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A Vision for Nepal

Policy Notes for the Government

THREE "I"S FOR GROWTH: INVESTMENT, INFRASTRUCTURE, INCLUSION

VOLUME 1 | SYNTHESIS REPORT

WORLD BANK GROUP

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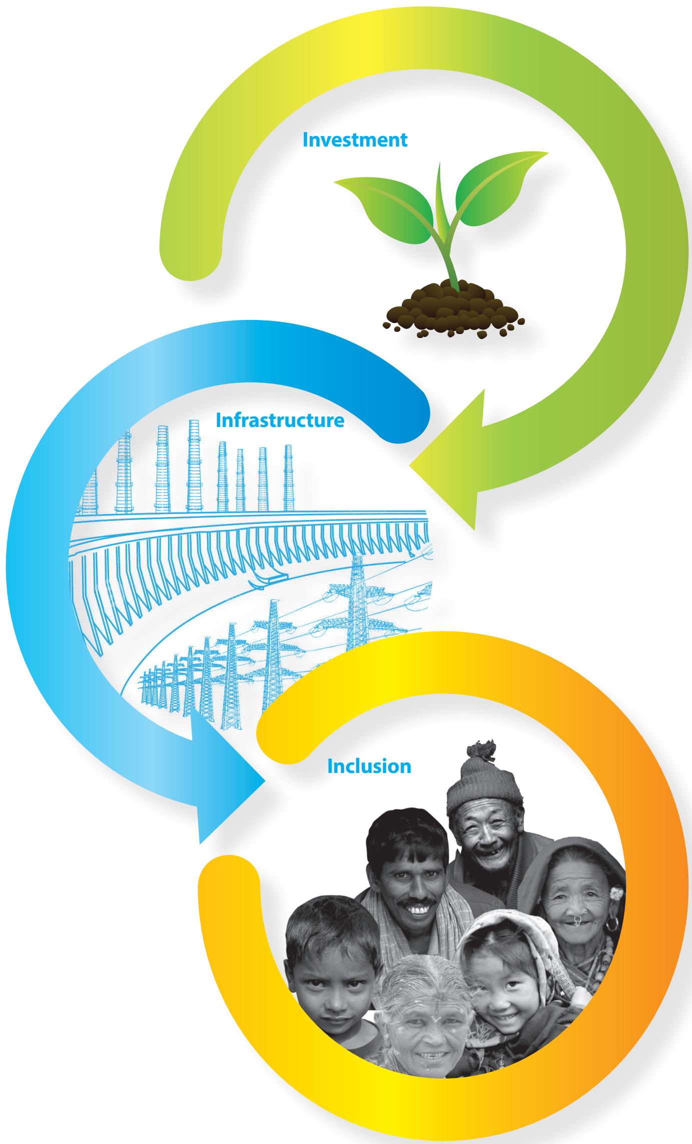

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WORLD BANK GROUP

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Table of Contents

SYNTHESIS REPORT

List of Figures

List of Tables

Abbreviations

ADB	Asian Development bank
ADBL	Agriculture Development Bank Limited
ADS	Agriculture Development Strategy
AML-CFT	Anti-Money Laundering – Counter Financing of Terrorism
BAFIA	Banks and Financial Institutions Act
BFI	Banking and Financial Institution
BIS	Bank for International Settlement
BOP	Balance of Payments
CIAA	Commission for the Investigation of Abuse of Authority
CIB	Credit Information Bureau
CIP	Country Investment Plan
CIT	Corporate Income Tax
CSR	Corporate Social Responsibility
DCGC	Deposit and Credit Guarantee Corporation
DCGF	Deposit and Credit Guarantee Fund
DDC	District Development Committee
DfID	Department for International Development
DMLI	Department of Money Laundering Investigation
DOI	Department of Industry
DoLIDAR	Department of Local Infrastructure Development and Agricultural Roads
DOR	Department of Roads
DPC	Development Policy Credit
DWSS	Department of Water Sanitation and Sewerage
EFA	Education for All
EGRA	Early Grade Reading Assessment
EVENT	Enhanced Vocational Education and Training Project
FCGO	Financial Comptroller General Office
FDI	Foreign Direct Investment
FI	Financial Institution
FIP	Foreign Investment Policy
FITTA	Foreign Investment and Technology Transfer Act
FIU	Financial Intelligence Unit
FMIS	Financial Management Information System
FRP	Financial Restructuring Plan
FSMD	Financial Sector Management Division

GA	Government Guarantee
GFCF	Gross Fixed Capital Formation
GFMIS	Government Financial Management Information System
IA	Indemnity Agreement
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
IPP	Independent Power Producer
IRD	Inland Revenue Department
JPM	Joint Monitoring Program
KUKL	Kathmandu Upatyaka Khanepani Limited
LLA	Land Lease Agreement
LPI	Logistic Performance Index
MDG	Millennium Development Goal
MDTF	Multi Donor Trust Fund
MFI	Micro Finance Institute
MIGA	Multilateral Investment Guarantee Association
MoAD	Ministry of Agriculture Development
MoF	Ministry of Finance
MoFALD	Ministry of Federal Affairs and Local Development
MOHP	Ministry of Health and Population
MoPIT	Ministry of Physical Infrastructure and Transport
NARC	National Agriculture Research Council
NASA	National Assessment of Student Achievement
NASDP	National Agriculture Sector Development Plan
NBL	Nepal Bank Limited
NEA	Nepal Electricity Authority
NEGRP	National Early Grade Reading Program
NIDC	Nepal Industrial Development Corporation Ltd.
NLSS	Nepal Living Standards Survey
NMIP	National Management Information Project
NOC	Nepal Oil Corporation
NPC	National Planning Commission
NPL	Non Performing Loans
NRB	Nepal Rastra Bank
NRBA	Nepal Rastra Bank Act
NSNS	Nepal Safety Net Survey
NWSC	National Water Supply Company
OAG	Office of the Auditor General
OCR	Office of Company Registrar
OECD	Organisation for Economic Co-operation and Development
ORA	Operational Risk Assessment
PAC	Public Accounts Committee
PDA	Project Development Agreement
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFMRP	Public Financial Management Reform Program
PPA	Power Purchase Agreement
PPMO	Public Procurement Monitoring Office
PPP	Public Private Partnerships
PRG	Partial Risk Guarantee

RBB	Rastriya Banijya bank
ROSC-A&A	Report on Observance of Standards and Codes – Accounting and Auditing
ROW	Right of Way
SCB	State Controlled Bank
SME	Small and Medium Enterprises
SMLE	Small Medium and Large Enterprises
SP	Social Protection
SPFMP	Strengthening Public Financial Management Project
SSRP	School Sector Reform Program
T&D	Transmission and Distribution
TEVT	Technical Education and Vocational Training
TIA	Tribhuvan International Airport
TIN	Taxpayers Information Network
TSA	Treasury Single Account
USAID	United States Agency for International Development
VDC	Village Development Committee
WHT	Withholding Tax
WUA	Water Users Association
WUC	Water Users Committee

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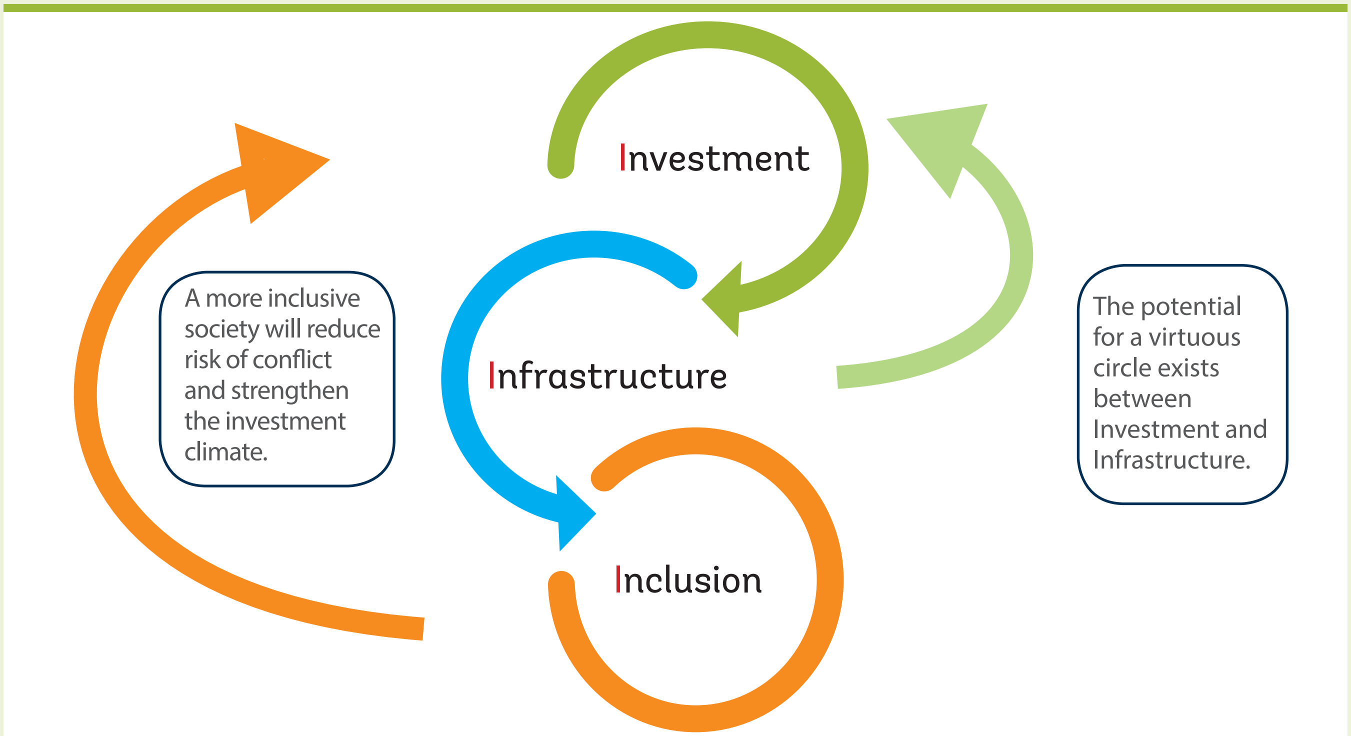
Executive Summary

Nepal needs a new economic model to achieve faster and sustained growth as well as further improvements in human development and poverty outcomes. Economic growth, while robust at around 4 percent annual average since 2005, is far from the level needed to achieve the government's ambitious targets. The economy, highly dependent on remittances, lacks the necessary dynamism. While substantial gains have been made to reduce poverty and expand access to services, achieving further progress will require more determined and targeted state intervention.

To redefine Nepal's growth model, public policy should focus on 3 "I"s: Investment, Infrastructure, and Inclusion. Investment is the bedrock of a sustainable growth model but in Nepal, the state, firms and households critically under-invest, with gross fixed capital formation between 19.9 and 22.2 percent of GDP over the past decade (compared to 30 percent or more in fast-growing countries in East Asia). In order to unlock investment as well as to expand access to services and opportunities for all, public infrastructure is critical, but Nepal is under-connect-

The 3 "I"s for growth



ed and under-powered. Finally, growth alone will not 'deliver' continued fast progress on inequality and poverty reduction unless the growth model is calibrated for inclusion, which in turn can help sustain dynamic growth.

To allow public and private investment to flourish, a more conducive environment is needed. In Nepal, the main building blocks of improving the environment for investment would include:

(i) *Strengthening the financial sector:* to make it more resilient to shocks, more efficient in intermediating savings for productive use, and better able to reach those firms and households currently un- or under-served.

(ii) *Improving the investment climate:* to remove the obstacles that firms (domestic and foreign) face in setting-up and expanding operations in Nepal. This agenda would focus on alleviating the regulatory burden on firms, reducing non-wage costs of labor, effectively incentivizing production for export and offering foreign investors easier access to Nepal.

(iii) *Streamlining public financial management:* to leverage the significant fiscal space that Nepal enjoys and enable public expenditure management to work better. This would require aligning budgets to policy priorities, boosting utilization and ensuring greater value for each rupee spent.

The state has a key role to play –and adequate fiscal space– to boost infrastructure, which is central to meeting both investment for growth and inclusion challenges. Good public infrastructure is necessary to crowd-in private investment in the first place. Moreover, improved supply of energy and transport connectivity can help small producers grow their business – with better access to markets– and households to make effective use of social services. But Nepal's infrastructural challenges are formidable. World Bank estimates suggest infrastructure investment needs per year of between 8 and12 percent of GDP (in 2010 terms) until 2020 across all sectors. Necessary investment would need to address both a quantity and quality deficiency, particularly in the two central infrastructure sectors: transport and energy. A minimum reform agenda would include:

Investment needs per year by sector 2011-2020

Sector	Average share of GDP, in %
Electricity	3.3 - 4.5
Transport	2.3 - 3.5
Water & sanitation	1.1 - 1.6
Irrigation	1.0 - 1.5
Telecom	0.3 - 0.4
Solid Waste	0.2 - 0.3
Total	**8.2 - 11.8**

Source: World Bank 2014

(i) *Unlocking Nepal's hydro-potential*: out of an economically viable 43,000 MW, Nepal has an installed generation capacity of only 746 MW (July 2013), of which 704 MW is grid-connected. But the peak demand can reach 1,095 MW and suppressed demand may be significantly higher. Hence, focusing on core bottlenecks that currently hold back public and private investment will be needed. This includes putting NEA on a sound financial footing, enhancing the policy framework to provide appropriate incentives to private investors, and enhancing policies for the compensation of affected persons (including those living along power line rights-of-way).

(ii) *Expanding connectivity within Nepal and with its neighbors:* this would require improving the efficiency of spending on transport infrastructure through more attention on maintenance and better coordination across implementing agencies, as well as greater focus on transformational interventions, such as the Fast Track (Kathmandu-Terai) project.

(iii) *Improving the supply of water and sanitation services:* this would involve a two pronged approach to improve the sustainability of rural water supply schemes and incentivizing urban providers to deliver better services.

Higher growth is a necessary but insufficient condition for reducing poverty and inequality at a fast pace. Past achievements have been enabled to a large extent by the private contributions of Nepal's migrants and highly resilient communities. In order to walk the extra mile, active promotion through inclusive public policies will be needed to reach remaining pockets of deep, entrenched poverty, ensure that opportunities –not just income- are effectively available to all Nepali and to provide those vulnerable with adequate protection against shocks. A more inclusive society –thus defined- would not only be conducive to social stability, but also enable all Nepalis to project themselves in the future and effectively participate, through greater investments in human and physical assets, in growing the economy. The building blocks of such an expanded inclusion agenda could include:

(i) *Boosting agricultural productivity and diversity:* because any gains in the agricultural sector, which accounts for over one third of GDP and employs around three-quarters of Nepal's population, would immediately and automatically reach the poor. This could be achieved by public initiative to boost cooperation and research in agricultural technologies as well as targeted programs to develop agribusiness and value chains with export potential.

(ii) *Expanding the opportunity set of all Nepalis:* through interventions in the health and education sectors to remove remaining social and economic barriers to access to services and to enhance service quality in order to leverage access gains.

(iii) *Enhance the poverty impact of social protection programs:* by limiting further proliferation of programs, strengthening core administrative systems and developing a program explicitly designed to address poverty and other priority risks and vulnerabilities.

(iv) *Preparing for decentralization:* because the move to a federal state will imply a fundamental administrative restructuring, it is key to ensure that the administrative systems are in place for service delivery to proceed and that the new roles of each level of government are clear and funded. At a minimum, the Government should establish the institutions that will be responsible to steer the transition process and determine intergovernmental financial flows and develop a framework for transferring tasks and staff across levels of government.

Nepal has a fantastic opportunity to lay solid foundations for future prosperity. The framework outlined above is proposed as an input for discussion and backed-up by detailed analysis in the Policy Notes and the synthesis report.

Introduction

1. A Nepalese proverb states that "opportunities come, but do not linger", and in Nepal the time to seize them is now. Indeed, missed opportunities do stick around: the failure to create and nurture a dynamic growth environment has long lasting negative effects – so called opportunity costs – in terms of welfare and development. In recent years, Nepal has not fared as well as its peers and neighbors in South Asia. But with increased political stability comes the opportunity to catch up, by fully leveraging the country's untapped potential.

2. Nepal has achieved important progress in the past, but the current growth model needs to be re-engineered for further and faster improvements to materialize. Today, economic growth in Nepal is essentially attributable to consumption – backed by remittance transfers – and a significant expansion of the services sector. This is problematic because investment – not consumption – is needed to expand the economy's productive potential going forward, while the industrial sector offers greater potential to achieve productivity gains and integration in global value chains, as well as to absorb excess labor. A glaring manifestation of Nepal's investment deficit is the country's formidable infrastructure gap. Moreover, it may not be wise to assume that surplus labor can be indefinitely absorbed oversees nor is it optimal from a social point of view. In other words, faster growth is needed "at home" to create jobs domestically for Nepal's youth. It follows that one of the key challenges for Nepal in the middle run will be to unlock its resources – public and private – for investment. Given that efficient infrastructure is at the center of a dynamic investment climate, the immediate task will be to tap Nepal's hydropower potential to solve energy bottlenecks and boost public income through electricity trade with India and other neighboring countries. Another immediate priority is to develop transport infrastructure to assure connectivity across the country and access to markets, including foreign ones.

3. Inclusion policies are highly complementary – and in fact integral – to growth strategies. On the one hand, growth alone does not guarantee commensurate improvements in human development or a fair distribution of related benefits; on the other hand greater inclusion can also promote faster growth. First, it would be misguided to assume that the impressive progress achieved to date in reducing poverty and inequality will continue automatically and in linear fashion: this is because the poverty reduction elasticity to growth diminishes in the absence of supportive policies. In fact, many countries at more advanced stages of economic development have struggled to bring poverty prevalence below the 25% mark where Nepal has arrived today. Moreover, fast progress in the past materialized from a low starting point and much more needs to be done in Nepal to promote true equality of opportunity, social mobility as well as to leverage significant gains in access to services by respective improvements in quality. Second, more inclusive societies, where all have access to similar opportunities irrespective of initial economic and social conditions, also grow faster. Because individuals and households have greater incentives to invest into human capital and the future.

4. The policy notes propose a framework to promote faster, sustainable and inclusive growth in Nepal. Today, the country is characterized by persistent weakness in its investment climate and infrastructure, jointly constituting significant constraints to exploiting the country's full growth potential. Although Nepal was able to achieve solid improvements in human development in spite of these constraints and even during conflict, future development, further poverty eradication and progress towards an inclusive Nepalese society will crucially depend on achieving faster economic expansion. This will be done by creating an attractive business environment for investment and forcefully resolving infrastructure bottlenecks. Higher growth, in turn, needs to be calibrated for inclusion to ensure that the benefits of greater prosperity are adequately shared, with additional safeguards so that those vulnerable or unable to exploit or access the opportunities allowed by higher growth are not left behind. In short, the overall development challenge for Nepal is to promote faster, sustainable and inclusive growth. The government has the great opportunity and responsibility to build strong foundations for the future, not only through a new constitution, but also through implementing a focused and strategic development vision.

5. Developing a clear vision is a first necessary step, which must be matched by implementation. Because Nepal faces a myriad of challenges, identifying those that are most binding and urgent is a precondition to developing plans that are workable, prioritized and that can be effectively monitored. Articulating such a vision that reflects the aspirations of the Nepali people is the government's prerogative. In this report, the World Bank simply seeks to facilitate such discussions by outlining the possible contours of a minimum agenda focused on 3 "*I*"s for growth: investment, infrastructure and inclusion. In doing so, the policy notes implicitly recognize the importance of implementation (and related institutional) challenges across all areas by focusing the proposed reform agenda on feasible policies and quick wins that can be achieved realistically in the short run. Implementation of those policies can kick start a virtuous policy cycle, while signaling to prospective investors that the Nepali authorities are serious about and focused on reforms.

6. This synthesis note lays out a strategic vision for Nepal's development, based on 3 "*I*"*s* for growth. The next two sections provide a short analysis of Nepal's recent and current growth model and performance. It puts into perspective the substantial achievements in human development and poverty reduction the model enabled, and its limitations in moving towards faster growth, middle income status and shared prosperity. Then, the concept of the 3 "***I***"***s*** is introduced in more detail, explaining why the chosen dimensions are so central in the short to middle run. The last section summarizes and concludes with key policy recommendations presented in a summary table. Each of the subjects discussed in this synthesis note are covered in greater depth – including detailed analysis and policy recommendations – in individual policy notes.

Nepal's Recent Development Experience

7. Nepal's recent development trajectory has been atypical, reflecting the country's unique sources of strength and resilience as well as fragility. Most countries that emerge out of conflict experience growth accelerations (linked to reconstruction), while poverty and human development outcomes (more dependent on systemic improvements) tend to lag. Nepal offers a mirror image of this standard pattern. Its economy has grown reasonably, but comparatively slower than in the past and its neighbors and peers in South Asia. Moreover, structural transformation characterized by a growing contribution of light manufacturing and integration in international value chains if anything, has taken place in reverse. This calls into question the dynamic potential for economic expansion in the future. By contrast, poverty has been reduced sharply, while most indicators of human development and access to services have improved, albeit remaining at basic levels and with enduring concerns over quality.

8. Therefore, the main challenge going forward will be to rekindle growth and to put the economy on a permanently higher expansion path. This implies focusing on investment-led growth – rather than consumption – which is necessary to achieve economic diversification (and to actually give the manufacturing sector a chance). It is also necessary to increase the potential to reap productivity gains in existing sectors.

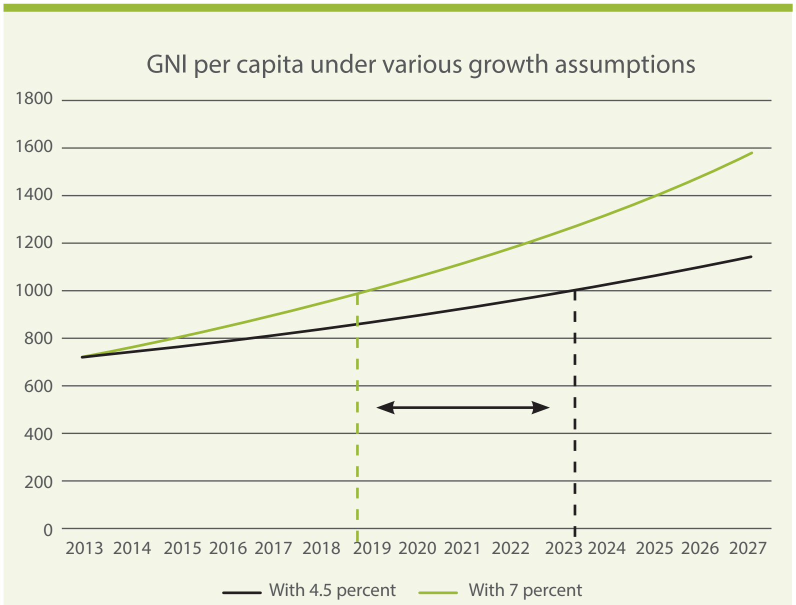
9. At the same time, the fight against poverty is far from over. Two challenges stand out. First, while poverty has fallen significantly in recent years, there are still pockets of entrenched deprivation including in Nepal's more remote regions and marginalized communities. Reaching these pockets –and walking the extra mile of poverty reduction – will be significantly harder. Second, while most Nepalis are now above the poverty line, a large majority remains precariously close to it. This means that the risks of falling back into poverty are still high for many and the scope for families to accumulate the capital (including human) needed for sustainable prosperity remains limited.

10. Inequality in access to key opportunities also remains high. Income equality is only one dimension of an inclusive society, which, ideally, should also deliver equality of opportunity (the ability for all to achieve their full potential irrespective of initial conditions). In Nepal, while there has been notable progress in expanding the reach of social services, inequalities in access persist significantly at all but the most basic levels of provision. Moreover, the quality of even basic education and health services is too low to offer their beneficiaries a meaningful chance at increasing their prospects of becoming more productive and competitive participants in tomorrow's labor markets.

Economic growth and structural transformation

11. In order to make a major development leap towards middle income status, Nepal should strive to boost middle-run real GDP growth to around 7%[1]. While possible in theory, such an increase in average annual growth from the current 4.2% (2005-2013) will require tapping Nepal's growth potential to the fullest through substantial recalibration of the country's growth model towards investment. Even under favorable conditions such as solid public finances, a stable and well financed current account balance (through solid export performance and stellar remittance growth) and increasing agricultural and service sector output, long run growth projections remain in the 4-5% range. Hence, Nepal's growth challenge is nothing less than formidable and will need maximum political determination across all major policy areas.

FIGURE 1: The opportunity cost of current growth



Source: Authors' calculations

12. The civil war which lasted almost a decade – from 1996 to 2006 – coincided with a clear kink in Nepal's hitherto ascending growth trajectory. From the late 1960s / early 1970s onwards, growth began to pick up significantly and steadily (on average), albeit with significant swings. It started at a low average of just under 2% between 1965 and 1974 but rose consistently to 3.2% and 5.2% in the following two decades, respectively. Growth also became significantly less volatile. While economic activity swung sharply until the mid-1980s, with peaks at 8.3% and 9.7% in 1981 and 1984 followed by sharp decelerations, the band narrowed thereafter with growth oscillating between a onetime low of 1.7% and a high of 8.2% in the following decade. However, while this relative stability remained during the years of conflict (1996-2006), the pace of growth slowed down significantly – though not dramatically – by a full percentage point on average. Going forward a key challenge will be to achieve greater stability and higher growth concomitantly.

13. Economic activity did not rebound once hostilities subsided. The absence of a clear-cut peace dividend can be explained in a variety of ways. First, though protracted and deadly, the civil war in Nepal did not result in a significant destruction of physical infrastructure, nor did it trigger massive inflows of aid and investment once it ended. Second, while active conflict effectively subsided, the conflict's legacy of political instability (with a rocky transition from autocratic rule to multiparty democracy) has persisted until today.

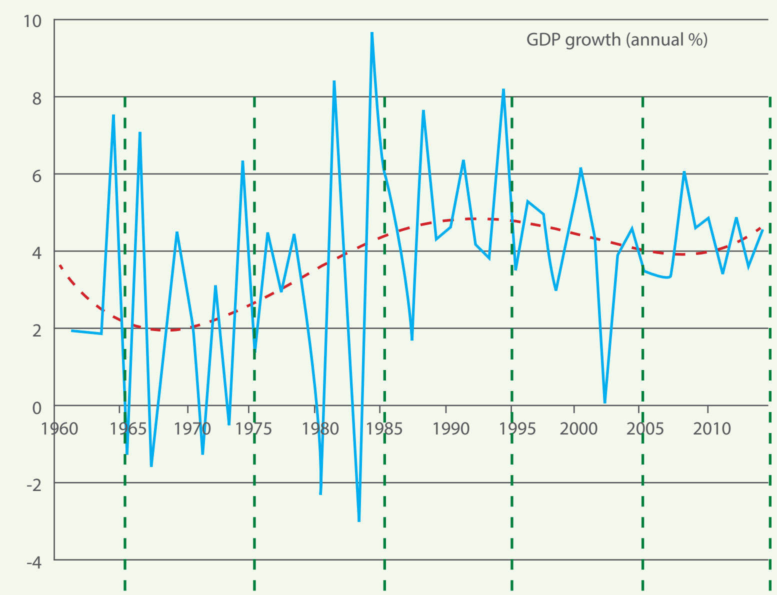
14. Rather than the absence of a sharp 'one off' growth spurt following the conflict, a more worrisome feature of Nepal's recent economic performance has been the fail-

[1] More precisely, assuming an average GNI growth rate of 7 percent from FY2014 onwards and a constant annual population growth rate of 1.2 percent, Nepal would achieve lower middle income status as defined by a GNI per capita>1035 US$ by 2020, while maintaining the current 4.2 percent annual growth would yield this outcome only by 2025.

ure to maintain the steady rise in the rate of growth. Indeed, since 2005 the average rate of economic growth has remained close to 4%. This failure to rekindle growth in the aftermath of the civil war has resulted in a gradual de-linkage between Nepal and the rest of South Asia. While Nepal's GDP per capita has been consistently below that of Bangladesh, India or Pakistan, the gap has increased sharply as the latter countries experienced strong *and sustained* growth accelerations. In 1995, at the onset of the civil war, the difference in GDP per capita between Nepal and Bangladesh was US$35. By the end of the conflict, in 2005, it had widened to US$100. Seven years later it stood at almost US$200 indicating Nepal's failure to maintain, let alone close the gap with its faster growing neighbors.

15. The apparent "growth plateau" at which Nepal appears to have arrived – and possibly remained stuck – has been associated with (i) a shift in the drivers of economic growth, and (ii) low levels of investment. Nepal has not followed the path of structural transformation typically experienced in fast growing emerging economies. Although Nepal remains overwhelmingly rural, the contribution of agriculture to total value added has been declining steadily. While it made up three fourth of total gross domestic product in the mid-1970s, that share has fallen to under 35% today. Until the mid-1990s and the onset of conflict, the relative decline in agriculture benefited both industry and services – each gaining importance in roughly equal proportions. However, after that, there was an inflexion with the share of industry falling from a peak of 23% in 1996 to a paltry 15% today. By contrast, the relative contribution of services in GDP grew from 36% at the onset of civil war to over half of the total today. In the period from 2005 to today, industrial growth was negatively correlated with overall growth indicating the declining contribution of industry to economic growth[2].

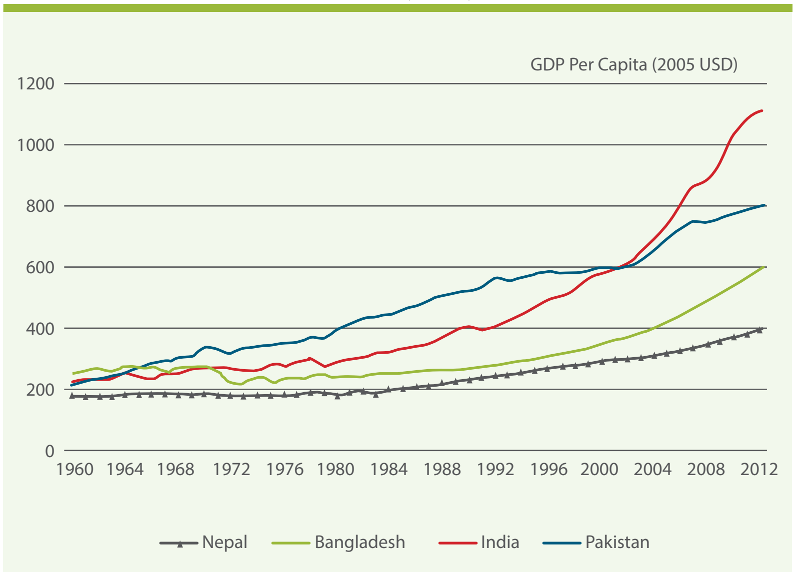
FIGURE 2: **Nepal's growth trajectory at a plateau**



Avg. Growth annual %	1.98	3.22	5.16	4.10	4.18
	1965-74	1975-84	1985-94	1995-04	2005-13

Source: World Bank, World Development Indicators

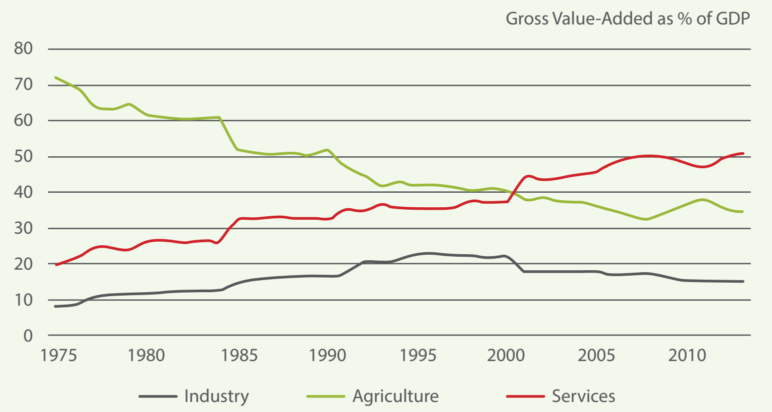
FIGURE 3: **Per capita income has increased only slowly, despite slower population growth**



Source: World Bank, World Development Indicators

2 and possibly even –although this would require fuller documentation- the adverse effect of remittance driven real appreciation on Nepal's external competitiveness

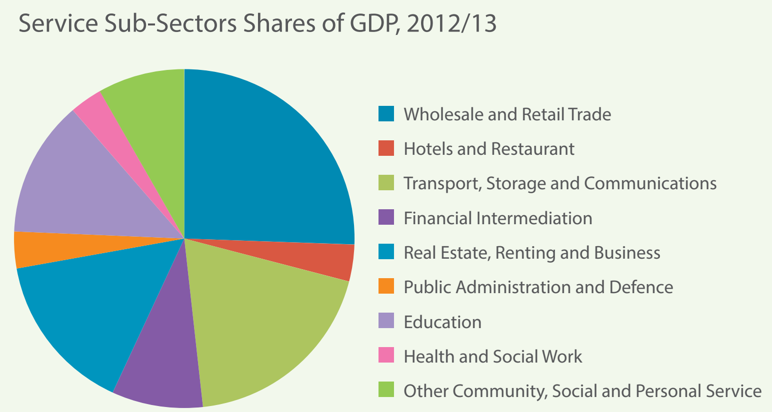
FIGURE 4: Shifting drivers of growth and the rise of services

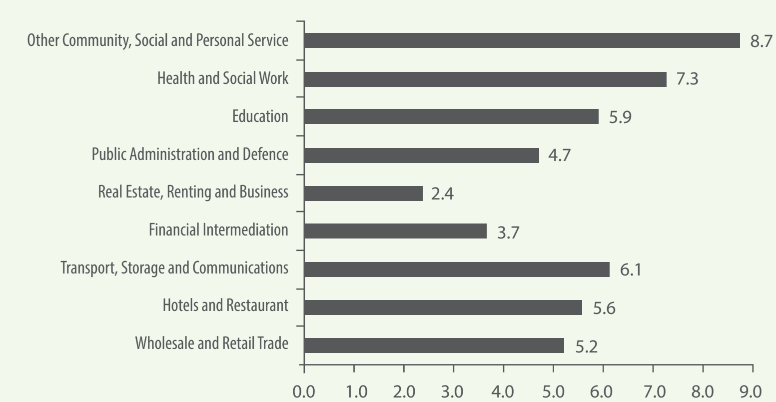


Coefficient of correlation with overall growth			
Value-Added Growth	Agriculture	Industry	Services
1974-1984	0.81	0.39	0.78
1985-94	0.68	0.36	0.33
1995-2004	0.49	0.74	0.81
2005-2012	0.65	-0.48	0.84

Source: World Bank, World Development Indicators (and authors' calculations)

FIGURE 5: Basic services dominate the landscape





Average Growth Rates of Service Sub-Sectors, 2008/09-2012/13 (Constant Prices)

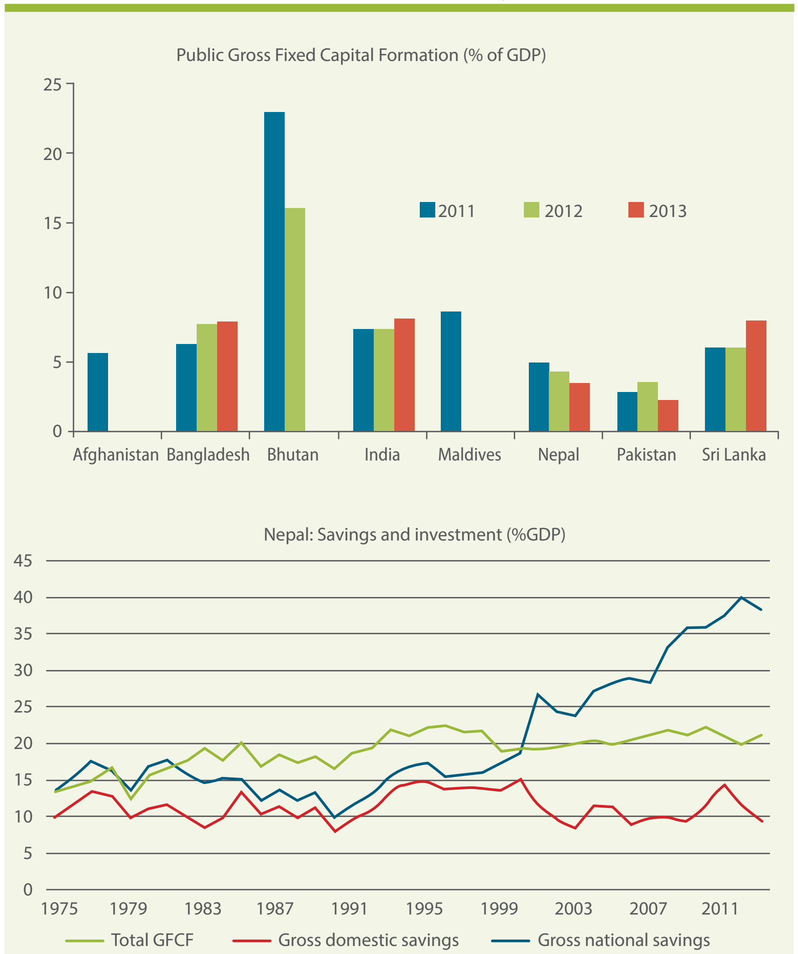
Source: Nepal Rastra Bank

16. An important question is whether the services sector constitutes a solid foundation for future economic expansion. The extent to which Nepal's services sector can drive faster growth in the future is doubtful for at least two reasons. First, unlike in India, the services sector is overwhelmingly informal and unsophisticated with little potential for productivity growth or generating spillover effects. The services sector – in terms of contribution to GDP – is dominated by wholesale and retail trade, followed by community and social services, real estate and education services. In terms of growth, the most dynamic subsectors have been community and social services, health and social work and education. Second, the expansion of the services sector has been closely linked to the dramatic rise in remittance transfers, whose potential for further growth appears limited (given already very high levels).

17. The economy-wide potential for growth has been depressed by low levels of public and private investment, despite available financing. Gross fixed capital formation (GFCF) as a share of GDP has risen only moderately between FY05 and FY10, from 20% of GDP to a peak of 22.2% before ebbing again down to just above 21% in FY13, significantly below the shares observed in other South Asian countries (Pakistan excepted). During that period, government GFCF has remained in a narrow band between 2.7% and 4.7% of GDP, falling to a paltry 3.5% of GDP in 2013. Strikingly, such modest levels of investment are not symptomatic of tight fiscal balances and/or excessive recurrent spending: between FY10 and FY13, the budget balance has oscillated between a low (deficit) of 1% of GDP and a high (surplus) of 2% of GDP in FY13 – with Nepal the only country in South Asia to report a budget surplus in that year. Likewise, private investment has remained subdued despite expressed potential interest of foreign investors (and Nepal's unexploited hydroelectric capacity) and high private external inflows amounting to over 25% of GDP. The spectacular growth in remittance transfers in recent years has translated into a buildup of liquidity in the financial system but relatively low uptake by the private sector in terms of credit. Moreover foreign direct investment has increased but from a minuscule base (from US$38 million in FY10 to US$102 million in FY13) and remains marginal as a share of GDP (0.5% in FY13).

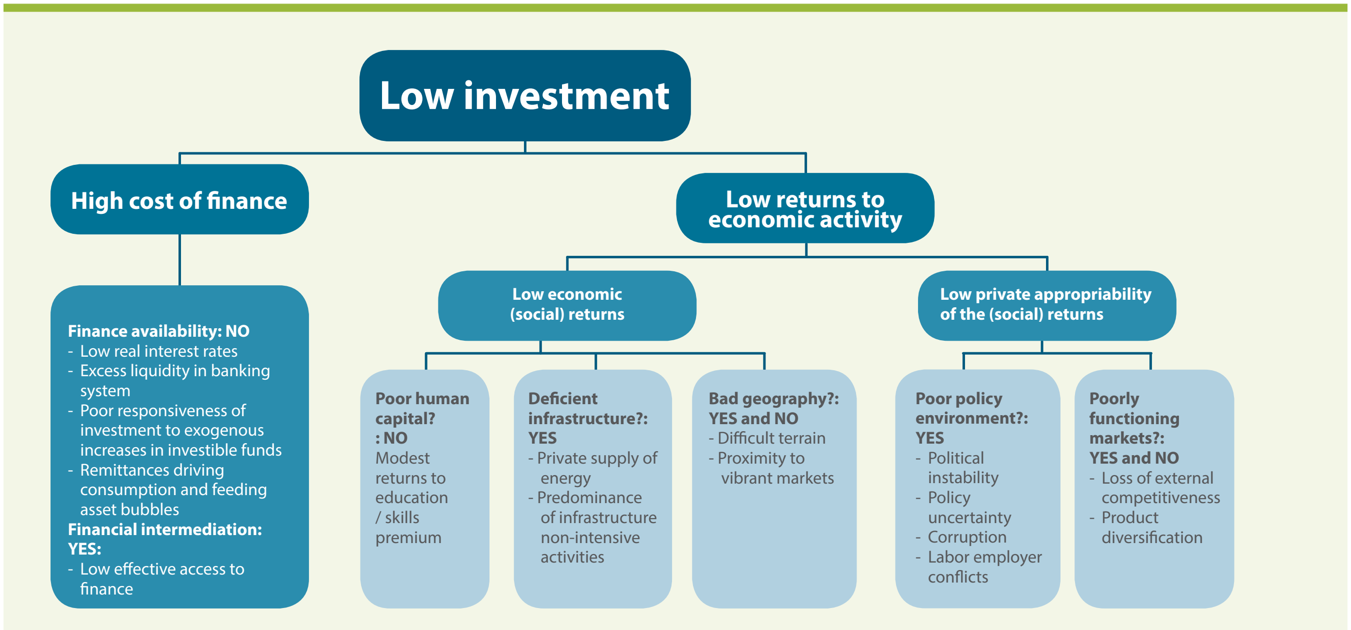
18. Understanding and overcoming the constraints to both public and private investment is probably the single most important development challenge for Nepal in the short term. Addressing some of these constraints, such as political instability or the competitive disadvantage brought about by real currency overvaluation (under the combined impact of the peg to India's currency and large inflows of private transfers) may not be politically feasible or economically desirable in the short run. However, much can still be done to boost investment and put Nepal back on a higher growth trajectory. At minimum, policies should target core bottlenecks to private investment including a weak investment climate and a massive infrastructure gap.

FIGURE 6: Total investment too slow to support dynamic growth



Source: World Bank, World Development Indicators and Nepal Rastra Bank

FIGURE 7: Bottlenecks to investment



Source: Authors' elaboration based on growth diagnostic studies

Achievements and Remaining Challenges in Poverty Reduction and Human Development

19. Despite relatively modest growth, Nepal has achieved major strides in poverty reduction and human development. Over the past fifteen years, real per capita consumption has grown by an average of 3.5% per year and the Human Development Index has improved at a rate of 2.6% per year through 1980-2010. In terms of poverty, some 25% of the Nepali population found themselves below the poverty line in 2010-11 a significant drop of about 30 percentage points from 1995-96. Using the international poverty line of Purchasing Power Parity (PPP) US$1.25 per capita per day, the proportion of poor in the population halved to 24.8% and Nepal 'overtook' both Bangladesh and India in terms of poverty prevalence.

20. Most of the poverty reduction, reflecting Nepal's low level of urbanization, occurred in rural areas. Nearly 92% of the poverty reduction happened in the rural areas of the country with rising incomes from self-employment in farming, wage employment in non-agricultural (rural) jobs and remittance receipts accounting for three fourths of the increase in incomes of the bottom two quintiles. With the population dependent on agriculture stable at 15 million (due to declining family size and people moving out of agriculture) agriculture income growth (around 3% per year) registered fully as per-capita income growth on the back of higher returns to agricultural inputs and rising wages in the rural economy.

21. Although improvements in living standards have been shared across all parts of the country (ecological belts, regions and ethnic groups) and have in fact been faster among lower expenditure classes, poverty prevalence continues to vary widely across areas, regions and groups while remaining essentially a rural phenomenon. Over the period 2004-05 to 2010-11 every expendi-

TABLE 1: Poverty headcount disaggregated

2010-11 Poverty Estimates					
Region	Incidence			Distribution of the	
	Headcount rate	Poverty gap (x100)	Poverty gap squared (x100)	Poor population	Total population
Urban	15.5	3.2	1.0	11.7	19.0
Rural	27.4	6.0	2.0	88.3	81.0
Eastern	21.4	3.8	1.0	19.8	23.3
Central	21.7	5.0	1.8	30.8	35.7
Western	22.2	4.3	1.4	16.9	19.2
Midwestern	31.7	7.7	2.7	16.4	13.0
Far western	45.6	10.7	3.8	16.0	8.8
Mountain	42.3	10.1	3.5	11.8	7.0
Hill	24.3	5.7	2.1	42.8	44.2
Terai	23.4	4.5	1.3	45.4	48.7
Mountains	42.3	10.1	3.5	11.8	7.0
Urban - Kathmandu	11.5	2.8	1.0	2.6	5.7
Urban - Hill	8.7	1.7	0.5	1.5	4.4
Urban -Terai	22.0	4.3	1.3	7.5	8.6
Rural Hills - Eastern	15.9	2.9	0.8	4.0	6.3
Rural Hills -Central	29.4	8.5	3.7	10.8	9.3
Rural Hills - Western	28.0	5.3	1.8	10.5	9.5
Rural Hills - Mid and Far Western	36.8	8.9	3.1	13.3	9.1
Rural Terai - Eastern	21.0	3.7	0.9	9.6	11.6
Rural Terai - Central	23.1	4.1	1.1	13.9	15.1
Rural Terai - Western	22.3	4.4	1.4	5.9	6.6
Rural Terai - Mid and Far Western	31.1	7.2	2.5	8.5	6.9
Nepal	**25.2**	**5.4**	**1.8**	**100.0**	**100.0**

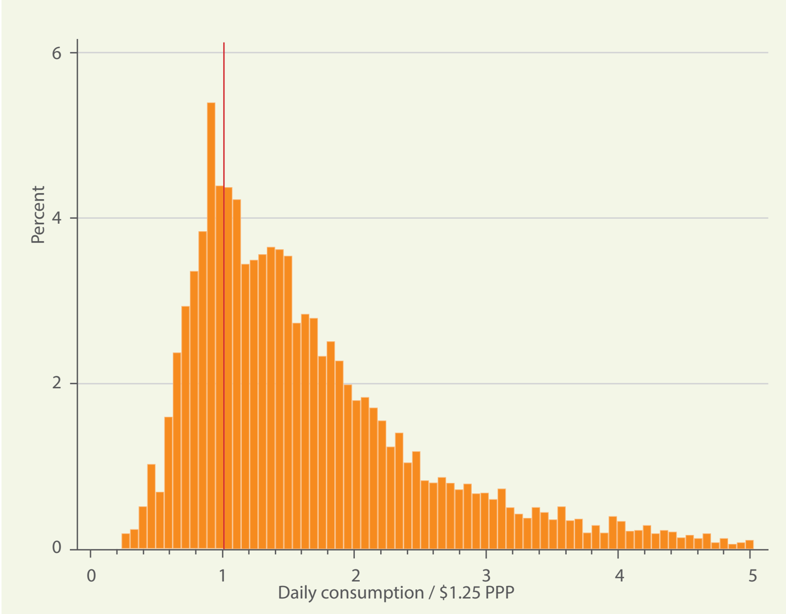
Source: World Bank staff estimates based on 2010-11 NLSS.

ture class enjoyed a rise in per capita consumption with the poorer classes experiencing the greater increase, thereby lowering overall inequality. Nonetheless important contrasts remain. Poverty is significantly higher in rural than in urban areas (27.4% vs. 15.5%) and highest in the Far-Western development regions (45.6%) and Mountainous ecological regions (42.3%). Nearly 90% of the poor live in rural areas but poverty prevalence and share in the total are otherwise inversely related with most of Nepal's poor found in the central regions (with relatively low prevalence), the Tarai and Hills.

22. Overall consumption inequality is low but nonmonetary dimensions of inequality (such as health and education outcomes) paint a different picture. With a GINI coefficient at 30% in 2010-11, Nepal is one of South Asia's most equal countries in terms of per capita consumption, with urban areas slightly more unequal than rural but only modest differences between the more (Eastern) and less (Western) equal regions. At the same time, regional consumption and subjective poverty rankings differ greatly. For instance people living in relatively less poor urban areas and the poorest mountain areas both feel underprovided in schooling and healthcare. Among the ecological zones the sharpest lack regarding the availability of public goods provision is felt in mountain areas, with over 25% reporting inadequate schooling against 16% in the *Terai*.

23. Access to public goods has improved significantly but with widening gaps between income groups and consequent gaps in opportunity and social mobility. Most multi-dimensional indicators of poverty have declined sharply over the past fifteen years as public provision of education and health infrastructure – and services –the most immediate priorities for a developing country such as Nepal – complemented private provision made affordable by rising remittance incomes. The largest improvements were in the categories "child out of school", "time taken to primary school" and "safe deliveries" while more modest gains were recorded for improvement in undernourishment, sanitation and access to reasonable cooking fuels. While multi-dimensional indicators of poverty declined for consumption-impoverished people as well, they did so at a slower pace than for the population as a whole. Moreover the quality of services delivered is low and presumably also unequal across types of beneficiaries. As a result, opportunities remain unequally distributed with one's "possibility set" largely predetermined by conditions at birth, including ethnic, socio-economic, and geographic factors as well as gender.

FIGURE 8: Nepal's population clustered above the poverty line



Source: Authors' calculations based on the Nepal Living Standards Survey 2010

24. Finally, although fewer households than ever remain below the poverty line, a majority of the population is still clustered just above the line making vulnerability to shocks a salient issue. The vast majority of Nepalis consumes less than twice the bare minimum that defines the boundary with poverty. Moving to a more inclusive and resilient society will mean finding a growth path that maximizes gains not only for those that still live in utter deprivation but also for lifting the majority of the population economically and socially, while providing sufficient support and social protection along the way so that households do not face the risk of falling into poverty and can leverage effective protection against adverse shocks to invest into the future.

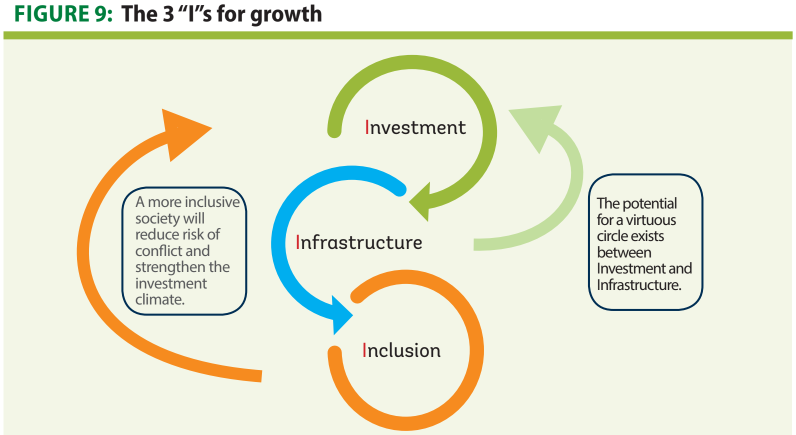
25. To sum up, promoting further inclusion will require both faster growth and determined policies. First, poverty reduction will continue to be tributary to productivity gains in agriculture; hence supporting agricultural development and diversification is essential both on efficiency and equity grounds. Second, social policies should strive to equalize basic opportunities – starting with health and education – if only because increasing the scope for mobility and returns to human capital incentivizes households to invest into the future. Third, Nepal can strengthen its social safety nets, to allow households and individuals to effectively deal with shocks, which also promotes investment and entrepreneurship: this in turn can be done at minimal fiscal cost by streamlining existing programs and targeting them better at those who need them most.

Introducing the 3 "I"s

26. The proposed pillars of a development vision for Nepal can be summarized by three "I"s: investment, infrastructure and inclusion. The three "I"s capture the fundaments of a dynamic and successful long term growth environment or, in other words, a set of necessary policy challenges to be addressed in the near term, rather than a fully-fledged roadmap for the long run. Ideally, getting these fundamentals right will begin to unleash Nepal's full growth potential through 1) allowing market forces and policy makers to jointly allocate resources efficiently (e.g. through public and private investment for infrastructure), and 2) providing the public as well as private services, infrastructure and macroeconomic environment necessary for dynamic sectors to thrive and create equal opportunities.

27. Investment and infrastructure are intrinsically linked to each other. That link, however can be as much a vice as a virtue for an economy. On the one hand, as is the case for Nepal today, severe infrastructure gaps act as a disincentive for private investment, both domestic and foreign. However, private investment is critically needed to finance an extensive portfolio of necessary but expensive infrastructure projects. On the other hand, this vicious circle can become virtuous: once investment in infrastructure bears fruit, it almost certainly will contribute to the attractiveness of the business/trade environment, thereby increasing overall investment across sectors and kick-starting growth. In other words, the key challenge is to break the vicious circle and build and improve energy and transport infrastructure, a task that will involve significant and well-targeted public investment, strategically enhanced through donor funds, loans and leveraged private financing.

FIGURE 9: The 3 "I"s for growth



28. Inclusive policies are required, because the gains from faster growth may not necessarily be distributed equally among people with different levels of income or among different geographic areas, and because equalizing opportunities in turn incentivizes households to invest. In order to boost shared prosperity, the growth model should be calibrated towards inclusiveness, taking into account relevant aspects of Nepalese economic and social structure as well as geography to maximize inclusion. Three key strategic and highly complementary areas stand out. First, given that three in four Nepalis and most of the poor and marginalized groups work in agriculture, gains from increasing productivity and diversification in the sector would immediately and directly be owned by a large share of the population, without further need to rely on redistribution. Second, a more inclusive society can only come about if basic opportunities are equalized irrespective of income status, community / identity or geography. Nepal has done well in reducing income inequality but opportunities remain largely predetermined by initial conditions. Moreover, the fact that a majority of the population remains clustered above but close to the poverty line means that vulnerability is high for households, which depresses their ability to invest in the future. To meet the next set of inclusion challenges, targeted health and education efforts will be needed to level the playing field and ensure that all Nepalis have a fair chance in tomorrow's job market while. Enhanced social safety nets should ensure that those vulnerable are protected and fewer Nepalis are left behind. Third, Nepal is on the brink of implementing a federal structure, however, decentralization needs to be "managed for inclusion" in order to avoid pitfalls that could increase inequality.

Investment

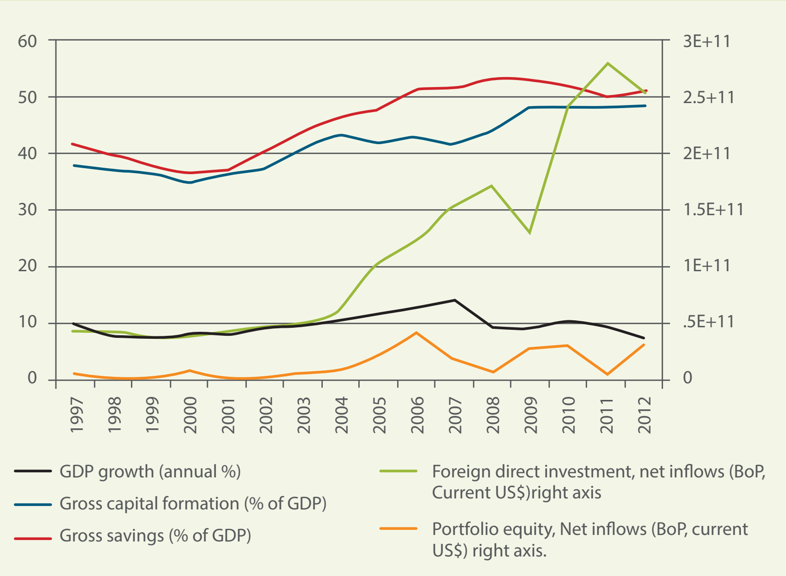
29. The key to accelerating growth in a sustainable way is investment. Top growth performers such as China have clearly shown the virtues of investment driven growth (see Figure 10), underlining the crucial role that investment plays in infrastructure development, technology upgrading, knowledge spillovers and structural change.

30. Nepal's investment rate has been relatively low compared to its regional peers, reflecting a triple challenge on the supply side of investment. Gross fixed capital formation has remained in a narrow band between 19.9% of GDP and 22.2% of GDP over the past decade. Furthermore, FDI has been stagnant at around US$100 million per year, a number that is well below the average given Nepal's economic and population size.

31. First of all, there exist substantial barriers to private investment. Beyond the fact that political instability remains the top constraint identified by Nepalese firms in the most recent Enterprise Survey (World Bank 2013), lack of reliable electricity, often limited access to finance as well as costs due to labor issues continue to dis-incentivize investment. While little can be done in the short term to address political stability concerns or energy bottlenecks, there are low hanging fruits for reform which can signal the Government's commitment to attracting private investment, such as improving access to finance for households and firms, alleviating the regulatory burden and allowing more flexibility in labor markets, while FDI and export-oriented activities can also be proactively encouraged. More detailed analysis and concrete policy recommendations are included in the policy note: *"Towards a more effective investment climate"*.

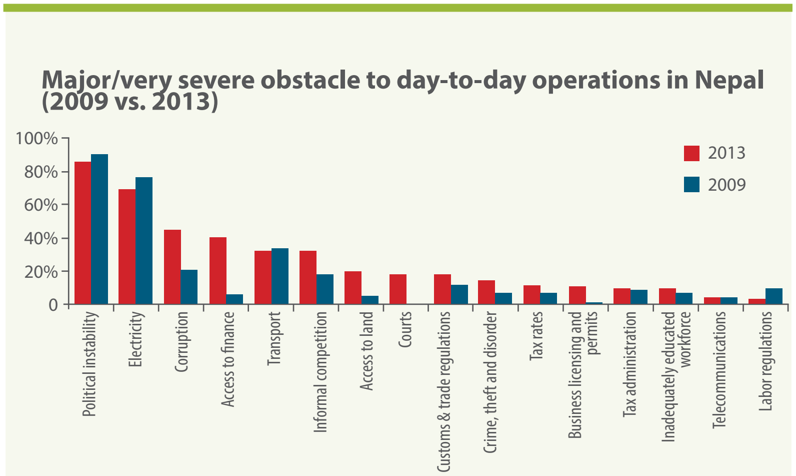
32. Second, weakness in the macroeconomic environment in general, and risks to financial sector stability in particular constitute additional constraints. Significant solvency risks pertain in Nepal's banking sector, mainly fueled by ever greening of bad (non-performing) loans and the probable inflation of reported capital adequacy ratios. The government does not have adequate regulatory and supervisory tools or sufficient operational capacity to identify or address financial sector vulnerabilities, nor would it be able to efficiently manage and limit the sig-

FIGURE 10: China's experience; Investment driven Growth



Source: World Bank, World Development Indicators

FIGURE 11: Biggest constraints to firms' operations in Nepal



Source: Enterprise Survey for Nepal, 2013 nificant fiscal costs[3] of a potential financial crisis. Hence, an important policy priority will be to set up a crisis management toolkit, ranging from a sound resolution framework to deal with banks in trouble to a strengthened deposit insurance scheme.

33. As far as supply of and access to finance is concerned, a variety of constraints are present. First, as a likely result of prolonged risk aversion after the financial liquidity crisis of 2011 and perceived lack of investment opportunities, a bank driven "voluntary" credit squeeze, (i.e. the decision to maintain relatively high interest/lending rates although demand remains well below supply) creates excess liquidity in the system. Second, the market structure of Nepal's banking sector causes additional problems. On one end of the spectrum, 4 large state-owned banks need to be restructured, basically removing the implicit state guarantee of their liabilities that provides an unfair advantage over private competitors. On the other end, the market increasingly presents itself as fragmented among small (class C and D and non-regulated cooperative) lending and deposit institutions. Here, the small scale of the individual business presents a strong viability challenge in that absence of scale usually makes for high costs, increased risk taking and limited hedging or portfolio diversification. The exposure of class A banks to cooperatives remains relatively small (3-5%) but may still be an issue in light of limited/thin bank capital bases. Ultimately, due to the fact that MFIs do not rigorously engage in credit reporting and bottom of the pyramid borrowers often take advantage of multiple credit lines, over indebtedness may pose a significant risk to "micro-financial stability" and lead to severe negative social impact. In this respect, and related to the above crisis management capacity gap, also regulation and supervision of all relevant subsectors must rest on solid legal footing and be implemented by capable institutions with clear mandates and no conflicts of interest between sector promotion and supervision (e.g. for class D banks). These issues are covered in more detail in the policy note *"Consolidating financial sector stability"*.

34. Third, a major public sector challenge will be to unlock efficient and well-targeted public investment. Similar to private sector investment, its public counterpart does not appear to be per se constrained due to lack of availability of funds. The key question to be addressed here is: why is the state actually under-investing relative to its potential? The answer lies in Nepal's formal Public Financial Management (PFM) systems and processes, which are well defined through acts and rules, but exhibit critical gaps in strategic and targeted budget formulation, execution and oversight. These gaps have resulted in low levels of effective utilization, significant bunching of expenditures (with associated concerns over the quality of spending) and heightened fiduciary risk. The most pressing areas for policy intervention span the whole spectrum of PFM, from a need to strengthen budget formulation and preparation, to boost effective and well governed execution and capital spending, to improve transparency and oversight along the way. Furthermore, ongoing reforms need to be embedded in and sequenced according to a longer term strategic vision for PFM. This will help to create the necessary institutional backbone and implementation capacity along the way to ultimately sustain benefits from reform. *Relevant background and policy recommendations can be found in the policy note: "Building PFM systems to deliver more and better spending".*

[3] The IMF estimates the average fiscal cost of a banking crisis in Nepal at around 22% of GDP, with an output loss range of 31-98% and a reserve losses and depreciation range of 28-32% cumulative over the first 2 crisis years. (IMF 2012)

Infrastructure

35. Infrastructure plays a central role in the vision for Nepal's development and growth. Not only is it at the core of the challenge to unleash (private) investment and support strong growth of almost any possible composition. But it also is a fundamental pillar in building the bridge from economic growth to promoting inclusion and shared prosperity through its direct impact on the life of the poor and marginalized.

36. The direct and indirect linkages between investment in infrastructure and economic growth are well-known. By providing access to remote (unconnected yet populated) areas, roads or bridges make private investment possible. Likewise, by giving entrepreneurs access to services such as electricity or telecommunications, public investment in critical parts of infrastructure networks enables corresponding private investment. Furthermore, efficient infrastructure investment fosters indirect GDP magnifiers, which increase private capital durability, labor productivity, economies of scale, and human capital development via health and education channels. Investment can also offset private capital adjustment costs, which by reducing the need to hedge against disruptions in business, can free up more private capital for re-investment, thereby generating a positive feedback loop. Ultimately, infrastructure, acting as an intermediate input in the production process, eventually affects the levels of aggregate income, output and employment.

37. However, Nepal faces significant funding gaps for essential infrastructure projects. World Bank estimates suggest infrastructure investment needs per year of 8-12% of GDP (in 2010 terms) until 2020 across all sectors. Necessary investment would need to address both a quantity and quality deficiency, particularly in the two big and central infrastructure sectors: transport and energy. Given the difficulty to break the vicious investment – infrastructure circle in the short run, the importance to use scarce resources in a highly efficient manner must be underlined. Hence, a first crucial step involves strengthened focus on rehabilitation and maintenance of assets, where the ex-ante mindset

TABLE 2: Investment needs per year by sector 2011-2020

Sector	Average share of GDP, in %
Electricity	3.3 - 4.5
Transport	2.3 - 3.5
Water & sanitation	1.1 - 1.6
Irrigation	1.0 - 1.5
Telecom	0.3 - 0.4
Solid Waste	0.2 - 0.3
Total	**8.2 - 11.8**

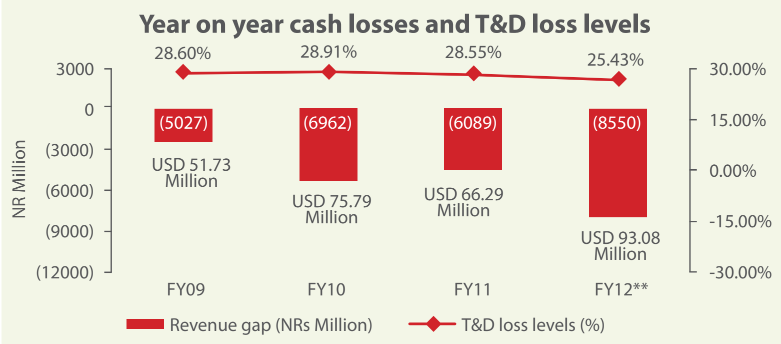
(Source: World Bank 2014)

as well as management systems become conducive to a "build-maintain" approach rather than its costly current alternative, "build-neglect-rebuild". In addition, besides the above outlined necessary improvements in the broader, regulatory investment climate, public investment will have to increase its strategic focus not only generally (as outlined above in the context of PFM), but also with respect to infrastructure in particular. In order to maximize the impact of each Nepalese Rupee spent, infrastructure investment planning should have clear priorities, be sequenced accordingly, be subject to economic and financial viability analysis, and executed by a technically capable government agency, in this case the National Planning Commission.

38. Although 75% of Nepalis have access to electricity, both the quality and overall level of electricity supply/consumption remains extremely low. Even with a large hydropower potential, chronic underinvestment in Nepal's power sector has been leading to severe supply shortfalls. Nepal has 84,000 MW of theoretical hydropower potential out of which 43,000 MW are economically viable. The installed generation capacity is merely 746 MW as of July 2013, of which 704 MW is grid-connected, while the peak demand can reach 1,095 MW. In addition, since most of the hydropower plants are of run-of-river type, the available generating capacity is low during dry seasons (472 MW in November 2012) when the system demand is high (1,095 MW in November 2012). In 2012, the supply-demand gap was recorded to be around 1,228 GWh which was resolved through load shedding.[4] According

[4] NEA Annual Report, 2013

FIGURE 12: Revenue Gap and TD losses



Source: Nepal Energy Authority

to the Independent Power Producers' Association of Nepal (IPPAN), load shedding could cost the country almost US$1billion a year in lost revenues.

39. The poor financial performance of the power utility is dis-incentivizing private investors, thereby stalling the required investments to scale up power production to meet demand. The Nepal Electricity Authority (NEA) has been suffering from severe financial losses since tariff charges are about 25% lower than the cost of service. While high system loss (around 26.5% now) results in high costs, poor quality of services contributes to strong public resistance to tariff increases. In addition, inadequate power sector policies are also halting investments and construction. With generation being competitive (almost 34% of generated power comes from Independent Power Producers - IPPs), and NEA being the single buyer in the downstream market, potential NEA payment default, in addition to other country risks such as political force majeure or exchange rate or operational risks, are major bottlenecks for sizable private investment in large hydropower generation. Hence, reducing cost of service and achieving cost recovery of tariffs will be first crucial steps to achieve financial sustainability of NEA and the power sector. The tariff reform would need to consider a step-wise approach to deal with social impacts and allow tariff adjustment, with indexation to inflation, foreign exchange rates, tariff categories restructuring, as well as cross-subsidies among consumer categories to address impacts on the poor. In parallel, a corporate development plan for NEA (based on the prepared financial restructuring plan) should detail the technical and financial improvements and the implementation of a loss reduction master plan. Additionally, lack of proper policies for providing government guarantees to mitigate the above outlined risks constitutes yet another major hurdle for private investment. The fact that key risks, such as NEA payment default, would have to be covered by a reluctant government, since Nepal still does not have a financially and technically robust power sector able to internalize such risks without government backstops, dampens private investment appetite and would need to be addressed.

40. Furthermore, lack of transmission capacity significantly undermines the rationale for added generation. Transmission line projects have suffered prolonged delays due to disputes on compensation for the right of way (ROW). Compensation disputes with affected communities have resulted in unacceptable delays. Under one World Bank-funded project, which had been under implementation for 10 years, a major transmission line could not be completed due to a dispute over a minor 3.8 km ROW stretch. Another project funded by an international donor could not be completed and has become a stranded asset due to the same type of unresolved dispute. While government laws and regulations allow adequate compensation for transmission projects, NEA does not have a clear corporate policy for compensation and often compensates at 10% land value of the ROW. Hence, there is need for a transmission line ROW compensation policy that provides justifiable compensation for restricted land use within the legal framework of Nepal taking into account the location and land use. Concrete policy steps required to remove these core bottlenecks are outlined in the policy note: *"Unlocking Nepal's Hydropower Potential"*.

41. Improving connectivity throughout Nepal is a key consideration for ensuring that economic growth can pick up and is inclusive. Access to markets (e.g. in rural agriculture), private sector activities, social services, or assistance during emergency events directly depends on the quality of transport services. However, to achieve transportation connectivity in Nepal is very demanding. While many transport challenges are new and unprecedented, notably those related to urbanization, effective maintenance of existing infrastructure remains the foremost challenge to improving transport services. Given that maintenance is extremely cost effective vis-à-vis new construction, the GoN's most important challenge will be to ensure that maintenance work is actually implemented. Current monitoring mechanisms for maintenance grants stop at the level of expenditures, which is insufficient to ensure that maintenance funding actually achieves its intended purpose. Cost effectiveness gains even more importance given that there is no short term solution to satisfying the level of investment needed to improve Nepal's transport infrastructure. Neither GoN nor the development community can fund the entirety of transport investments that Nepal will need to drive development. And PPPs to leverage private investment are no panacea to fill funding gaps as private developers may finance infrastructure investment in exchange for financial returns only. Further, the debt and equity instruments they use to do this will require repayment (with interest and dividends). Hence, PPPs as implementation tools should be seen mainly as efficiency enhancing and risk allocating mechanisms.

42. The transport sector is also facing a governance challenge. The fact that roughly 70% of transport spending occurs in the last trimester of each fiscal year shows that the budgeting, planning, procurement, and contract management processes applied throughout the transport sector need to work more smoothly. The capacity of local government entities and the accountability framework that applies to their transport sector investment activities also requires significant improvement. At the national level overlapping institutional roles and mandates, particularly for urban transport interventions that simultaneously aim at improving physical infrastructure, traffic management, and policies, adds complexity to the functioning of the sector. Furthermore, necessary efforts to build capacity within the Ministry of Federal Affairs and Local Development (MoFALD), in charge of the local (rural) road network, and Ministry of Physical Infrastructure and Transport (MoPIT), in charge of the strategic (national) road network, will benefit from consistently channeling greater portions of development partner support through their fiduciary and technical systems.

43. From a strategic investment perspective, two efforts crucial to Kathmandu's development should be envisaged. First, a 'fast track' alternative connection between Hetuada and Kathmandu would yield estimated potential time savings of 4-5 hours and potential fuel savings in the order of NPR 3,000 (US$30) per one-way trip for a heavy truck[5]. Preliminary economic analysis conducted in 2008 forecasts economic rates of return in excess of 30%, while rough cost estimates came in at approximately US$1 billion. Second, within Kathmandu, managing rapid motorization more effectively will be critical for improving transport and the urban environment and overall welfare in the Kathmandu valley. In particular, investments to improve public transport facilities, bus services and pedestrian infrastructure would have a far reaching impact for resident's mobility, safety and ultimately their health (The average concentration of course particulates -PM_{10}[6] - in the Kathmandu valley's air between 2003 and 2006 was more than six times the World Health Organization's standard.). Policy steps required to improve the provision of transport services are detailed in the policy note *"Connecting Nepal".*

44. Similarly to energy and transport, there are major issues with quality and sustainability of water and sanitation services. While indicators of access to water and sanitation services are in line with regional averages, the quality of services is variable and tends to be deteriorating overall, especially in the Kathmandu Valley. In rural areas, where schemes are relatively simple, there are high levels of non-functionality. In both urban and rural areas investment is needed – with an estimated annual investment need between 1.2 and 1.6% of GDP between 2011 and 2020 – but public policy has tended to overemphasize asset creation rather than long term asset management and service delivery. At the same time, private sector provision remains anemic.

45. The water sector suffers from major shortcomings in governance, lack of financial viability and strategic and sustainable planning. First, existing assets need to be properly maintained in order to improve their sustainability and lifetime return on investment. Absence of clear governance structures reduces accountability of service providers and hence the quality of services, particularly in urban areas. Second, as in the energy sector, service providers are not able to recover costs through user fees, further aggravating incentive misalignment and quality deteriorations. This also makes improvements in environmental performance more difficult. Ultimately, sector planning is inadequate and the lack of a clear strategy at this point threatens sustainability of vital water and sanitation services. Measures to increase the sustainability of rural schemes and improve the quality of urban services are proposed in the policy note "*Increasing the sustainability, coverage and quality of water and sanitation services.*"

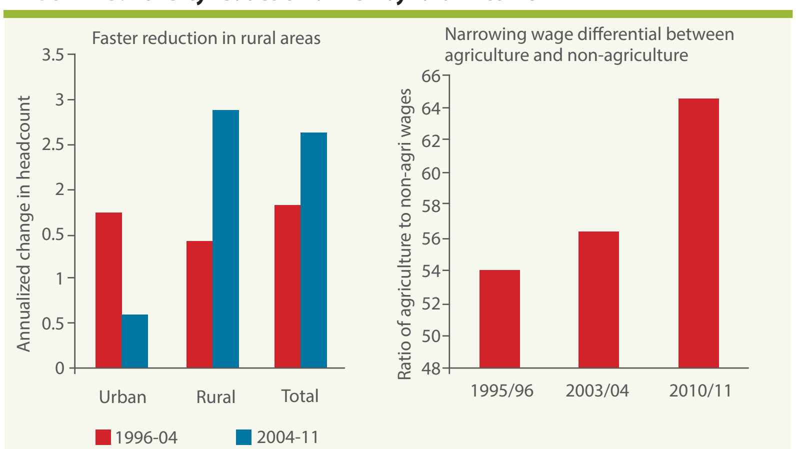
[5] Asian Development Bank "North South Fast Track Project: Final Report," May 2008

[6] PM10 is particulate matter of measuring less than 10 microns (.01 millimeters) in diameter.

Inclusion

46. Inclusion is a necessary condition for both further poverty reduction as well as growth and, despite substantial progress, Nepal still has a long way to go to make poverty history and effectively promote equal opportunities for all. Economic growth is a necessary but not sufficient condition for poverty reduction and equity. Indeed, achieving better living standards for those at the bottom of the income distribution and reducing Nepal's current dependence on foreign labor markets will be almost impossible in the absence of significantly higher overall levels of economic activity. But growth alone will not be sufficient. First, the poverty reduction elasticity of growth is not linear and removing entrenched pockets of poverty and deprivation will require targeted policies. Second reducing income inequality is not an end in and of itself: just as important is to ensure that opportunities to fulfill one's capabilities are also equalized. On that front Nepal can still do much better. Third, a majority of Nepali remain dangerously close to poverty levels, rather immobile in social terms and vulnerable to shocks. Taken together, policies to equalize the opportunities playing field and to protect those most vulnerable to shocks can boost private investment in human and physical capital and reinforce growth further. These challenges call for calibrating growth to promote inclusion and shared prosperity objectives. Moreover, inclusive policies – specifically those that expand the opportunities of all Nepali to lead a productive and healthy life – would drive overall output growth by allowing greater numbers to participate more productively in tomorrow's job market. For those that remain left behind, because of exclusion or age, social safety nets will need to be relied upon.

FIGURE 13: Poverty reduction driven by rural income



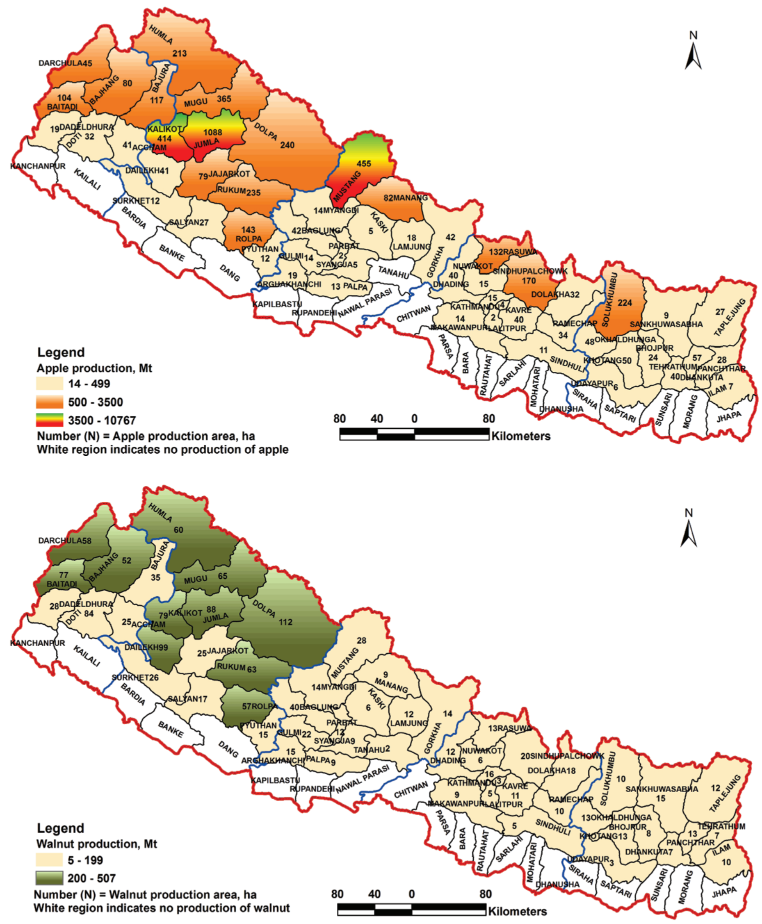
Source: WB Poverty Diagnostic Study 2013, NLSS

47. Expanding productivity in Nepal's large agricultural sector is an obvious priority to simultaneously expand overall output and achieve poverty reduction. Agriculture is still the second largest contributor to value added in the economy – it makes up over one-third of GDP- and, more importantly it still employs around three-quarters of the population. About 92% of the poverty reduction achieved over the last seven years took place in rural areas, and incomes in the rural areas are expected to continue to drive poverty reduction over the medium-term due to the concentration of the poor in the countryside. This is because, despite recent gains, Nepal's agriculture remains characterized by low productivity, the use of traditional crops and methods and overly dependent on weather outcomes. Recent underperformance in agriculture points to the need to modernize agriculture through increased productivity, commercialization and diversification.

48. A shift away from traditional subsistence agriculture to a more diversified production has the potential to raise output and incomes, especially in remote areas. As a consequence of poverty, the rural population prioritizes food security through local subsistence agriculture, whose output is of low value, thereby perpetuating a vicious cycle of low income leading to low output. Breaking this pattern will require initiative to leverage available technological advances, particularly for food grains, through strategic cooperation with India as well as revamping agricultural subsidies and refocusing investment on research and extension. Crop diversification away from low value cereal production to cash crops has high potential especially in Western Nepal—the regions with the highest and most severe incidence of poverty. High-value agricultural products include fruits, nuts, spices, herbs, certain vegetable products and livestock products for which there is a growing demand on the Indian market and an opportunity for Nepal to export.

49. A key policy challenge would therefore be to assist with the diversification through increasing the role of the private sector in providing input supply, developing agricultural value-chains as well as to identify and support production of non-traditional crops for the Indian market. This could be done by refocusing the role of the state away from input production with the private and cooperative sectors weighing-in. Relevant experience of commercial seed production comes from projects like the Seed Sector Support Project, funded by United Kingdom's Department for International Development (DfID), which helped organize and train Nepalese farmers in vegetable seed production and expanded the amount of vegetable seed for sale. In assisting the private and cooperative sector, the government should provide facilitation, quality control, policies and regulations, information, and monitoring and evaluation in order to ensure that subsistence orientated smallholding farmers have access to markets and information. The government can provide further support to smallholding farmers and agro-enterprises by developing competitive value chains to increase the value added through a strengthened Agribusiness Promotion Unit of the Ministry of Agriculture (MoAD).

FIGURE 14: Production area of Apples (top) and Walnuts, 2010/11 (bottom)



Source: Agriculture Atlas of Nepal (2012)

50. Boosting productivity and accelerating private sector-led growth in agriculture will require targeted measures by the government. While encouraging the private sector to take the lead in providing input supply, the government can assist agribusiness development through reducing transaction costs for farmers by bridging infrastructure gaps, providing better access to financial products and supporting selected commodity value chain development. In particular, lack of adequate infrastructure, such as roads for market access and irrigation systems are inhibiting agriculture productivity growth. Improving irrigation infrastructure will be a major driver of agricultural growth. The government should prioritize more efficient management of irrigation systems through better governance mechanisms and promoting water users association. Additional gains can be reaped from revamping and refocusing agriculture subsidy programs. Programs like the US$42 million fertilizer subsidy program have proven ineffective in bringing materials appropriate in type and volume, while starving research and extension services of adequate budget allocations. It would be more efficient to streamline the subsidy program and reallocate resources to research and extension, while also permitting Nepal's research and extension staff to engage with Indian agricultural research systems, public and private. A detailed set of policy recommendations is provided in the policy note: *"Towards a more productive, commercialized and diversified agriculture".*

51. For the benefits of growth to be equitably distributed among the population, access to opportunities needs to be improved. Nepal has done well in expanding the reach of social services and in achieving poverty reduction despite modest economic expansion. This is a reflection of strong resilience anchored in a high-level of community engagement and enabled by the decisive contribution of Nepal's migrants – with remittances almost entirely channeled to daily consumption and education expenses. However, Nepal can do better still by leveraging these traditional sources of resilience through smarter and better targeted public interventions to expand opportunities of all, and specifically the poor and marginalized. In particular, the focus should be on targeted interventions to equalize access to health care, and education beyond primary. Additionally the expansion of access should be matched by focus on quality so that investments in social infrastructure are effectively leveraged. Local service delivery needs to be managed transparently, efficiently and fairly in order to improve the legitimacy of the government as service provider. Taking these steps will help to make growth more sustainable in the long-term and assist Nepal in successfully reaching a higher level of development.

52. Access to education and health services are key drivers of opportunity and more can be done still to ensure that access is more equitability and quality enhanced. Nepal has made good progress in expanding the supply of education and health services. But there remain concerns about inequities in effective access to and the quality of these opportunities. Several groups of individuals are systematically less able to access opportunities due to circumstances, including parental income, location of residence and other factors. For Nepal to successfully make poverty history as well as to enable greater investment by households into human and physical assets, children, women and the young need to be able to access the same set of opportunities regardless of socioeconomic and other constraints. Furthermore, lack of decentralized accountability in the health, education and social protection sectors hinder the provision of high-quality services possibly reinforcing access inequities.

53. Increasing access to key opportunities requires better targeted incentives so that those needing them more receive support in higher quantity. In other words a key prerequisite to expanding opportunities is to make sure that existing programs in health, education and social protection are reaching the poor and those otherwise excluded. While education access improved in Nepal, there are still high levels of inequality in net attendance rates and quality of education outcomes based on poverty, ethnicity and geography. Disparities increase progressively at higher levels of education. For example, in 2010 secondary (grades 9-12) attendance for the poorest and second poorest quintile was 18% and 26%, respectively. Scholarships for poor students at post basic levels of education could result in more equalized educational attainment and opportunities over time. A key policy target should therefore be to develop a strategy for expanding poverty-targeted scholarships especially at the secondary and tertiary levels while phasing out category-based scholarship programs.

54. Similar challenges are present in the health sector, which also often fails to reach the poor. In 2011, 78% of births in the richest quintile took place in health facilities, but the corresponding number was only 11% for the bottom quintile. Only about 54% of the poorest 40% of Nepali are satisfied with the availability of quality health care, as opposed to 67% of the richest 20%. Furthermore, high out-of-pocket expenditures for health care constitute a significant poverty trap: based on 2003 data about 6.7% of households fall below the poverty line in a given year as a consequence of these expenses. A key policy initiative would therefore improve targeting to allow the poor to better utilize health services and increase their nutritional status. Any policy initiative in the health sector should also be geared toward reducing out-of-pocket expenditures of the poor for healthcare. This could be achieved through targeting demand and supply side financing schemes for the poor and testing options for moving towards a national health-insurance scheme.

55. Another key prerequisite to lift people out of poverty will be to provide them with skills enabling them to find better jobs and become socially mobile. Nepal is facing a youth bulge with significant shifts in its demographics (57% of the population is aged between 15-59 years according to the 2011 Census), but limited skills prevent people from transitioning into the type of jobs that could lift them out of poverty. Challenges remain in increasing workers' productivity and technical skills in both the formal and informal sectors, as well as domestic and abroad. Over 300,000 workers migrate abroad each year for employment purposes, providing the remittances that currently fuel growth and poverty reduction. But of those migrants, more than 75% are engaged in low-skilled jobs. To tackle this challenge, Nepal needs to develop a program for skills development with an employment focus, fostering partnerships between the public and the private sectors, while giving special attention to skills demand in the informal sector and for migrating labor. Greater detail on feasible opportunity-equalizing policies is provided in the policy note: "*Improving opportunities for all to escape from poverty*".

56. A more efficient and poverty-focused social protection system is needed to effectively address extreme poverty and prevent vulnerable people from falling into poverty. The existing social protection system is inadequate for providing reliable safety nets to the poor and vulnerable. Social protection spending in Nepal has increased substantially in recent years from around 1% of GDP in 2004/05 to more than 3% in 2011/12. Yet despite this increase, social protection programs, including cash transfers and scholarships, have only a limited impact on reducing poverty and inequality. As shown in Figure 15 below, according to World Bank estimates, the poverty headcount would only increase marginally by 0.5 percentage points (from 25.2% to 25.7%) in the absence of social assistance programs. Most programs are not explicitly targeted at the poor and feature considerable levels of under-coverage, leakage and administrative inefficiency. In addition, Nepal's social protection system is fragmented and uncoordinated—delivered by a range of line ministries and agencies, which results in possible benefit duplications or gaps in effective safety net coverage. Coverage is limited with only 17.5% of Nepali either directly or indirectly benefiting from a cash transfer program, well below the current poverty rate of 25%. Benefits also accrue more or less equally across income quintiles, e.g. the richest quintiles are as likely to receive an old-age pension as the poorest. Social insurance programs cover only 7% of the total population, mostly public sector retirees. Targeting is mostly by category (age, ethnicity, etc.) regardless of recipients' income and welfare status.[7] Furthermore, the system lacks the necessary administrative setup to support monitoring and informed policy-making as well as efficient program administration such as a transparent and reliable payment system.

57. Central to improving Nepal's social protection system would be to: (i) limit further proliferation of social protection programs while finalizing the social protection policy framework as a basis for guiding future decisions to introduce new schemes, and/or phase out or reform some of the current ones, (ii) invest in strengthening the administrative systems, starting with the largest programs and eventually making them a common management platform across programs and ministries, and (iii) address the effective coverage gaps in the current mix of social safety net programs based on robust analysis of existing poverty, risks and vulnerabilities. In addressing

FIGURE 15: Nepal Social Protection system: impact on poverty and inequality

	Poverty Rate	Gini Coefficient
Current	25.2%	0.328
In absence of social insurance programs	26.6%	0.329
In absence of social assistance (cash transfer+scholarships) programs	25.7%	0.330
In absence of cash transfer programs	25.6%	0.330
In absence of scholarship programs	25.3%	0.329

Source: World Bank team estimates from NLSS 3 analysis

[7] Exceptions are the two public works programs managed by the Ministry of Federal Affairs and Local Development (MOFALD) which target districts characterized by food insecurity and/or high incidence of poverty.

the risks and vulnerabilities that are inadequately covered in the current mix of programs, it will be necessary to consider explicit targeting of the poor, irrespective of the specific method chosen to do so, in order to ensure the limited fiscal resources are most efficiently deployed to provide maximum safety nets for those in need. Specific steps in that direction are proposed in the policy note: *"Toward a streamlined, efficient and poverty focused social protection system."*

58. Last but not least, the eventual transition to a federal state structure will have far reaching implications for service delivery and, if not managed well, could result in service delivery failures, heightened political tension as well as greater geographic inequities. First, the transition foreshadowed by the work of the first Constituent Assembly would involve the creation of two entirely new levels of subnational government with expanded responsibilities. Their creation will trigger profound restructuring of the mission and size of the central administration, and a considerable transfer of powers, assets, and resources (both fiscal and human). International experience suggests that this is extremely difficult both logistically and politically. It is therefore imperative that this process is managed through the creation of specific institutions with the resources, independence, mandate and analytical capacity needed to succeed. Following international experience, this typically involves creating a high level institution with expanded powers to coordinate the entire process as well as a dedicated body to oversee the development and evolution of intergovernmental financial arrangements. In turn, ensuring that all levels of government are adequately funded to carry out their missions will require detailed unbundling and costing of such functions as well as predefined mechanisms to ensure periodic and evidence based review. Secondly, because the bulk of key social and economic services will be delivered locally, in a new federal state, it is of utmost importance that the new subnational governments have both the required technical capacity and resources (financial and human) to deliver services. Although lagging regions will get greater control over their destinies, the challenge for them will be greater as they will be lacking –relatively – technical and financial capacity and experience, and may find it difficult to attract core human resources in management, administrative and service delivery functions. Therefore it will be key to ensure that there is a plan in place to (i) transfer functions over time in a way that balances the need to deliver on effective transfer of power and the need to build adequate core capacity (ii) promote a restructuring of the civil service in which special attention and incentives are built in to prevent severe skills gaps in the country's lagging regions. The key building blocks of such a plan are presented in the policy note: *"Preparing for decentralization"*.

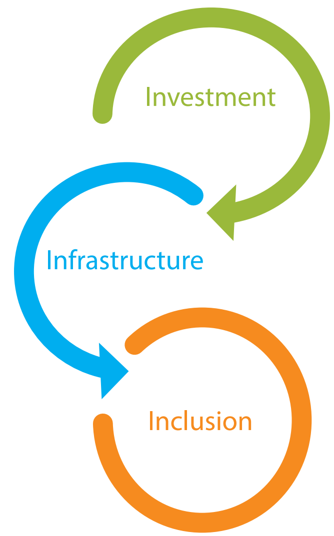
Summary and Conclusion

59. Nepal's new government is facing a daunting growth challenge; however, international experience suggests that removing key binding constraints to investment and strategic policy making can alter a country's growth potential and trajectory significantly. The purpose of this note is to offer precisely such strategic input into the identification and prioritization of core areas for policy intervention. It is worth reemphasizing that Nepal has a lot going for it: reasonable economic diversification (relative to its income), valuable resources, highly resilient communities and newfound political stability. The challenge is to get the fundamentals into place for enabling Nepal to live up to its economic potential.

60. While the overview chapter lays out a strategic vision for growth, individual policy notes provide complementary in depth information and sector specific policy recommendations. They outline a set of options for the government to consider and can serve as a basis for dialogue between stakeholders. This is the beginning of a conversation with significant scope to (i) reshape and refine the main policy prescriptions, as well as (ii) move over time toward more granular diagnostics within each sector.

61. The 3 "*I*"*s* framework outlines how a policy focus on investment, infrastructure and inclusion can create a dynamic and sustainable growth environment in the middle run. First, a stable financial sector, a conducive investment climate and strategic public investment can go a long way to create virtuous investment-infrastructure circles, not only boosting overall economic activity but also directly benefitting poor and remote segments of Nepal's population. Second, to promote shared prosperity and move towards sustainable high growth, a focus on agricultural productivity as an initial broad welfare enhancing platform can complement efforts to enhance opportunities along the income, ethnic and geographic distribution of Nepalis. Third, ongoing decentralization bears large potential to increase efficiency in public social and administrative service provision but will need to be actively managed and calibrated along the way.

Key Policy Priorities



Infrastructure

Unlock Nepal's hydro-potential: focusing on core bottlenecks that currently hold back public and private investment alike.

Expand connectivity within Nepal and with its neighbors: through more efficient spending and focus on transformational projects.

Improve the supply of water and sanitation services: through better sustainability of rural schemes and accountability of urban providers.

1. **Prepare a corporate development plan for NEA,** outlining technical and financial improvements and a loss reduction master-plan
2. **Update the Power Development Agreement** to provide coverage of country risks through guarantees for obligations of government entities
3. **Formulate a transmission ROW policy** that provides justifiable compensation for restricted land use within the legal framework taking into account land location and use
4. **Prioritize maintenance of transport assets over new constructions** and enhance monitoring mechanisms for maintenance
5. **Codify criteria for transport investment selection** to insulate the process from political interference
6. **Get the fast-track project back on track** by stabilizing the project environment, preparing technical fundamentals and updating cost and traffic projections

Investment

Strengthen the financial sector: to make it more resilient to shocks, more efficient in intermediating savings and extend its reach.

Improve the investment climate: to remove the obstacles that firms face in setting up and expanding operations in Nepal.

Streamline public financial management: to leverage the significant fiscal space the Nepal enjoys.

1. **Accelerate the enactment of the NRB Amendments Bill and new DCGT Bill**
2. **Build FSMD capacity** to manage the divesture of NBL and define a clear mandate for RBB
3. **Develop an overall strategy toward access to finance**
4. **Streamline licensing** procedures at the OCR and DOI
5. **Review the Bonus Act** to provide additional flexibility
6. **Revamp the export subsidy** and export finance schemes
7. **Scale up the TSA system** into a Financial Management IS
8. **Front load the approval of feasibility studies,** workplan and procurement documents prior to budget approval
9. **Develop national norms and rates for project costing**

Inclusion

Boost agricultural productivity and diversity: through cooperation and research in agricultural technologies and programs to develop agribusiness and value chains

Expand the opportunity set of all Nepali: through interventions for high quality health and education sectors.

Enhance the poverty impact of social protection programs: by limiting further proliferation of programs, strengthening core administrative systems and developing a program explicitly designed to address poverty and other priority risks and vulnerabilities.

Prepare for decentralization: by setting up the institutions required to manage the transition and clarifying mandates and functions of each level of government.

1. **Identify and acquire improved agricultural technologies from abroad** and leverage spill-ins from India through closer cooperation
2. **Encourage private sector participation** in seed production and refocus the role of government on regulation and facilitation
3. **Identify and support non-traditional high value production targeted to the Indian market**
4. **Develop a strategy for expanding the coverage of poverty-targeted scholarships** especially at secondary and tertiary levels, while phasing out categorically targeted programs
5. **Ensure that NASA is institutionalized and learning outcomes are monitored systematically**
6. **Establish a contracting / purchasing capacity at MoHP**
7. **Consolidate social protection programs** under one administrative system and monitor the performance of the system against a set of national indicators
8. **Create a strong finance commission** with its own technical secretariat capable of conducting financial analysis and to devise and manage inter-governmental transfers

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