

MACRO ECONOMIC POLICIES, PERFORMANCE, AND SUSTAINABILITY ISSUES

1. Introduction

- 1.1 A tiny landlocked country in South Asia, Nepal remains as one of the 48 least developed countries in the world. The country's per capita income at 220 US dollars in 1999 was one of the lowest in the Asian continent (WB, 2000). The country has not so far been a party either to any economic miracle or debacle. The country's per capita income has been growing at little over two per cent per annum at a situation when more than two-fifth of the country's population is in absolute poverty. Nepal's current economic situation is beset with nearly half of the population living below poverty line, and unemployment and disguised unemployment together depriving one half of the labour force.
- 1.2 Low economic growth rate, growing unemployment, and intensifying poverty culminating into the vicious cycle of low income, low saving, low investment and low growth have led the country to low level of equilibrium. The macro economic stability observed in the recent years is the virtual outcome of such a low level of economic activities. Low saving resulting in over dependence on foreign capital for investment has in fact been a limitation for the country's sustainable development process. Further, inefficiencies in resource management resulting in high capital-output ratio has led to a high cost economy and retarded country's relative market competitiveness. Very weak development administration to carry on programmes initiated in the Development Plans has resulted in undershooting of most of the plan target. Achievement made in the agricultural sector is a glaring example in this regard. Deteriorating performance of the agricultural sector in spite of highest priority laid on it has been the major factor hindering economic growth and well being for more than three- quarters of the population.
- 1.3 The challenges facing Nepal relate to addressing the long-standing constraints to significantly higher growth, the key to poverty reduction in Nepal, while maintaining economic stability. With nearly half of the population falling below poverty line and economic growth hovering at less than 5 per cent on average when population is growing by 2.5 per cent, the main policy issue is how to enhance a broad based economic growth with built-in-distribution of income. Then there are structural and institutional barriers to such a growth. Identified growth constraints include vulnerable agriculture, fragile industrial base, weak financial sector and inefficient public expenditures and state enterprises. Moreover, low agricultural productivity growth combined with a high population growth rate and high illiteracy has perpetuated widespread poverty.
- 1.4 As a least developed country with pervasive poverty, Nepal's foremost development objective has been to achieve the prime goal of poverty reduction as implicit objective of most of the development plans and as explicit objective of the current Ninth Plan and expressed in the Reform Agenda in the Nepal Development Forum in Paris in April 2000 (IMF, 2000). The poverty challenge for Nepal is to attain a broad based and sustained high economic growth given the limited investment resources available within the country.
- 1.5 A sustained high growth of the economy is quite unexpected without a strong turnaround in agriculture, continued surge in exports, large foreign direct investment, and effective policy interventions of the government. A very conflicting situation characterized by supply bottleneck in the agricultural sector and demand bottleneck in the non- agricultural sector prevails in the Nepalese economy. This is quite a unique situation juxtaposed to general problem of either demand or supply deficiency in most of the countries.

2. Overview of the Recent Macroeconomic Performance

- 2.1 In the recent years, Nepal has maintained broad macroeconomic stability and attained further improvement in the overall external balances. Economic growth has accelerated while inflation subsided. Exports have grown significantly and balance of payments is strongly in the country's favour. Capital market activities have remained very active with share prices picking up and non-bank financial institutions rapidly expanding financial services. However, the exchange rate of the Nepalese rupee has remained volatile whereas interest rates have come down as a result of high liquidity in the economy and sharply decelerating prices. However, in the absence of a stable political environment, structural reforms have been delayed, new investments are sluggish, pervasive weaknesses in the fiscal and financial sectors persist, and a backdrop for sustained economic growth has been impaired. Repeated threats to business and industrial communities and growing industrial insecurity have added uncertainties to long term investment in the country.

- 2.2 Improved agricultural production followed by low international commodity prices has resulted in a marked deceleration in the inflation rate in the recent years. The annual average inflation recorded a rise of 3.3 percent during 1999/00 compared to a rise of 11.3 percent in the previous year. But sustainability of low inflation has been a problem for Nepal for several reasons. First, agricultural production which is critical factor for ensuring smooth supply of food grains is vulnerable to weather condition; and cyclical nature of agricultural production growth has also created cyclical pressure on the prices of agricultural produces. It may be recalled that a fall in the prices of food and beverages group has contributed to dipping down the annual average inflation rate to a lower single digit level. Second, due to open border with India and free flow of goods across the border facilitated by the free and unlimited convertibility of the Nepalese rupee into Indian rupee, prices in Nepal can remain low only when Indian prices are also low. Third, gradual deregulation of the administered prices leading to price rise in critical areas like electricity, fertilizer, and petroleum products has escalated the cost of production leading to inflationary threats in the immediate future. Finally, Nepalese market suffers from fragmentation, asymmetric information, lack of competition, and adequate regulatory mechanism which often results in price distortions and inflation.
- 2.3 The monetary sector continues to expand in the recent years. Money supply (broadly defined) has registered a growth of more than 20 percent in the recent years. This is mainly due to the surge in foreign exchange holding of the banking system coming from strong balance of payments. The continued high monetary growth has raised demand for imported goods and services, and thus exerted a negative impact on the current account situation in the external sector of the economy. High liquidity, however, has not exerted much internal and external instability owing to improved domestic supply situation, declining international commodity prices, and inflow of foreign capital.
- 2.4 The capital market has remained more buoyant in the recent years with improvement in both the securities and non-securities market activities. In the share market, share transactions as well as share prices have grown significantly. The market capitalization of the share transaction went up from 7 per cent of the GDP in the previous year to 11.5 percent in 1999/00. The recent share market price is, however, unwarranted by the fundamentals of the companies and the economy as well. Marked correction in the stock prices is likely to reduce demand by suppressing income and hence slow down economic activities. Besides, the restructuring of the two large banks, which is in the offing, might result in credit crunch and suppression of financial services for some time. This might exert compression in overall growth of the economy as well.
- 2.5 The fiscal situation continues to remain weak, although there has been some improvement in revenue collection and development spending in 1999/00. The re-enforced value added tax system and surge in imports contributed for the better revenue performance. The growing need for maintaining law and order situation entailed an upward pressure on current spending while structural weakness in development administration undermined the development spending target of the budget. The resulting fiscal deficit at 5.0 percent of the GDP was slightly less than 5.3 percent observed in the previous year. However, in absolute amount, the deficit was 7.1 percent higher than that in the previous year. As there was some progress in foreign loan mobilization, the overdraft borrowing of the government has in the recent years stood within the permissible limit (Rs 1 billion). But as the recent trend of revenue and expenditure reveals, it may be very difficult for the government to remain in the fiscal discipline without compromising for development spending.
- 2.6 Nepal's fiscal sector is structurally weak and vulnerable owing to low level of revenue mobilization for financing government activities, high dependence on foreign financing of development budget, and continued deficit in the budget. Attempts made to streamline fiscal situation have so far borne little success. No doubt, there has been a progress towards streamlining revenue structure with the reduction of tax rates to a few, introduction of account based tax system, strengthening of tax administration, and withdrawal of distortionary taxes, the revenue compliance has not improved to offset the revenue loss emanating from these reforms.
- 2.7 The under-spending of the development budget has remained a permanent feature with not more than 80 per cent of the targeted budget being spent. Similarly aid utilization has also been problematic with aid disbursement remaining far below the commitments. This implies that not only resource availability but also resource utilization capacity is a major problem in the public sector of Nepal.
- 2.8 Nepal is a very low saving country with gross domestic savings at 13.3 per cent of the GDP in 1998/99 and 14.6 per cent in 1999/00. Most of the domestic saving comes from the private sector. In fact, the public sector remained a dissaver for the last several years. The magnitude of such dissaving stood as high

as 1 per cent of the GDP in 1998/99. Recently, the saving rate has improved due to higher GDP growth rate, low inflation, and better revenue collection of the government resulting in a marginal saving in the public sector as well. Gross national savings have remained higher than gross domestic savings, as a result of significant inflow of savings in the form of transfer and factor income. As the external labour market is very much vulnerable, it is hard to completely rely on remittance as the major financier of Nepal's external sector gap.

- 2.9 Total investment of the country has slowed down in the recent years with investment to GDP ratio coming down to 20.9 per cent in 1999/00 from more than 27 per cent in 1995/96. The sluggishness in investment in the recent years comes from both the private and the public sectors. There was a marked slow down in development spending of the government in the last few years resulting in low capital formation in the public sector. In the private sector also, investment slowed down due also to the fear psychosis following Asian financial crisis and banking system opting for more cautious approach to lending. In 2000/01 and beyond, the investment situation is estimated to improve with pick up in development spending of the government and rise in bank credit flow to the private sector.
- 2.10 Nepal's external sector is historically weak with perpetually increasing trade deficit. In the external sector, exports continued to surge in 1999/00 also while there was a rebound in imports as well against a decline in the preceding year. The export-import ratio, which was 40.8 percent in the previous year, improved to 48.3 percent during 1999/00. Although the growth rate of exports outpaced that of imports, trade deficit widened mainly due to the relatively larger volume of imports. The current account situation deteriorated due to higher trade deficit and lower income receipt from services sector. Nevertheless, the current account deficit was about 1 per cent of the GDP. As this deficit was over-financed by capital inflows mainly in the form of official aid and private capital, the country witnessed a record high balance of payments surplus to the tune of 4.0 per cent of the GDP in 1999/00. This resulted in foreign exchange holding of the banking system to increase to US\$1.2 billion at mid July 2000, ensuring a cover of more than 10 months of merchandise imports.
- 2.11 Aid imports which used to be nearly one fifth of the total imports in the 1980s has now been limited to less than 10 per cent. Such imports have witnessed a sharp dip in the recent years due to very slow implementation of aided projects. In the recent years, increase in total imports is observed mainly due to the increase of non-aid imports which went up by 22.4 per cent compared with 5.9 per cent in the preceding year.
- 2.12 The rebound in import resulted in a wider trade deficit in 1999/00, despite the fact that exports also had gone up. The trade deficit in 1999/00 accounted for 14.7 percent of the GDP. Owing to significant export growth to India, trade deficit with India, the major trading partner has declined but trade deficit with rest of the world has gone up. The share of trade with India in total trade increased to 40.1 percent from 36.2 percent of the preceding year.
- 2.13 The sustainability of the external sector is marred not only by the structure of trade but also by the structure of production and capital inflows. No doubt the structure of imports is continuously switching towards industrial raw materials and capital goods contributing for exports to increase further. But as the import elasticity of GDP is very high (1.7 in the 1990s) and export elasticity very low, it implies that fast GDP growth would further deteriorate the trade balance unless the structure of production itself changes. As most of the domestic economic activities are imports based with low value added, investment requirement for high growth also calls for high imports. Nepal heavily depends on donor assistance in financing development activities most of which contains imports of goods and services. This also implies for higher imports associated with higher government spending. Besides, the country is encouraging foreign direct investment which also has a built in destabilizing character in terms of the current account. This is because foreign direct investment has high import intensity and inflow of such capital deteriorates the trade and current account balances creating room for speculation of a weaker exchange rate of the domestic currency. Such expectation has a role to destabilize the exchange rate further through various speculative activities in the foreign exchange market.
- 2.14 As Nepal has received substantial foreign capital in the form of official loan and as capital outflow is limited due to low debt servicing obligation and restriction for making investment abroad, net capital inflow in a sizable amount has strengthened the capital account balance of the external sector. This has improved the balance of payments situation of the country and increased the foreign exchange reserves position to a record high level. However, foreign exchange liabilities are also rapidly growing due to high

demand for foreign exchange for repatriation of investment income, particularly to those related to hydropower, growing convertible currency accounts as bank deposits, and higher forward liabilities. If the foreign exchange facility extended in the past to a few hydropower projects is to continue, generation of even a few thousand megawatt of power with foreign investment would create stress in the foreign exchange position of the country once the repatriation of the investment income starts.

- 2.15 Nepal's foreign trade is growingly re-concentrating towards India. Till mid 1980s, about half of the country's trade used to be concentrated with India. By the end of the 1980s, the share of India in Nepal's total trade came down to a quarter. In the recent years, both exports to and imports from India are growing at rate faster than the overall growth. A number of factors are attributed for such a swing in the direction of trade. First, exchange rate of the Nepalese rupee vis-à-vis the convertible currencies and particularly the US dollar depreciated fast in the 1990 whereas that vis-à-vis Indian rupee remained almost unchanged. This provided incentive for higher imports from India. Second, with India opening up its trade and investment regime, the types of goods Nepal required to import from third countries could subsequently be available in India. Third, with India relaxing non- tariff trade barriers to the exports of Nepal¹ and raising free private sector direct investment ceiling for Indians investing in Nepal, a large number of Indian private sector investment in export oriented industries has taken place. As most of their raw materials are imported from India and as most of the final products are also destined towards India, the volume of trade with India has grown significantly. Finally, the liberalization of foreign exchange regime both in India and Nepal has left not much hidden incentive for trade diversion to third countries with which trade is undertaken in convertible currencies².
- 2.16 The structure of Nepalese trade is altering over years with the changing structure of production. From basically a primary goods exporting country till mid 1980s, Nepal has now turned to manufacturing goods exporting country. Notwithstanding the satisfactory performance in the recent years, the vulnerability of Nepal's export trade can be gauged from its continued concentration to a few commodities and countries. Readymade garments, woolen carpets, and Pashminas account for more than 60 per cent of the country's total exports and more than four-fifth of the overseas exports. With quota system for garment being over by 2004 and growing concern in the industrial countries on labour and environmental standards, Nepal's third country export market remains highly vulnerable.
- 2.17 The structure of imports is recently changing with growing imports of primary and capital goods. The import of petroleum products alone now accounts for nearly 10 per cent of the total imports. With swelling international oil prices, the oil import bill is likely to go up substantially in the near future. Further with Nepalese rupee depreciating at an annual rate of 5 per cent on average in the last 5 years, its implication on the import bill of essential consumer items and capital goods has been more severe. The depreciation of the rupee against convertible currencies has rather diverted Nepal's import destination towards India from third countries, not necessarily reducing the total volume of imports³. As Nepal maintains a fixed exchange rate regime with India, any change in the exchange rate of the Indian rupee vis-a-vis convertible currencies is transmitted to the exchange rate change of the Nepalese rupee against convertible currencies, necessitated for defending the peg without creating distortions in trade and capital flows.
- 2.18 The stability of the exchange rate of the Nepalese rupee depends on the strength of the Indian rupee against convertible currencies. This is because Nepalese rupee is pegged to Indian rupee for practical reasons like the present trade and financial relations. As Indian rupee is freely convertible in Nepal along with free mobility of goods, services, and capital across the border, and as Nepal has to compete with India for some of its third country exports, the depreciation of the Indian rupee calls for corresponding adjustment in Nepalese rupee exchange rate as well. That was the reason behind recent depreciation of the rupee against US dollar. The exchange rate of Nepalese rupee vis-à-vis Indian rupee has remained unchanged for the last 7 years. As Nepal and India are facing similar price movements and as trade between these two countries has been prospering, there seems to be no immediate need for the exchange rate adjustment with

¹ The major non tariff barrier was indigenous input content which had to be at least 50 per cent of the value added of the product for its eligibility to concessional entry into the Indian market.

² Previously, Nepalese exports to third countries used to get incentives in terms of export subsidies or free imports voucher which in a controlled trade regime could result in high profit in the import of third country goods.

³ Empirical studies have shown that Nepal's import trade is less sensitive to exchange rate changes (see Options for Exchange Rate policy in the Least developed Countries in Asia, ESCAP, 1998)

Indian rupee. This is the reason why exchange rate change of Indian rupee vis -a-vis US dollar is reflected in exchange rate change of Nepalese rupee as well vis-à-vis the dollar.

- 2.19 With foreign exchange reserves growing by leaps and bounds and price situation also improving, there seems to be no domestic reason for the depreciation of the Nepalese rupee for the time being. But as the rupee is pegged to Indian rupee and breaking the peg at the present moment is uncalled for, the stability in the exchange rate of the Nepalese rupee will largely depend on the exchange rate movement of the Indian rupee.
- 2.20 Broadly speaking, Nepal continues to maintain capital control. Although current account convertibility of the rupee was attained back in 1993, capital account convertibility has been rather selective. Foreign investment is fully convertible in the capital account as well. Nepal has adopted for very liberal trade, industrial, foreign exchange and tax policies for encouraging foreign direct investment. As a result, foreign investment in the country is growing. Nepal has to compete with neighbouring countries to attract foreign investors. In the recent years, Nepal's competitive strength in attracting foreign investment has been eroded by factors like domestic political instability and creation of more congenial atmosphere by the neighbouring countries for foreign investment. The only area where Nepal could be a destination for investors is hydropower and tourism related industries. The achievements made so far in these areas are noteworthy, as a number of sole investments or joint ventures in these areas have been initiated in the recent years.
- 2.21 The major source of foreign capital inflow in Nepal is foreign aid. As a least developed country, Nepal has been receiving ODA and particularly IDA loan in a large scale followed by loan assistance by other multilateral institutions like the AsDB and the IMF. Besides, bilateral assistance has also been the source of financing development activities in Nepal both in the government and non-governmental level. This has developed dependency syndrome in the development process and eroded policy autonomy of the government.
- 2.22 The external debt position of the government seems to be at a sustainable level so far. As a sizable chunk of the government development spending is foreign assistance financed, official capital comprises the major portion of capital inflow. Of this, nearly 95 per cent accounts for multilateral loan which is concessional and of long term maturity. The outstanding external debt of the government increased from Rs 169 billion in July 1999 and further to Rs 190 billion in July 2000. The outstanding debt accounted for 50 per cent of the GDP in July 1999 and 51 per cent in July 2000.
- 2.23 As most of the country's loan is of long term nature with very low interest rate, debt servicing has not so far been a critical problem, and Nepal does not qualify for the debt relief package initiated by the IMF and world Bank under HIPC initiative. However, debt service burden is growing over years with old debts maturing and size of outstanding debt increasing. From 15.2 per cent of the regular expenditure in 1998/99, external debt servicing increased to 19.3 per cent in 1999/00 and it is projected to remain at 18 per cent in 2000/01. The debt burden has further been aggravated by the depreciation of the Nepalese rupee resulting in higher debt servicing liability in rupee terms.
- 2.24 Nepal has so far little benefited by the debt forgiveness of the bilateral or multilateral donors. French and USAID loans have been partly waived with loans converted into grant. Japan has been providing indirect loan waiver through debt relief fund. As Nepal does not owe much to the US government loan, the country did not benefit much from the recent US announcement of debt relief programme. Notwithstanding this, as most of the country's debt is from multilateral institutions, not much relief could be expected from the bilateral initiatives to forgive loan. For multilateral loan, the enhanced HIPC initiative needs to be made wider, deeper and greater so that least developed countries like Nepal could benefit from the initiative.
- 2.25 The continued flow of concessional aid and commitment by the donors on Nepal Development Forum in April 2000 indicate that Nepal need not go for commercial loan for some time to come. When short-term commercial borrowing of the government could be avoided and short-term private borrowing except for specific trade credit could be discouraged, the capital outflow problem seems to be minimum for some years to come. However, growing repatriation of foreign investment proceeds is likely to pose a pressure on the foreign exchange reserves position of the country. In particular, foreign currency liability created in terms of developing hydropower projects is likely to bit the foreign exchange reserves position.

3. Development Challenges and Reform Requirements

- 3.1 As the recent economic developments are broadly positive with international reserves continuously increasing, exports picking up, inflation subsiding, and the short-term growth outlook being encouraging, these improved macroeconomic conditions have given the government an opportunity to shift policies decisively towards poverty reduction. It has been realized that a substantial increase in per capita income is a prerequisite for achieving a meaningful reduction in poverty. A number of reform measures are deemed necessary for this.
- 3.2 A front-loaded fiscal adjustment and a comprehensive package of structural reforms is deemed essential to realize Nepal's growth potential and provide a favorable basis for improving social indicators. In this context, the government has emphasized the importance of maintaining an appropriately strong fiscal position. In the medium term, and notwithstanding the potentially important role of foreign financing, Nepal has to raise its exceptionally low revenue-to-GDP ratio in order to finance necessary public expenditure--notably, on poverty reduction and other well-targeted social programs, infrastructure, and bank restructuring. High priority needs to be given to broadening the tax base, especially by reducing tax concessions, and strengthening tax administration.
- 3.3 Healthy growth of the financial sector is essential for sustainable economic development since it plays the important role of efficiently allocating funds. Allowing the financial sector to play its important role in Nepal's economic development necessitates financial sector reforms. Towards this goal, Nepal has initiated a financial reform project in association with the Bank, the Fund, and Asian Development Bank. So far, an examination of the status and the planned management change of major government owned banks have been carried out. Additionally, a study on reforms of the banking regulation to strengthen the supervisory function of the Nepal Rastra Bank has also completed. All these reforms are aimed towards having the financial sector play crucial role in economic development of Nepal. While the progress of these financial sector reforms thus far has been satisfactory, challenges like growing non-performing assets, high operational expenses, and narrow banking coverage exist in the financial system.
- 3.4 Other reform actions have to deal with strengthening private sector developments through changes in existing legislation to promote a more friendly business environment. Additionally, the government plans for decentralization of central level institutions to accelerate development of local bodies. A reflection of this is shrinking the number of government ministries from the present level by one fifth. Also, the government expects to put forward a framework for civil service reforms which aims to have a clean, strong, efficient, accountable, productive and right sized civil service. In this vein there has been remarkable increment in the pay scale of the civil service to increase their work efficiency and to maintain transparency in the civil service also with optional retirement scheme.

Reforming Agriculture for Poverty reduction and Sustainable Livelihood

- 3.5 Experience has shown that economic growth of the country is contingent upon the performance of agriculture sector, which in turn is affected by weather condition. The overall growth rate of the economy during the recent past three years averaged at 4.3 per cent, suppressed by the growth in agriculture which stood at less than 3 per cent on average. Better performance of agriculture is not only necessary for sustained high growth of the economy but also for ensuring food security and reducing rural poverty. In fact poor agricultural performance in the recent past could not deliver added purchasing power for better living of the average Nepali people during these years causing a slow down in demand leading to a further sluggish growth of the economic activities. The non-agricultural sector also witnessed a decelerating growth due mainly to sluggish industrial activities following suppressed demand in the domestic market (because of squeezed income of the agricultural household sector) and also contracting external market. Moreover, the fear- psychosis following the East Asian crisis has also dampened industrial investment activities and led the economy to a low growth path. Then the question is how to improve agriculture which is beset with so many structural and market barriers.
- 3.6 There has been no positive impact of reforms in agriculture as evidenced from low growth in agriculture with declining per capita domestic food supply. The share of agriculture in resource allocation of the government has declined over years despite the implementation of Agricultural Perspective Plan which envisages nearly 5 per cent growth in agriculture in the long run making the country not only food sufficient but also enabled to exports. But so far the achievement is frustrating, as agricultural GDP has increased by little over 2 per cent during the last decade as a whole. Privatization of fertilizer supply has helped more of its import but low quality of the fertilizer has damaged crops and soil. The government policy of open trade often allowed exports of rice even when the country had a production short fall. This

raised the price of rice by more than 30 per cent in 1999 posing food security threat for rural landless workers, marginal and small households who are net food buyers, unskilled wage earners, labours, and even low class formal sector employees. This year, the situation has reversed with low priced Indian paddy overwhelming the Nepalese market.

- 3.7 The recent crash of agricultural commodities prices in Nepal following cheap imports from India has indicated that Nepal's withdrawal of subsidy in fertilizer, irrigation and credit to small farmers was a pre-matured decision. Our experience in the past has shown that Nepal has to synchronize her economic policies with those of India in order to sustain the reforms and adjustments. However, in the agricultural sector, India is still maintaining substantial subsidy which leads low cost of production for the farmers and low farm gate price. With no subsidy at home and open border with India, Nepalese products have failed to compete with the Indian products. This calls for either diversification of the cropping pattern, if possible, or reintroduction of subsidy.
- 3.8 Economic liberalization has contributed to growth through a tiny formal sector with most of the income being concentrated to urban, industrial and business communities. There has virtually been no growth of per capita income in the agricultural sector as population growth is nearly at par with the growth of agricultural sector. There has been no real wage increase for labours and salaried people as well. At the same time, there has been a marked exchange rate depreciation. During the last decade, Nepalese currency depreciated against US \$ by more than 60 per cent making imported food items very expensive. The only supportive factor has been continued food surplus in neighbouring country India with free trading provisions at a fixed exchange rate which remains unchanged for several years.
- 3.9 There are studies which show a strong positive correlation over time between the poverty rate and the relative price of food. In developing countries food items constitute more than half of the consumption expenditure for the low middle income group of households. For people below poverty line, the share of food expenditure is more than two-thirds. With structural adjustment, food subsidies are done away with, food items are left to market forces, and input subsidies are also withdrawn. The combined effect of such measures is abruptly rising food prices with no corresponding income growth of the net food buyers as prevented by wage freeze conditionalities imposed under the programme. There are cases where poverty has worsened in the short run with the implementation of these measures.
- 3.10 Agriculture is expected to benefit from structural adjustment, largely because of dismantling of controls that favour urban industrial interests by keeping food prices low and input prices high through import restrictions. With decontrols, agriculture is expected to take off due to price incentives, and exports are supposed to grow to earn more foreign exchange which could work as a cushion in case of import requirement. In essence, imports facility, foreign exchange availability, 'right prices' for the produces, and export incentives are supposed to promote agricultural production and ensure food security from the supply side. But if Nepalese experience is any indication, it is not always true. After adjustment programme was introduced in Nepal, public expenditure share in agriculture has declined, agricultural productivity has stagnated, growth of agricultural sector has remained below that of non- agricultural sector, and terms of trade has gone against agriculture.
- 3.11 The existing government policies also indicate that food security could be attained through open trading system. Declining budget share in agriculture, no initiatives to land reform, no proper land use policy, no subsidy to agriculture even when those countries who overly believe in international trade are continuing it, and lackluster to the implementation of agricultural perspective plan indicate that we are not serious in food security.

Public Resource Management

- 3.12 Effective public resource management for poverty reduction and sustainable development has also been one of the key challenges for the country. Low revenue mobilization coupled with inefficient utilization of the resources and leakage in their uses has not only posed a question on the role of the government in the development process but also de-motivated tax payers to comply with tax the system. Besides, limited resources being scattered to a large number of programmes and projects, selection of projects on political considerations, and corruption on public resources have resulted in low rate of return on public investment. A Public Expenditure Review Committee has been recently constituted to review this and recommend the government on proper allocation of the resources. This, along with other measures to strengthen public sector, is likely to ensure better public resource management.

- 3.13 As the Nepalese government is firmly committed to improving the structure and performance of the economy and to promote the welfare of the poverty-ridden people, the government's immediate priorities have been maintaining law and order situation, controlling corruption and pushing ahead civil service reforms for good governance. Besides, the government is forging ahead with financial and fiscal restructuring for reshaping the role of the state, improving the quality of the public sector and raising national productivity through enhancement of economic structure, expansion of economic activities and employment, and better income distribution through appropriate revenue and resource allocation policies.
- 3.14 The reforms have been intensified recently. The government is working towards creating a prudent expenditure framework by curtailing unproductive expenditure and limiting its scarce resources in viable and feasible projects. The recently constituted Public Expenditure Review Commission is reviewing the current expenditures and will recommend the ways to trim the size of the recurrent expenditure and create a healthy expenditure framework. In order to meet the increasing expenses of the government and development expectations, the base of internal resources are being widened. The government is simplifying and enforcing the tax related procedures to increase the government receivables to achieve an annual increment of 0.5 percent revenue/ GDP ratio in the medium-term.
- 3.15 The main reform action being pursued by us deals with enhancing macro economic and fiscal structures. For the pursuit of this objective, greater reduction in public involvement is envisaged. Simultaneously we also plan on increasing the scope for private involvement in such key areas as fertilizer distribution, higher and secondary education, energy and tourism. Additionally, we are in the process of increasing revenue collection to strengthen government financing by consolidating value added tax, and we plan for enacting new income tax legislation. Also, we expect to increase public expenditure management, through rationalizing regular expenditure and strengthening project screening and appraisal, as well as improving our fiscal structure by raising the ratio of government revenue to GDP while maintaining appropriate levels of our expenditure and borrowing.

Financial Governance

- 3.16 As the law and order situation has remained under threat due to growing Maoist activities, the government has been emphatic on preventive, curative and overarching strategies to combat such activities. The budget for fiscal year 2000/01 has substantially raised the amount allocated for beefing up the security in the terrorism-affected areas and to implement pro-poor policy, plan and programs. The government has issued guidelines for efficient service delivery on the part of government offices. Arrangements have been made for each government agency to inform the people about its programs, activities, and decisions. All Ministries have also been directed to prepare action plans under their jurisdiction with a clear time frame.
- 3.17 Recently, the government made a legal provision to ban strike by the workers involved in essential services like banking, telecommunication, electricity and solid waste management. In view of the politicized labour union movement, these legal provisions are regarded as big strides in keeping social life in normalcy and promoting public interests. These moves are, however, taken with skepticism by some political parties when democracy is yet to be fully consolidated.
- 3.18 The donor communities like the AsDB, World Bank and the IMF are coming together to improve governance and efficiency in Nepal's corporate and financial sector. This effort includes improving selected parts of the legal and regulatory framework, standards and policies, particularly relating to accounting, auditing, companies' securities and rural finance. This also encompasses capacity building of essential regulatory, supervisory or service institutions, and capacity building for legal enforcement. The other agenda is improving financial service delivery by strengthening the payment system and promoting investment in information and communication technology, and preparing for the restructuring and development of selected financial intermediaries.

Fiscal restructuring

- 3.19 Initiatives to fiscal consolidation have taken place since more than a decade. The primary objectives of fiscal sector restructuring are to improve buoyancy and elasticity of the tax system, contain regular or current spending, and gradually enhance development or capital spending to GDP ratio. The fiscal restructuring also aims to increase allocation of budget to social sector, reduce fiscal deficit and contain net domestic financing to less than 1 percent of the GDP. Besides, the fiscal reform intends to minimize

budgetary drain for the operation of public enterprises, streamline subsidy and transfers, opt for domestic borrowing at market rate of interest, improve quality of development outlays, strengthen financial accountability through improved accounting framework and streamlined auditing procedures, and ensure better utilization of foreign assistance through enhancing aid absorptive capacity of the economy.

- 3.20 There has been progress in restructuring the tax system with downward revision in the tax rates, reduction of the tax slabs, introduction of value added tax, removal of distortionary taxes, and widening tax base. This has not, however, been reflected in a growing buoyancy of the tax system, higher share of direct taxes in the revenue structure, declining dependence on imports trade as a source of revenue, and higher share of dividends and royalties in non tax revenue rather than of fines and forfeitures. But introduction of VAT has led to a more account based tax system and a cutback in the discretionary power of the tax officials. Very recently, the departments of Vat and Income Tax have been amalgamated to make the tax system broader, more transparent, and account based.
- 3.21 The budgetary reform programme is normally oriented to allocating more resources towards the social sector. This is because economic sector is supposed to be taken care by the private sector with economic liberalization and privatization. During the last 15 years, budget allocation to economic sector increased at an average rate of 13.5 per cent whereas social sector budget allocation increased by an annual average growth rate of 18 percent compared with the 15 percent growth rate of total budget expenditure.
- 3.22 Juxtaposing the budgetary performance against the "20/20-compact" which envisages 20 per cent of the government to be allocated in the social priority sector with same share of the donors as well, it can be observed that the budgetary process is heading towards that direction. In the government sector, resource allocation to social priority sector increased from 8.3 percent of the total budget in 1976 to 17.3 percent in 1997 whereas that in the donors' side also went up from 7.5 per cent in 1993 to 15.5 per cent in 1997 (NHDR, 1998).
- 3.23 A number of measures were initiated in the process of fiscal reforms in order to improve the built-in-elasticity in the tax structure and attain efficiency in the tax system. Some of the measures were reduction in the tax rates, consolidation of tax rate slabs to a few, withdrawal of exemptions and rebates by amendment in the Industrial Enterprise Act, introduction of value added tax, change of taxes from specific to ad valorem, constitution of a separate revenue cadre, and updation of customs valuation. Notwithstanding all these measures, there has been little progress in revenue efforts even after reforms. Revenue has stagnated at less than 11 percent of the GDP for the last several years. Buoyancy of the tax system has not improved and elasticity deteriorated.
- 3.24 One of the areas of performance evaluation of the government is fiscal discipline. In particular, adherence to budgeted domestic borrowing ceiling and resorting to minimum overdraft facility for financing the deficit are indicators of the budgetary discipline of the government. The fiscal adjustment and reform programmes also put a ceiling on internal borrowing of the government at not more than one per cent of the GDP. But domestic borrowing was more than 2 per cent of the GDP in most of the years. Similarly, overdraft borrowing also stood as high as 2 per cent of the GDP in some of the years revealing a laxity in fiscal discipline of the government.
- 3.25 Various types of transfers and subsidies have been provided in the budget consuming a significant chunk (about 16 percent in 1997 and 15 percent in 1998) of the resources raised by the government. There has been substantial reduction in the level of subsidy which is less than 3 percent of the budget expenditure and 0.5 percent of the GDP. More important than subsidy is, however, the problem of transfers that the government has to make through budgetary provision. Such transfers range from financing the operational cost of some of the public enterprises, universities, and hospitals. As these entities have very low cost recovery in their service delivery, the government needs to review the situation and improve cost recovery by more appropriate pricing of the services for those who can really afford them. For the targeted people, cross subsidization could be adopted; and it has to be adopted because nearly 20 per cent of the population comprises of the 'hard core poor' who can not afford even the basic services by their own means.
- 3.26 Domestic debt servicing is consuming a sizable chunk of the budget. There are growing concerns that the country may fall in debt trap mainly due to the burden of domestic debt. When debt servicing is siphoning off a significant portion of the government resources, there is definitely a crowd out impact on resource allocation to social and economic sectors, which could be instrumental to poverty reduction--the overarching goal of the government. Therefore, efforts are to be made to convert domestic debt into equity

by offering the shares of public enterprises likely to be privatized. Besides, the sale proceeds of public enterprises could be used in paying domestic debt. Efficiency in public debt management like borrowing at the appropriate time and rate, redeeming high interest liability bonds, and issuing long term debt instruments at a time when market interest rates are low would definitely help reduce debt servicing burden.

- 3.27 Controlling regular expenditure is necessary to enlarge the share of revenue surplus in development financing. Freezing defense and police expenditure at nominal term, implying a reduction in real terms is also called for. This could save some resources for development expenditure. Public procurement of expensive cars, furniture, and office appliances is to be discouraged. Decentralization of some of the basic services would also minimize pressure on the regular expenditure.
- 3.28 Administrative reforms could also save some public resources. Amalgamating Ministries, consolidating district offices of different Ministries and even closing down unimportant ones, closing down some regional offices of the Ministries, and voluntary lay-off of the excess employees. Control of corruption with the introduction of transparency and accountability, and strengthening of the institutions to check corruption could be the measures with which administrative efficiency could be improved and public resources saved. Although the civil service reform agenda of the government is taking care of these issues, a number of problems- political and economic- might delay this process. If public resources could not be saved this way, financing high current expenditure demand through limited revenue might become unsustainable in the medium term.

Addressing Unemployment and Poverty

- 3.29 Nepal's population is growing at a higher rate from the world standard. High fertility rate, declining infant mortality rate, improving longevity due to expanding health care facilities and health consciousness, early marriage and inadequate supply of family planning services have remained as the major reasons behind the high population growth. Mass illiteracy (nearly three fourth of the female population remaining illiterate), lack of knowledge, social values biased towards sons, and lack of social security measures also prompted high population growth. Besides, immigration from neighbouring countries and particularly refugees from Bhutan have also multiplied the population problem.
- 3.30 As a large portion of the population is of young age and entering the work force, the increase of labour force has been about 3 per cent. When the economy is growing at a rate of less than 5 per cent, on average, and employment intensity of GDP growth is only 0.45, it is obvious that the growth of economic activities has not been able to absorb the growing labour force. This is resulting in a growing stock of unemployed and underemployed labour force in the country. Further, as the GDP growth rate is largely the contribution of the non-agricultural sector, which is less labour intensive than agriculture (agriculture which contributes for 40 per cent of the GDP and provides employment to 80 per cent of the labour force grew by only 2.5 per cent on average during the last decade), job creation in the course of economic growth has decelerated.
- 3.31 The present structure of production and macroeconomic policies adopted to accelerate economic growth indicate that unemployment and underemployment situation would further deteriorate if no interventions are made immediately. Given the trend GDP growth rate with the existing employment intensity of economic activities, such problems would aggravate in future with unemployment rate exceeding 10 per cent in 20 years time. Even a higher GDP growth rate of 6.5 per cent would take 30 years for completely addressing unemployment problem. So, if no structural changes in the economic activities are made, and if GDP growth could not be accelerated to more than 7 per cent, attainment of better employment situation in the near future seems very unlikely.
- 3.32 There has been a growing trend towards seeking job in the international market as domestic economic activities have failed to provide adequate job for the growing young labour force. The flow of Nepalese workers going to Middle East has significantly gone up in the recent years and wage income and remittance of the workers has been a major factor for improving the national savings as well as current account balance in the external sector of the economy. In fact, remittance money which is estimated at more than 10 per cent of the GDP has been reflected in high foreign exchange reserves in the external account and high time deposit growth in the internal account of the banking system as well. Taking into account the favourable impact of the external job opportunities to the growing labour force, the government has also taken initiative to further exploring such job opportunities through diplomatic efforts.

Sustainability of the present expanding external labour market and receipt of huge remittances to support trade and current account deficit is again a question.

- 3.33 The low economic growth coupled with high population growth has made poverty reduction a formidable challenge. Unless the economy grows by more than 6 per cent, addressing poverty through growth impulses is difficult when population is growing at a high rate. This is the reason why absolute number of the people in abject poverty is ever growing in the country. Attaining high and sustained economic growth requires some catalyst sectors with strong resource base taking the lead. The country's two major resources --water resources and human resources-- are yet to contribute for attaining high growth of the economy sufficient enough for reducing poverty as well. The growing poverty and unemployment amid high population growth has been instrumental for growing violence, social unrest and threat for the political stability of the nation in the recent years.
- 3.34 The trend GDP growth rate of less than 5 per cent coupled with the present income distribution pattern can not solve the problem of poverty even in 30 years time. A higher growth rate of 6.5 per cent would take 20 years to bring the proportion of population living below poverty line to 10 per cent. Only if the GDP growth rate is attained at more than 7 per cent that the problem of poverty could be addressed earlier. However, attaining such a high growth rate calls for huge investment which is also difficult to sustain if no proper balance between the public and the private sectors, and between the domestic and external resources are made.

4 Macroeconomic Policies and Social Development

- 4.1 The level of education and health services, level of income and its distribution, access to work and employment, and above all access to public resources are closely linked with social development. It is observed that structural barriers impede the growth of the economy; and without economic growth with equitable distribution of the productive resources, it is not possible to enhance the level of social development. Besides, economic growth alone can not enhance social wellbeing if public resources are not fairly allocated for social services like education, health, drinking water, and social security schemes.
- 4.2 Cross country experiences reveal that unless the growth process is broad based and reform measures are oriented towards more equitable income distribution, higher economic growth does not necessarily improve human well being. Therefore, attaining higher growth and making this growth meaningful for social development in Nepal calls for access to assets, reallocation of public resources, restructuring tax and subsidy system, improving credit delivery system, and alleviating poverty through broad based income and employment generation in the process of growth. Particular emphasis has to be laid on institutional reform, higher resource mobilization and reallocation, reorientation of economic liberalization, human resource development and provision of social security.
- 4.3 In Nepal, so far the economic growth oriented development model has contributed for a reasonable growth in the non-agricultural sector with its poor re-distributive effect and has left the agricultural sector in stagnation. That has resulted in continued high proportion of the population in absolute poverty. The incidence of poverty is growingly reflected in deprivation, no access to education and health services, social disharmony, and environmental stress. In many social indicators like infant mortality rate, adult literacy rate, access to safe drinking water and sanitation, life expectancy, and women empowerment, Nepal still lags behind even the average Least Developed Countries standard. Improving these indicators calls for reorientation of fiscal policy, state interventions in targeted sections and regions, and restructuring of property rights system.
- 4.4 It has long been realized that land reform is inevitable in the Nepalese socio-economic structure for enhancing economic growth, alleviating poverty, creating an exploitation free-egalitarian society, transforming agriculture, and pushing ahead social transformation. But land reform has never been taken seriously, neither at the policy-level nor at the implementation level. In the past, the distribution aspect of land reform was much more focussed and the production aspect was not given due emphasis. However, in the absence of clear-cut strategy, both the distributional and production aspects of land reform could not become effective and hence, neither production relationship nor productivity in agriculture observed any improvement. The land based political, economic and social structure has now undermined both political and social transformation and intensified poverty. As such, poverty has become a structural problem of unfavorable institutional settings in agriculture, and thus the overriding challenge for social development.

- 4.5 One of the elements of the social development is breaking the traditional, informal and exploitative credit system. As informal financing is the only source of borrowing for 80 percent of the borrowing household in the rural areas, access of the poor for formal financial source of credit has not improved. In the absence of access to formal source of credit, the poor have to resort to informal financing which is too exploitative in terms of interest charge and other conditionalities associated with loan (such as free labor, bonded labor, gifts and premiums). In this context, the twin tasks before the financial policy makers are to enlarge the access of the households to formal /institutional source of credit and enlarge the access of the poor households to the institutional source of credit. Although the former could be performed by opting for financial liberalization and expanding financial services network, the latter calls for interventions in the financial market and restructuring the financial system.
- 4.6 A number of credit programmes are targeted to the poor in Nepal. These programs also incorporate other activities like skill development, literacy, health, education, family planning, agro-forestry, environment protection and agro-marketing which in turn can contribute not only for income and employment generation but also for enhancing socio-economic development, and environment protection. However, many operational and institutional constraints have impeded these programs from being effective in uplifting the society. Some of them could be mentioned as - high cost of service delivery, low rate of loan recovery (except for some rural development banks for which the recovery rate is almost 100 percent), erosion of capital due to continued loss, lack of wholehearted commitment on the part of the institutions implementing these programs, defunct groups due to absence of cohesiveness and homogeneity among group members, and now growing insecurity and threat to the functioning of micro credit institutions.
- 4.7 Attaining regional balance in socio-economic development has also been a daunting task for the government to maintain social harmony and avoid conflicts like the ones we have witnessed over some years now. Deprivation from basic needs of life, deteriorating economic condition due to degrading land quality (due to deforestation, soil erosion and landslide) and no additional employment opportunities in relation to population growth has forced people to migration from the mountains and hills to terai. The population imbalance has then created other challenges for development. Unless, development process trickles down to those undeveloped areas, regional imbalance continues to widen and the push factors of migration remain very active.
- 4.8 The experience of many developing and transition countries, which initiated liberalization and market reform, shows undesired repercussion also. In many countries, poverty has deepened due to withdrawal of food subsidy; unemployment has risen due to privatization and downsizing of the government; social security provisions have been dismantled with the reform process; inflation has swollen up; and even growth has stagnated. The process of economic liberalization in Nepal has set industry, trade and services almost free of government intervention. Most prices have been deregulated; subsidies are withdrawn and administrative regulations are relaxed State enterprises are being privatized. This would result in social development only if resources so saved could be allocated to the basic social services like primary education, basic health care and sanitation, safe maternity and nutrition, and rural infrastructure. However, non-core social services like university, big hospitals, urban drinking water, and administrative services and defense are demanding more of such resources in the recent years.
- 4.9 During the last 15 years (1986 - 2000), social sector budget allocation increased by an annual average growth rate of 18 percent compared with the 15 percent growth rate of total budget expenditure. During the period, the growth rate of budget allocation in social priority sector stood at about 20 percent per annum, higher than the growth rate of either total expenditure or social sector expenditure. However, irrespective of the budgetary allocation, the basic social sector indicators remained very low due to insufficiency of the allocated budget and also inefficiency in resource use. Per capita spending in education and health is still one of the lowest in the world (HDR, 2000).
- 4.10 The UN World Summit on Social Development in 1995 had emphasized three important elements-eradication of poverty, expansion of productive employment, and promotion of social integration for people-centered sustainable development. To address the resource problem, the summit had endorsed the "20/20 Initiatives" in its programme of action. It implied 20 per cent of the ODA to be allocated for the social priority sector and the development partner governments also to allocate 20 per cent of their resources to this sector. The Nepalese government has also adopted this norm and resources are growingly allocated to the social priority sector. However, both the donor and government allocations to this sector have remained less than the proportion proposed under the 20/20 compact. In 1998, 14 per cent of the government budget was allocated to the social priority sector and donors' proportion was only 10 per cent.

This calls for further restructuring of both the budgetary and foreign assistance programmes towards the core social sector.

- 4.11 The initiation of allocating, since 1995, a lump sum amount of budget to the local authorities for development activities of their own priority under the spirit of decentralization has enabled the local governments also to allocate more budget to social priority sector. However, studies show that whereas 31 per cent of the expenditure at the VDC level was allocated in the social priority areas, only 8 per cent of the expenditure at the municipality level and 7 per cent at the district level was allocated to this sector during 1992-96 (NPC, 2000). The provision made in the budget announcement of 1995/96 that at least 25 per cent of the budget made available by the central government for the local government bodies and land revenue collected by the local bodies be allocated to the social sector needs to be adhered to and even scaled up.
- 4.12 The size of public spending in social sector has always remained less than that envisaged under the '20/20 Compact' of the UNDP and UNICEF. The compact hints for a size of the public sector spending at 25 per cent of the GNP and social sector spending to be 40 per cent of that. Thus had the government followed the social priority sector expenditure norms as developed by UNICEF and UNDP, the size of FY 2000/01 budget should have been as high as Rs. 109 billion, an one-fifth higher than the current provision. Similarly, social sector expenditure alone should have been about Rs. 55 billion which comes to be more than the size of present development budget itself. Likewise, social priority expenditure, which is recommended to be 50 per cent of the social spending, should have been as much as Rs. 27 billion, almost double the amount allocated in the current budget. This demands enhancing the size of the budget and its continued higher allocation to the social sector. Besides, as there exists a wider gap between the allocated and actual expenditure in the social sector, a drastic improvement in the implementation of social sector budget is needed in order to bridge the spending gap.
- 4.13 The contribution of foreign aid in social development during the last three decades shows three distinct natures; its magnitude has been rapidly increasing over the years, its intra-sectoral allocation has been changing and it has been increasingly channeled through the non-government organizations. In terms of the impact of foreign aid in social development in Nepal, the outcome has remained rather mixed. Aid through the non-government organizations has somehow been instrumental in uplifting the social status whereas that through the government level, along with providing some social infrastructure, has also deterred self-reliant social structure, added dependency syndrome, created sustainability problem for the aided projects, and often failed to meet the local requirements. A tendency to seeking donor assistance in any type of social development activity has impeded local initiatives, local resource mobilization, and local participation in development process.
- 4.14 Social security is highly desirable for relieving people from the deprivation and hardship; although it is also the fact that sustainability of the intervention policy in social security requires continued growth of the economy which could spare resources for this purpose. In a country like Nepal where economic growth remains low along with low distributive feature, the notion that growth will take care of social security provisions leaves majority of the population in ever deprivation and misery (NHDR, 1998). Social security is closely related to minimum standards of living, protection of human life from untimely death due to sickness, maternity, famine, unemployment and the like. Unless human mind is free from the fear and threat of hunger, sickness, disability and ignorance, it is almost impossible to maximize psychological satisfaction and happiness which is one of the basic requirements for good quality of life and social development. Nepal has yet to initiate intensive social security programmes to attain the same.
- 4.16 In a liberal economy, high level of government intervention may be undesired. But this is one of the areas in Nepal where considerable level of state intervention is inevitable. In the face of limited job opportunities and growing educated unemployment, social security measures could initially focus on unemployment benefits. However, as a permanent solution, the effort could be directed toward the creation of job opportunities for able citizens so that direct social security support can be concentrated for disables including aged citizens. In a democratic country, citizens must have the right to survive, grow, develop and actualize their potentials. For this, the government should be able either to create adequate job opportunities or provide social security support for needy citizens (NHDR, 1998).
- 4.17 Some good beginnings have already been made in social security aspects. A token amount of old age pension for citizens above the age of 75, pension for widows and disables are some of the social security measures taken by the government. Success of these programs depends to a large extent on correct

information and willful distribution by the village development committees. Other security measures opted by government and semi-government institutions are pension, gratuity, medicare facilities and welfare fund for their employees. However a larger number of needy citizens is not protected through social security measures. Besides, effective administration of even the minimum social security measures has been one of the challenges faced by the government. The allocated budget for such provision has often fallen short of the requirement creating disenchantment among the elders. The experience shows that unless such popular programmes are targeted, resource-wise they are difficult to sustain.

5. Macroeconomic Policies and Environmental Issues

- 5.1 Environment is one area which private sector does only deteriorate and does nothing to improve it. Desertification, growing air pollution due to emission and use of intoxicating chemicals, water pollution due to industrialization and urbanization and trilling of solid waste are some of the by-products that private sector activities in the economy produce. In the absence of adequate preventive measures the problem has become grave in Nepal. For economic development which is sustainable, the state must take initiative to address these environmental issues. That economic growth (through private initiatives) would automatically take care of environmental issues channels from enhanced capabilities to spend more for environment protection, research and development for nature and environment conservation, people's consciousness for environment, and capabilities to conserve it takes a long time to materialize. Unless direct interventions in the form of tax and incentives, resource allocation and regulations is made by the government, market-mechanism is likely to fail to serve the purpose of better environment.
- 5.2 Notwithstanding the efforts made to promote growth and reduce the incidence of poverty, low economic growth coupled with high population growth has made poverty reduction a formidable challenge. Unless poverty is addressed, it is difficult to break the nexus between poverty and environment degradation. The growing poverty and unemployment amid high population growth has been instrumental not only for degrading environment but also for growing violence, social unrest and threat for the political stability of the nation.
- 5.3 A number of government policies are also accountable for the environmental degradation of the country. Past economic policies like the industrial, trade, financial, and fiscal policies along with private sector development and infrastructure expansion policies have had a crucial implication for the environment. Liberalization of industrial policy without land zoning led to the haphazard establishment of industries in the urban areas with little sanitary and environment safety measures. Expansion of carpet and garment industries in the capital city is a telling example in this regard. New job opportunities concentrated in the urban areas has led to rural urban migration for work contributing for haphazard settlement, lack of drinking water and sanitation facilities, poor solid waste management, and traffic congestion due to growing demand for transportation. International trade liberalization has resulted in the heavy import of vehicles whereas the government has not been able to expand the urban road network as per the growth of vehicle imports. This has led to intense traffic congestion in the capital city with growing air pollution.
- 5.4 In order to manage population and environment together for sustained development of the country, a separate Ministry of Population and Environment has been established a few years back. The Ministry is working for legal and institutional framework for managing population and environment and the outcomes are definitely noteworthy. Many non-government organizations are also working in this field. Besides, the Local Self-Governance Act, which has come into implementation recently, has integrated local development activities with population programmes. All these activities have somehow helped towards containing population growth, maintaining environmental balance, and attaining sustainable development.
- 5.5 With new environmental laws in effect, a number of initiatives are taken in the area of environment. Assessment of environmental impact of any development project or industry has been made mandatory. Industrial establishments and Hydropower projects are asked to internalize the environmental cost of the projects. Financial institutions have started assessing environmental issues in the feasibility study or appraisal of the business and industrial projects. However, 'green business' like tea and coffee plantation, commercial forestry and agro-enterprises are yet to get priority in the loan portfolio of the financial institutions. The fiscal authority is initiating discriminatory tax policies for *clean* and *dirty* industries. Pollution tax has been introduced in the sales of petroleum products following the 'polluters pay principle'. There is still a high tariff, one of the highest, for the import of vehicles despite that pressure is mounting for a revision on it. Heavily polluting vehicles are being phased out and the replacement investment is

definitely going to be a huge amount. A minimum standard of the imported vehicles is also set for. These measures could be seen as the fiscal and financial initiatives to maintain environmental quality.

6. Concluding Remarks

- 6.1 Macro economic policies have a critical role towards sustainable development of the country. Particularly, fiscal, financial, and external sector policies have a bearing not only on the sectoral policies like agricultural and industrial policies but also on the economic growth and its distribution over economic agencies, sectors, regions, and even generations. They have then implications for sustainable development in the long run. Structural measures are to be adopted for the promotion of broad-based growth. These include rightsizing the public sector, improving corporate and financial governance, restructuring budgetary system and allocating more resources to the social sector, accelerating market oriented reform programmes for ensuring level playing field for the private sector, and combating corruption. Government priority needs to be given to enhancing private and foreign investment, accelerating project implementation, and strengthening rural infrastructure. Wide-ranging reform of the public sector has been felt necessary in this regard to improve administration, promote good governance and accountability, streamline the civil service, and tackle the problems of inefficient and loss-making public enterprises.
- 6.2 Ensuring wider and deeper participation of the private sector in economic activities has been essential for accelerated and sustained growth of the economy. To enable the private sector to come in a wider spectrum of economic activities and not to distort the market price mechanism, the government has recently taken policy initiatives to adjust administered prices and tariffs, and has reinforced its commitment to an open trade and investment regime. For benefiting from open trade and investment regime, the government has to be effortful towards diversifying exports, initiating productivity boosting reforms in promoting export competitiveness. Further, well planned and ongoing measures to reform the banking system, mobilizing budgetary revenue, improving fiscal transparency, and tackling the problems of governance and corruption have to take place.
- 6.3 Promotion of economic growth is a must for employment creation, poverty reduction and sustained development. This is because high economic growth, if it is labor intensive or job creating, promotes employment opportunities, reduces the stress on environment, and enhances the level of income and consumption of the poor. Besides, high economic growth widens the scope more revenue collection which enables the government to allocate higher level of resources for social sector, in particular to the social priority sector, and for environment protection. Unless high economic growth takes place, the re-distributive measures to be adopted at the existing low level of income can hardly distribute prosperity in a sustainable basis. This implies that any effort oriented towards poverty reduction and sustainable development must be inclined towards attaining high economic growth rate which is built-in distributive in nature, does not tax much the environment and does not create huge debt liability to the future generation.

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