lack of information, language, and soft skills on the part of migrants.** Most migrants (55 percent) report having a problem in their destination country. In most cases, this is due to the terms of work: 40 percent were paid less than agreed and 41 percent had a job different from the one in the agreed upon contract.¹⁴⁰ Migrants tend to overestimate how much they can earn.¹⁴¹ Providing more information on unexpected working conditions and other problems migrants face would help first-time migrants be more prepared, know what to expect, and know what recourse they have. It may also help some would-be migrants to better understand whether they will in fact benefit from migrating. Evidence shows that individuals respond to information when provided in a clear and concise manner by changing their priors and beliefs, and by changing their migration decision.¹⁴² In addition, learning the language in the destination country and some basic laws and legal rights would help migrants negotiate for better working conditions when possible. Migrants report no shortage of sources of information prior to departing, but nearly half were not satisfied with the information received because it was inaccurate or inadequate.¹⁴³ Making migration safer may also make it possible for more women to migrate.
- ii. **Macro-level risk from an undiversified pool of migrant countries.** Eighteen percent of Nepalese are out of the country, of which 6 percent go to India and 10 percent to Malaysia, Qatar, Saudi Arabia, and the United Arab Emirates. Demand for migrant workers to any one destination is subject to the specific economic and political shocks that country faces. Of concern is that some of these countries are vulnerable to the same macro-shocks, potentially rendering the total demand for Nepalese workers quite vulnerable. Diversifying the pool of countries would help reduce the risk. An additional justification for diversifying is to explore employment in labor markets (such as in East Asia and Europe) that have better labor laws, transparent visa systems, and protection of migrant workers, including the possibility of better contract enforcement. Diversifying into more skilled migration seems less feasible.

75. In addition, more evidence is needed to determine whether the cost of non-India migration is prohibitive for the poorest households. The cost of non-India international migration is much higher than India migration, and there is a tendency for individuals from poorer households with lower levels of education to migrate to India rather than to the Gulf or Malaysia.¹⁴⁴ Although data on the costs of migrating are limited, the cost data that are available do not suggest that the costs of travel and fees associated with non-India migration are particularly high.¹⁴⁵ However, the additional costs incurred via interest rates on loans to cover the cost, and the costs of working through manpower agents, make the costs much higher for some people. Household survey data reveal that households with migrants are more likely to be in debt than those without migrants, and interest rates

can be high.¹⁴⁶ More evidence on this is needed. It could be that financial market development for migration loans might make the most beneficial forms of migration more available to poor households.

Summary of Priorities

76. The SCD has highlighted priorities in each of the six areas for action, summarized in table 3. The most important priorities to address are considered in bold. Together these actions would allow Nepal to take advantage of opportunities for growth and poverty reduction that are being missed, would address sources of fragility, and would increase resilience. Failing public institutions underlie many of the challenges discussed. Federalism is a huge opportunity to address this constraint, and it is a priority to support Nepal’s transition to federalism to ensure that it results in more inclusive public institutions, and so that accountability, the rule of law, and capacity for governing are strengthened. Politically feasible progress in the other areas identified is also needed to address constraints to private investment—particularly in natural resource sectors such as agriculture, hydropower, and forests—through investment in infrastructure, the removal of barriers to competition that currently constrain private investment, and greater openness to external markets. It is also necessary to ensure that all Nepalese have equal access to the jobs created by addressing inequities in basic services based on proximity, affordability, and social norms; allocating jobs on merit; tackling high malnutrition; and developing quality secondary and tertiary health and education services.

77. Consultations confirmed these constraints as key challenges that citizens face in their everyday lives (see consultations annex for full details). Regulations and government involvement were ranked as the most important set of constraints in job creation, across all surveys. Access to markets and regulations were ranked most important for natural resource development. Quality of service delivery was the key issue for respondents of the face-to-face and Facebook surveys, but for the less educated SMS respondents from poorer districts, access to basic services was more important than quality. There was near-unanimous agreement that the main constraint to resilience is taking care of the environment, and that getting more from migration requires more opportunities for return migrants to invest their skills and capital.

78. Although many surveys are conducted in Nepal, there is a lack of current official data on household welfare, labor market performance, and firms. It is urgent that investment be made in updated data that allow disaggregation of these statistics for the newly created provinces. In addition, analysis of key development challenges can help encourage evidence-based public discourse on policy priorities. The SCD highlighted key knowledge gaps in this regard. The key knowledge gaps include (a) poverty trends since the earthquake, blockade, and slowdown of remittances; (b) how best to increase the accountability and strengthen the capacity of local governments; (c) the impact of lack of competition in specific sectors on job creation, prices, and welfare; (d) the potential for reducing environmental vulnerability through investments and of what type; (e) the political economy of multiple ministries in natural resource management and how to encourage consolidation; (f) which interventions are most effective to reduce malnutrition in different parts of the country; and (g) how to make the cost of migration more affordable for poor households. Throughout the report the importance of underlying political constraints to progress have been identified, and this points to the need for careful political economy analysis prior to new policies and projects being designed, to ensure politically feasible proposals are developed.

Table 3 Summary of priorities

Public institutions	Private sector investment	Human capital	Natural resources	Resilience	More from migration
Support for the federal transition and increased inclusiveness in the political process	Encourage investments in infrastructure (roads and electricity)	Address barriers to health and education posed by remoteness, low income, and norms	Support agricultural growth by improving market access, and year-round irrigation (particularly in the Tarai)	Increase action to reduce environmental risk	In addition to addressing constraints to private sector investment:
Improve accountability and strengthen rule of law	Strengthen regulation and reduce government involvement in markets	Reduce the role of social networks and nepotism in labor markets	Enable private sector investment in hydropower	Improve targeting and coverage of social protection	Provide information, language, and soft skills for migrants
Invest in capacity at subnational levels	Increase openness by reducing tariffs and increasing FDI	Reduce high malnutrition rates	Improve planning and interagency coordination	Enable the development of insurance markets, particularly in health	Diversify destinations for temporary migration
	Increase access to credit for women, rural entrepreneurs, and SMEs	Support the provision of quality secondary health and education			

Note: most important priorities are in bold.

Notes

¹ It is estimated that a third of economic activity is concentrated in the Kathmandu Valley, which accounts for 10 percent of Nepal's population (Nepal Rastra Bank 2012).

² World Bank 1964.

³ Poverty and welfare statistics are derived from a series of Nepal Living Standards Surveys conducted in 1995/96, 2003/04, and 2010/11. The years are referred to as 1996, 2004, and 2011 throughout the SCD.

⁴ Slides 1 and 2.

⁵ See slides 59 and 60 for selected macroeconomic indicators from 2013 to 2020.

⁶ World Bank 2017a.

⁷ The adult literacy rate in Kathmandu valley was 83 percent in 2011 compared to 43 percent in the mid-Western mountains (UNDP 2014)

⁸ World Bank 2016a; Shrestha 2017a (slide 4).

⁹ Shrestha 2017a (slide 5).

¹⁰ Shrestha (2017a) suggests village-level migration has a positive effect on labor force participation among households with a migrant (although less than the impact on households with a nonmigrant). Phadera 2016; Lokshin and Glinskaya 2009 (slide 6).

¹¹ Slide 7.

¹² Pattison 2013. However, Shrestha (2017b) documents lower mortality rates among migrants despite higher risks of some types of mortality such as cardiac arrest. This could be due to self-selection (migrants may be marginally healthier than nonmigrants), lower exposure to some types of health risk present in Nepal (such as traffic accidents), or misreporting of deaths.

¹³ World Bank 2016a.

¹⁴ World Development Indicators (WDI).

¹⁵ Slide 8.

¹⁶ Slides 9 and 10.

¹⁷ Ostrom 2002.

¹⁸ Slide 11.

¹⁹ Witter et al. 2011; DFID 2010 (slide 12).

²⁰ Slide 13.

²¹ Slide 14; World Bank 2017a.

²² Worldwide Governance Indicators (2015) reported in World Bank (2017b).

²³ World Bank 2017b.

²⁴ Slide 15; World Bank 2016a.

²⁵ Asia Foundation 2012.

²⁶ World Bank 2017b.

²⁷ Government of Nepal National Planning Commission 2015. The earthquake of 1934 killed 10,000 people and destroyed much of Nepal's infrastructure (World Bank 2017a).

²⁸ Tiwari, Jacoby, and Skoufias 2017; Shively 2017 (slide 16).

²⁹ World Bank 2016a (slide 16).

³⁰ Slide 18.

³¹ An asset framework has been used to structure the actions needed for Nepal to take advantage of opportunities for growth and poverty reduction: (a) increasing the return to human capital by addressing the constraints to firm investment and productivity; (b) using Nepal's rich natural capital—land, hydro, and forests—more productively and sustainably; and (c) enhancing human capital and equitable access to employment opportunities. This framework is taken from Bussolo and Lopez-Calva (2014).

³² Acemoglu and Robinson 2012; World Bank 2017a.

³³ IOM 2016.

³⁴ Raju and Rajbhandhary, forthcoming

³⁵ Slide 17.

³⁶ World Bank 2017a.

³⁷ Raju and Rajbhandhary, forthcoming (slide 15).

³⁸ World Bank 2016a.

³⁹ World Bank 2017b.

⁴⁰ Acemoglu and Robinson 2012.

⁴¹ Throughout the SCD, Nepal is compared to the South Asia average, and to a group of “structural” peers, countries that were identified as having a similar structure to Nepal: landlocked, agrarian, non-resource rich, population of 5 million to 50 million, and a per capita gross national income of between US\$600 and US\$1,400. This includes the following countries: Afghanistan, Burkina Faso, the Kyrgyz Republic, Mali, Tajikistan, Uganda, and Zimbabwe. Nepal is sometimes also compared to the low-income average, and the average for remittance-dependent countries (countries with a population between 5 million and 50 million and remittances of more than 15 percent of their GDP:

El Salvador, Haiti, Honduras, the Kyrgyz Republic, Lebanon, Tajikistan, and Zimbabwe). The Find My Friends tool was used to perform the comparisons.

⁴¹ World Bank 2017c.

⁴² This and the next three paragraphs draw heavily from World Bank (2017b).

⁴³ World Governance Indicators 2016 (slide 20).

⁴⁴ Asia Foundation 2016, 1.

⁴⁵ Adhikari et al. 2014.

⁴⁶ Slide 21 and The Record, Nepal 2017.

⁴⁷ Mathieson and Brown 2014.

⁴⁸ Asia Foundation 2012.

⁴⁹ The two castes are Chettri (warrior class) and Brahmins (intellectual elite and spiritual preceptors).

⁵⁰ Khanal, Sollewijn Gelpke, and Prasad Pyakurel 2012.

⁵¹ High caste groups refer to Brahmin and Chettri and excluded groups refer to Dalit and Madhesi. Data from Paudel (2016).

⁵² Paudel 2016.

⁵³ Adhikari et al. 2014.

⁵⁴ World Bank 2017d.

⁵⁵ The discussion of political criminality in Biratnagar in Adhikari et al. (2014) provides an example of this.

⁵⁶ Asia Foundation 2012.

⁵⁷ Asia Foundation 2012.

⁵⁸ Roubini (1990).

⁵⁹ ADB, DFID, and ILO 2009; MCC 2014; ODI 2014; World Bank 2015.

⁶⁰ World Bank 2017a.

⁶¹ Enterprise Survey 2013.

⁶² World Bank 2016b.

⁶³ The ICOR measures the marginal amount of investment capital necessary to generate an additional unit of production. Overall, a higher ICOR value indicates that investment is inefficient.

⁶⁴ World Bank 2017a.

⁶⁵ World Bank 2017a.

⁶⁶ World Bank 2017e.

⁶⁷ Two waves of World Bank Enterprise Surveys were conducted in 2008 and 2012. The data reveal that the average firm age (years of operation) increased from 9.6 to 14.2 between the two surveys. The difference in average age (4.6 years) corresponds with the time elapsed between the two waves of surveys, indicating that either no new firms were formed or that their rate of survival is very low. The same conclusion holds for manufacturing companies, the average age of which increased from 11.4 years to 15.6 years between the two surveys. Both cases point to significant barriers faced by new entrants.

⁶⁸ World Bank 2017a.

⁶⁹ Poudel 2015.

⁷⁰ Samriddhi 2016.

⁷¹ World Bank 2017e.

⁷² Slide 23.

⁷³ World Bank 2017d; (slide 24).

⁷⁴ World Bank 2016b

⁷⁵ World Bank 2017a; (slide 25).

⁷⁶ SMEs comprise more than 96 percent of the total industrial establishment, contribute 83 percent to industrial employment generation, and share 80 percent of the industrial sector's contribution to national GDP (Dahal and Sharma n.d.).

⁷⁷ Slide 26.

⁷⁸ Slide 28.

⁷⁹ Slide 27.

⁸⁰ Aryal and Holden 2011.

⁸¹ Rates of landlessness among rural households are very low in the Hills and Mountains (3 to 4 percent), and while they are higher in the Tarai (29 percent), only a third of these households are engaged in agricultural wage labor (Jacoby 2017). The Gini coefficient of landownership among all rural households is also higher in the Tarai (0.65) than in the rest of the Nepal (0.47 to 0.51), but it does not perform much worse than other countries in the region (India is 0.74), Bangladesh is 0.80), and South Asia does not compare poorly to global averages.

⁸² World Bank 2017h.

⁸³ Slide 29.

⁸⁴ Divanbeigi and Saliola 2017.

⁸⁵ Slide 30.

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- ⁸⁶ Emran and Shilpi 2012; (slide 31).
- ⁸⁷ ADB 2005.
- ⁸⁸ World Bank 2016c. Input use is relatively high (4 out of 5 households use fertilizer), and with a few exceptions do not show large gradients across consumption quintiles; (slide 32).
- ⁸⁹ Price transmission from regional, central, and border markets to local markets is very weak, suggesting low market integration (Shively and Thapa 2016).
- ⁹⁰ Shively and Thapa 2016.
- ⁹¹ Shrestha 2012.
- ⁹² In 2014, price inflation was 1.1 percentage points higher as a result of trucking syndicates in the Nepal Valley (Poudel 2015).
- ⁹³ World Bank 2017h.
- ⁹⁴ Meeks and Thompson 2017.
- ⁹⁵ Although the Power Purchase Agreement for Chilime started with Rs 3 per unit, the project had an escalation rate of 8 percent for 12 years. By year eight, the rate had equaled that of Khimti. Later, after much outcry from other interest groups, the escalation was revised to 6 percent per year for four more years. Chilime has established three separate subsidiary companies and there are concerns that they are also receiving beneficial Power Purchase Agreement rates.
- ⁹⁶ Rai and Neupane 2017.
- ⁹⁷ ADB 2005.
- ⁹⁸ North 1991.
- ⁹⁹ Multi-Stakeholder Forestry Programme, March 2014.
- ¹⁰⁰ World Bank 2011.
- ¹⁰¹ Slide 33.
- ¹⁰² World Bank 2016a; (slide 34).
- ¹⁰³ Bennett, Sijapati, and Thapa 2013.
- ¹⁰⁴ World Bank 2016a; (slide 35).
- ¹⁰⁵ Slide 36.
- ¹⁰⁶ Slide 37; and Kiran et al. 2013.
- ¹⁰⁷ Slide 38.
- ¹⁰⁸ Slide 40.
- ¹⁰⁹ World Bank 2012.
- ¹¹⁰ Slide 41; Miller et al. 2017; Shrestha and Cisse 2017.
- ¹¹¹ Cunningham et al. 2017; Shively and Sununtnasuk 2015; Harris-Fry et al. 2017; Andrews-Trevino and Ghosh 2017.
- ¹¹² Although benchmarking data show Nepal performing poorly on cooperation in employer-employee relations, hiring and firing practices, and flexibility in determining wages, there is little evidence that this affects the ability of individuals to access jobs that exist (Raju and Rajbhandari, forthcoming).
- ¹¹³ World Bank 2017f.
- ¹¹⁴ Eighty-seven percent of youth migrants are male; 30 percent of male youth had migrated for labor, compared to 5 percent of female youth (Raju and Rajbhandary, forthcoming).
- ¹¹⁵ Bennett, Sijapati, and Thapa 2013.
- ¹¹⁶ Slide 39; World Bank 2017f.
- ¹¹⁷ See, for example, Bernard et al. (2014), and Campos et al. (2015).
- ¹¹⁸ Slide 42.
- ¹¹⁹ Ministry of Health et al. 2017.
- ¹²⁰ Grade-specific literacy test scores are low, but better than those of several other countries, and average scores on the quality of the primary education system are at the same level as structural peers (slides 43 and 44).
- ¹²¹ Lack of comparable data on test scores at higher grades limits comparisons of quality at the secondary level. The low pass rates in the School Leaving Certificate are more an indicator of inequitable screening at higher grades than evidence that education quality is low.
- ¹²² Slide 45.
- ¹²³ World Bank 2017b; Asia Foundation 2012.
- ¹²⁴ For example, the personal driver of a national-level politician secured funding for the District Education Offices for relief teachers and then personally selected the relief teachers to be hired (Asia Foundation 2012, 19).
- ¹²⁵ Slide 48.
- ¹²⁶ Shively 2017.
- ¹²⁷ Slides 46 and 47.
- ¹²⁸ Ministry of Forests and Soil Conservation 2014.
- ¹²⁹ World Bank, forthcoming.
- ¹³⁰ Slide 49.

¹³¹ Slide 50.

¹³² Slide 18.

¹³³ Slide 51. In the case of transfers from family and friends, this may in part reflect the role of remittances, although family and friends are relied on only marginally more in Nepal than in other comparator countries with much lower rates of remittances.

¹³⁴ Slide 52.

¹³⁵ Slide 53.

¹³⁶ Raju and Rajbhandhary, forthcoming.

¹³⁷ IOM 2016; (slide 54).

¹³⁸ Slide 55.

¹³⁹ Finscope (2014).

¹⁴⁰ Slide 56.

¹⁴¹ Shrestha 2017b.

¹⁴² Shrestha 2017b.

¹⁴³ Slide 56.

¹⁴⁴ Slide 57.

¹⁴⁵ Slide 58.

¹⁴⁶ World Bank 2016a.

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