

## **Understanding Reform: The Case Study of Nepal**

### **1. Introduction**

Nepal is one of the least developed countries surrounded by two fastest growing Asian economies, India and Peoples' Republic of China. In its modern history the country opened up to the outside world only in 1950s. The first budget came up in 1951, which also coincides with the inflow of foreign aid in Nepal. The year 1956 heralds a new era in Nepal's drive at economic modernization. It is the year when Nepal started its first five-year national economic development plan. The central bank and the Public Service Commission were also established in the same year. Following the socialistic orientation of the developing countries especially giant neighbors, Nepal initiated state led industrialization policy. In the process, public sector became dominant. To facilitate that course Nepal adopted controlled economic policy regime. The economy was guided through industrial licensing, commercial, fiscal, and financial and foreign exchange regulation policies. This was manifested by import substituting industrialisation policy (ISI). Under this, a number of state owned enterprises (SOEs) in the production, services, trading and financial sectors came into existence. The government also encouraged SOEs through the mobilisation of foreign aid. The political framework dictating the economic policymaking after 1960 was the then autocratic party less Panchayat system.

Until the 1980s the economy remained largely agrarian with respect to output, employment and social relations. In the process neither agriculture nor industrial and commercial sectors of the economy could grow and modernize. The protectionist measures encouraging rent-seeking behaviour throttled the inherent productive capacity of the economy. The authoritarian political regime encountered a series of political and social upheavals until the end of 1970s. Such unrest culminated into a nation wide mass protest. This forced the king to declare a referendum on political choice between party-less and multi-party political system. To bring the referendum results in favour of party-less system, the Panchayat regime went into the climax of fiscal irresponsibility. This resulted into an unprecedented rise in the magnitude of budgetary deficit, which ultimately spilled over into the trade, current account and the BOP gaps. For the first time in its economic history, Nepal faced a deficit in the balance of payments (BOP) for consecutive three years, 1982/83 through 1984/85. This forced Nepal to change its economic policy from completely state regulated into the market-oriented regime since the mid 1980s.

The economic stabilization programme was put in place in 1985. Nepal sought the financial help from the International Monetary Fund (IMF). The Stand-by loan arrangements were made with the IMF. Nepal also went for structural Adjustment Facility (SAF) programme with the IMF in 1986 for three years. During that period, Nepal initiated most of economic reforms under the aegis of SAF with the IMF and Structural Adjustment Loan (SAL) programme with the World Bank. The focus of reform was on fiscal side.

Following the restoration of democracy in 1990, Nepal intensified the liberal economic policy regime. Nepal changed the economic policy regime from inward looking and import substituting industrialization policy to outward and export-orientation. The focus of the shift in policy regime was on economic globalisation,

liberalization and privatization. The agreement with the IMF for the Enhanced Structural Adjustment Facility (ESAF) sets the frameworks under which reforms in economic policies were initiated in early 1990s. This simply means that the reform program was initiated abruptly without consultation with the various stakeholders including political forces represented in the parliament. Hence, rather than being a political process, Nepal's reform measures were implemented by the bureaucrats under the donors policy prescriptions. At the same time, reform focused on few areas assuming that the outcome would spillover throughout the economy.

Accordingly, various components of economic policy reforms were carried in Nepal during the last one and half decade. In the beginning, the emphasis of economic reform was on the fiscal side. Fiscal reforms were carried on the revenue, expenditure and borrowing side. On the revenue front, taxes were rationalized both on levels and slabs. Tax rates were drastically slashed and tax brackets were also reduced. The objective of doing so was to enlarge the tax base and thereby increase the tax collection. As Nepal is a least developed country, revenue collection from direct taxes is less compared with the indirect taxes. So, in view of indirect taxes occupying important place in total revenue, reforms were focused on indirect taxation.

Nepal has also made various efforts to open up to the outside world since early 1990s. Quantitative restrictions on imports have been done away with. Any amount of goods can be imported into the country by opening letter of credit with banks. Customs duties have been rationalized and brought down substantially. Nepal's tariff rates are now lowest in South Asia. Reforms have also been executed in foreign exchange front. There are no foreign exchange controls on the current account. As a result, Nepal obtained the status of IMF Article VIII in 1994. Although the exchange rate of Nepalese rupee vis a vis Indian currency is fixed, exchange rate of Nepalese currency with convertible currencies has been left to market forces.

Nepal has also made some relaxations on capital account. Nepalese foreign exchange earners are allowed to retain cent percent of their foreign exchange earnings. Foreign exchange earners are free to maintain foreign currency deposits with the local banks. Exporters are also permitted to borrow in foreign currency from local banks. The Nepal Rastra Bank has taken the policy measure to provide refinancing against such loans in foreign currency. The refinancing rate against such loans was reduced to 2.0 percent from 4.0 percent recently. Commercial banks are also allowed to retain any amount of foreign exchange with them.

Suitable changes are also initiated in industrial policy and foreign investment and foreign technology transfer policy. With a view to making these policies compatible with the liberal commercial policies, industrial licensing policy has been removed. Foreign investment both direct and portfolio are welcome. With a view to attracting foreign investment, Nepal has removed any restriction on repatriation of foreign capital invested in the country and earnings from such investment. Single window facility has been provided to both domestic and foreign investors.

Along with the external sector reforms, Nepal has also initiated financial sector reforms. Removal of entry barrier, enactment of Finance Companies Act 1985 and its amendment in 1992, abolition of pre-emption of bank resources in the form of statutory liquidity requirement, establishment of prudential norms of Basle Accord,

enactment of NRB Act 2002 granting autonomy to the central bank and introduction of Loan Recovery Act 2002 are the key reform measures introduced in the financial sector. Reforms in the conduct of monetary policy are also carried out. Removal of credit ceilings, differential interest rates, margin requirements and deregulation of interest rates are the key reform measures introduced in the realm of monetary policy conduct. Nepal has been emphasizing on indirect monetary policy instruments such as bank rate, variable cash reserve requirement and open market operations.

Along with the initiation of financial sector reforms, quite a few joint venture banks have come up in the private sector. The number of commercial banks has increased to 16 from 5 in early 1990s. The deposit mobilisation has increased to 45 percent of GDP from 30 percent in 1990. The enactment of Finance Company Act 1985 and its amendment in 1992 has resulted in the establishment of a number of finance companies. The number of finance companies stands at 54. The enactment of Development Bank Act 1996 has led to the establishment of 16 development banks from just two before 1990. A number of credit co-operatives have also come up. Similarly, the number of NGOs carrying limited banking transactions stands at 33. Besides these, 17 insurance companies, Rural Micro Finance Development Centre (RMDC), Employees Provident Fund and Pension Fund one each are operating in the economy.

In the reform process, all type of subsidies including fertilizer, irrigation, food transportation and interest were completely withdrawn. In many areas the cost recovery principle has been applied. This is true in the case of public utilities also. Equal priority has been given to privatise the public enterprises. So far more than eighteen enterprises have been privatised and more than two-dozen are in the pipeline.

## **2. Statement of the Problem**

Nepal's major thrust on the liberal economic policy is due to the realization that being small open economy it cannot grow fast without getting integrated into the world economy. However, despite number of reform measures initiated during the last one-decade or so, the overall outcome and impact of reforms has remained less than satisfactory. The growth performance of the agricultural sector has been very poor, hardly surpassing the population growth rate during the last decade or so. So much so, since last year both industrial and tourism sectors have registered negative growth rate with wide-ranging impact on the sustainability of outcomes and speed of reforms. The over dependency on few exportable products and their volatility associated with the mounting volume of non-performing assets (NPA) of the financial institutions in a situation of big gap between deposit and lending rates have increased the vulnerability of the Nepalese economy. A host of structural and corporate governance related problems are undermining the reform process. This calls for the need to immediately review the whole gamut of reform policies and accompanying processes for identifying their strengths and weaknesses. From the standpoint of ensuring the sustainability as well as positive outcomes of the reforms, a review of series of legal, institutional and political factors is an urgent necessity.

Similarly, in view of poverty and unemployment problems deepening at the time of economic reforms have also necessitated finding out where the weaknesses remain. As a result of rise in poverty both in absolute and relative terms, majority of Nepalese

people are still finding it hard to live a decent living. Such a phenomenon has even generated and intensified social conflict in the Nepalese society, demanding further the necessity of reorienting reform policies in the best interest of the majority of the people.

### **3. Why Nepal be Included in the GDN studies on "Understanding Reform?"**

Nepal has some unique features needing special attention while implementing economic reform and other policy measures. It is a landlocked country situated between two giant neighbours and therefore it faces additional per unit cost in the production process. At the same time the transit problems and other cumbersome procedural matters hinder industrialization process to a greater extent. Likewise, the economy is still predominantly agricultural as more than 76 percent of the people depend on this sector for their livelihood. As a corollary of this, more than 85 percent of the people remain in the rural area and hence special policy consideration from the point of view of rural urban linkages becomes extremely important. However, in Nepalese context, the poverty pattern indicates that poverty is more rampant among the deprived and indigenous community living in rural areas. The growing social conflict reveals that resentment of such a community has worked in disguise to widen and intensify conflict in the Nepalese society. This is happening at a time when serious problems are emerging in either sustaining or broadening the positive outcomes of the reform despite Nepal being a pioneer in South Asia in initiating economic reform.

Yet there are other factors that characterize the uniqueness of Nepalese economy. Despite its smaller geographic size, Nepal is immensely rich in biodiversity. Nepal is also very rich in water resources and it has competitive advantages in tourism industry too. Having a relatively small population of 24 million, Nepal enjoys a lot of diversities with respect to language, religion and cultural practices. The social relation is still dictated by the feudal traditions in which a few upper castes and other privileged people enjoy the real political power. This also means that both the liberal democratic processes and economic reform measures have helped very little to change such a social fabric and hence upliftment of socially excluded people has become a major problem. As a result, by socio-economic status, Nepal falls far below its neighbours in respect of life expectancy at birth, literacy rate and mortality rates despite more than five decades of development efforts. Finally, Nepal is a unique case in terms of its economic dependence to a single country. In these backgrounds, Nepal may be a unique case for in-depth study examining whole gamut of reform process.

### **4. Objectives of the Study and Analytical Framework**

**4.1 Objectives:** In the light of this fact it is imperative to understand the economic reform process in Nepal. A study is required to trace out the origin, processes and sequence of reform measures introduced in Nepal. This will necessitate the analysis of the extent of involvement of the various stakeholders in the formulation and execution of the reform process. The initial conditions of economic reform will also need to be examined at length from the standpoint of political, economic, social and external factors. The following will be the objectives of the study.

4.1.1. To understand reforms, a detailed study of imperatives against which reforms were initiated will be made. This is needed to understand the dynamics leading to the initiation and implementation of economic reforms in Nepal.

4.1.2. The study will also evaluate the speed of reform across various economic sectors. In this process, the study will try to capture the socio-economic and political factors leading to inhibiting or accelerating the speed of reform.

4.1.3. The study will also make an in-depth study of the frameworks under which economic reforms were introduced. This will shed light on the approach of economic reforms.

4.1.4. Attempts will also be made to trace out the sequence of economic reforms in Nepal. This is important to pinpoint the appropriateness of sequence under which reform measures were carried out in Nepal.

4.1.5. The study in addition to identifying the reasons of reform confining in particular areas will also examine the heterogeneity in the mechanism of reform applied in various sectors.

4.1.6. The study after examining the outcomes at the aggregate and sector level will attempt to draw some lessons for future reforms.

4.2 **The main components** of the study of economic reforms will be (i) real sector reforms, (ii) fiscal reforms, (iii) external sector reforms and (iv) financial sector reforms.

4.3 **Time period** to be covered for the study: The time period covered for the study will be from 1985 through 2002. The study period will be split into two parts: (i) from 1985 through 1990 and (ii) after 1990.

4.4 **Analytical Framework to be used:** The analytical framework for the study will be largely descriptive distinguishing two sub periods viz, 1985-90 and 1990 onwards. The political economy of reform process will be the major basis of analysis and evaluation. Accordingly, it will begin with the discussion of initial social, economic and political conditions leading to economic reform in various sectors. The analysis will also focus on the rationale of the sequencing of reforms. While analysing the reform process, various mechanism of reforms such as rationalization of tariff, revision of input and output prices (including the interest and exchange rates), deregulation, privatisation, withdrawal of subsidy, revision and enactment of laws, bylaws and regulations as well as other various forms of market oriented reforms will be examined in details. The analysis will investigate the convergence and divergence of various interest groups in accelerating or impeding the reform and its speed. In the process the study after identifying the losers and gainers of the reform will shed light on the reasons of growing socio-economic vulnerability leading to social conflict in Nepal. The study will also try to evaluate the role of various domestic institutions and external agencies in the reform process. Finally, the study will lay out the outcomes and deficiencies of the reform based on the critical review of the findings of the

earlier studies and socio-economic trends of the economy for drawing lessons for the future.

#### **4.5 Main Questions**

- a. Why Nepal initiated reforms?
- b. What factors led to Nepal to adopt reforms and how did these factors contribute to shape reform design and its implementation?
- c. Did the reform fulfill the intended objectives? What are the outcomes and shortcomings?

#### **5. Main testable hypotheses: The study will test the following hypotheses**

- 5.1 Was there serious domestic crisis calling for reform?
- 5.2 Was external factor responsible for initiating reform?
- 5.3 Were the various stakeholders including political forces involved in the reform process?
- 5.4 Was the reform framework suitably designed?
- 5.5 Was the sequence of reforms proper?
- 5.6 Were reform measures initiated properly?
- 5.7 Were reforms delayed because of asymmetric distribution of costs and benefits to the different groups?
- 5.8 Was reform delayed due to problems of government credibility?
- 5.9 Did reform contribute to promote private sector and enhance efficiency in the economy?
- 5.9 Was reform broad based?
- 5.10 Did reform contribute to the economic sustainability and social justice?

#### **6. Methodology**

The research methodology will comprise of three-pronged approach. In the beginning a complete review of origin, sequence and process of reform including legal aspects will be made based primarily on secondary information and government's published documents. In-depth study of outcome and effect of reforms based on various data sources and earlier studies in this area will follow this. While analysing data, clear cut distinction between the reform input, reform output and reform effects will be made. The causal factors or driving forces of reform will be delineated and analysed based on three questions viz, why, what and how well reforms. Similarly, intensive interaction program will be carried out with different stakeholders to get-feed back about the strength and weaknesses of the reforms. In the course of analysis, special consideration will be given to find out the reasons of limited spill over and other effects toward enlarging the positive impact of the reform program. Finally, the question of sustainability of outcomes will also be dealt with at length by looking into both the structure and institution related issues.

#### **7. Research output and dissemination**

The research output will be published in book form, which will be widely disseminated to the media, policy makers from both the private and public sector and the general public.

## **8. The Research Team**

The research team consists of the following three researchers and one research associate as given below:

Dr. Dilli Raj Khanal	: Principal Researcher
Dr. P. R. Rajkarnikar	: Principal Researcher
Mr. Keshav Pd. Acharya	: Principal Researcher
Mr. Dill Ram Upreti	: Research Associate

Dr. Dilli Raj Khanal, a senior economist will coordinate the team.

## **9. Why is the research team suited for this work?**

All the members of the study team are well acquainted with the process of development in the country. Dr. Khanal has been involved in policymaking process in various capacities. He was member of the National Planning Commission and Privatisation Committee of the government. He is member of the UN expert group on global economy, which discusses frequently the general pattern of global economy and policy issues associated with globalization. He is also a member of Policy Dialogue Committee of the Federation of Nepal Chamber of Commerce and Industries. He has wide experience of economic research. He has participated and presented papers in several national and international workshops and seminar. He has several publications to his credit. Among them followings are the seminars, workshops and papers directly related with economic reforms.

- i. Attended a Tripartite Workshop on Social Dimensions of Economic Reforms in Asia Organized by ILO/ARTEP in collaboration with HMG of Nepal in Kathmandu From 24 -26 August 1993 and Prepared a Summary of Report of the Proceedings, ILO/ARTEP, New Delhi, India.
- ii. Presented a Paper, Economic Liberalization and Its Impact on Third World, in a South Asian Workshop on Economic Liberalization Organized in Dhaka, August 7-12, 1993.
- iii. Participated and Presented a Paper in a Review Meeting, "Trade Liberalization Among SAARC Countries and Its Impact on Employment", Organized by ARTEP, New Delhi, 1987.
- iv. Indiscriminate Liberalization and Nepali Economy, New Business Age, December 2001.
- v. 5 Macroeconomic Impact of the Structural Adjustment Program and the Role of NGOs in Nepal's Development (Mimeo), CECI, 1992.

- vi. Nepal Case Study on Impact of Trade Liberalization Among SAARC Countries on Employment (Mimeo), ILO/ARTEP, New Delhi, 1988.
- vii. Consultant, Economic Liberalization and Expenditure Policies and Their Impact on Poverty, UNDP/NPC Decentralization Project, UNDP, 1994.

Similarly, Dr. Rajkarnikar also has long and wide experience of socio-economic research. Among others he has co-authored, a briefing paper titled "Liberalisation and Regulatory Reforms in South Asia" prepared for South Asia Watch on Trade, Economics and Environment (SAWTEE) and headed a research project on "Implementation of Full Convertibility of the Nepalese Rupee in the Capital Account". He was also Deputy Governor of the Central Bank (Nepal Rastra Bank).

Mr. Keshav Acharya, a senior economist, also has long and wide experience of economic research. He had authored and co-authored various books on subjects ranging from foreign aid, public debt and development issues. One of them is "Understanding Economic Liberalisation in Nepal". He had also been involved in policymaking process as a senior advisor to the Finance Minister. Mr. Acharya also holds the experience of board director of various enterprises.

As all the members of the research team are well familiar with development process and have sufficient practical experience on policy research, the team is well suited for this work.

## **10. Research Institution**

Institution for Policy Research and Development (IPRAD) is a non-profit organization, established in 1995 by a group of economist, social and political scientist and lawyers. The specific objectives of the organization are:

- to undertake research on economic, social, management, institutional, legal and environmental issues;
- to conduct training and workshops in areas which directly enhance the skills and awareness of the low income and disadvantaged groups;
- to formulate and implement action plans and programs in various development areas; and
- to evolve and draw up policy alternatives for ensuring sustainable development process.

During the last seven years IPRAD has organized several seminars and carried out several research projects. Among them the major studies are :

- i. Conducted a research on Women and Development for MOPE/JHU/PCS/USAID Video Project, Johns Hopkins University, Population Communication Services and Ministry of Population and Environment, 1998.

- ii. Studied and prepared a Report on Value Added Tax and Its Implication on Nepalese Economy, Nepal Chamber of Commerce, October 1996.
- iii. Conducted Seminar on Budget for fiscal year 1996/97.
- iv. Conducted Seminar on Budget for fiscal year 1997/98.
- v. Macro-economic Forecasting Model for Nepal, Prepared in 1996 and Regularly updated to present half yearly in the World Economic Conference (UN Headquarter New York).
- vi. Theme paper on "Application, Issues and Future Prospect of Quantitative Tools in Economic Planning: Nepalese Experience" (United Nations Center for Regional Development, Yokkaichi)
- vii. Data Entry and Prepare a Report on "Socio-Economic Study on Anapurana Conservation Area" Funded by ACAP, King Mahendra Trust for Nature Conservation, 1998/99.
- viii. Studied and prepared a Report on "Implementation of Full Convertibility of the Nepalese Rupee in the Capital Account", Funded by Nepal Rastra Bank, 1998.
- ix. Studied and prepared a Report on "Assessment of the Effectiveness of Ongoing Local Level Programs" Funded by DASU/DANIDA, 2000.
- x. Studied and prepared a Report on "The Feasibility/Baseline/ID Study of Community Development Twinning Cooperation (Project) in Okhaldhunga District" Funded by Nepal Red Cross Society, 2001.
- xi. Studied and prepared a Report on "Feasibility/Baseline ID Study of the Proposed Community Development Project (CDP) in Dang District" Funded by Nepal Red Cross Society 2002.
- xii. Studied and prepared a Report on "Feasibility/Baseline ID Study of the Proposed Community Development Project (CDP) in Siraha District" Funded by Nepal Red Cross Society.
- xiii. Studied and prepared a Report on "Evaluation of Impact of Renewable Energy Programme on the Poor People" Funded by Intermediate Technology Group- Nepal (ITDG).
- xiv. Organized Symposium on Mahakali Treaty.

IPRAD has adequate logistic support and pool of qualified resource persons of different disciplines.

### **13. Study Period**

The research will be completed within six months.