NEPAL: CLIMBING HIGHER

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WORLD BANK GROUP POLICY NOTES

Nepal Policy Notes

Overview

These Policy Notes seek to distill key findings from a broad range of World Bank Group engagements in Nepal, including policy dialogue, analytical work, strategic documents, project lending and trust funded activities. They are based on extensive discussions with Government of Nepal counterparts, development partners, non-governmental organizations, representatives of the private sector, and other stakeholders. These Policy Notes are selective in their coverage, and include synopses on each topic, highlighting key issues and challenges, and concluding with actionable policy recommendations. This effort seeks to make these findings readily available to the incoming Government of Nepal. The Policy Notes are compiled under three broad thematic groupings:

1. **Achieving Faster, Stable and More Inclusive Growth**
   - 1.1 Generating More, Better and Inclusive Jobs
   - 1.2 Affording the Transition to Federalism
   - 1.3 Strengthening Public Financial Management

2. **Improving the Business Environment for Domestic and Foreign Firms**
   - 2.1 Unleashing Nepal's private sector
   - 2.2 Strengthening the Financial Architecture
   - 2.3 Facilitating Trade and Deepening Integration
   - 2.4 Expanding the Road Network and Enhancing Resilience
   - 2.5 Powering the Economy
   - 2.6 Achieving Universal Clean Cooking
   - 2.7 Underpinning Resilient and Sustainable Urban Development
   - 2.8 Boosting Agricultural Competitiveness and Creating Rural Jobs
   - 2.9 Managing Forests for Prosperity

3. **Developing Human Capital**
   - 3.1 Promoting Health
   - 3.2 Enhancing the Competitiveness of the Workforce
   - 3.3 Protecting the Poor and Vulnerable
   - 3.4 Promoting Gender Equality and Social Inclusion

Meeting heightened development aspirations, including reaching lower-middle-income status by 2030, will require bold reform initiatives. The Policy Notes listed above aim to contribute to the growing momentum behind seeking a shift in Nepal's development trajectory, and topics can be elaborated or added upon request.

1. *Achieving Faster, Stable and More Inclusive Growth*

This will require a stable macro-fiscal framework that supports private sector activity, an enabling business environment, development of new sources of growth, revitalization of existing sources of growth and investment in human capital. Reforms in these areas will support the creation of a vibrant and job creating private sector which will help make the growth process more inclusive. With a fixed exchange rate and a closed capital account, the key macroeconomic stabilization tool with the government is fiscal policy. Going forward, prudent fiscal management will be crucial as expenditures are likely to rise with a transition to a federal state as well as the reconstruction and infrastructure related spending needs. Public financial management systems will also need to be strengthened, especially, in a federal context. The following policy notes outline the key medium-term challenges, the jobs agenda and fiscal and public financial management related issues in Nepal and suggest some policy recommendations.

Nepal Policy Notes

1.1 Generating More, Better and Inclusive Jobs

Key issues and challenges

Nepal's labor force remains overwhelmingly rural and informal. Over 80 percent of the population lives in rural areas and over 70 percent of Nepal's jobs are in agriculture. Some 35 percent of jobs are in self-employment while 46 percent are unpaid family jobs. Unpaid family jobs account for 57 percent of all agricultural jobs and are especially common among youth and females. Only 17 percent of the labor force had wage jobs (13 percent of them in the private sector and 4 percent in the public sector) which are primarily concentrated in urban areas.

Nepal's emerging demographic transition will steadily reduce the dependency ratio up to 2030. A shifting age structure offers the possibility of a significant "demographic dividend" if the emerging workforce can be channeled into more productive jobs. The labor force is growing by around 400,000 a year. Labor Force Participation rates are high (83 percent in 2016) and unemployment rates (3.2 percent in 2016) are low both for men and for women, reflecting the low-income and agrarian nature of the economy. Youth unemployment (for those aged 16 to 34) ranges from 1 to 5 percent, depending on gender and location, with most working in low productivity informal self-employment.

Domestic jobs growth is constrained by multiple factors. Private business investment is relatively low, averaging 18 percent of GDP during 2007-2015. This reflects multiple market and policy failures including competitiveness and business climate challenges, financial sector weaknesses, a weak supporting environment for entrepreneurship, and significant infrastructure gaps. The level of human capital has improved but the education level of the workforce remains relatively low compared with South Asian neighbors. Education and health gains have also been unevenly distributed and economic exclusion of women remains.

Male migration has helped to reduce poverty, but migration will not solve Nepal's jobs challenges. Migration to the Gulf and Malaysia explains around 40 percent of the decline in poverty from 2001 to 2011. The migrant outflow declined considerably in 2015 and 2016 owing to a recession in Saudi Arabia and lack of demand for Nepali workers in Malaysia. Consequently, the remittances, and the stock of migrants abroad are expected to decline in subsequent years.

Nepal also faces challenges in labor supply and labor market intermediation. Youth entering the labor market have higher educational attainment than older generations and aspire to wage jobs outside agriculture. But as such jobs are scarce, school-to-work transitions are slow, with 30 percent of women and 15 percent of men in the 16 to 24 age group neither working nor in school. The share of rural women aged 16 to 34 who are not in employment, education or training (NEET) increased by 20 percentage points between 2003/04 and 2010/11. In the same period, the proportion of women with wage jobs declined while the share in self-employment increased significantly.

Challenges to female labor force participation seem to continue to exist more in rural than in urban areas. Female labor force participation (estimated at 82.8 percent) is only a few percentage points lower than that of males and is higher than female labor force participation rate in other South Asian countries. This number probably masks urban-rural differences. The share of young females (16 to 34) who are NEETs has increased for rural areas and decreased for urban areas between 2003/04 and 2010/11. Of those employed, the share of young females in wage employment decreased by approximately 20 percentage points between 2003/04 and 2010/11.

The Government of Nepal has several initiatives underway to address aspects of the youth jobs agenda. These initiatives are fragmented and the available evidence suggests an uneven pattern of effectiveness. On the labor supply side, although strong advances have been made with market oriented

vocational training programs, there is no systematic approach to supporting young women and men as they enter the labor market to make the best choices about where to work or what additional skills to acquire. Nor is there a sufficiently strong emphasis on intermediation between workers from disadvantaged backgrounds and potential employers. On the labor demand side, there are no interventions that focus clearly on correcting the market failures linked to job creation. The newly announced Prime Minister's Employment Program (PMEP) can possibly address some of these issues.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Draft a national Jobs Strategy which addresses both labor supply and demand issues including increase in the number of jobs, improving the quality of jobs and expanding access to jobs.
- Ensure that the jobs flagship program including the PMEP strengthens coordination across ministries and with the private sector and corrects supply- and demand-side market failures that constrain job growth in high potential sectors and regions.
- Undertake a rapid impact review of ongoing youth employment programs to identify successful interventions and gaps.
- Develop a time-bound action plan to improve the job impacts of skills training programs by strengthening the employment and income gains from such training.
- Develop a time-bound action plan to promote equal opportunities in the labor market, especially for women and minority groups, by providing training and labor market linkage programs focused on women and other excluded groups; and incentives to employers who provide them with opportunities.

To address these issues, in the medium to long term, the government needs to:

- Expand programs that provide access to income generating opportunities to low-skilled youth and women in rural areas through micro-entrepreneurship training, psycho-social support and life skills training, and a capital injection.
- Support the labor market integration of rural-urban labor migrants and returning international labor migrants.
- Create tailored labor market programs to address multiple constraints that prevent youth from engaging in more productive employment.
- Establish a single labor market information system and provide a full set of labor market intermediation services. The labor market information system would provide updated, relevant information on job seekers, employed workers (self- and wage-employed), employers, and vacancies.

Nepal Policy Notes

1.2 Affording the Transition to Federalism

Key Issues and Challenges

Managing spending pressures will be crucial going forward. The 2015 Constitution established Nepal as a federal country. The impetus for transitioning to a federal state was the inability of the centralized government to deliver on greater inclusion. The country has established 7 states and the district offices and sub-offices have been replaced by 753 local governments. The cost of establishing and running these sub-national units, the need for post-earthquake and flood reconstruction, higher spending on social assistance programs and larger outlays on the much-needed infrastructure are likely to strain the government's finances if fiscal management is not prudent.

While total government spending has historically been low, expenditures are rising. Recurrent spending which averaged 15.6 percent of GDP between FY2012-FY2016 increased to 20 percent in FY2017 because of higher civil service wages, increased fund transfers to local governments and larger social security outlays. Capital spending which had historically averaged at 3-4 percent of GDP increased to nearly 8 percent in FY2017 primarily due to reconstruction related expenditures. Social assistance spending has also grown considerably in recent years from 1 percent of GDP in FY2008 to 3.6 percent in FY2017.

The additional cost of the transition to a federal state is estimated at 3.4 percent of GDP a year during FY2019–21.[1] While there is considerable uncertainty on the scope and pace of the implementation of fiscal federalism, higher spending is likely. Lack of clarity on functional assignments between the three tiers of government could add to the spending pressure. Many responsibilities have been assigned as "shared or concurrent responsibilities" of the federal, provincial, and local governments and could potentially result into duplication of work.

On the revenue side, performance has been strong but concerns remain. Nepal's domestic revenue collection has seen an impressive increase from 16 percent of GDP in FY2012 to 24.8 percent in FY2017, primarily because of large remittance-fueled private consumption. Consequently, indirect taxes, at 14.7 percent of GDP in FY2017, dominate revenue collections. They have been driven by imports for consumption and reconstruction. In addition, Nepal's tax regime faces other challenges including large tax exemptions, high tax-free allowance for personal income taxes, high compliance costs due to multiple corporate income tax rates, multiple excisable items, and ad-hoc revenue commissions that make tax collection arbitrary. Consequently, firms in Nepal have lower rates of taxation than regional peers or structurally similar economies.[2]

Revenue collection is likely to face additional challenges in the context of a federal structure. Major sources of revenue—income tax, VAT, customs, and excise—are to be collected by the central government while sub-nationals will have limited own-source revenues.[3] Consequently, approximately 80 percent of the existing revenues are likely to remain with the center. With limited capacity in subnational governments, revenue collection efficiency is likely to be low. In addition, confusion around revenue collection across various tiers of government has already cropped up such as the recent tussle on the collection of house rent taxes.

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[1] Preliminary estimates by World Bank staff.

[2] The corporate income tax rate in Nepal is 25 percent compared with 30 percent in India and 28 percent in Sri Lanka.

[3] Some of the taxes to be collected by sub-national governments include house and land registration fees, motor vehicle tax, entertainment tax, wealth tax, and house rent tax.

Intergovernmental transfers will be a central element of Nepal's fiscal framework going forward. The gap between constitutionally mandated expenditure assignments to sub-national governments and insufficient revenue assignments will create a large vertical fiscal gap. Additionally, large disparities in socioeconomic development among various parts of Nepal have resulted in high 'horizontal imbalances.' For example, own-source revenue per capita in Kathmandu district was 10 times higher than in *Darchula* district in pre-federal Nepal and this is likely to continue in the federal context too. Hence, the sub-national governments will rely heavily on fiscal transfers from the federal government and these transfers are likely to finance around 80 to 85 percent of their total spending.

Inefficient cash management has led to an increase in short term domestic borrowing. The absence of reliable cash forecasting results in liquidity mismatches. The government tides over these shortages with ad-hoc borrowing from the domestic market for short maturities. These borrowings not only crowd out the private sector but they also increase the government's interest payments. At the same time, government's non-interest-bearing deposits with the central bank are as large as government's domestic borrowing. While ad-hoc borrowing inhibits the development of a reliable government securities market, the large government deposits limit availability of loanable funds in the banking system.

Nepal's public debt, at 27.6 percent of GDP in FY2017, remains low. Public debt, as a share of GDP, has fallen dramatically from around 64 percent in 2002 to 27.6 percent in FY2017. While prudent fiscal management by the government played a part in early 2000, it is largely the result of higher revenue collections - annual growth rate of 0.5 percent of GDP - and persistent under execution of capital expenditures. The Joint World Bank- International Monetary Fund (IMF) Debt Sustainability Analysis (2017) has maintained the "low" risk rating of debt distress. In the federal context, the central government will be able to regulate subnational borrowings.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Clarify functional and revenue responsibilities for all three tiers of government.
- Determine the cost of delivering services in the federal structure.
- Design a transparent and evidence based system for fiscal transfers (revenues and grants) to sub-national governments.

To address these issues, in the medium to long term, the government needs to:

- Carry out a spending review to identify and cut wasteful expenditures and duplication of activities.
- Review the social protection and pension schemes which have expanded rapidly.
- Implement the medium-term expenditure frameworks at all levels of government to help realistically plan and develop annual budgets, improve cash management and develop and adhere to a domestic borrowing calendar.
- Implement a comprehensive tax reform to reduce reliance on trade taxes, remove tax exemptions, reduce tax brackets, rates and thresholds, simplify tax administration and broaden the tax base.
- Build capacity of state and local governments to ensure effective use of public funds.

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1.3 Strengthening Public Financial Management

Key Issues and Challenges

Nepal's budget does not adequately fulfill its role of supporting service delivery and allocating resources to development priorities. This is because the budget preparation process is incremental and is not anchored in a strong multiyear fiscal framework and the quality of spending is poor. Inefficiencies in this area are manifested in the public investment process, which does not deliver completed productive assets and infrastructure in a reasonable time period. Projects, on average, go on for more than 11 years, and some roads and irrigation projects have gone on for more than 30 years. In 2017, the capital budget execution rate was 65.5 percent, which is significantly below the six-year average of 71.6 percent. Budget execution is also erratic which leads to chronic underspending. This is because of unrealistic budget targets, allocations to large infrastructure projects that are not ready for implementation, substantial variance in expenditure composition during the fiscal year, and the absence of consistently reliable cash forecasting and commitment control systems.

Financial reporting, despite recent progress, is still weak. The consolidated financial statements are not prepared based on Nepal Public Sector Accounting Standards (NPSAS) (which are aligned with International Public Sector Accounting Standards [IPSAS]). However, financial statements based on NPSAS were prepared by 31 of 44 central government line ministries for FY2016/17. There are some delays in preparing financial statements by the line ministries, which has an adverse effect on the country's consolidated financial statements. Many core government agencies, such as Autonomous Government Agencies (AGAs) and universities, are not consolidated into the main financial statements of the government. The Government of Nepal provides substantial funding to public sector enterprises through its budgetary system by way of loans and grants. Due to inadequate reporting, the government finds it a challenge to monitor fiscal risks arising from state-owned enterprises (SOEs). The Institute of Chartered Accountants of Nepal (ICAN) has pronounced the rollout of Nepal Financial Reporting Standards (NFRS), (which are aligned with International Financial Reporting Standards) to SOEs; however, compliance has been low due to capacity constraints.

Internal control and internal audit are key areas of concern. The government has submitted a new Federal Financial Procedures Act to Parliament and plans to revise the Financial Procedures Rules after the bill is enacted into law. The annual reports of the Office of the Auditor General (OAG) have repeatedly mentioned weak internal control and the unreliability of internal audit reports. Further, the analytical works on Public Expenditure Financial Accountability (PEFA) and earlier analytical works have singled out a need for a credible internal audit system.

Many information technology systems are used, in a stand-alone disintegrated mode, to record core financial management transactions. These systems were implemented to respond to the immediate challenges during the earlier phase of reforms but need to be assessed to inform a coherent approach toward establishing an Integrated Financial Management Information System (IFMIS) platform. The current set-up has resulted in manual systems operating in parallel, delayed bank reconciliations, lack of ex-ante commitment controls, and delayed financial reporting at the sector and federal level.

The move toward federalism has compounded the PFM challenges. There are many uncertainties in the country as new local governments are yet to become fully functional. The Parliament approved core bills related to intergovernmental fiscal transfers, allocation formulas, a Local Government Framework, and Staff Adjustments in October 2017. These laws lay out the landscape for Public Financial Management (PFM) in the federal structure, but the Public Finance Law remains to be voted on. On the revenue side, tax administration is under pressure in the new structure of the state. While most of the buoyant taxes like the value-added tax, income tax, customs duties, and excise duties have been assigned to the federal government, many of the costly expenditure responsibilities such as health, education, irrigation, and roads

are now within the mandate of subnational governments. This will create imbalances in the fiscal system of subnational governments and the gap will need to be bridged by intergovernmental transfers. Besides, there is still potential for increasing own revenue from subnational governments, for which they will require substantial capacity building. In addition, the weak PFM capacity at the subnational level is likely to constrain the management of funds at the local level, along with the delivery of public services.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Revise the National PFM Reform Action Plan (2016–2026) to include recommendations of the PEFA assessment and subnational PFM aspects under the leadership of the PFM steering committee.
- Issue an IFMIS diagnostic and action plan toward integration and increased coverage (for which a Concept Note has been issued).
- Conduct a PFM capacity needs assessment at the subnational level using internationally recognized methodology like Public Expenditure and Financial Accountability (PEFA).
- Adopt key laws and regulations at all tiers of government that will encourage efficiency, accountability, and transparency in the use of public funds.
- Deploy report formats and a basic budgeting and accounting system as a quick interim solution to meet immediate local government reporting requirements.
- Design and implement a basic PFM curriculum (including procurement, public investment management, and tax administration modules) for subnational finance staff.

To address these issues, in the medium to long term, the government needs to:

- Formulate an institutional development plan for (a) the establishment of key public-sector agencies at the subnational level; (b) provision of adequate premises, equipment, and operating facilities; and (c) funding modalities.
- Introduce a performance orientation in the fiscal transfers to sub nationals (particularly for equalization grants) through the existing activity-/output-based budgeting systems and high-level performance indicators. This would incrementally support the design of a framework for results-based budgeting at the provincial and municipal levels, ensure a good match between resources and expected service delivery results, and ensure monitoring and reporting of results.
- Design an accountability framework for the three levels of government including (a) constitutionally mandated external audit of subnational governments by the Auditor General; (b) development of an internal control and internal audit function at the provincial and federal levels; (c) citizen engagement modalities in PFM, at the federal and subnational levels, in line with the PFM reform action plan and the existing political and legal framework in this area; and (d) development of the Parliament's and councils' capacity to discuss, vote, and control the budget.
- Implement an IFMIS including the three tiers of government in a single platform.
- Improve the capital project selection process by improving the project appraisal and selection criteria, and building capacity of the three tiers of government in this area.

2. *Improving the Business Environment for Domestic and Foreign Firms*

Some of the key factors constraining private investment in Nepal include inadequate infrastructure, particularly power and transport, limited access to finance, and political and policy instability. As a result, domestic and foreign investments are low. Foreign firms face several tariff and non-tariff barriers and the country shows export and import orientation below average, considering its size, distance from main markets, and landlocked geography. Many firms lack marketing knowledge, and access to appropriate technology, value chain integration, certification and networks. Also, Nepal's agricultural sector and abundant forest resources are under-utilized because of certain regulatory gaps and capacity constraints. With the successful completion of elections and the formation of a new government, Nepal has the opportunity to ensure policy stability and undertake reforms which will strengthen the business environment. The following policy notes outline the key challenges faced by domestic and international firms and suggest some policy recommendations which will help boost private investment.

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2.1 Unleashing Nepal's Private Sector

Key issues and challenges

Nepal's private sector has shown resilience in the face of an uncertain political environment, but productivity is very low. The share of private investment in gross fixed capital formation to GDP has been steadily increasing reaching 26.5 percent in 2017 from an average of 20.1 percent during 1997-2007. The private sector is dominated by a few large family-run businesses, but the bulk of firms are small and do not grow much over their lifecycle. Only 18 percent of Nepal's formal firms have more than 20 employees compared to 37 percent and 43 percent in India and Bangladesh, respectively. Productivity levels in Nepal appear to be remarkably low and show high dispersion. For example, estimates on value added per worker in manufacturing are half those of Bangladesh. Very few firms engage in trade or technology transfer with other countries. The percent of Nepalese formal firms that export (directly or indirectly) is 5.1 percent compared to 21.8 percent and 8.8 percent in Bangladesh and India, respectively.

Foreign direct investment (FDI) inflows into Nepal have been negligible, depriving the economy of an important source of financing, technology transfer, and access to new markets. In the last five years, annual FDI inflows to Nepal have averaged 0.4 percent of GDP, compared to 1.3 percent and 1.8 percent in Bangladesh and India, respectively. FDI is highly concentrated in hydropower, communications and energy. FDI faces special challenges including sector caps, a long "negative list" of sectors barred from FDI, and restrictions on non-equity modes of investments that are often implemented in a non-transparent way. Foreign trade and FDI are also hampered by restrictions on foreign exchange transactions and difficult procedures for opening dollar denominated accounts.

Poor infrastructure and governance, including a weak regulatory environment, have been serious constraints to private sector investment. According to the 2013 Enterprise Survey, two-thirds of Nepali firms identified electricity as a major constraint, much higher than the regional average, and about a third considered transport a major constraint. Weak governance is reflected in Nepal's low ease of doing business ranking. In 2018, Nepal had an overall rank of 105 out of 190 countries, with very low scores in 'Dealing with Construction Permits' (157), 'Enforcing Contracts' (153), 'Paying Taxes' (146), 'Getting Electricity' (133), and 'Starting a Business' (109). Weak governance has also affected Public-Private Partnership projects across the economy.

Another important tier of constraints include shortages in managerial and technical skills, access to finance, and access to land. The scarcity of medium- to high-skilled technical and managerial workers is a problem for firms seeking to grow or move up the value chain. Strict visa regulations for foreign workers further worsen the supply of technical and managerial talent. There is no distinction between temporary and permanent movements of workers, and the visa process is non-transparent and expensive. Although the share of Nepalese firms with a bank loan is in line with regional comparators, 40 percent of them identify access to finance as a major constraint. Several gaps in Nepal's financial infrastructure (e.g. low coverage of the Credit Information Bureau and regulatory gaps in movable asset-based financing) limit the system's ability to provide credit to firms. Long-term finance is also very limited. An outdated Land Acquisition law and weak institutions have also affected private sector investments.

Several sectors hold promise for Nepal, but economy-wide constraints and sector specific ones hold back their potential. Hydropower will be critical to the new growth strategy, helping to overcome the country's serious electricity gap and boosting exports. Few jobs, however, would be created. Other sectors such as tourism and agribusiness could also benefit from Nepal's unique endowments. In the tourism sector, average receipts per international visitor (US$592 in 2017) are only half of the global average and one third of those in Thailand and India. Poor connectivity infrastructure puts many destinations out of reach, and outdated regulations hold back investors. Regulations for protected areas need

to balance legitimate environmental protection with enabling more economic opportunities to local communities. Furthermore, lack of coordination among government entities and between the public and private sectors have prevented the implementation of an effective strategy to attract higher-end tourism. The agribusiness sector is currently small and focused on the domestic market. Poor connectivity and logistics fragment domestic markets and increase aggregation costs, weakening value chains and the competitiveness of local produce. This is compounded by inefficiencies in government procurement and distribution of basic inputs, like fertilizers and improved seeds. Aggregating land is also difficult resulting in small and unproductive farms. In addition, the nascent IT services sector has opportunities for expanding exports in low- to mid-range segments and raising the productivity of government and other economic sectors but is hampered by weaknesses in the educational system and poor access to quality infrastructure such as IT parks.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Streamline business regulations by developing a Doing Business reform map.
- Use platforms like the Nepal Business Forum for regular public-private sector dialogue.
- Develop a network of business advisors and management extension programs to enhance managerial skills and SMEs capabilities.
- Simplify visa procedures for highly skilled foreign workers while investing in domestic skills.
- Review negative FDI list to rationalize it, review and adopt the Draft Foreign Investment Act, and streamline approvals of FDI investments and repatriation of profits.
- Finalize the PPP Law and develop pipeline of projects.
- ***In tourism,*** (a) upgrade airport safety, accelerate construction of Gautam Buddha International Airport and Pokhara airport, assess need for second international airport, and improve road access to key destinations; (b) review regulations governing the use of protected areas to allow investments that are not in conflict with conservation; and (c) designate organizations in charge of designing and implementing plans for the integrated development of key destinations.
- ***In agribusiness,*** (a) allow private sector participation in procuring and distributing fertilizers and seeds, and strengthen the efficiency of subsidies; and (b) identify priority activities to improve food safety/SPS measures to facilitate access to higher value markets.
- ***In ICT,*** (a) together with industry review the market relevance of the IT curriculum; and (b) improve the existing IT park through greater private sector investment and attraction of anchor firms.

To address these issues, in the medium to long term, the government needs to:

- Simplify business regulations, including implementation of Doing Business Reform map, and introduce single-window interfaces for regulatory compliance.
- Implement management extension programs and program to develop a network of business advisors.
- Approve Foreign Investment Act.
- Implement new PPP Law and pipeline of priority projects.
- Develop industrial parks using PPP models, e.g., agribusiness, ICT and other sectors.
- ***In tourism,*** (a) involve the private sector in the management and construction of airport through PPPs; (b) review Tourism Act and clarify Investment Approval Criteria under the Industrial Enterprise Act; (c) lease state-owned land for private investment in destination gateways; and (d) implement integrated destination management plans in priority areas.
- ***In agribusiness,*** (a) enhance land availability by strengthening land management, introducing land pooling, and supporting contract farming; (b) build quality infrastructure to implement international food standards in collaboration with the private sector; and (c) determine PPP investments needed to enhance logistics for agribusiness.
- **In ICT,** (a) Improve quality and relevance of IT skills; and (ii) assess finance needs of ICT startups.

2.2 Strengthening the Financial Architecture

Key Issues and Challenges

Nepal's financial system is bank dominated and characterized by a large number of institutions, fairly significant state ownership, and multiple banking licenses. The banking sector accounts for more than 87 percent of system assets and has expanded by 223 percent between 2009 and 2017. Notably, domestic credit to the private sector jumped from 33 to 78 percent of GDP from 2005 to 2017.

The underlying weaknesses related to the severe liquidity squeeze of 2011 have been partially addressed. Excessive credit growth, weak supervision and enforcement of prudential regulations, and a liberal bank licensing policy contributed to weaknesses. The collapse of a real estate bubble, coupled with a slowdown in remittance growth, led to a severe liquidity squeeze in mid-2011. The Nepal Rashtra Bank (NRB) responded with large-scale liquidity support and regulatory forbearance, and a resurgence of remittance flows eventually eliminated pressures. The authorities have subsequently undertaken significant regulatory and institutional reforms with support from development partners.[4]

There are, nevertheless, still significant financial sector risks that also limit financial intermediation. While headline bank capital adequacy and asset quality figures appear comfortable, there are concerns over evergreening of bad loans and under-provisioning, leading to an understatement of the nonperforming loan ratio and an overstatement of the capital adequacy *ratio*. There are also indications of a need for further bank consolidation, vulnerability to exogenous factors (such as earthquakes, trade disruptions, and remittance slowdowns), and an underfunded safety net. Fueled by remittances and exposed to maturity mismatches, the system is unable to channel long-term finance (e.g. to infrastructure investment).

Despite progress on financial inclusion, significant gaps in access to finance for smaller firms, and unequal access across gender and geography, are hampering firm growth and productivity. Access to finance for firms has shown some progress, but 40 percent of firms still report access to finance as a major constraint. Significant gaps exist for SMEs, startups, women, and rural businesses. These are firms that contribute significantly to job creation, but only 9 percent use banks to finance investments, compared to 17 percent on average nationally.[5] Access is limited[6] by financial institutions' relatively high cost of personal screening and due diligence for typically modest loan amounts, high reliance on conventional collateral-based lending approaches, and concerns that borrowers might be accumulating many loans from multiple lenders. A regulatory cap on the spread on interest rates that financial institutions (domestic and international) can charge further reduces their ability to accurately price in risk or provide long-term financing. When firms can access credit, financial institutions have to rely on conventional collateral-based lending approaches, given the lack of credit information[7]. In addition, existing legal provisions of the Country Civil Procedure (Code) Act do not afford foreign financial institutions the same protection as local banks in terms of creditors' rights.[8] Finally, the agriculture sector receives less than 5 percent of bank loans, and agricultural finance is often impeded by ineffective government policies.

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[4] The reforms include restructuring and consolidating the financial system; strengthening the legal and regulatory framework for crisis management, banking, and insurance supervision; and enhancing the governance and transparency of the banking sector.

[5] SMEs comprise more than 96 percent of the total industrial establishment, contribute 83 percent to industrial employment generation, and share 80 percent of the industrial sector's contribution to national GDP.

[6] FINDEX, 2017: About 45 percent of the adult population has a formal bank account (compared to 69 percent in the region). The numbers fall further for those in rural areas (at 43 percent) and the poorest (at just 38 percent).

[7] The Credit Bureau coverage is merely 1.7 percent of adult population (the South Asia average is 14.1 percent).

[8] They typically resort to partnering with a local bank or a consortium under a pari-passu security arrangement for debt recovery.

While advancements on payment systems hold significant promise to improve access and the authorities are increasingly focusing on relevant reforms, the system is still at a nascent stage. The Payments and Settlement bill is in the process of approval and is expected to provide an enabling framework for implementing digital financial services (DFS) that enhance the safety, reliability and efficiency of the payments system. Combined with efforts on a unique National ID System, this can improve financial inclusion, minimizing the costs and expanding the provision of formal financial services (including remittance services). A unique National ID System can also provide detailed background information on an individual and reflect their credibility, which can be used by the banks as a "reputational collateral".

The nonbank sector presents challenges to both stability and access to finance. Financial cooperatives account for more than 12 percent of financial system assets and have significant links to the banking sector, but there is no meaningful regulation or supervision. While a new Cooperatives Act was recently approved, the regulator (Department of Cooperatives) lacks capacity and any implementing regulations for effective supervision. The insurance sector, which is of equal systemic importance in the financial sector, lacks adequate supervision and operates within an archaic legal framework.

Capital market infrastructure is relatively weak, supervision capacity is poor, and the private equity/ venture capital (PE/VC) funds lack a specific legal or regulatory framework. A few PE funds are in operation, but growth is limited relying on a combination of disparate laws and regulations (e.g. Company Law, Laws on Banking, FDI, etc.). There is only one stock exchange that lacks depth, with listings dominated by financial institutions (over 80 percent) that account for 67 percent of trading volume while foreign investment faces restrictions. The corporate bond market is almost non-existent, and there is no yield curve. The market capitalization is close to 70 percent of GDP.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Take stock of emerging vulnerabilities that include adequate capitalization of the deposit insurance scheme, further strengthening of regulation/supervision (framework and capacity), and improvements to market practices in the insurance industry and cooperatives sector.
- Revisit the access to finance policy at the firm level and identify legal, regulatory and institutional reforms that can help broaden the range of acceptable collateral by alternative market-based instruments like partial credit guarantee schemes, warehouse receipt financing, and insurance products.
- Expand the coverage of the credit bureau, enhance financial literacy and promote DFS.

To address these issues, in the medium to long term, the government needs to:

- Strengthen the payments system by implementing regulations and a roadmap for migrating government payments to electronic means, and enhancing inclusive finance through DFS and fintech solutions.
- Improve access to credit information by strengthening the legal, regulatory, and institutional framework and raising stakeholder awareness. Key measures include microfinance institutions sharing information with the credit bureau, eliminating the minimum threshold of credit reporting, capturing positive information of borrowers, and developing value added services like credit scoring of borrowers.
- Implement regulatory changes to expand alternative market-based financing instruments for small and medium enterprises.
- Set up a unique national ID System to promote financial inclusion, enhance financial stability and reduce the transactional cost of doing business.
- Increase the availability of long-term finance by (i) deepening capital markets (increased listing of non-bank corporations, promoting the bond market), (ii) creating an enabling environment (by amending the Foreign Investment and Technology Transfer Act, automating FDI procedures, revising central bank regulations that gives foreign banks equal creditors' rights) to attract international financing, and (iii) promoting PE/VC through the development and adoption of prudent legal and regulatory framework for Alternative Investment Fund Regulations (AIF).

Nepal Policy Notes

2.3 Facilitating Trade and Deepening Integration

(i) Facilitating Trade

Key issues and challenges

For a small economy like Nepal, strategically located between two emerging powerhouses—India and China—and with preferential access to many high-income and fast-growing economies, trade and investment can be an important driver of growth. Nepal has been the slowest-growing economy in South Asia with growth over the past decade averaging 4.5 percent. It has not been able to keep pace with the fast-changing global environment and build on the major reforms carried out in the early 1990s. Export growth has remained almost stagnant in the last decade while imports have been rising, thereby, resulting in a large trade deficit. Nepal has been unable to diversify its exports, in terms of both products and destinations, and more than two-thirds of trade is with India. In terms of investment, Nepal has among the lowest participation in global value chains (GVCs) compared with other countries in the region, with annual foreign investment of less than 1 percent of GDP over the last decade. While challenging supply-side constraints associated with inadequate infrastructure, landlocked status, rugged terrain and the presence of non-tariff barriers are major bottlenecks, the current trade policy framework could be improved to make it more conducive to trade and investment.

The pace of tariff liberalization has been slow and uneven - and the country still applies significantly higher tariffs on key intermediate and capital goods creating an anti-export bias. Reforms initiated in the early 1990s cut both the level and variation of tariffs in Nepal substantially. Between 1989/90 and 20001/02, the unweighted average customs duty fell from almost 40 percent to 13.7 percent. More recently, it fell to 12.2 percent in 2017. Nepal has consistently applied higher tariffs on the import of intermediate and capital goods than countries that benefit from integration into global value chains (GVC) such as Vietnam and Malaysia. For instance, in 2015, Nepal had a simple average tariff of 10.2 percent on intermediate goods, which was 6.3 percent higher than Vietnam's and 6.9 percent higher than Malaysia's.

Firms have been unable to tap opportunities to reach markets with which Nepal has agreements or trade preferences. Evidence suggests that Nepal has only benefitted from the South Asian Free Trade Area (SAFTA) agreement as an importer, but hardly as an exporter. Firms have also struggled to increase the utilization rates of trade preferences (under the Generalized System of Preferences, GSP) provided by high-income countries. On the latter, the opportunities are large because the agreement with the European Union (EU) allows the formation of regional value chains to produce exportable products to the EU. Nepal has been unable to capitalize on these opportunities because of (a) inadequate access to finance, electricity and poor connectivity; (b) low firms' capabilities; and (c) policy barriers that hinder foreign direct investment and prevent firms from connecting with multinationals. In addition, to qualify for duty-free treatment under GSP, the product needs to comply with the rules of origin and the exporter needs to be able to provide production and accounting records to verify the GSP claim. This means that, apart from the firms' capabilities to maintain records to prove local content, the main binding constraint for utilization may be related to rules of origin.

The duty-drawback system and the cash incentive scheme for exporters are complex and non-transparent. Nepal offers a variety of duty and tax relief schemes designed to ensure that goods imported for manufacturing and export are exempt from various duties and taxes. However, anecdotal evidence from exporters suggests that the duty-relief scheme is not administered effectively and efficiently. Similarly, a recent impact evaluation of the Cash Incentive Scheme for exporters revealed weaknesses like the following: (a) the subsidy has not been reaching the firms it is meant to support due to a lengthy and complex filing procedure, coupled with limited resources and a first-come first-serve allocation mechanism,

(b) it has subsidized firms that were already exporting, and (c) it has not had any impact on export values or quantities.

Nepal's trade complementarity indices suggest that dynamic export growth requires some diversification, particularly into fast-growing economies in East Asia and the Pacific. With these economies, it substantially under-trades relative to a benchmark, constructed based on both partners' sizes and distance. The SAFTA has stumbled in its efforts to liberalize trade in goods, so it appears relatively unfeasible for it to progress into deeper forms of integration. Moreover, evidence suggests Nepal overtrades with India, and in addition, that export complementarities have been declining. Thus, the concentration of the export basket in India may be impeding faster export growth. Therefore, to deepen its integration with the world, Nepal needs to look beyond the region and start with trade and investment in services – crucial for diversification and for supporting the productivity of other sectors that use services intensively. It also needs to improve trade facilitation, by strengthening, for example, its stance in the Bhutan, Bangladesh, India and Nepal transit agreement.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Reduce the anti-export bias by lowering tariff rates starting with tariff reductions on crucial intermediates, which are key to producing priority products (and provide negligible tariff revenues to the government).
- Simplify the duty-drawback system by making it accessible to both direct and indirect exporters (sellers to tourists), simplifying certification rules and providing faster duty refunds to firms.
- Support firms in complying with GSP rules of origin, through the provision of trainings on bookkeeping and management of input certifications. Liaise with main GSP-granting country trade representatives to support these efforts.
- Redesign the Cash Incentive to Exporters, by allocating the subsidy to new rather than existing flows, by implementing the fast track for certification of domestic value added.
- Allocate funds for the provision of export intelligence services for high-potential markets and products and subject to strict monitoring and evaluation mechanisms.

To address these issues, in the medium to long term, the government needs to:

- Consider a comprehensive tax reform in the context of the new federal structure, to offset potential revenue losses from eliminating import-based taxation including the reduction in tariffs on intermediate and capital goods.
- Seek to partner with regions exhibiting greater trade complementarities, and that offer deeper integration opportunities (for example, the Association of Southeast Asian Nations (ASEAN)—a bloc including countries with which Nepal faces high unexploited export potential).
- Strengthen the Bhutan-Bangladesh-India-Nepal (BBIN) transit agreement to improve connectivity and reach some of these high-potential markets.

(ii) Deepening Integration

Key issues and challenges

Nepal's trade integration performance over the last two decades has been lackluster. Many factors affect Nepal's trade prospects. Apart from the political instability that the country has experienced for over 20 years, which has stifled firms' investment and innovation, other factors are structural (such as geography, infrastructure deficiencies and skill shortages). In terms of trade integration, Nepal shows export and import orientation below average taking into account the country's size, remoteness from main markets, and landlocked geography. Integration offers Nepal an opportunity to move towards a new growth model. This would be achieved through (a) regional and global value chains for both goods and services, (b) services trade in activities of marked comparative advantage, and (c) e-commerce for high-quality, low-volume segments. The incoming foreign direct investment (FDI) to support these activities will help domestic firms overcome obstacles to successful internationalization.

FDI will be crucial in helping Nepal to transition to a lower middle-income country (LMIC). FDI typically comes with increased access to sophisticated markets and can facilitate the absorption of new technologies and managerial practices, and can alleviate the financial constraints that local firms face. Currently, Nepal's FDI inflows are the lowest in South Asia (0.8 percent of GDP in 2017). FDI is mainly hampered by entry barriers including foreign ownership limitations, sector caps, a long negative list, and restrictions on non-equity modes of investment. For example, Nepal retains a foreign ownership limit of 51 percent in select sectors, such as legal, accounting, and engineering services. Non-equity modes of investment, such as franchising, which can be a source of access to technology, training, and skills transfer, also face restrictions. Among other factors, they are subject to slow and arbitrary approval processes, dual registration procedures, delays in trademark registration, and difficulties in remitting royalties. Similarly, repatriation of funds and hiring foreign workers is difficult and obtaining approvals is a lengthy process.

E-commerce opportunities are yet untapped. Many Nepalese firms are concentrating on small-scale production of high-quality products. There appears to be an opportunity for Nepalese e-commerce to penetrate distant markets as it allows firms to connect through an online platform directly with final consumers and reduces transaction costs. More countries are allowing greater amounts of duty-free e-commerce purchases, thus unilaterally providing increased market access to foreign firms, including Nepalese firms. Some progress has been achieved in setting up the necessary soft infrastructure through the approval of the e-signature. However, the lack of an international payments gateway and restrictive regulation in Nepal prevents firms from using this platform.

Firms face external obstacles to trade integration. These include: (a) policies that either are not supportive of or impede firms' access to foreign markets for selling outputs or sourcing inputs (both for goods and services); (b) restrictive investment policies that prevent the attraction and retention of foreign investment, and its linkages with domestic firms; (c) anticompetitive practices in domestic markets, with implications for provision of quality key backbone services (transport, telecommunications, construction, finance); (d) inadequate national infrastructure (both hard and soft), particularly quality infrastructure and (e) a challenging regulatory environment: Nepal ranks 105th overall among 190 countries in the 2018 Doing Business survey, and 109th on the ease of starting a business.

Internally too, firms face many constraints. Many firms lack marketing knowledge, and access to appropriate technology, value chain integration, certification and networks. They also face problems recruiting and retaining workers. Despite a steady improvement in the educational qualifications of the emerging cohort of workers, firms in the formal sector persistently complain about the difficulty of hiring and retaining skilled workers. This is partly because young people with good educational qualifications often aspire to professional jobs in the public sector and exhibit high reservation wages. But it is also partly because graduates of the education system do not yet have the specific skills needed by firms. An early-stage pool of ecosystem builders (like incubators, accelerators, shared space, event organizers, and consulting services on legal and accounting) are offering services to strengthen firms' investability. This

ecosystem support network, although in its infancy, comprises dedicated champions of entrepreneurship. Yet, the network lacks coordination, scale and capacity to provide a holistic solution to firms to expand and create jobs.

There are also significant gaps in access to finance for smaller firms. Nearly 40 percent of firms, particularly small and medium enterprises, report access to finance as a major constraint. While short-term trade finance credit lines are available through international banks, long-term source of debt finance is not. When firms can access credit, it comes at a high cost and with significant collateral requirements. Non-collateral solutions are typically not available because of lack of institutional capacity and relevant policies.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Promote e-commerce platforms with necessary infrastructure and deregulation of restrictive policies, including a gateway for foreign payments into Nepal.
- Strengthen competition in the logistics service sector to fully tap into the potential of e-commerce.
- Improve long-term debt financing by granting similar credit rights to international and domestic financiers.
- Enhance the quality of business advisory services for small and medium enterprises (SMEs).
- Streamline the approval of foreign investments by amending the Foreign Investment and Technology transfer (FITTA) Act, rationalizing the negative list, and improving the process for repatriation of funds.

To address these issues, in the medium to long term, the government needs to:

- Improve the quality of national infrastructure by removing barriers to foreign investment and streamlining business processes.
- Reduce restrictions on trade in services and promote competition by amending relevant legislation (Companies Act, Patent Design and Trademark Act and Special Economic Zone Act).
- Encourage foreign investment by streamlining the process for hiring foreign workers, re-evaluating the rationale for low equity limits in foreign ownership and removing restrictions on non-equity modes of investment for franchising.
- Unify efforts for investment promotion under one authority and coordinate these efforts with those related to export promotion of both goods and services.
- Improve access to finance by formulating a Micro, Medium and Small Enterprise strategy and strengthening the credit information system to reduce the financial intermediation costs.
- Promote competition in key backbone services markets, specifically in transport and logistics, as well as in finance (e.g. equity limits for foreign investment in finance).
- Reduce rigidities in the labor market, and ensure access to qualified labor.
- Identify regional value chains with maximum potential and focus efforts on strengthening these.

Nepal Policy Notes

2.4 Expanding the Road Network and Enhancing Resilience

(i) Expanding the Strategic Road Network

Key Issues and Challenges

Being a land-locked country with a hilly terrain, road and air transport in Nepal are critical for the movement of people and goods within and across the country. Nepal's road network of about 71,060 kilometers (km) comprises the Strategic Road Network (SRN), of about 13,060 km, which serves as the primary arterial network of the country; and the Local Road Network (LRN), of 58,000 km.9 Within the SRN, the roads serving cross-border movement merit special mention because they are pivotal for the country's trade in goods (about 36 percent of GDP). The SRN is under the purview of the federal government and is managed by the Department of Roads under the aegis of the Ministry of Physical Infrastructure and Transport (MoPIT).

Although government spending on the SRN increased 24 percent (compound annual growth rate) between FY2014 and FY2017, the network continues to be of low quality and a significant constraint to growth. Nearly half of SRN roads are either only graveled (16 percent) or earthen (31 percent, which provide connectivity only in fair weather). In a 2015 survey of 2,626 km of national highways, only 8 percent of the roads were found to be "good" condition as measured in terms of the International Roughness Index; the condition of feeder roads is much worse, with only 3 percent in "good" condition.

The increase in government spending is disproportionately directed toward capital expenditure, and not necessarily in a strategic and effective manner. This is because the government's priority plans are (a) rarely based on an objective assessment of the network needs and priorities; (b) often include many "mega" projects of "national significance"; and (c) are seldom backed by credible financing plans or funding allocations. For example, the most recent five-year strategic plan envisaged construction or upgrading of many roads at an estimated cost of US$6.5 billion, which is several times the average annual expenditure of about US$285 million during FY2014/16 for the entire SRN. With no commensurate efforts to mobilize additional resources or to step up preparation, implementation of the plan made little progress over the last two years.

Yet another issue is the ad hoc and paltry allocation of funds to projects. For instance, for FY2017, the government allocated US$1 million for Karnali Corridor, with a balance investment requirement of US$37 million, and US$9 million for the Kaligandaki Corridor, with a balance investment requirement of US$266 million. At that rate of investment, the projects would take more than 25 years to complete.

Even in the case of projects that move from the planning to the procurement stage, the contracts are often based on a traditional item-rate approach, with significant limitations. Among these are that they (a) are not easily amenable for harnessing economies of scale or new technologies, and (b) offer few incentives for increased efficiency or cost reduction. The maintenance expenditure, which is already meagre, suffers from similar limitations. It often leaves out sizable portions of the network and is spent via small, annual contracts that are also administratively onerous.

Some of these issues can be addressed through better performance-based contracting with private participation. However, these contracts require assured cash flows to pay for those services through direct or indirect user fees and predictable budget support. The Roads Board Nepal (RBN), established in 2002 with the aim of providing sustainable funds for the planned maintenance of roads, is a laudable initiative,

[9] The LRN is the primary channel for rural populations to access economic opportunities, social services, and key centers of government.

but the cash flows it is endowed with are inadequate to fully cover even the maintenance requirement of its networks.

In addition, little or no attention is being paid to other emerging imperatives such as road safety and climate resilience. According to the road accidents data available, which are admittedly not comprehensive, the number of people killed in road accidents has increased from 1,356 in FY2009 to 2,006 in FY2016. The International Panel on Climate Change (IPCC) suggests that Himalayan regions like Nepal will experience significant changes in weather patterns due to climate change, and the Bank's Climate and Disaster Risk Screening tool further confirms that SRN roads and bridges are facing high risks of extreme precipitation and landslides.

Another key priority for the government is the Fast Track Project (FTP)—a proposed approximately 75-km new segment. This could significantly reduce the time and cost for 50 percent of Nepal's imports. The responsibility for FTP implementation is currently vested with the Nepalese Army. At an estimated cost of more than US$1 billion, this project is far more complex than any other road project ever implemented in the country. This further underscores the imperative for robust preparatory work with respect to technical, environmental and social, contracting, financing, and institutional aspects.

Policy Recommendations

To better manage the SRN, the government needs to focus on selected high-density and strategic national highway segments (say, 2000 km to 2,500 km), with the following aspects:

- Create a robust and credible phasing and financial plan for the program, with good estimates of all key expenditures (for example, land acquisition, government's payment obligations) and likely sources of revenue for meeting them (for example, budget support, tolls). If there is a financing gap, the plan should identify feasible options for bridging the same and, if not, suitably recalibrate the program.
- Make the aforementioned cash flows credible and sustainable, through appropriate regulatory or legislative actions by, for example, (a) making a multiyear commitment to devote a specified portion of overall capital allocation; or (b) ring-fencing levies on fuel into a non-lapsable fund.
- Establish a dedicated team or unit within the Department of Roads, with an explicit mandate to implement the program and equip it with requisite human and financial resources.
- Adopt better contracting structures such as combining of construction and maintenance and long-term maintenance contracts, where payments are squarely linked to achievement of prespecified outcomes and performance.
- Ensure due attention and allocations to road safety and climate resilience.

On the Fast-Track Project, the government needs to focus on the following:

- Establish an updated and accurate traffic estimate and a corresponding final alignment and design that optimizes costs and mitigates environmental and social impacts.
- Arrive at an accurate assessment of the cash flows likely to be available to support the project and design a contracting/financing strategy that matches these means and preserves incentives for efficiency.
- Establish a Fast-Track Project Authority, preferably backed by legislation, with an explicit mandate of developing the project, and endow it with requisite financial resources, technical expertise, and special powers to expedite progress in key areas.
- Expedite preparatory work on the part of the government for securing funds and land acquisition.
- Implement options to relieve congestion on the existing roads while the FTP is under construction.

(ii) Enhancing the Resilience of the Road Network

Key Issues and Challenges

Geohazards pose a significant and frequent threat to Nepal's roads. Heavy rainfall during the monsoon season, instability of soil and rocks due to weathering, and (sometimes) earthquakes, trigger landslides, floods and erosion. Furthermore, melting of snow and ice and subsequent flash floods, although infrequent, also pose high risks to road assets. Every year the national highways in hills and mountains are blocked due to numerous landslides, and highways in southern plains get blocked due to floods – the aftermath is heavy damage to road assets. Yearly losses in transportation from natural hazards is significant, and unfortunately the trend is rising. This does not even account for the inconvenience, higher vehicle operating costs, reduced safety, and indirect economic losses due to closure of roads and poor road conditions. Nepal is deeply entangled in the vicious cycle of disaster and response.

Every year, on average, 650 kms of roads are constructed by different institutions, with or without proper geotechnical investigation and design inputs. With the ongoing transition to federalism, the budget allocation for road construction is likely to increase significantly. It is a government requirement to conduct an Initial Environment Examination (IEE) or the Environmental Impact Assessment (EIA) for construction of any roads and safeguards measures are part of the project design. However, there are major environmental safeguards violations by companies contracted to build rural roads and bridges, with some of the roads not even fulfilling the basic design requirements. This problem is compounded because the contracting agencies often do not have adequate technical capacity to design and supervise construction, and monitor compliance.

In addition, not enough attention is given to maintenance of roads and bridges. This results in the deterioration, higher repair or reconstruction costs, and eventual loss of investment. Each road asset has a nominal design life and it is important to ensure functionality of these assets throughout their design life and beyond. Unfortunately, emergency repairs and remedial interventions are carried out every year, which is the least effective approach to asset management. These erode the infrastructure and economic gains of the country.

Roads data is also not systematically archived. The Department of Roads has been publishing the Nepal Roads Statistics since 1998 in two-year intervals. However, there is not yet a central database of all existing roads network and assets in the country. Effective asset management is critical to the sustainability of road investments.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Launch a comprehensive national disaster risk assessment program for roads, create geohazard maps, identify and document major landslides and flooding areas, and mitigate geohazard risks.
- Launch a comprehensive earthquake risk assessment for bridges, identify vulnerable bridges and reinforce them and plan for redundancy.
- Prepare road asset inventory, condition survey and geomorphological profiles and create an online database and ICT-based M&E system for geo-hazard risk analysis, planning and monitoring. Build capacity of the local governments to monitor commitments made by the contractors of projects in EIA and IEE.
- Build capacity in bio-engineering, a low-cost technique that can stabilize slopes and mitigate against shallow landslides.
- Include geo-technical and engineering inputs at the design stage for roads and bridges based on geohazard mapping and ground investigation.

To address these issues, in the medium to long term, the government needs to:

- Create an ICT-based decision support system to help government agencies take decision on maintenance, repair and risk mitigation for roads and bridges.
- Establish a Quality Assurance and Monitoring system at all tiers of the Government to ensure all roads have adequate engineering geology and geotechnical engineering inputs.

Nepal Policy Notes

2.5 Powering the Economy

Key Issues and Challenges

Nepal faces significant shortages in electricity. Although 95 percent of the country's population has access to electricity (a quarter of which is off-grid), power cuts had been rampant until recently. Annual average per capita electricity consumption, at 160 kilowatt hours (kWh), is a twentieth of the global average and a fifth of South Asian average. Installed generation capacity (1070 megawatts [MW]) has not kept up with the growing electricity demand (~1,500 MW), leading to power outages of up to 16 hours a day during most of the last decade. While increased imports from India and demand side management have reduced the severity of power cuts, the country faces a significant electricity shortage, and the situation worsens during winter. The transmission and distribution network is aging and stressed, while metering, billing, and collections need to be modernized.

Two-thirds of Nepal's firms identify electricity as a major constraint to doing business. Commercial and industrial consumers rely on expensive diesel generators, which has raised costs and impacted productivity, competitiveness, and growth. This in turn has limited job creation, which has pushed more than 5 million people to work overseas. Agriculture is the largest contributing sector to GDP, but it's productivity is also constrained by the lack of electricity for irrigation. Despite large hydropower generation potential, Nepal still does not export electricity to its neighbors.

Substantial generation capacity is under development but is facing delays in completion. About 1,400 MW from run-of-river hydropower plants are under construction but are experiencing delays due to shocks such as earthquake and trade blockade as well as weak implementation. Subsidiaries of the vertically integrated utility, Nepal Electricity Authority (NEA), or small domestic independent power producers (IPPs) with take or pay power purchase agreements (PPAs) with NEA are developing most of the new generation capacity.[10] Timely commissioning of these projects could lead to surplus generation in the summer months from 2020 onwards. The electricity shortage in the dry season is expected to continue in the medium term until storage hydropower plants come online. In the meantime, the shortage will need to be met through electricity imports from India.

Investments must increase substantially to meet the medium-term needs of the country. To meet the growing demand, investments must increase to at least US$2 billion per year from an average annual investment of less than US$500 million during FY2010–15. This can only be achieved if the government addresses the following bottlenecks: (a) the unavailability of long tenor loans for hydropower projects, (b) limited capacity of local banks and financial institutions to appraise hydropower projects, (c) unclear PPA and Project Development Agreement (PDA) guidelines, (d) lack of mechanisms to manage foreign exchange risks of dollar-denominated PPAs, and (e) weak management of environmental and social issues.

The development of hydropower projects for electricity exports is lagging. Projects have not materialized despite interest from reputed international developers. The government has signed PDAs for two large export-oriented projects, but despite years of effort, none has reached financial closure.[11] Nonetheless, the potential for export to India and Bangladesh remains, and exports could take place once the right political, institutional, and regulatory conditions are in place.

An inefficient institutional and regulatory framework is constraining the development of the sector. Electricity sector agencies have overlapping and multiple roles and unclear mandates. The NEA is highly

[10] Foreign IPPs have not achieved progress given foreign exchange and country and sector risks.

[11] These include (a) the 900MW Arun III, to be developed by the Indian state-owned developer SJVNL; and (b) the 900 MW Upper Karnali, to be developed by India private developer GMR.

politicized, has been loss making until 2017, and has weak capacity. A fifth of the electricity is lost due to technical and nontechnical reasons, unfairly increasing the cost of electricity to paying consumers. Electricity sector decisions are mostly undertaken on a project-by-project basis without long-term planning. Electricity tariffs are subject to approval by the government through the Electricity Tariff Fixation Commission. Tariff increases have been highly irregular and do not cover the cost of providing electricity.

Significant institutional and regulatory reforms, delayed by the long political transition, need to be pursued urgently. The 1992 Electricity Act needs to be updated to facilitate increased competition, private sector participation, and electricity trade, and to underpin the transition to the new federal structure. The Electricity Regulatory Commission (ERC) Act needs to be implemented to establish an independent, transparent, and accountable regulator. New electricity sector institutions established by the government to build capacity and support the transition to a competitive electricity market—the Nepal Power Trading Company Limited (NPTVL), Electricity Generation Company Limited (EGCL), and National Grid Transmission Company Limited (NGTCL)—need to be developed into modern, efficient, and capable institutions.

Policy Recommendations

To address these challenges in the short, medium, and long term, the government needs to:

- De-risk the sector through institutional and regulatory reforms. **In the short term:** (a) make the ERC operational and submit the new Electricity Act to parliament for approval, (b) issue a roadmap for NEA restructuring, (c) implement the NEA financial viability plan, and (d) prepare and endorse a least cost generation plan. **In the medium to long term:** (a) complete NEA restructuring, and (b) seek integration into the regional electricity market and/or establish a wholesale electricity market.

- Support large hydropower and renewable energy development. **In the short term:** (a) issue standardized PPA and PDA guidelines, (b) issue competitive bidding guidelines for new generation, and (c) issue new environmental and social guidelines for hydropower development. **In the medium to long term:** (a) deepen the domestic capital market to increase availability of long tenor loans for hydropower projects, and (b) introduce nonrecourse project finance to the sector.

- Assist state-owned entities such as NEA subsidiary companies and the newly established Electricity Generation Company Limited (EGCL). **In the short term:** (a) identify large hydropower projects to be developed through concessional financing from development partners; (b) prepare and approve the business plan for EGCL, and (c) strengthen the capacity of EGCL and NEA subsidiary companies to develop and manage projects. **In the medium to long term,** use EGCL to develop and construct large hydro projects leveraging commercial financing.

- Pursue greater regional energy integration. **In the short term:** (a) prepare and approve the business plan for NTPCL, and (b) pursue dialogue at the regional level to establish a regional power market. **In the medium to long term:** (a) issue regulations and complete infrastructure upgrades to enable Nepal to participate in a regional electricity market, and (b) use NPTCL as the nodal agency to undertake power trading in the Indian/regional power exchange.

- Undertake timely investments in the country's transmission and distribution network. **In the short term:** (a) approve and implement the loss reduction master plan to reduce high levels of technical and nontechnical losses; and (b) pilot advanced metering infrastructure. **In the medium to long term:** (a) modernize the distribution networks with information technologies, (b) develop a high-voltage transmission corridor, and (c) develop high-voltage regional interconnections.

Nepal Policy Notes

2.6 Achieving Universal Clean Cooking by 2030

Key issues and challenges

There are well-recognized negative environmental, health, and economic externalities associated with traditional biomass use. As a result, the Government of Nepal (GoN) views the achievement of universal clean cooking (UCC) as a national priority[12]. A combination of incomplete combustion in sub-optimal cook stoves, unclean fuel practices, and poor ventilation in kitchens results in significant health impacts.[13] Unsustainable increases in the use of biomass causes environmental degradation and increased economic vulnerabilities. Furthermore, the burden of fuel gathering and meal preparation rests largely upon women and girls, leading to disproportionate health impacts on them, and on infants who are near their mothers. It also results in an adverse gender bias in educational and other opportunities for the girl-child. In addition, the rural and the poor are much more exposed to these negative externalities.

The government has developed a clear roadmap and Investment Prospectus (IP) for achieving universal access to clean cooking by 2030 but implementation will be key. The IP was duly adopted by the government in November 2016, and thereafter, targets in line with the IP were included in the country's Biomass Energy Strategy (BEST) 2017, a governing policy framework. This signals strong government commitment and a paradigm shift towards market approaches and higher-quality, factory-manufactured cook stoves. Efficient and effective implementation of this strategy in a timely manner will be crucial.

Supply and affordability constraints limit the penetration of liquefied petroleum gas (LPG) and electricity-based cooking in Nepal. Nepal has over 5.42 million households, spread across three ecological belts: Terai–50.3 percent, Hills–43 percent and Mountains–6.7 percent.[14] All of Nepal's LPG supply is imported and energy security concerns along with broader macroeconomic constraints limit government support for expanding LPG imports. Wider use of electricity for cooking can occur only when access to electricity increases, and sufficient investments and reforms are undertaken to make the grid reliable and affordable.[15] Therefore, traditional fuels will continue to dominate the country's energy mix, and alternatives in the medium term are limited.[16]

The existing government programs focused on building mud cook-stoves have limitations for successful scalability. Going house-to-house, trained stove artisans built some 1.4 million in-situ mud cook-stoves over a 15-year period. Since typical stove lives range from 2-4 years, the actual number of such stoves still in service is likely much smaller. Further, the ability to check standards and quality is constrained by the artisanal nature of these stoves. Stretched budgets and poor processes for accountability have also limited participation by large private players for scaled-up production of factory-made cook stoves. Limited institutional and technical capacity was developed in specifications, product testing, and quality assurance. As a result, it is now recognized that it is not possible to reach UCC with this approach.

The potential for biogas-based cooking, estimated at 1.2 million households, has reached only a fraction of this number, due to techno-economic, socio-cultural and resource hurdles. The government

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[12] The Multi-dimensional poverty index report published by NPC cited below, shows that not having clean fuels is a significant factor contributing to poverty in Nepal; Link

[13] CLIMATE AND HEALTH COUNTRY PROFILE – 2015 published by WHO and UNFCCC, shows that about 22,000 deaths are attributable to Household Air Pollution (HAP). Further, studies show that HAP is a significant contributor to ambient air pollution (about 25% in South Asia), there by exacerbating adverse effects on public health and environment.

[14] Per the National Population and Housing Census of 2011 (or CBS, 2011); link

[15] Despite large hydro resources, Nepal is currently a net importer of electricity.

[16] Per GoN, 75 percent of Nepal's current energy consumption is met by burning traditional fuels – mostly solid biomass.

has declared its intent to have biogas installed in about 600 thousand households. Solid biomass is used in 75 percent of Nepal's households and is expected to remain the most widely used fuel in Nepal, at least over the next decade. Hence, this is the central focus of the proposed national program to achieve UCC over the next decade.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Establish and adopt labeling standards and testing practices, strengthen quality assurance, and introduce monitoring and evaluation for biomass based cook stoves and related infrastructure.
- Disseminate information to generate national awareness, inform consumer preferences and incentivize behavioral change towards adoption of higher tier cookstoves.
- Build capacity of local governments in a phased manner, to achieve movement towards UCC.
- Involve the private sector to support quality manufacturing and distribution of higher tier cookstoves and processed fuel.
- Pilot Tier III and higher cook stoves in a few strategically selected "early-adopter" areas where local governments are interested, and private sector can be crowded in.
- Establish a special Clean Cooking Project Management Unit (PMU) within Ministry of Energy, Water Resources and Irrigation (MEWRI), with reporting and coordination role between local and provincial governments.
- Work with local bodies to build co-benefits such as job-creation, women's participation and self-help into the design of the clean cooking pilots, and the national initiative.

To address these issues, in the medium to long term, the government needs to:

- Roll out the cook stoves nationwide after incorporating the lessons learnt from the "early adopter" pilots.

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2.7 Underpinning Resilient and Sustainable Urban Development

Key Issues and Challenges

Nepal is the least urbanized country in South Asia. However, with an annual urban population growth rate of about 6 percent, the country is urbanizing fast. Urbanization in the country has not been able to generate economic opportunities and transformation due to the challenges related to deteriorating levels of basic services, inadequate resources and weak governance systems. Municipalities in Nepal have been struggling to provide adequate infrastructure, basic services, and housing. Access to piped water in urban areas declined from 68 percent to 58 percent from 2003 to 2010 because of inadequate service delivery and the sustained increase in urban populations. The share of the urban population living in slums (60 percent) in 2010 is much larger than the share living below the national urban poverty line (10 percent).

In particular, rapid urbanization has presented a unique set of challenges in the Kathmandu Valley. The Kathmandu metropolitan area accounts for about one-third of the country's urban population and its annual population growth is among the fastest across all metropolitan regions in South Asia. The Kathmandu Valley urban center also serves as an economic hub where as much as 40 percent of overall manufacturing employment is generated. Despite its significant potential in generating high-productivity jobs and attracting investments and tourists, the Kathmandu Valley has been unable to realize its potential. A lack of coordination across different tiers of government (e.g., central, provincial, local governments) has left urban development largely unplanned and ineffective. Poor enforcement of regulation has also led to uncontrolled urban sprawl, degradation and poor access to basic services, and dysfunctional land and housing markets. Unplanned and unsystematic urbanization has left the Kathmandu Valley with spatial urban infrastructures that are highly vulnerable to natural disasters (e.g., earthquakes), congestion, and pollution, thereby undermining livability and failing to bring about potential economic gains from the agglomeration economies. With the transition to a federal system, local governments will now be responsible for public service delivery.

Weak urban governance and implementation capacity poses a challenge to urban service delivery. Local governments have increasingly assumed the functions related to planning budgets, managing finance, and providing public services to their citizens. However, they lack institutional and financial capacity to perform some of these functions. Building the institutional capacity of urban municipalities is thus a critical step to ensure the delivery of quality public services to urban residents.

Public investment in municipal infrastructure has remained low despite the growing urban infrastructure deficit. It is estimated that Nepal needs to invest 8-12 percent of its GDP in infrastructure on an annual basis to graduate into a middle-income country. However, capital investment in infrastructure has remained low (roughly 4-5 percent of GDP) and public investment in municipal infrastructure declined in real terms from US$14 per capita to US$11 between 2008 and 2010.

Urban governance in Nepal is fragmented. In particular, the lack of coordinated institutional responsibilities between central and local authorities and across different ministries has hampered the efficient provision of urban basic services and infrastructure. The new federal architecture with the re-structuring of ministries has opened up opportunities to ensure that local governments can receive adequate technical support and guidance from the federal government as well as key ministries—particularly from the Ministry of Urban Development and the Ministry of Federal Affairs and Local Development.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Clarify and coordinate the functional, expenditure and revenue assignments of central, provincial, and local government institutions as well as key ministries directly involved in urban governance, planning, finance and service delivery.
- Invest in building the institutional and financial capacity of local governments and develop robust systems to plan and execute budgets and provide basic public services to their citizens.
- Help build the capacity of local governments to improve their financial capacities by raising their own revenues to finance the provision of quality public service as well as establishing robust PFM and budgeting systems in local governments
- Establish a robust, coherent and comprehensive intergovernmental fiscal transfer system for provincial and local governments.
- Identify key priority infrastructural gaps in urban municipalities—particularly, metropolitans and sub-metropolitan areas—and provide both technical and financial support to municipalities for infrastructure and urban planning.
- Invest in core municipal services and urban infrastructures such as water supply, waste water and sanitation, solid waste management, urban transportation, storm water drainage to improve quality of life in cities.

To address these issues, in the medium to long term, the government needs to:

- Establish coherent policy and regulatory framework at national and sub-national level for municipal service delivery including technical, financial and operational aspects.
- Support long term infrastructure investments in strategic urban clusters including Kathmandu Valley, Pokahara and others along the eastern terai belt of Nepal, for inclusive economic growth.
- Improve the organizational capacities and build robust fiduciary systems in local governments to access commercial sources of financing for addressing rapidly growing infrastructure needs.

2.8 Boosting Agricultural Competitiveness and Creating Rural Jobs

Key Issues and Challenges

Agriculture remains central to achieving the twin goals in Nepal, where poverty is concentrated in rural areas and vulnerability to climate change and natural disasters prevails. Agriculture employs two-thirds of Nepal's workforce, and accounts for one-third of the GDP and half of the exports.

Federalism poses major challenges to the delivery of core services necessary for a competitive, productive and resilient agriculture, but also creates opportunities for public-private provision. Strengthened capacity is critical for technical service delivery. While capacity for full public-sector provision of agricultural services has historically been challenging, new integrated solutions are possible through the provision of an enabling environment and regulatory oversight that promotes greater participation of the private sector.

The competitiveness of Nepal's private sector driven agriculture – from small household farms to large agri-businesses – depends on profitable linkages and strong efficiencies along the value chain, starting with on-farm productivity. In addition to the absence of general infrastructure and the weak enabling environment, low productivity and weak corporate governance also undermines the competitiveness of agri-businesses. It thereby limits the development of job-creating activities and stymies profitable linkages with small-holder producers. Constraints faced by women entrepreneurs – who dominate the rural non-farm employment space – are especially severe. While off-farm employment is growing, it remains largely informal[17].

N**atural resource management is critical to both agribusiness growth and to smallholder inclusion in these opportunities.** Small-holder farmers face numerous, environmental (impacts of climate change) technological and agronomic constraints, including: the weak development and low uptake of improved practices; outdated post-harvest and processing technologies; the limited capacity to monitor input use in farming and inability to enforce regulations on input quality. Land governance is contributing to fragmentation and diminishing farm size. Water management is weak with low water productivity in the Terai, and limited watershed development in the hills and mountains.

Nepal is also extremely vulnerable to climate change and seismic activities which will adversely impact agriculture. These events will have a disproportionately larger impact on the poorer and remote western regions. Therefore, Nepal requires an agriculture and food system that can anticipate, prepare for and respond to shocks whether they be climatic, technological or economic.

In recognition of the above challenges, the 14th Development Plan recognizes agriculture as one of the top three priorities for alleviating poverty and enhancing rural economic growth. The Agriculture Development Strategy (ADS) has four priority areas: (i) Improved governance; (ii) Technology adoption, especially Climate Smart Agriculture for resilience and productivity; (iii) Increased commercialization and (iv) Competitiveness and private sector development. Further, the government recently set a target to double agricultural production in the next five years through modernization and commercialization.

[17] The Nepal Labor Force Surveys (NLFS) (CBS, 1999; CBS, 2008) indicate that more than 90 per cent of the workers in the agricultural sector and 60 per cent of the workers in the non-agricultural sector are outside the formal sector.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Support the decentralization and de-concentration of essential agricultural services by
    - Strengthening and improving public institutions and innovative public-private partnerships in agricultural service delivery.
    - Prioritizing public sector interventions which are essential for leveraging private investment.
    - Strengthening resilience and climate adaptation through climate smart practices that improve water productivity, improve soil management and support agricultural diversification into more resilient and remunerative cropping patterns.
- Promote rural job creation through agricultural commercialization and creation of an ecosystem for Micro, Small and Medium Enterprises (MSMEs) by
    - Supporting producer organizations and agriculture-based MSMEs to be linked with markets and financial institutions to achieve the scale required to be competitive.
    - Creating an eco-system for private sector entities of all sizes, including women entrepreneurs, with better linkages for smallholders and SMEs to larger off-takers.
    - Strengthening financial sector development with emphasis on access to finance for SMEs and agribusiness as well as long term finance.

To address these issues, in the medium to long term, the government needs to:

- Enforce the implementation of Land Use Policy for efficient land use and administration systems.
- Strengthen agribusiness regulations that will streamline regulatory processes, promote quality and standards, and stimulate private sector investment.
- Promote extension delivery models (including private sector, universities and NGO based models) and use of disruptive technology in agriculture for effective service delivery.
- Invest in agricultural education and technical human resource development to nurture high quality agricultural cadres, technicians and researchers.

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2.9 Managing Forests for Prosperity

Key issues and challenges

The 2015 Forest Policy supports an enhanced contribution of the forest sector to Nepal's economy and job creation. Nepal's Forest Sector Strategy (2016) further details the policy and targets the economic contributions of forests to be at least 7.5 percent of GDP by 2025. It also proposes generating at least six times more jobs, reducing annual timber imports by 50 percent, and increasing by six fold the yearly commercial timber supply to the domestic market by 2025. In its Nationally Determined Contribution to mitigate climate change, the Government of Nepal has committed to reduce greenhouse gas emissions from deforestation and forest degradation.

The new Constitution of Nepal (2015) represents a major transformation for the country, including for forest sector governance. States and local governments will develop some of their own policies, laws and regulations and collect some taxes. While forest protected areas will continue to be overseen at the national level, forest management responsibilities have been devolved to the provincial and municipal levels.

Although Nepal is richly endowed with forest resources, the sector does not contribute much to economic growth. While Nepal's forest cover is 44.7 percent of the national territory, the forest sector contributes on average only 3.5 percent to the national GDP due to low productivity. Moreover, the country imports timber. The potential for creating more jobs in Nepal's forest sector is between 3 to 10 times the current level. Absorption of the informal workforce into formal employment could be achieved by involving workers in enterprise-oriented forest management, producing a wide range of goods and services. Forest ecosystem services, such as habitat provisioning, sediment retention, or water and climate regulation are currently not valued and hence often underestimated in terms of their contribution to the economy and peoples' livelihoods.

Whilst the current policy and regulatory framework is broadly supportive of the forestry sector, there are still important regulatory gaps and governance challenges that need to be addressed. These challenges include (a) non-implementation of the forest policy; (b) poor coordination of activities supported by the forest sector policy and other sector policies; and (c) limited implementation of Nepal's Land Use Policy (MoLRM, 2015) and associated lack of effective systems for land-use planning at sub-national levels (provinces and municipalities). The forest clearance process for businesses (for example, the power or transport sectors to enable them to build necessary infrastructure and offset associated forest losses elsewhere), is bureaucratic and consequently, negatively impacts the investment climate.

There is limited public and private investment in the forest sector and wood-based industries. Although the budget of the forest sector is comparatively lower, the Ministry of Forests and Soil Conservation has continuously underspent, an indicator of low institutional capacity and governance challenges. Currently, commercial banks are unwilling to lend for forestry investment because they do not recognize forestry as a productive sector as they do with the agricultural sector. Other impediments include high import taxes for forest machinery and lack of market access services for micro/small forest-based enterprises in rural communities.

There is a need and potential to further develop forest-based enterprises and promote a business model that better suits Nepal's needs. Smallholders are poorly integrated in the market and have no access to modern technology that could increase the value added of their products (for example, timber processing, Non-Timber Forest Products) and reduce timber imports. Small and medium forest-based enterprises could generate more than US$8.7 billion and 1.38 million work days through 400,000 sustainable full-time equivalent green jobs. With limited business capacity, the participation of medium and small enterprises in

the market is compromised. Capacity development on sustainable business practices is not available, which includes the ability to develop plans for sustainable business management and produce commercially viable products.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Review and assess the compatibility of legal and regulatory frameworks relevant to forests by examining the various rules, regulations and procedures that are not only inconsistent but also negatively impact forests and are barriers for private sector investments in the forest sector.
- Build capacity of new sub-national structures to effectively and efficiently plan and manage natural resource assets, including forests.
- Raise awareness about and value forest ecosystem services for sustaining infrastructure (e.g. hydropower, roads), agriculture and carbon stocks; and contributing to resilience, ecotourism and peoples' livelihoods.
- Continue the transfer of government-owned forests to community-based forest user groups to ensure sustainable forest management, increased forest productivity and improved livelihoods.

To address these issues, in the medium to long term, the government needs to:

- Ensure implementation of the 2015 Land Use Policy by the National Planning Commission and the Ministry of Land Reform and Management (or successors)
- Work with sector ministries to revise policies and regulations that negatively impact forests and forest investments while reforming the forest clearance process.
- Raise awareness of commercial banks on potential financial returns from forestry investments.
- Incentivize the private sector to invest in sustainable plantations and forest-based industries using locally produced timber and involving community-based forest user groups.
- Ensure development of spatial management plans that govern land uses at the local level in a participatory manner by the local government.

3. Developing Human Capital

Skills shortage is another key constraint that the private sector in Nepal faces. With improved access to health and education, the level of human capital in Nepal has improved but critical gaps remain. High out-of-pocket health spending hinders access to health services and places families at risk of impoverishment due to health shocks. Low learning achievements at all levels remains one of the foremost challenges in the education sector. Concerns on the quality and relevance of the education system have limited school to work transitions. In addition, drawbacks in the existing social protection programs have led to intergenerational transmission of poverty and have limited the prospects of human capital development for the poor. The following policy notes outline the key constraints to developing human capital in Nepal and suggest some policy recommendations.

Nepal Policy Notes

3.1 Promoting Health

Key Issues and Challenges

During the last two decades, Nepal has achieved noteworthy improvements in health outcomes but critical challenges remain. The improvements have primarily been in the areas of reproductive, maternal, neonatal, and children's health. Neonatal deaths, which had stagnated at 33 per 1,000 live births for nearly a decade have now declined to 21 deaths per 1,000 live births. However, challenges remain in basic service delivery and in achieving universal health coverage. Despite the significant improvement, basic health indicators are still at low levels: maternal mortality is 239 per 100,000 live births, under-five mortality is 39 per 1,000 live births, stunting is 36 percent, anemia in women aged 15 to 49 is 41 percent, anemia in children aged 6 to 59 months is 53 percent, and only 69 percent of the potential demand for family planning is met. Health outcomes are also inequitable across wealth quintiles, geographic regions, and ethnic groups: only 34 percent of the lowest quintile give birth in a health facility compared with 90 percent of the richest quintile, Province 6 has 54 percent of stunted children while Province 4 has only 29 percent, and Province 2 has 59 percent of anemic children while Province 3 has 43 percent. Under the federal structure, resources are to be allocated to local governments to address equity more broadly. However, this may not necessarily translate into more equitable health outcomes.

The quality of health service delivery is compromised, particularly in remote areas. This is primarily because of shortages in qualified workers, absenteeism of appointed workers, lack of female health staff, language barriers, stock-outs of even essential drugs, and a shortage of adequate and appropriate physical infrastructure (such as health facility buildings with water and electricity, and equipment). Although the situation of municipalities in less remote locations has improved over the last few years, the more remote municipalities are still facing major challenges with regard to the quality of health services. In addition, with few public health facilities in Kathmandu, the urban poor largely face a choice between expensive private health care provision or the use of unqualified providers, like pharmacy outlets. Overall, a system it not yet in place to measure, regulate, and promote quality assurance of health service providers.

Limited public financing and high out-of-pocket (OOP) health expenditures hinder access to health services and place families at risk of impoverishment due to health shocks. The most significant mechanism in the country to protect against high medical costs – which can be a barrier to access or reason for impoverishment – is the free delivery of basic health services for all. However, services are not always available, which particularly affects the poor who have fewer options available. There are also programs focused on addressing financial and transportation barriers in accessing certain services. Anecdotally, the effective implementation of these programs is being impacted by the current transition to a federal structure. However, even when these programs were fully operational, OOP health expenditures accounted for about half of the country's total health spending. The government has introduced a health insurance scheme to address the high OOP expenditures and the low level of service utilization by the poor. However, the pilot and subsequent rollout face challenges resulting in very low coverage. It is likely to remain so unless some fundamental aspects of its design are changed. Currently, there is limited scope to increase public spending except for improving the efficiency of spending. While the share of health in government spending has been relatively high compared to other countries in the region, the share has been declining since 2011, indicating that lower priority has been given to health. In a federal structure, budget and expenditure data of local governments will be critical for monitoring public spending on health and for making informed policy choices.

In the transition to federalism, there is risk of disruption in service delivery. The life and health of the population could be significantly affected by a lack of health services (for example, stemming from a lack of pharmaceuticals, other medical supplies, or human resources) as the country transitions into a federal state. In the previous governing structure, the district played a significant role in coordination, procurement

of basic pharmaceuticals and supplies to reduce stock-outs, provision of additional contractual staff to fill vacancies, and information management. These responsibilities and resources have now shifted to local governments, which do not necessarily have the capacity to fulfill these functions. A good monitoring system is needed to identify where service delivery disruptions are occurring. For the procurement of pharmaceuticals and medical supplies, full decentralization is being considered by the government. This has risks in terms of the capacity and ability of local governments to ensure good pricing through economies of scale and good quality through sound procurement and supply strategies. It will be important to consider different purchasing models that are responsive to local needs and local purchasing, but have the benefits of pooled purchasing (economies of scale and quality).

Capacity at both the federal and the local level needs to be enhanced in the decentralized structure. In the transition to a federal structure, the role of the Ministry of Health is expected to change. The required stewardship functions—policy analysis and monitoring; quality improvement and quality assurance such as standard setting, licensing, and accreditation; regulatory frameworks and supervision systems; sector performance monitoring and evaluation; surveillance; and the use of financing mechanisms to support health sector policy—as well as the specialized institutions to undertake these functions at the local level, are weak if not absent altogether. While local governments are responsible for local service delivery and public health, their systems are not yet in place. Areas that require investment but are less visible, such as disease prevention and disaster preparedness, may be more at risk.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Develop detailed plans with clear accountabilities, coordinated with all levels of government, to protect the continuity of high-priority programs such as immunization coverage, family planning, and institutional delivery.
- Establish a monitoring and reporting system to identify and report on key service delivery disruptions.
- Support local governments in undertaking procurement, storage, and supply of pharmaceuticals, particularly to ensure the quality and safety of the drugs provided.
- Develop and implement a roadmap for a mixed procurement model including pooled (particularly of those available on the international market such as vaccines and reproductive health commodities) and decentralized purchasing (readily available in local markets), and a phased approach to procurement while capacity is being built.
- Ensure that systems are put in place in the local governments to monitor budgets and spending on health and to build other institutional capacities.
- Develop a health financing strategy responding to the local government needs and addressing equity and sustainability concerns.

To address these issues, in the medium to long term, the government needs to:

- Analyze the options for and adopt a national program, with participation of local governments, to address the inequities and quality concerns in health service delivery and provision of free care;
- Develop a health financing roadmap for expanding financial protection to the poor and other vulnerable groups and improving access to health services.
- Develop capacity of the local governments and revamp the functions of the Ministry of Health and Population to effectively guide the health sector in a decentralized environment.

Nepal Policy Notes

3.2 Enhancing the Competitiveness of the Workforce

Key Issues and Challenges

Nepal is currently experiencing a youth bulge, with more than 50 percent of its population under age 25. Due to vastly expanded education access, youth today are, on average, significantly more educated than in the past. The school sector has successfully expanded access, with gender parity, at the primary (grades 1–5), basic (grades 1–8), and secondary (grades 9–12) levels. In addition, disparities in education access across income groups and ethnic/caste groups have decreased. Progress in expanding access is likely to be further strengthened with the transition to a federal state. This human capital is a powerful resource to accelerate economic growth and reduce poverty. However, Nepal's youth bulge remains a largely underutilized resource because of low levels of learning outcomes and skills attainment. Learning achievements at all levels of education—from kindergarten to tertiary—remain one of the foremost challenges in the education sector in Nepal. Concerns about the quality and relevance of education become even more pronounced in a global economic backdrop, where demand for advanced skills and innovation is continuously increasing.

Even though unemployment rates in Nepal are low, the 2008–09 National Labor Force Survey estimated overall underemployment to be as high as 43 percent. The overall unemployment rate is 3.2 percent while youth unemployment is 5.3 percent. There is a considerable wage premium from completing higher levels of education in Nepal, but a large share of those aged 16 to 40 have never attended school. Most of the new labor market entrants get absorbed in low-income jobs in the informal sector (which constitutes over 90 percent of all employment) or in unskilled jobs abroad.

The school sector is largely plagued by low learning outcomes. In the school sector, 9 percent of school-age children still do not receive basic education, and there is low transition to and retention in secondary schools, particularly for children from disadvantaged backgrounds. The most pressing challenge is unequal quality and low learning outcomes primarily because of outdated curriculums, inability to address the diverse learning needs of secondary school students, an examination system that encourages rote learning instead of conceptual understanding, and lack of attention to the development of noncognitive skills. With respect to school and teacher management, inadequate teacher performance management systems, a supply-driven approach to school financing, and insufficient support to the training of science and math teachers also impacts the quality of education.

Higher education institutions (HEIs) have also failed to play a catalytic role in the country's development. This is because of inadequate quality and relevance of the system and their inability to adopt cutting-edge technologies from the global market. They also lack research, development, and innovation (RDI) capabilities, particularly those related to science and technology. In addition, there are serious systemic and governance challenges that plague the tertiary sector.

Despite the growing scale and scope of the technical and vocational education and training (TVET) sector over the last decade, the system suffers from critical constraints that reduce its effectiveness, efficiency, and reach. More than 14 ministries provide some form of TVET training, with little coordination on standards and quality. The quality of training at the institutional level is compromised due to inadequate quality assurance, lack of leadership and management competencies, and outdated instructor skills. The current TVET sector does not encourage innovations in training delivery, financing models, and partnerships that can fill institutional gaps. Work-place-based learning and employment services, which are increasingly characteristic of evolving TVET systems, are available only in a tiny fraction of institutions. In addition, lack of information on the labor and jobs market leads to skills gaps and job mismatches.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Mainstream proxy-means-test-based student financial assistance into regular government programs and expand coverage.
- Complete federal transition guidelines consistent with Local Government Operations Act and ensure uninterrupted education service delivery.
- Establish a quality assurance system for TVET institutions and make quality the basis for funding these institutions.
- Develop experimental methodologies for providing apprenticeship training and employment services for youth.
- Shift from the practice of appointment of HEI staff based on political considerations to academic and managerial performance track record.
- Accelerate the pace of conferring governance/academic autonomy to constituent and affiliated campuses.
- Fast track approval of requests for additional programs from accredited campuses, especially in technical and high-demand areas.
- Provide block grant support to schools without government teachers and expand implementation of block grants and performance grants in a select number of community schools.
- Accelerate the pace of quality assurance and accreditation of HEIs.
- Adopt a higher education act with provisions for, among others, extensive autonomy of universities/HEIs, a clear accountability framework, a clear financing policy, and flexibility to adopt suitable governance structures.

To address these issues, in the medium to long term, the government needs to:

- Revise the National Curriculum Framework (NCF) with a provision to diversify secondary school curriculums.
- Expand the scale of employment-focused and market-relevant skills training for youth.
- Implement apprenticeship training and employment services for youth.
- Increase enrolment in science and technology and other programs in high demand to 40 percent.
- Shift from input-based financing to output-/outcome-based financing of HEIs.

Nepal Policy Notes

3.3 Protecting the Poor and Vulnerable

Key issues and challenges

Nepal's social protection (SP) programs have evolved and expanded significantly over the last decade. The government implements a wide portfolio of SP programs which include public sector pensions, and cash transfers, public works programs, scholarships and various health schemes (including health insurance) aimed at protecting the poor and vulnerable. Consequently, Nepal's spending on SP programs increased from 1.5 percent of GDP in FY2002/03 to an estimated 3.6 percent in FY2016/17.

However, a large number of people remain poor and vulnerable. The existing SP programs have limited poverty impact. A quarter of the population is poor and a large portion remains vulnerable to falling into poverty in the event of shocks (natural disasters, health or economic). Almost half of the households reported experiencing a shock in FY2014/15 and FY2015/16 and about 30 percent reported two or more shocks in the same period. The government has been working on establishing a database of the poor households but a proper discussion on refocusing SP program to directly address poverty is yet to happen.

The existing SP programs are inflexible in times of disasters. The 2015 earthquakes and the recent floods have demonstrated that while the government was able to mobilize significant external aid, the existing SP programs could not be mobilized to provide disaster relief. International experience shows that SP programs can be effective channels for delivery of disaster relief. The existing SP programs in Nepal are not flexible enough to be used in situations of disasters due to rigid program design and fund flow arrangement, and limited coordination between Ministry of Home Affairs (responsible for disaster response) and the SP agencies.

The SP programs have weak delivery systems. The SP programs are also constrained by the lack of robust delivery systems. Paper-based systems with manual delivery of cash hinder efficient and timely delivery of benefits and monitoring, and allow for potential leakages. The government has initiated modernization efforts which include digitization of the civil registry and Social Security Allowances (SSA) beneficiary database, approval of a strategy to roll out e-payments, and development of a management information system. It is expected (based on a previous pilot) that these measures could lead to the elimination of an estimated 22 to 25 percent of ineligible beneficiaries of SSA.

The SP programs are fragmented and lack vision. The existing SP programs are fragmented and implemented by over 15 government agencies and lack an overarching vision and strategy. In addition, the objectives of many programs and the risks and vulnerabilities they are intended to respond to are not clear. Cognizant of this, the government, particularly through the National Planning Commission (NPC), is working to develop more coherence and efficiency across these disparate programs. However, the national social protection framework (NSPF) led by the NPC is yet to be finalized.

The move to a federal state will present new opportunities and challenges for social protection. SP is a concurrent function across the three levels of government in the new constitution. For each program, it will be important to define the relative roles of each level of government in policy formulation, identification of beneficiaries, delivery of assistance and grievance redressal, according to their mandates and capacities. Currently, the local governments with extensive responsibilities for the delivery of SP programs, lack capacity. The lack of clarity in vision and in the roles of each level of government has resulted in the arbitrary expansion of programs or benefits by newly elected officials. These new programs, the rampant expansion of the Social Security Allowances, and the new Voluntary Retirement Scheme could threaten fiscal sustainability. Further, in light of the new Social Security Act and proposals to reform the public-sector pensions, it is necessary to review the entire portfolio of contributory schemes.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Clarify the roles of the three levels of government in delivering SP functions
  - Ensure that large national SP programs remain under the purview of the federal government to ensure a minimum safety net and equity across the country.
  - Ensure communication of federal guidelines on SP processes/mechanims to the local level.
  - Develop a national policy framework to emable evidence-based interventions.
- Conduct a public expenditure review to assess efficiency of existing programs and fiscal implications before expanding or adding new programs.
- Develop a coherent framework for contributory pensions which integrates public sector pensions and benefits, schemes under the Social Security Fund, and Employees Provident Fund.
- Review the existing information systems (civil registry, national ID, health insurance, poor households, and others) to explore interoperability and efficiency of data collection and management.
- Map and sequence services currently provided in the early years across education, health and social protection to explore coordinated and more efficient delivery.

To address these issues, in the medium to long term, the government needs to:

- Develop an integrated and robust SP system by
  - Reviewing and consolidating SP programs and systems
  - Establishing the civil registry as a core database to enable efficient service delivery
  - Ensuring that the National/Unique ID is linked to the civil registry
  - Scaling up electronic payments for more efficient delivery of cash
  - Establishing robust federal and sub-national mechanisms to monitor and coordinate programs
  - Reforming key SP programs and working modalities with MOHA to allow SP programs to be more effective to promote resilience and be scaled up in times of disasters
- Address the gaps in the current mix of SP programs by either reforming or phasing out existing programs or by introducing a new program that explicitly addresses the gaps.
- Review targeting modalities and the productive role of SP programs to improve impact on poverty.
- Develop public work programs as an instrument to improve household and community resilience, enhance productivity and to respond to disasters.
- Explore ways to rationalize contributory and non-contributory pension schemes under one coherent framework with a goal to reduce the fiscal burden.
- Strengthen capacity for service delivery at the local level by
  - Providing adequate infrastructure and personnel to establish and update the civil registry, conduct outreach and mobilization, enrolment, payment and grievance redress.
  - Establishing integrated institutional architecture at the local level for coordinated delivery of social services covering education, health and social protection.

3.4 Promoting Gender Equality and Social Inclusion

Key issues and challenges

Nepal has made overall progress in poverty reduction, but disparities based on social background, gender and geography persist. The difference in rural and urban poverty remains high - with 15.5 percent poverty incidence in urban areas compared with 27.4 percent in rural areas. The 2018 multi-dimensional poverty index[18] identified 28.6 percent of Nepal's population as multidimensionally poor, with certain ethnic and caste based groups and certain geographic areas having an overall higher incidence of poverty; Women headed households (25.7 percent in Nepal) are more likely to suffer from poverty than other households.

Gender, caste and ethnicity – along with geographic location– remain highly correlated with exclusion and vulnerability, and are often interdependent. Gender-based social stratification and prevailing ethnic and caste-based hierarchies continue to structure economic and social relationships across Nepal.

While women are 51.8 percent of the total labor force in Nepal, they are mostly employed in the agriculture sector as wage labor or in informal, insecure, lower paid jobs. Women tend to have lower levels of education and mobility, are often time poor with heavy household responsibilities, and lack financial resources and risk-taking ability. With limited access to economic resources, it is difficult to avail of other productive assets such as land, credit, or technology. The National Gender Equality Policy specifically targets economic empowerment of women as key to combating a range of economic and social barriers faced by women.

Gender Based Violence (GBVs) is arguably at crisis levels in Nepal, as the leading cause of violence related deaths in the country. GBV is fueled by cultural practices such as early marriage, son-preference, menstrual exclusion, dowry system, and veiling (purdah) practice. Mobility constraints and subordination in decision making continue to disadvantage women and girls throughout their life cycle and hinders their access to opportunities to better their lives. GBV not only impacts all aspects of a women's life, the intergenerational affects are also well documented. In Nepal, there is not only an urgent need to work on structural discrimination, but also on mind-sets and attitudinal change. Ultimately there is a need for initiatives that enhance the voice and agency of women.

The new constitution clearly envisions Nepal as an inclusive state and has guaranteed several fundamental rights to women and marginalized groups, including the right to equality and non-discrimination. Several policies and reform initiatives have been initiated by the government to guarantee equal rights. The 14th Three Year Plan, (2016/17- 2018/19) has dedicated chapters on gender equality and women's empowerment and on social inclusion. It also emphasized institutionalization and localization of the Gender Responsive Budgeting (GRB) system and set a target of achieving 27 percent of budget for gender responsive programs. It will be crucial to continue this effort in the federal context. Nepal is also signatory to various international commitments, such as Sustainable Development Goals (SDGs) and 'Leave No One Behind' policy. Further, the government has taken various efforts to make public services more accessible to women and socially excluded groups (like social mobilization to ensure participation in planning processes, use of social accountability tools like public audit, public hearing, and citizen's charters). Eight ministries developed gender equality and social inclusion (GESI) operational guidelines.

[18] Nepal's Multidimensional Poverty Index: Analysis Towards Action, Government of Nepal National Planning Commission and Oxford Poverty and Human Development Initiative (OPHI) University of Oxford, 2018. World Bank and DFID provided technical support for the study.

The federal structure has created new opportunities for women's increased engagement in the governance process. Among the newly elected officials at the local level, 40.8 percent are women (94 percent of the deputy mayor and 92 percent of vice- chair positions), mostly newcomers to politics and often from marginalized constituencies. But only two percent of the positions of the mayor and chair (out of the total 753) was won by women. These new women leaders need training and capacity building on the roles they are expected to perform and in enhancing leadership skills. The Local Level Governance Bill has outlined the Functions of rural and urban municipalities, which includes GESI responsibilities and the planning process to prioritize issues of women and the marginalized including special programs with additional budgets for remote regions. However, how these provisions will be translated and delivered is not clear. The capacity development of sub-national governments to manage grants and internal resources equitably based on the priorities of women and marginalized needs reinforcement through GESI responsive participatory planning and budgeting.

While the changes to the enabling environment are encouraging, in is clear that implementation of policies and regulations remain weak and there is limited institutional capacity on the ground. Limited institutional mechanisms exist to ensure requisite targeting and attention, and the impacts on service delivery remain marginal in most parts of the country. Many social groups continue to experience very limited access to basic services based on their geographic location, ethnicity, caste or gender.

Policy Recommendations

To address these issues, in the short term, the government needs to:

- Ensure that fiscal decentralization regulations, guidelines and implementation incorporate GESI dimensions (gender responsive budgeting).
- Provide targeted budget allocations for women, poor and the excluded in a transparent manner.
- Ensure that local level planning guidelines include the women and marginalized groups in local decision-making processes.
- Carry out a capacity needs assessment of newly elected women representatives and representatives from marginalized groups and provide them with targeted training for capacity building.
- Finalize National Gender Equality Policy and prepare road map for its roll out in coordination with other sectoral ministries at local, provincial and federal level.

To address these issues, in the medium to long term, the government needs to:

- Finalize the National Action Plan on GBV and prepare roll-out plan at the local, state and federal levels and ensure resources and support for effective functioning of judicial committees at the local level.
- Strengthen the capacity of service providers on GESI with focus on:
    - Providing adequate resources and institutional incentives for targeted programs addressing the priority needs of women, poor and excluded.
    - Ensuring the integration of GESI perspectives in local level service delivery mechanisms, for basic services such as education, health, and social protection.
- Review and revise GRB guideline to reflect both gender and social inclusion priorities in the new federal context.
- Promote human resource development and entrepreneurship among women and disadvantaged groups to increase their participation in non-agriculture and non-traditional sectors.