

Poverty, Growth and Economic Inclusion in Nepal¹

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A. Inequality, Poverty and Economic Growth in Nepal

A1. In Nepal, there has been some reduction in poverty in recent years. From 42 percent in 1996, the proportion of the population below the absolute poverty line declined to 30.8 percent in 2004. During this period, per capita income increased by 1.7 percent. The decline in poverty by 1.4 percent every year during this period given the per capita income growth would imply a poverty elasticity of growth at 0.82. This is a significant improvement over the poverty elasticity of 0.46 percent estimated for 1990-96. However income inequality widened due to a worsening income distribution as indicated in the period between the conducting of NLSS I (1996) and NLSS II (2004).

A2. Analyzing poverty reduction by economic growth and income distribution shows that growth contributed to a 24 percent decline in poverty whereas redistribution of income exacerbated poverty by 13 percent in 2004. This resulted into an estimated 11 percent net decline in poverty from the 1996 level. Had income distribution remained neutral, the decline in poverty could have exceeded 24 percent. Had there been no growth and income distribution only worsened, absolute poverty would have gone up to 44 percent (Table 1).

Table 1: Contribution of Growth and Redistribution of Income to Poverty Alleviation

	NLSS years		Contribution to the incidence of poverty		
	1995/96	2003/04	Growth	Redistribution	Actual change
All Nepal	41.8	30.9	-24.1	13.2	-10.9
Rural	43.3	34.6	-17.2	8.6	-8.6
Urban	21.6	9.6	-11.9	-0.1	-12.0

Source: Computed from the CBS (2004) poverty results.

A3. Income distribution in the urban areas was not a deterrent to poverty reduction, but rural income distribution was. Had income distribution not worsened in the rural areas, the decline in poverty in rural areas would have been at least 17 percent.

A4. Nepal has been striving for inclusive, equitable and sustainable growth, since the restoration of democracy in 1990. The country experienced a higher economic growth rate, and growth in exports and revenue until the escalation of violent conflict around 2001-2002. Nevertheless even with an unstable security climate between 2001 and 2006, Nepal was able to maintain macroeconomic stability in terms of a lower fiscal deficit, BOP surpluses and low and stable inflation. As a consequence, between 1996 and 2004, the share of people living below the poverty line mainly due to higher remittances from overseas workers.

A5. But the positive story ends here. The period 1996-2004 was also the period when inequality widened further whether viewed by income or consumption or asset considerations. The same scenario emerges when viewed from an ethnic aspect. Poverty reduction was not equal among caste/ethnic groups. Macroeconomic policy developments that relied on the virtues of deregulation, privatization and support to free market enterprises generated outcomes that were hostile to the stated objectives of inclusive or equitable growth. The withdrawal of all subsidies and the falling relative share of public investment in agriculture; crowding out of growth and efficiency enhancing capital expenditure by recurrent spending; the relative decline in the share of equity enhancing direct taxes and extremely urban concentration of private financial

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institutions are some of the critical macroeconomic policies that resulted in widening inequality between the rich and the poor, and the upper castes and the disadvantaged groups in the population. Furthermore, deregulation of prices made two-thirds of the total population dependent on agriculture worse against the relatively smaller section of the population that prospered from the modern services sectors.

A6. Inequality beyond a certain threshold could if not addressed in a timely manner, manifest in the explosion of social and political unrest. There is a widely held perception in Nepal and overseas, that the decade-long conflict, which still needs to be finally resolved, is in essence an outburst of widening inequality. With the deregulation in particular of private investment in education and health, a stark inequality is visible in the quality differences between public and private health and education services. This is likely to perpetuate and entrench potential inequality in the future. Given imperfections and externalities, the market is not in a position to address the issue of inequality and deprivation. The only agency that can resolve this problem is the state.

A7. There is thus a pressing need to implement macroeconomic policies that foster a level playing field across sectors, population groups and geographical regions. There is an equal urgency for good governance, priority for skill enhancing programmes for the deprived, and also for their social safety nets.

B. Economic Performance and Inequality

B1. Despite a dip in the growth rate during the escalation of Nepal's conflict in the first half of this decade, poverty in the country declined. However, income inequality widened and remained high. Growth in the agricultural sector, which is a source of livelihood for two thirds of the population, was undermined by low public and private investment, un-remunerative prices, and poor access to credit.

B2. The decade-long conflict had a negative impact on the government's fiscal position. . There was a sharp rise in defense spending, which in turn led to an increase in recurrent expenditure. Although government expenditure on social services was maintained during the conflict, increased defense spending resulted in lower expenditure on economic services and infrastructure.

B3. Accelerated tax reform has led to a tax system where indirect taxes (such as customs duties and value added taxes) increased faster than direct taxes. The falling share of direct taxes did not contribute to lowering inequality.

B4. There was some improvement in wage employment, given that the income and consumption shares of the lowest quintile of the population, vis-à-vis the upper most quintile, improved between 1996 and 2004. However, during this period a marginal gain in non-agriculture wage employment was offset by a sharp drop in wage employment in the agricultural sector.

B5. Remittances from Nepalese workers abroad have remained the second largest source of income after agriculture. These remittances helped maintain macroeconomic stability during the conflict and contributed to growth. However, even among overseas workers, those who were relatively better off in terms of resources, skill and information earned more than unskilled workers. Although remittances have helped to reduce poverty, such differences in earnings also contributed to widening inequality.

C. Way out to Socio-economic Equality

C1. To meaningfully make a dent in poverty and inequality, policy intervention should primarily target the agricultural sector. Intervention should aim at structural change through land reform, as well as increased public investment in irrigation, rural roads and technology support to agriculture.

C2. The paper cautions that the urgency of economic reform should not bypass the basic socioeconomic interest of the poor, deprived and disadvantaged. The state should pursue an inclusive growth strategy where a meaningful participation of the poor and disadvantaged is ensured. Targeted interventions leading to an increase in the income and employment of the poor and vulnerable are key factors in reducing inequality. Encouraging the private sector to generate employment is another important strategy.

C3. Public policy should target enhancing the skills of poor migrant workers and also increase their access to finance. There should be a concerted effort to encourage and facilitate the migration of the poor to higher income destinations.

C4. Easy and affordable access to finance, particularly in rural areas, can contribute significantly to alleviating poverty and can narrow the inequality gap. Given low income, underemployment, scattered settlements and a limited credit culture, private banks tend to avoid operating in rural areas. Taxes and other incentives should be offered to make rural banking more attractive.

D. Efforts of Government for Enhancing Equality

D1. Access to higher income generating opportunities varies both at the individual and household level and is determined by several factors including initial income levels, asset ownership, education and access to capital. It is clearly evident, that in the growth process in the last decade, only a minority had access to new opportunities while the greater majority of the population tended to be excluded from the process. In particular, rural areas lagged behind; and the poor, less educated and landless had to contend with low income opportunities. Thus inequality widened.

D2. Alleviating inequality is important for stable and sustainable socio-economic progress. Nepal has already passed through a decade long armed conflict, which was primarily triggered by inequality. Now that the country has emerged from the conflict period, proactive policy and programmes aimed at poverty reduction and equitable development are essential. In the 2008/09 annual government budget, innovative attempts have been proposed by the government to raise the capability of and provide new opportunities for the disadvantaged section of the population (Table 2).

Table 2: Nepal Government Program for the Reduction of Inequality in 2008/09

- A. All senior citizens of age 70 years or more shall receive Rs 500 per month.*
- B. All Dalits, single women, and population of designated remote areas of age 60 years or above shall receive an allowance of Rs 500 per month*
- C. All fully handicapped and disabled individuals will be entitled to a monthly Rs 1000.*
- D. Provision of debt relief to small borrowers up to Rs 30,000*
- E. Local construction initiatives to employ 100,000 people for 100 days each*
- F. Total literacy to be achieved in 2 years*
- G. Maternity health made free*
- H. Youth self-employment fund to lend to the young entrepreneurs in commercial agriculture, agro-industries and service sector.*
- I. Intensive poverty alleviation programmes in 55 districts directly focusing on backward community.*

E. Policy Suggestions for Socio-economic Inclusiveness

Nepal needs to review macroeconomic policies and implement structural reforms with the ultimate aim of providing equitable access to higher income opportunities to the entire population. The recommendations are grouped into two categories, macroeconomic and structural reforms.

Structural Framework

E1. While maintaining macroeconomic stability is important, the central challenge for poverty and inequality reduction in Nepal is to increase economic growth and in particular, agricultural growth. Given the widespread nature of poverty and low average income levels, rapid economic growth, particularly from agriculture is essential for poverty reduction. The central theme is therefore increased investment in agriculture.

E2. There is a negative correlation between income poverty and access to assets. Thus, there is a need to formulate macroeconomic policies that aim at developing agricultural infrastructure, enhancing market inputs and promoting extension services along with the creation of physical assets for the poor. For growth process to be inclusive, land reform is an essential pre-condition to address issues such as inequality in landholdings, and landlessness among rural households. .

E3. Macroeconomic policies need to focus on the distributive aspect of economic activities. As inequality in Nepal has widened in the last decade, along with the reduction in poverty a reorientation of fiscal, financial and external sector policies is essential to attain higher poverty reduction within the given rate of economic growth. The economic, social and political inclusion of disadvantaged and marginalized population groups is the key to the decrease in inequality and faster poverty reduction in Nepal. State authorities need to convince donors that addressing inequality and achieving MDGs requires increased public investment, including subsidies to agriculture.

E4. Any analysis of the potential effects of an irrigation subsidy removal must analyze its longer term, dynamic impact in order to present an accurate assessment of relative costs and benefits. It is apparent that these effects have been overlooked when advocating the removal of irrigation and fertilizer subsidies in Nepal. A committed and time-bound implementation of the long overdue Agriculture Perspective Plan (APP), which has garnered political consensus, is needed. Its implementation can help transform agriculture into a vibrant sector.

E5. Nepal would benefit from the new trade regime being created with the arrangements of WTO, South Asia Free Trade Area (SAFTA) and Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC) only if international competitiveness is maintained. To achieve this, it is essential that strategic interventions be undertaken to build supply side capabilities. Industrial policy must be strengthened to create a dynamic manufacturing export sector with strong backward and forward linkages. It is necessary to diversify both export products and export markets and also to increase the competitiveness of existing exports.

E6. Given the growing magnitude of the food deficiency, particularly in the western hills and mountains, and increasing food prices, there is a compelling need for maintaining an adequate buffer stock of food items to stabilize supply and prices. But the resource crunch remains a bottleneck, and addressing this crunch needs enhanced donor support. Simultaneously greater efforts need to be made to expand and deepen food for work programmes.

E7. The lack of employment opportunities for the poor and deprived has helped perpetuate poverty and deepen inequality. Launching labour intensive public works in targeted areas adds to wage employment and capital formation. Such projects require increased allocation of resources,

greater capacity building and technical backups for local governments at the village and district levels.

E8. There is little doubt over the key role of remittances in enhancing the level of consumption of the poor and thus reducing poverty. However, enhancing the access of the extremely poor to foreign employment, particularly to countries other than India, is essential in order to increase the flow of remittances to the poor. To enhance equity, the government should use programmes that target skill development training, credit facility, and employment quota reservations for poor and targeted groups for foreign employment.

Macroeconomic Policy

E9. Nepal has limited room for raising domestic revenue to the level of expenditure requirement. This implies that in the medium term, external grants and loans will continue to be the major source of resources for investments in social and economic services. Directing the benefits of aid to the poor is an equally challenging task, as less than 15 percent of aid is channeled towards human development. With domestic revenue accounting for just 13 percent of GDP, there is scope for further revenue mobilization. This would require structural reform that targets transforming the vast informal sector into a dynamic market economy framework. A key implication of such reform is the transformation of low-yielding self-subsistence farming into a modern profit generating commercialized operation.

E10. Integrating pro-poor activities by International NGOs with the central and local governments and official development partners can ensure more cost-effective delivery of services to the poor and will also contribute to enhancing the capacities of local governments and communities in dealing with poverty.

E11. Given the fixed exchange rate regime with India and the importance of India as a trading partner, the scope for using exchange rate policy as a tool of pro-poor growth is limited. However, the level of the peg should be subject to constant review and it must serve to enhance Nepal's trade competitiveness in at least the exports of primary products to India..

E12. Remittances are the single largest source of foreign exchange earnings. Its annual inflow exceeds the combination of total exports, tourism and foreign aid. Currently it is being used up for consumption and real estate in urban areas. Nepal has long been attempting to attract foreign direct investment but lacks a investor friendly environment. If however, the country takes steps to institute proper legal mechanisms that guarantee investment FDI can play an important role in the growth process. However given the current global recession, there is little scope in this area.

E13. The financial sector has made some positive contribution to growth and poverty reduction. But on a broader level, more reforms are needed. First, an alternative mechanism for rural financing needs to be instituted. Second, as microfinance institutions have a social cost component in their overall operations, even market based interest rates often do not suffice to cover the cost and there is thus a need to extend institutional support for such services. Third, as the new central bank act discontinues the provision of long-term refinancing facility to the financial institutions working in rural finance, measures to compensate for this should be considered by creating an alternative funding mechanism. Finally, bank restructuring and deregulation, including the withdrawal of the compulsion to open branches in the rural areas is resulting in the concentration of banks in urban areas, thus leaving rural areas devoid of finances.