



Inclusive Economic Growth in Nepal*

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Abstract: Inclusive economic growth is one of the most prominent development agendas. However, a systematic evaluation of progress toward greater inclusivity in the developing countries, and the required strategic foci for the future, remain largely absent from debates in both the academic and policymaking spheres. This paper applies and complements the Asian Development Bank's inclusive economic growth framework by including an intra-country analysis, and in particular, the convergence and divergence across a range of relevant indicators among consumption quintiles in Nepal. It finds three stark disparities: (i) Nepal's GDP growth and per capita growth remain the lowest in South Asia; (ii) the slow growth rate has failed to create adequate job opportunities, resulting in large-scale out-migration of workers from all consumption quintiles; and (iii) despite the overall inclusive pattern of growth over the last decade, there remains large disparities in the reach and

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utilization of social services and economic opportunities among the poorest quintiles. In addition, the pattern of growth could be made more inclusive by creating new opportunities and ensuring that the existing ones are shared more proportionately with the bottom quintiles.

Keywords: Inclusive Growth, Nepal, Poverty, Employment, Social Protection, Governance

Inclusive economic growth (IEG) is one of the most prominent economic development agendas in developing countries, and the major multilateral development banks have made it a cornerstone of their strategies. The Asian Development Bank's (ADB) midterm review of its *Strategy 2020* prioritizes poverty reduction and inclusive economic growth as one of the ten operational focuses over 2014–2020 (ADB 2014c). Similarly, the World Bank has made shared prosperity, i.e. increasing the income of the bottom 40% of the population, one of its two main development agendas (World Bank 2014a). Inclusive economic growth—determined mainly by the pace and pattern of growth¹—ensures that the economic opportunities created through growth are available to all sections of the population. In other words, it is essentially broad-based economic growth with equality of opportunity (Ali & Zhuang 2007). This is broader than so-called “pro-poor growth,” which focuses on only the welfare of the poor. The underlying assumption is that the benefits of GDP growth are not evenly distributed and those that are unable to reap

¹ Pace refers to the GDP growth rate and pattern refers to the creation and/or expansion of economic opportunities that are equally shared with or utilized by the bottom quintiles (usually the poorest and second poorest quintiles) of the population. In a somewhat related measure of inclusive growth, Anand, Mishra, & Peiris (2013) argue that it is dependent on (i) income growth and (ii) income distribution. This paper's approach to inclusive growth as being contingent upon the pace and the pattern of GDP growth broadly captures their definition as well.

the benefits are constrained by economic, cultural and institutional factors. Rather than outright redistribution of existing income (Ianchovichina & Lundstrom 2009), the government is seen as having a crucial role to play in ensuring that the benefits of growth and the economic opportunities created are equally shared by all—especially the bottom two quintiles of the population. Inclusive economic growth is essential to sustain high GDP growth rates and poverty reduction, and to foster peace and social stability (Berg & Ostry 2011; Commission on Growth and Development 2008).

Despite the increasing interest of the government and development agencies in promoting inclusive growth in Nepal, a systematic evaluation of progress toward increasing the inclusivity of economic growth since the 1990s and the evaluation of the appropriate strategic foci for the coming years remain largely absent. Furthermore, until now issues surrounding inclusiveness have been treated as of secondary importance, and deserve a higher priority going forward (White 2012).

This study fills this gap. It first compares Nepal with its South Asian neighbors, utilizing the inclusive economic growth framework developed by the Asian Development Bank (ADB 2013a). This is then extended and complemented with an intra-country analysis, looking in particular at convergence and divergence among consumption quintiles in Nepal. A set of additional indicators are applied that take into account the country's context, such as the stock of out-migrant workers, remittance inflows, worker earnings by sector, main source of fuel, per capita consumption and access to finance. The article relies mostly on the World Bank's World Development Indicators for the cross-country analysis and on data extracted from the previous two national living standards surveys (NLSS) for the intra-country analysis.

Overall, this study shows that Nepal has made remarkable progress in reducing poverty and inequality over the last decade. Furthermore, the expansion of opportunities and social services, mostly led by the public sector, has, on average, reasonably benefited the bottom quintile of the population as well. This is evident from the more than proportional

increase in access to electricity, cellular phone subscriptions, education enrollment, and other social opportunities. The expansion of, and access to, these economic opportunities are generally better in Nepal compared to other regional economies. However, three stark disparities remain: (i) GDP growth and per capita GDP growth remain the lowest in South Asia; (ii) the slow growth rate has failed to create adequate job opportunities, resulting in large-scale migration of workers out of Nepal from all consumption quintiles;² and (iii) the overall inclusive pattern of growth over the last decade has largely been due to exogenous factors such as foreign assistance and remittances. There still remain large disparities in the reach, utilization and quality of social services (economic opportunities) among the poorest quintiles. The pace of economic growth has been too slow to make a dent on the low rate of employment generation and inadequate economic opportunities. The pattern of growth could be made more inclusive by both creating new opportunities and by ensuring that the existing ones are shared proportionately more with the bottom quintiles. The findings of this study have important policy implications, especially on the policy and sectoral investment focuses of both government and development agencies.

The paper is organized as follows. The next section provides a brief discussion on the rationale for promoting inclusive economic growth. It is followed by an overview of the framework for inclusive economic growth as theorized by Ali and Son (2007) and distilled in terms of measurable indicators in the ADB's *Framework of Inclusive Growth Indicators* (2013a).³ Then, the proceeding section explores in detail the

² In addition to cross-country comparison, intra-country comparison is done by looking at the richest and poorest quintiles (disaggregated by gender where appropriate) as it tends to capture the progress and disparities in a fairly unbiased fashion when compared to analysis at the ethnic, caste or geographic levels. Moreover, at the policy and operational levels of development interventions, it provides relatively more constructive direction and guidance.

state of inclusive economic growth in Nepal, and the potential policy drivers of inclusive growth. The final section concludes.

Inclusive Economic Growth Framework

Making economic growth inclusive is essential not only to sustain growth rates over time, but also to create a harmonious society characterized by shared prosperity (Ianchovichina & Lundstrom 2009; Lopez & Serven 2004; Ostry, Berg & Tsangarides 2014). An increasing wedge between the “haves” and “have-nots” in society tends to undermine political and economic stability, which are essential for long-term sustainability of growth and poverty reduction. Hence, public investment and expenditure should be designed and allocated in such a way that it creates synergic effects between lagging and non-lagging regions—in others words, bridging the wedge and integrating all sections of the population.

It should also be noted that simply focusing heavily on redistribution without creating the pre-requisites for high growth and more job opportunities is not going to be effective and sustainable. For instance, a greater focus on education and skills development without the creation and expansion of economic opportunities is not going to be inclusive. High economic growth rates are necessary to provide the public revenues to engage in constructive redistributive policies as needed. Overall, high and sustainable economic growth, including the creation of productive job opportunities, remains central to the quest for

³ Ali & Son (2007) propose that inclusive growth could be measured by using a social opportunity function, whereby inclusive growth leads to the maximization of the function. They focus on the average opportunities available to the population, and the sharing or distribution of such opportunities among the population. Opportunity is defined in terms of access to various services such as education, health, and jobs. For a summary of the ADB literature on inclusive growth and development see Rauniyar and Kanbur (2010).

broad-based inclusive growth as it helps enlarge the economic pie in the first place (Ianchovichina & Lundstrom 2009).

The ADB (2013a: 3) breaks the task of making growth inclusive into three mutually reinforcing policy pillars in its inclusive economic growth framework:

1. *Sustained high growth* and creation of productive jobs and economic opportunities
2. Social inclusion to ensure *equal access to economic opportunity* by increasing human capabilities
3. Social safety nets to *protect the chronically poor* and to mitigate the risks and vulnerabilities faced by people

The first pillar takes into account the crucial role of high and sustained economic growth to not only create employment opportunities, but also to mobilize the required revenue to enable governments to successfully achieve the outcomes under the other two pillars. Furthermore, it also includes the implementation of investment-friendly reforms to stimulate private sector-led economic activities, which in turn become the basis for productive jobs and economic opportunities. Overall, a meaningful structural transformation—whereby economic activities and the workforce shift from low value added, low productivity activities to high value added, high productivity activities—is essential to attain and sustain a high growth rate.

Currently, about 76% of the workforce in Nepal is engaged in agriculture and over 50% of economic activities originate in the services sector (ADB 2013b). This pattern of structural transformation is largely overshadowing the important role of the industrial sector as the main absorber of the workforce that is exiting the agricultural sector, and as a major contributor to economic growth. Furthermore, most of the employment and economic activities in the services sector are either in the informal sector or consist of low productivity activities such as retail and wholesale trade.⁴ These are not high, broad-based and sustainable

⁴ As a share of GDP, the retail and wholesale trade sub-sector within the

growth-enhancing activities. A strong industrial sector stimulates value added economic activities and generates productive employment opportunities.

A high degree of public and private investment in physical and social infrastructure is essential to provide the foundation and drivers for growth-enhancing economic activities such as industrial production, and high value added agricultural and services activities. It also requires the government to create enabling conditions by maintaining macroeconomic stability, boosting institutional capacities, facilitating private sector investment, developing the financial sector, and instituting good governance.

The second pillar emphasizes equalities in access to economic opportunities by expanding human capabilities, adopting accommodative policies, and creating sound institutions that are especially responsive to the needs of the disadvantaged. The public sector is largely responsible for ensuring equal access to economic opportunities by investing in basic education, healthcare, drinking water, sanitation and basic infrastructure—all public goods with significant positive externalities. The dynamic economic activities and the corresponding revenue gains from the first pillar provide the government with the necessary funds for investment required to realize the outcomes of the second pillar. Furthermore, depending on the readiness of private sector, the government could also gradually open up social sector services delivery to the private sector. Institutional as well as governance improvements are essential in basic public services delivery, SME finance and microfinance, agriculture, irrigation, rural development, and gender equity in order to make access to economic opportunities, including jobs, more inclusive.

Inequalities of opportunities may arise either due to circumstances (social exclusion as a result of weaknesses in property and civil rights,

services sector is larger than the industrial sector, which includes mining and quarrying; electricity, gas and water; manufacturing; and construction.

traditions, caste, culture, etc.), or individual efforts (market-based individual incentives to earn higher income and optimally utilize available economic opportunities)—or both. The government has a crucial role to play in addressing these inequalities by expanding as well as ensuring equal access to economic opportunities. For instance, investing more in education (increasing the number of schools in lagging regions, ensuring better quality education, market-oriented skills development, etc.) and making it equally accessible to all will expand the capacities of disadvantaged populations to pursue better economic opportunities. It would also mean that over time the children of people in these population groups will be less likely to be disadvantaged, eventually resulting in a more equal income distribution (Ianchovichina & Lundstrom 2009). Similarly, investing in healthcare, expanding access to drinking water, and providing nutrition supplements targeting disadvantaged populations tend to boost labor productivity and income earning capacities. The role of the public sector is to ensure that the disadvantaged get adequate and equal access to the opportunities created, not just to boost investment. One of the ways to ensure this is to design and implement legal, regulatory, policy and institutional frameworks that specially cater to the needs of the disadvantaged population without distorting incentives. That is to say, it should be a market-driven process with the government playing a facilitating role.

Finally, the third pillar emphasizes the need to provide adequate social safety nets to the chronically poor and for those severely affected by external and transitory livelihood shocks such as sudden disease breakouts, loss of savings and purchasing power due to sudden macroeconomic shocks, structural economic shifts leading to permanent loss of jobs or wage shocks, and natural disasters. Some of the measures could be emergency medical assistance, minimum wages, public workfare programs, unemployment insurance, conditional and unconditional cash transfers, school feeding programs, and subsidized prices to utilize educational, health and market facilities. The public sector needs to shoulder the burden by efficiently utilizing the revenue

gains emanating from a high and sustained level of economic growth.

Progress in the three policy pillars are measured with specific inclusive growth outcome indicators. These fall into two categories:

Income: (i) Proportion of population living below the national poverty line; (ii) proportion of population living below \$2 a day at 2005 PPP\$; and (iii) ratio of income or consumption of the highest to lowest quintiles.

Non-income: (i) Average years of total schooling (youth and adults); (ii) prevalence of underweight children under five years of age; and (iii) under-five mortality rate per 1000 live births.

Overall—differing levels of development, country contexts and government priorities notwithstanding—there has to be some progress in all the three pillars for growth to be termed inclusive (ADB 2014a). These three policy pillars also must be supported by good governance and institutions. These are broadly measured by progress in standard indicators such as the voice and accountability, government effectiveness, and control of corruption in the Worldwide Governance Indicators (WGI) dataset.

State of Inclusive Economic Growth in Nepal

To assess the state of inclusive economic growth in Nepal, this study focuses on two types of comparisons: a regional cross-country comparison at the aggregate level, and an intra-country comparison at the consumption quintiles level.

Regional cross-country comparison

In comparison to its neighbors, Nepal's performance in poverty reduction over the last decade is impressive. Its share of population living below the \$2 a day poverty line stood at 56.0% in 2010,⁵ down

⁵ In 2011, 23.7% of Nepal's population was living on less than \$1.25 a day.

Table 1.

South Asian Poverty Headcount Ratios at \$2 a day (PPP)
(% of population)

		Ratio (%)	Annualized growth rate
Bangladesh	2005	80.3	1.0
	2010	76.5	
Bhutan	2007	29.8	12.6
	2012	15.2	
India	2005	75.6	3.6
	2011	60.6	
Maldives	1998	37.0	16.9
	2004	12.2	
Nepal	2003	77.3	4.5
	2010	56.0	
Pakistan	2006	61.0	3.6
	2011	50.7	
Sri Lanka	2007	29.1	6.4
	2010	23.9	

Note. Data from World Bank (2014d).

from 77.3% of the population in 2003. This annualized growth rate of 4.5% is faster than the rate of poverty reduction in Bangladesh, India and Pakistan over the two latest household living standard surveys (Table 1). However, Nepal's poverty headcount at rural and urban poverty lines stood at 27.4% and 15.5% of rural and urban population, respectively, higher than all South Asian countries except Afghanistan and Bangladesh.

The share of consumption of the poorest quintile increased from 6.5% in 2004 to 8.3% in 2011—an annualized growth rate of 3.4%, which is higher than in all South Asian countries except Maldives and Sri Lanka over the latest two household living standard surveys. Meanwhile, the consumption share of the richest quintile decreased from 51% to 41.5% over the same time period, resulting in an annualized growth rate of minus 2.9%. Another broad measure of shared prosperity is that the consumption share of the poorest 40% of the population increased from 16.2% in 2004 to 20.4% in 2011. This annualized growth rate of 3.4% is higher than all South Asian countries except Maldives over the two latest surveys. It means that the ratio of consumption share of the richest to the

poorest populations in Nepal is narrowing gradually. This broadly suggests an inclusive trend for poverty reduction over the last decade (Figure 1).

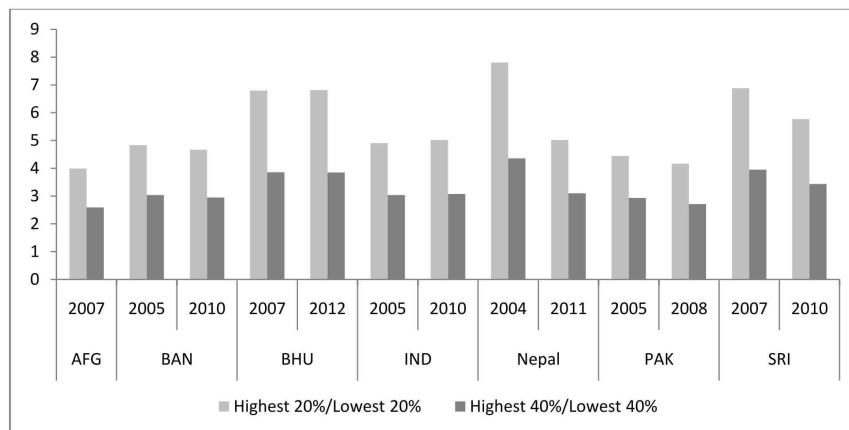


Figure 1. Ratio of consumption share of richest to poorest portions of the population. Abbreviations are as follows: AFG (Afghanistan), BAN (Bangladesh), BHU (Bhutan), IND (India), PAK (Pakistan) and SRI (Sri Lanka). Source: Author's computation based on data from World Bank (2014d).

Economic growth and opportunities

Despite these positive developments, Nepal's per capita GDP, which at \$694 in 2013 was the second lowest in South Asia, has not increased as expected. The average real growth rate of per capita GDP has been below the South Asian average (Figure 2). Nepal's GDP growth remains largely driven by monsoon-fed agriculture production and the services sector propped up by remittance-financed imported goods. Migrant workers send home remittances that are very significant in relation to these activities, equivalent to about 28% of GDP. This remittance inflow is the main sustaining factor for poverty reduction, high consumption, services sector growth, revenue growth, and external

sector stability (Sapkota 2013). Remittances have also disproportionately raised consumption among the poorest quintile, as growth rate of remittance inflows to the poorest quintile has been higher than that to the richest quintile.

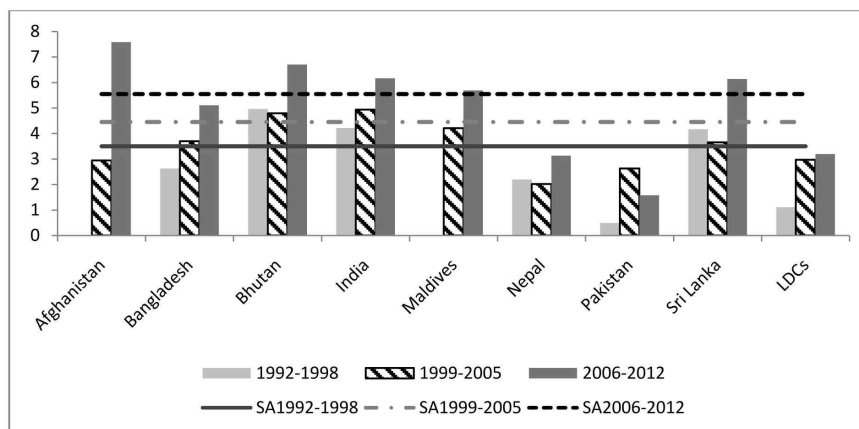


Figure 2. Average growth rate of per capita GDP (PPP in constant 2011 US dollars). Source: World Bank (2014b).

Remittance inflows—and the rising number of migrants workers that generate them—can be taken as a good proxy for the lack of domestic job opportunities to supplement the possibly incomplete picture provided by the unemployment data.⁶ There are an estimated 0.5

⁶ According to NLSS 2010/11, the unemployment rate stood at 2.2%: 1.5% and 3.2% for females and males, respectively. Meanwhile, the Annual Household Survey 2012/13 puts the unemployment rate at 3.3% and the labor underutilization rate (the summation of unemployment rate, time related underemployment, skills mismatched and inadequate earnings) at 27.7%. The labor underutilization rate (35.2%) and unemployment rate (6.4%) are highest for the richest quintile. The fact that there is a low unemployment rate yet an increasingly high number of migrant workers indicates that there is a large number of discouraged workers left out of the labor force.

million new entrants to the labor force each year. This figure is estimated to reach 0.6 million by 2020 (United Nations Conference on Trade and Development 2013). With insufficient attractive economic opportunities at home, an increasing portion of this growing working population is seeking jobs abroad. In FY2014, an average 1,450 migrant workers legally left the country each day for overseas work (up from 6 migrant workers daily in 1995). These migrants now represent some 3.8% of the population (UNDESA 2013).

However, remittances alone are not sufficient to generate and sustain inclusive economic growth. Gainful and respectful in-country employment is the most powerful tool for IEG in a low income country like Nepal where the fundamentals to support higher and sustainable economic growth are severely crippled. The government faces an uphill task to stimulate economic activities and provide job opportunities. Hence, a major push for higher and sustainable economic growth is essential (Government of Nepal & MCC 2014). In other words, Pillar 1 of the IEG framework should be the number one priority in the medium-term.

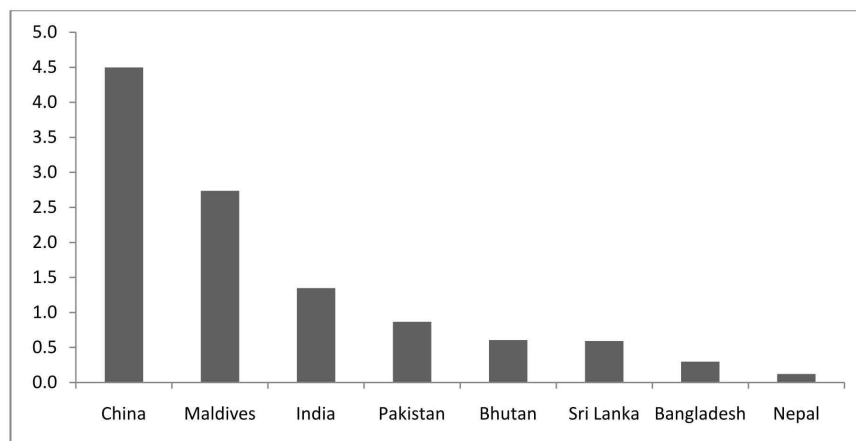


Figure 3. CO₂ emissions for Nepal and nearby countries (metric tons per capita). Source: World Bank (2014b).

Nepal's low carbon dioxide emissions are also an indication of the overall low level of industrialization. The growth in CO₂ emissions has remained low, registering an average growth of 7% over the last decade. In fact, Nepal's per capita CO₂ emissions are only 2.7% of China's, and are the lowest in the region (Figure 3). Nepal now has an opportunity to reignite industrialization, which lasted for a brief period over 1992-2000, in a low carbon, environmentally-friendly way through the adoption of the latest green industrial technology. For example, advances in hydroelectric technologies now make it more feasible to utilize Nepal's huge hydroelectricity potential than ever before.

The most significant binding constraint to economic growth-driving industrialization and inclusive economic growth is the inadequate supply of infrastructure (Government of Nepal & MCC 2014). Electricity is a particularly critical issue in this respect. Nepal faces a widening energy demand and supply gap, and experiences power cuts of up to 16 hours daily during the dry season. This has stymied industrial sector growth and constrained industrial capacity utilization, which stands at around

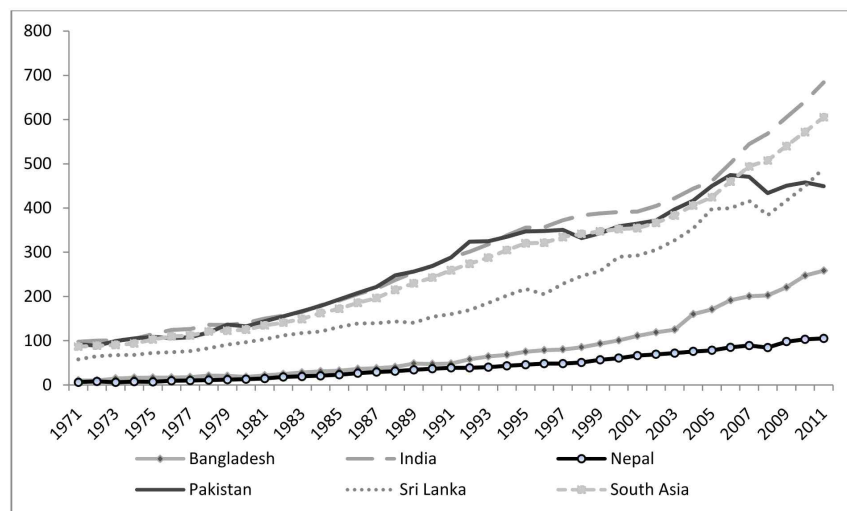


Figure 4. Per capita electricity consumption (kWh). Source: World Bank (2014b).

60% (ADB 2013b). At 105.5 kWh, Nepal's per capita electricity consumption is far lower than the South Asian average of 605.2 kWh (Figure 4). Furthermore, the growth rate of per capita electricity consumption over 2006-2011 was just 5.2%, lower than India's 7.8%, Bangladesh's 7.2% and the regional average of 6.1%.

Some infrastructure categories, such as road connectivity and cellular phone access, have contributed to making growth inclusive by connecting people and places in the most cost effective way. Nepal's share of paved roads in total roads stands at around 54%, which is higher than the regional average. Similarly, mobile phone subscription increased drastically from 4.5 per 100 people in 2006 to 71.5 per 100 people in 2013—an outstanding average annual growth rate of 55%, higher than any other country in the region (Figure 5). Nevertheless, there is room to accelerate this momentum by facilitating private sector investments, including on a suitable public private partnership (PPP) basis.

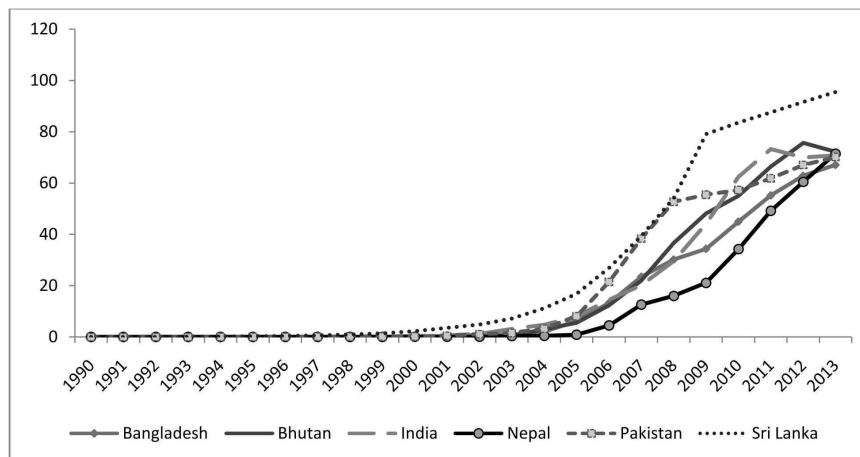


Figure 5. Mobile phone subscriptions per 100 people. Source: World Bank (2014b).

Adequate and affordable access to finance plays a vital role in

fostering entrepreneurship and helping small and medium enterprises (SMEs) scale-up their production or move up value chains. The number of depositors with commercial banks (a proxy for access to finance) stood at 317 per 1,000 adults in 2010. This was higher than the South Asian average of 268 per 1,000 adults, but lower than in India (726) and Bangladesh (513).

Overall, though Nepal has made significant progress in reducing poverty and increasing the consumption share of the poorest section of the population, the gains are largely contributed by exogenous factors, most prominently remittance inflows. The country's performance in building infrastructure fundamentals that hold the potential to sustainably drive high GDP growth remains weak.

Access to economic opportunity

On expanding equal access to economic opportunity, the second of pillar of IEG, Nepal has made commendable progress in the last decade. The primary and lower secondary school completion rate stood at 99.8% and 88.7%, respectively, in 2013. This represents quite a significant jump from 81.9% and 58.2%, respectively, in 2008. These completion rates are some of the highest in the South Asia region, and also much higher than the least developed countries (LDCs) average (Figure 6). Furthermore, Nepal's pupil to teacher ratio at the primary and secondary levels has improved over the last decade, reaching respectively 25.6 and 29.2 in 2013. The figures were 35.7 and 34.7, respectively, in 2003. The increase in the number of teachers with respect to pupils at primary level is better than the South Asia regional average of 35.9. However, it appears Nepal is yet to catch up with the South Asia regional average of 25.8 pupils per teacher for secondary schools (Figure 7). Regarding gender equality in education, the ratio of female to male enrollment at primary and secondary levels over 2008–2012 was 106 and 96, respectively. Both are higher than the regional average. However, the ratio of female to male enrollment at tertiary level is just 61, much lower than the regional

average of 74 (Figure 8).

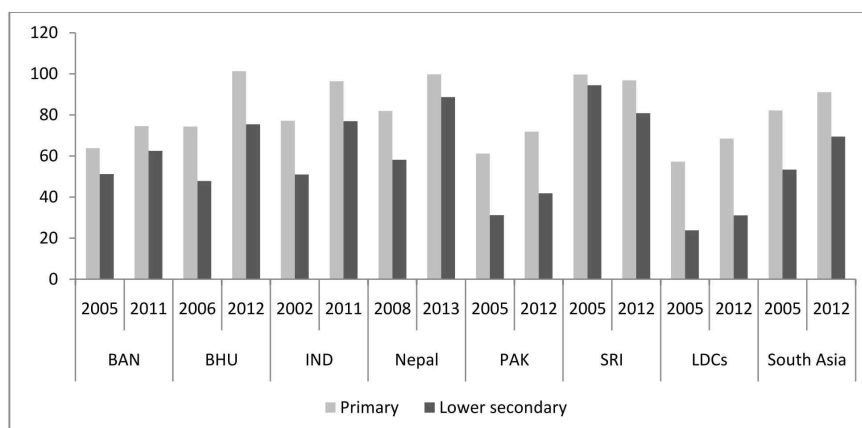


Figure 6. Primary and lower secondary education completion rates, showing percent of relevant age group. *Source:* World Bank (2014b).

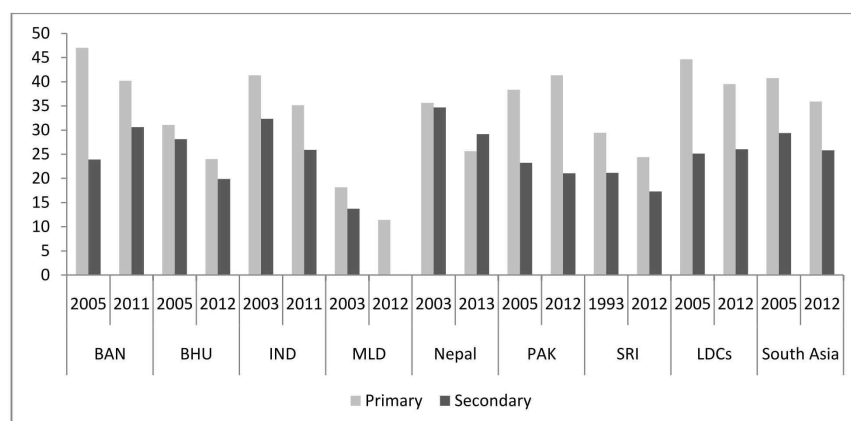


Figure 7. Primary and secondary pupil-teacher ratios. *Source:* World Bank (2014b).

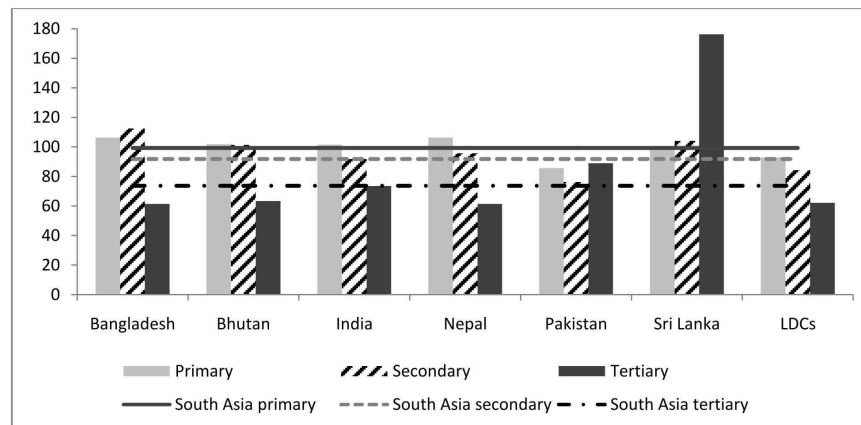


Figure 8. Average ratios of female to male enrollment (%), 2008-2012. Source: World Bank (2014b).

As a share of total public expenditure, average education spending (primary, secondary and tertiary) over 2002-2012 in Nepal stood at 23.4%. Nepal's public education spending as a share of total expenditure is the highest in South Asia (Figure 9). Similarly, as a share of total expenditure, Nepal's average public spending on health over 2002-2012 was the highest in South Asia.

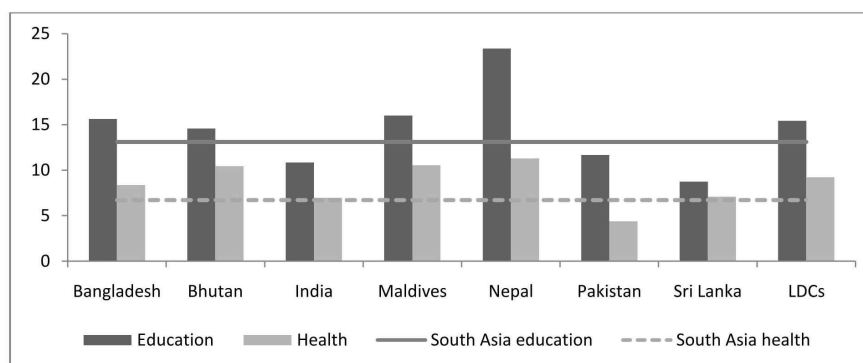


Figure 9. Public spending on health and education (% of total expenditure, 2002-2012 average). Source: World Bank (2014b).

Nepal has also made considerable progress in terms of access to health services. The share of children between 12 to 23 months with DPT immunization has increased consistently, reaching 90% in 2012. This is higher than the South Asian and LDC averages, but lower than in Bangladesh, Bhutan and Sri Lanka (Figure 10). The record on access to physicians is more mixed. The number of physicians stood at around 0.21 per 1,000 people, which is higher than the LDC average. However, it is much lower than South Asian average. This indicates that with respect to access to health facilities, Nepal still needs to cover much ground to reach the levels prevalent in other South Asian countries.

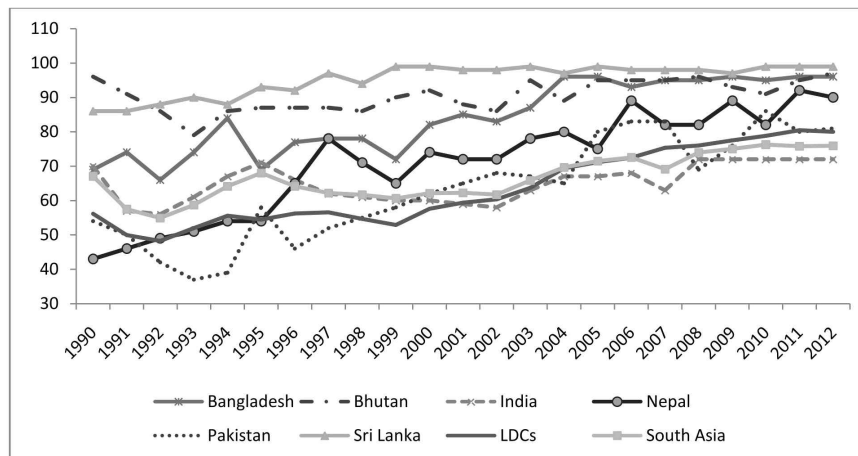


Figure 10. DPT Immunization (% of children aged 12–23 months).

Source: World Bank (2014b).

Nepal has made commendable progress on expanding access to basic infrastructure as well. Access to electricity stands at around 76.3% of population, second only to Sri Lanka, where 85.4% of the population has access to electricity (Figure 11). The access to an improved water source has also increased steadily, reaching the rate of 88.1% of the population in 2012. This is lower than the South Asian average of 91.2%, but higher than that of Bangladesh (84.5%) (Figure 12). However, Nepal

stands at the bottom of South Asian countries in regard to access to improved sanitation facilities, with just 36.7% of the population having such access. Though the access to improved water sources and sanitation facilities has expanded steadily in the last two decades, the rate of progress has been slow (Figure 13).

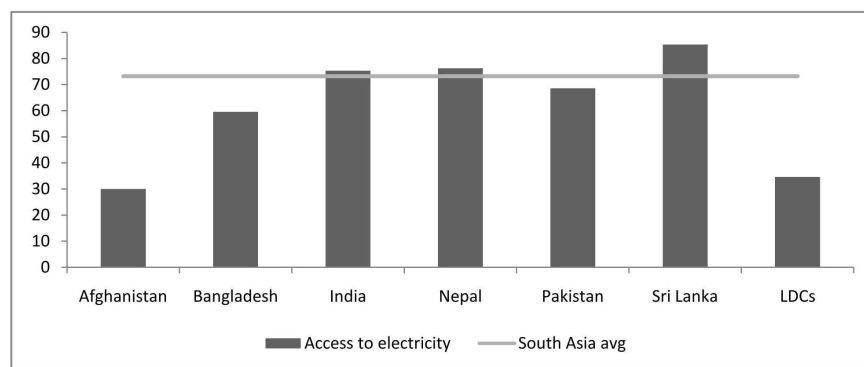


Figure 11. Percent of population with access to electricity in 2011.
Source: World Bank (2014b).

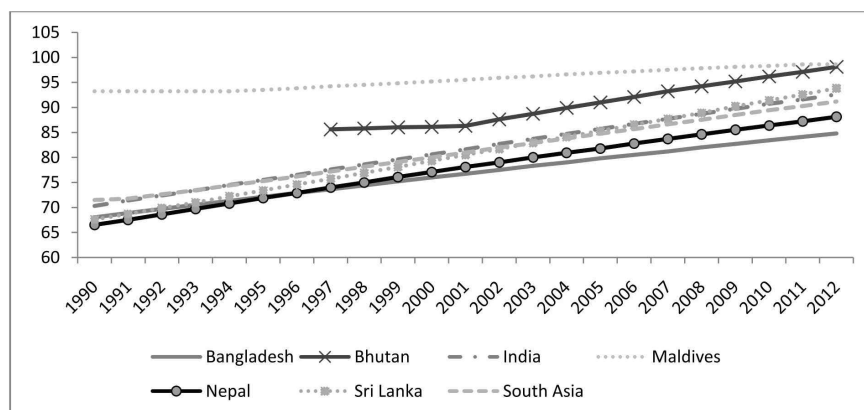


Figure 12. Percent of population with access to an improved water source. Source: World Bank (2014b).

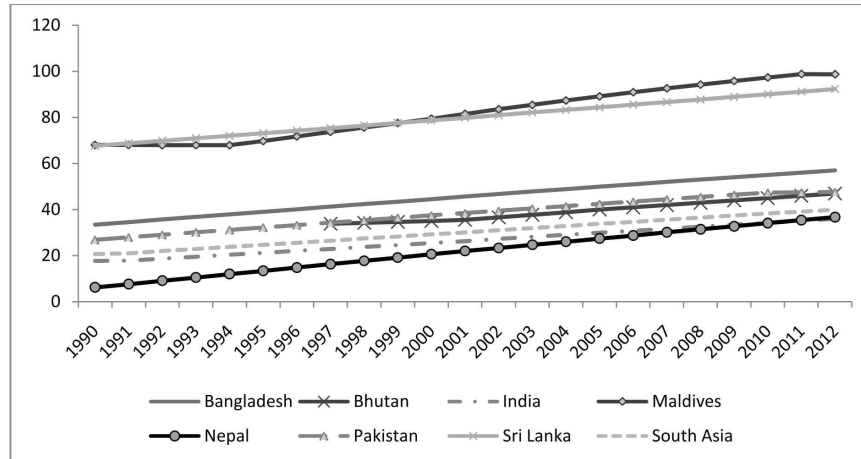


Figure 13. Percent of population with access to improved sanitation facilities. Source: World Bank (2014b).

Overall, Nepal has made quite remarkable progress in terms of expanding access to economic opportunity. However, much more needs to be done to enhance quality, reliability and adequacy of such facilities. The expansion of access to services without such quality, reliability and adequacy bears little substantive meaning (Government of Nepal & MCC 2014).

Social protection

On social protection, which is the third pillar of IEG, Nepal has also registered good progress. Its expenditure on social protection (as a share of GDP) has steadily increased from 1.5% in 2005 to 2.1% in 2010. Nepal's spending on social protection (as a share of GDP) is the third highest in South Asia (Figure 14). Similarly, its social protection index score has improved from 0.05 in 2008 to 0.07 in 2010. This means that total social protection spending (per intended beneficiary) represents 7% of poverty-line expenditures, which is fixed at one-quarter of per capita GDP (ADB 2013d).

Nepal provides a range of social protection measures such as

allowances for the elderly, single women over 60 years old, widows, the disabled, people from endangered ethnic communities such as Raute and Bankariya,⁷ and Dalit children less than 5 years old. According to the National Planning Commission, a total of 2.11 million people benefited from social security allowances in 2012, including 1.31 million senior citizens, single women, and widows; 21,989 people from endangered communities; and 26,361 with disabilities (National Planning Commission 2012).

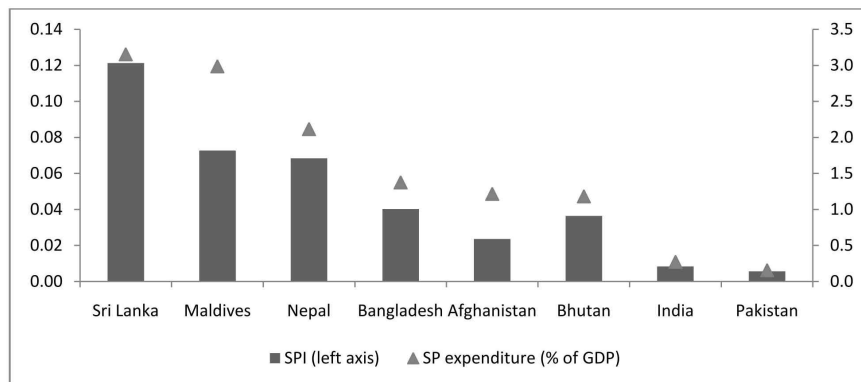


Figure 14. Social safety nets in South Asia. Source: ADB (2013c).

Governance and institutions

In terms of good governance and institutions, which support and sustain IEG, Nepal has made progress in ensuring voice and accountability, especially since 2005. The Worldwide Governance Indicators' (WGI) voice and accountability indicator reflects perceptions of citizen's ability to participate in government selection, freedom of expression and association, and a free media. The average percentile rank

⁷ The government has recognized 59 indigenous groups in Nepal. Based on socio-economic profiles, they are grouped into five categories: endangered, highly marginalized, marginalized, disadvantaged and advantaged. See: <http://un.org.np/oneun/undaf/endangered>

over 2008–2012 shows that 31% of countries worldwide rated below Nepal, including Pakistan and Sri Lanka in South Asia (Figure 15). This is reflective of periodic free and fair elections, a vibrant media, and the numerous civil society organizations freely operating in Nepal. However, in perceptions of the quality of public services, civil service, policy formulation and implementation, the credibility of the government's commitment to such policies and the degree of independence from political pressures, Nepal ranks the lowest in South Asia. Only 16% of countries worldwide rated lower in 2012. The declining ranking over the years also points to the steady erosion of government effectiveness⁸ (Figure 16) in formulating and implementing policies that would facilitate the efficient use of public resources as well as stimulate private sector activities to boost economic growth and jobs creation.

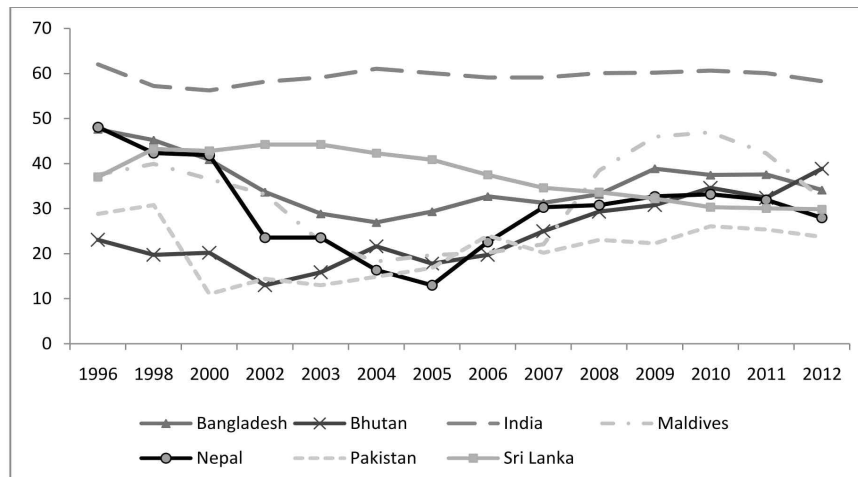


Figure 15. Voice and accountability (percentile rank). Source: World Bank (2014c).

⁸ According to Kaufmann et al. (2010), government effectiveness “reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.”

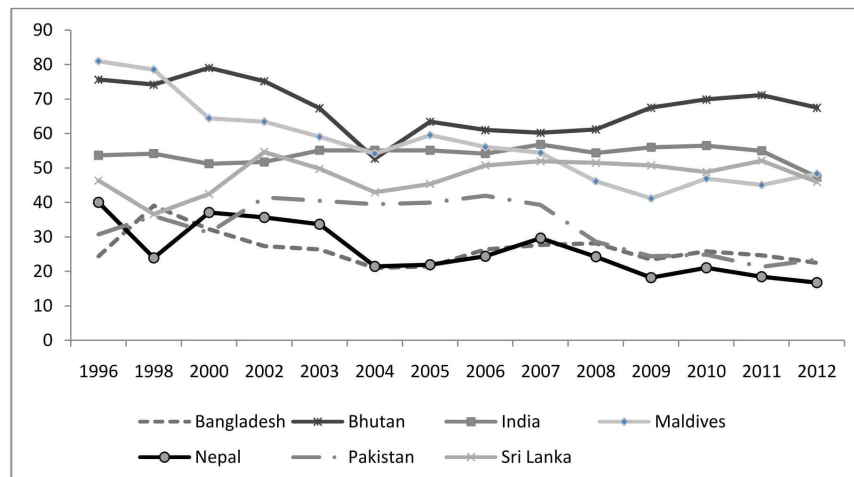


Figure 16. Government effectiveness (percentile rank). Source: World Bank (2014c).

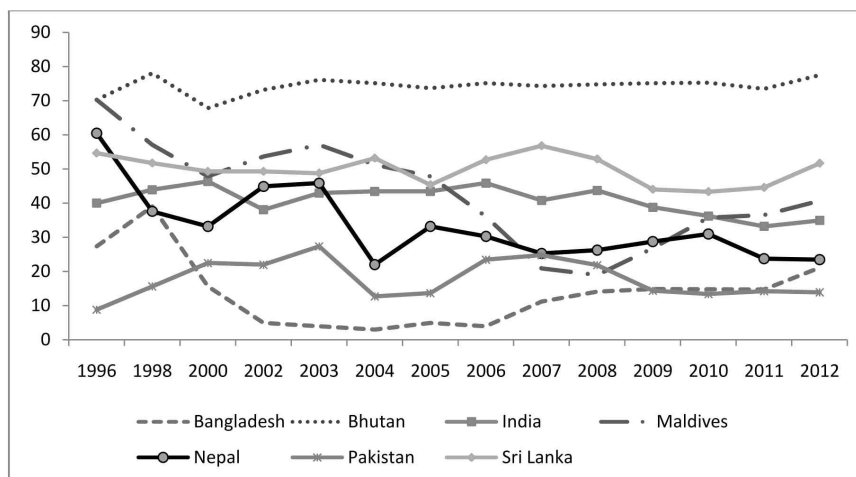


Figure 17. Control of corruption (percentile rank). Source: World Bank (2014c).

Related to government effectiveness is the control of corruption, which reflects perceptions of the abuse of public power for private gain. In this measure of good governance and institutions, Nepal has not fared

that well as its percentile rank has been declining over the years. In 2012, 23% of countries worldwide rated below Nepal (Figure 17). The gradual erosion of institutional capacity and government effectiveness reflects the increasing laxity of government and policymakers. This is partially attributable to the high inflow of remittances, which sustains macroeconomic stability and therefore lower pressure to enact reforms that stimulate growth and create jobs (Sapkota 2013).

Intra-country comparison

While the standard set of IEG indicators helps to track progress across countries, it does not offer concrete guidance on intra-country indicators.⁹ Hence, relevant indicators at the sub-national level should also be identified, especially those relating to access to various facilities by the poorest and richest quintiles of the population. This section analyzes such relevant indicators at the consumption quintile level, data for which are sourced from National Living Standards Survey (NLSS) II (2004) and NLSS III (2011).

Access to basic facilities

Overall, there has been a proportionately larger change in access to basic facilities among the poorest 20% of households than the richest 20%. For instance, access to electricity among the poorest consumption quintile increased from 10.3% in 2004 to 41.7% in 2011, a fourfold increase over seven years. Over the same period, access to electricity among the richest quintile increased 1.2-fold. However, 94.3% of the richest quintile already has access to electricity compared to just 41.7% among the poorest quintile. The access to electricity in rural areas

⁹ The latest thematic review of the ADB's inclusive growth initiatives by the Independent Evaluation Department (IED) encourages countries to adopt country-level targets for inclusive growth indicators to help improve outcomes. See ADB (2014a).

increased 2.3-fold, higher than the 1.1-fold increase in urban areas. Currently, 95.7% of households in urban areas and 63% in rural areas have access to electricity (Figure 18). In this regard, there is a significant gap that needs to be overcome through expanding access to electricity for the poorest households.

The expansion of access to landline telephones has benefited more the middle and richest quintiles than the poorest quintile. While access to a landline telephone expanded 1.2-fold among the poorest 20%, it expanded twofold among the richest 20% over 2004–2011. More significantly, the second and third quintiles saw a 15- and 19-fold expansion of telephone access, respectively. While less than 2% of households in the first and second quintiles have access to a landline telephone, the rate for the richest quintile is 36.6%. Note that the rapid expansion of cellular telephone access, which is fairly homogenous among all quintiles, has overtaken access to landline telephones. This reflects the fact that landlines are becoming increasingly obsolete with the rise of mobile telephony.

Access to a toilet expanded more among the poorest quintile than the richest quintile. While the households in the poorest quintile saw a 2.4-fold expansion, the richest quintile saw an expansion of just 1.4-fold. Furthermore, the expansion of access to a toilet was higher in rural areas than urban areas. Currently, 22.8% and 91% of households in the poorest and richest quintiles, respectively, have access to a toilet. The figures for urban and rural areas are 88.2% and 47.4%, respectively. As with access to electricity and a landline telephone, the poorest quintile and rural areas are starting from a low base. Hence, despite the rapid expansion, the absolute levels remain low. Hence, while there has been remarkable progress in expanding access to various facilities among the poorest sections of the population and in rural areas, there is still room for bridging the large discrepancies across quintiles and geographic areas by both investing more and concurrently expanding access.

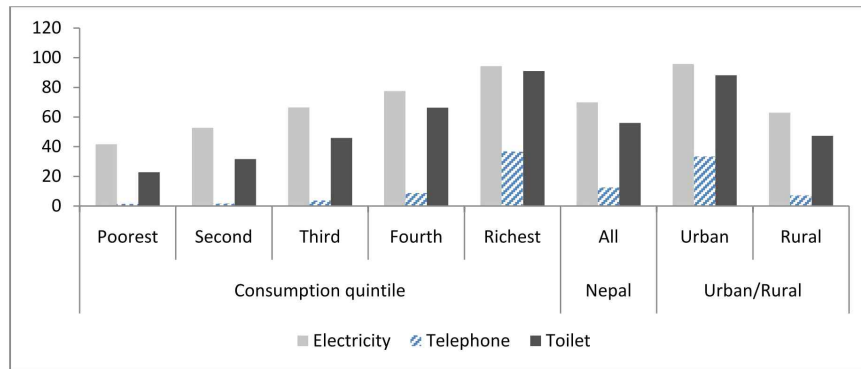


Figure 18. Percentage of households with access to various facilities in 2011. Source: CBS (2012).

In terms of progress in access to finance, the richest quintile seems to have gained more than the poorest quintile from the rapid expansion of banks and financial institutions (BFIs) over 2004–2011. While only 9% of people in the poorest quintile borrowed from BFIs—representing hardly any change from the 2004 level—the figure for the richest quintile was 34%, higher than 26.8% in 2004 (Figure 19). The poorest quintiles are more reliant on relatives for borrowing needs than the richest

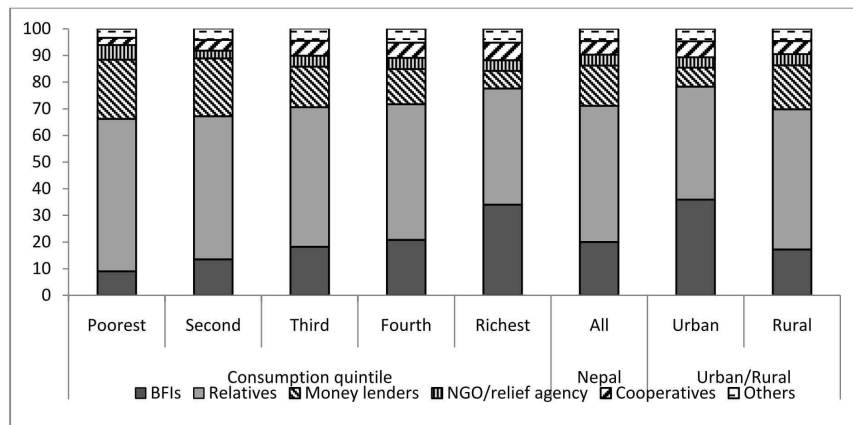


Figure 19. Distribution of household credit by provider in 2011. Source: CBS (2012).

quintiles. Hence, there is ample room for not only expanding access to formal channels of finance, including those by cooperatives, but also making access more inclusive.

Access to education

The primary, lower secondary and secondary¹⁰ net enrollment rates (NERs) among the poorest sections of the population has increased more than that for the richest quintile over 2004–2011. While the primary level NER increased 1.5-fold among the poorest quintile, it increased just 1.1-fold among the richest quintile. Similarly, the lower secondary school NER among the poorest quintile increased 3.6-fold versus the 1.4-fold increase for the richest. The case for secondary schooling was a 3.8-fold increase for the poorest quintile in contrast to a 1.9-fold increase for the richest.

At the higher secondary and tertiary levels, the NER among the richest quintile have increased more than for the poorest quintile. While the NERs for higher and tertiary levels among the poorest quintile stood at 1.6 and 0.6, respectively, the corresponding rates were 30.5 and 29.5 for the richest quintile.

Despite these improvements, the absolute NER among the poorest quintile is still lower than that among the richest quintile. For example, the lower secondary and secondary school NERs among the poorest quintile stood at 24.9 and 7.6, respectively. The corresponding figures for the richest quintile were 63.1 and 56.5. The exception is the near convergence of primary level NERs for the poorest and richest quintiles.

One of the most striking features of the data is that primary, lower secondary and secondary school NERs among girls have been growing more than that for boys, indicating the improvements in gender equality within and across all quintiles. Quite remarkably, primary, lower

¹⁰ The specified age group for primary level is 6–10 years, 11–13 years for lower secondary level, 14–15 years for secondary level, 16–17 years for higher secondary level, and 18–23 years for tertiary level.

secondary, and secondary level NERs for girls among the poorest quintile increased 1.8, 2.9 and 6.6 times respectively. These are higher than the increase seen among boys in the poorest quintile and also girls in the richest quintile. That said, the disparity in absolute NERs between the poorest and richest quintiles is still large.

So, overall, while there has been good progress in expanding NERs, with close convergence in primary level NERs among all the households in the consumption quintiles, there still is room for improving secondary and tertiary level NERs among the poorest quintiles. The existing low levels may be due to the inability of households to afford education costs, irrelevancy of curriculum to enrolled students, or discrimination from better-off peers (Porta et al. 2011). It is also possible that the opportunity cost of keeping children out of the workforce beyond primary education for households in the poorest quintile is higher, thus reducing enrollment rates.

Consumption, remittances and employment

The increase in consumption capacity over 2004–2011 has been broadly shared among the poorest section of the population. The poorest quintile saw a larger increase in nominal per capita consumption than the richest quintile.¹¹ While the per capita consumption jumped 2.7- and 2.6-fold for the first and second quintiles, respectively, it increased just 1.9-fold for the richest quintile. Consequently, the share of consumption of all quintiles increased except that of the richest quintile. Overall,

¹¹ Note that in terms of income, the richest quintile has seen a larger increase than the poorest quintile over the same time period. Consequently, the share of the richest quintile in income per capita stood at 56%, higher than the 54% figure for 2004. Over the same period, the share of the poorest quintile in income per capita decreased from 5% to 4%. Since the Gini coefficient (as well as the poverty rate) takes into account the changes in consumption aggregates—not income—inequality over the same period has declined.

though the richest 20% of population still account for 45.1% of total consumption, it is lower than the 53.3% share of total consumption in 2004 (Figure 20).

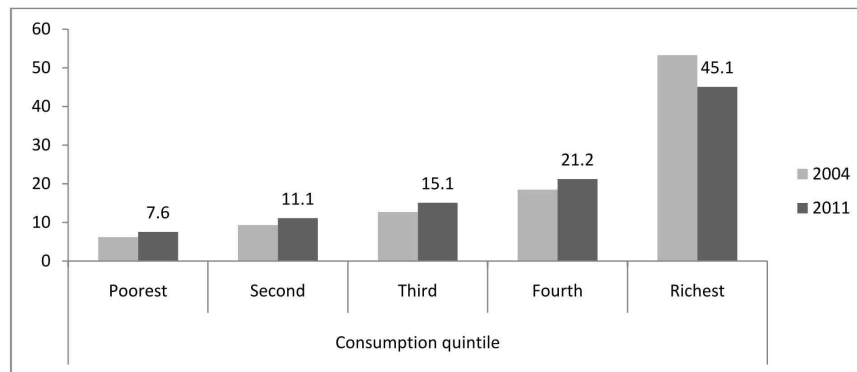


Figure 20. Share of nominal per capita consumption. Source: CBS (2012).

Unfortunately, this shift in the share of consumption away from the richest quintile is not due to a boost in production capacities, and subsequently more decently paying jobs in the economy. Rather, it has come from larger increases in remittances for the poorest households in relation to the richest households. Over 2004–2011, the poorest quintile saw a 4.5-fold increase in average per capita remittances received against a 4.3-fold increase for the richest quintile. The second and third quintiles saw a 4.4 and 4.9 fold increase, respectively (Figure 21).

The importance of remittances is also evident in changes in where households in the different quintiles derive their income. For instance, in the case of the poorest quintile in 2004, 62% of income came from the farm sector, 23% from non-farm, 8% from remittances, and the rest from other activities. This changed significantly in 2011, with 36% of total income coming from the farm sector, 41% from non-farm, 14% from remittances, and the rest from other activities. This shift is common among all consumption quintiles.

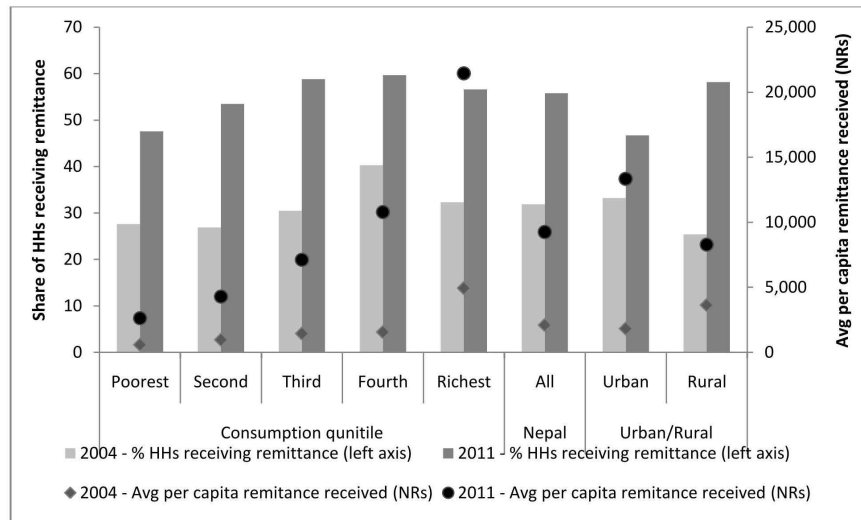


Figure 21. Share of households (HHs) receiving remittance and average per capita remittance received (NRs). *Source:* CBS (2012).

To share the benefits of growth and subsequent employment opportunities more broadly, the manufacturing and construction sectors should be pro-actively promoted. Most people across all quintiles, and especially most of the poorest people, are engaged in these sectors. According to NLSS III, among the poorest quintile, 61% earn their wages from construction and 15.6% from manufacturing (Figure 22). For the richest quintile, these figures are 36.9% and 17.1%, respectively. Note that the manufacturing sector has seen a decline in the share of wage earners across all consumption quintiles. It is reflective of the overall shrinking of manufacturing activities—a mere 6% of GDP in 2014—due to unresolved supply-side constraints and structural bottlenecks.¹² Furthermore, to boost construction activities, the

¹² The major structural bottlenecks are low quality human resources and skills, weak backward and forward linkages, fragmented value chains, negligible research and development, distorted labor market characterized by high minimum wages and low productivity, and policy inconsistencies among others. The major supply-side constraints are lack of adequate

government needs to boost capital spending, which also “crowds in” more private investments (ADB 2013b).

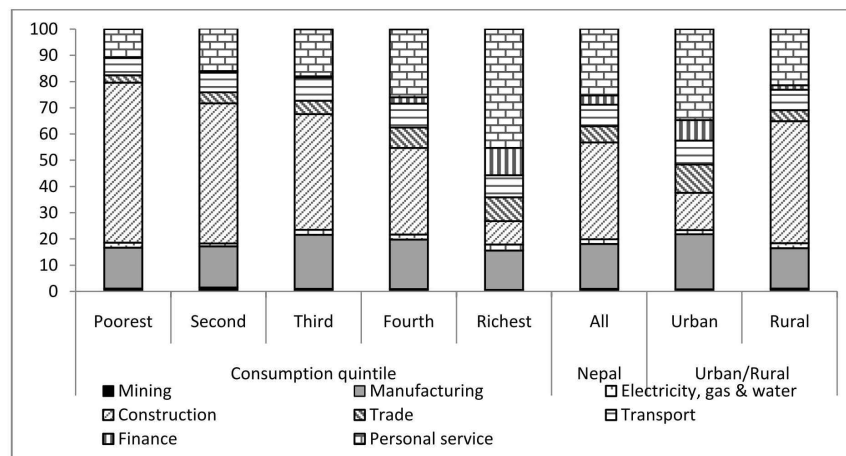


Figure 22. Distribution of wage earners by activity (%) in 2011. Source: CBS (2012).

Policy drivers of inclusive economic growth

The government has an important role in facilitating IEG by initiating actions on all three pillars. Specifically, fiscal policy should be formulated to promote inclusive economic growth without compromising fiscal sustainability. It could deploy two conventional fiscal tools, namely public expenditure and taxes, to achieve this objective. Furthermore, other tools include legal, regulatory and institutional reforms for enhanced efficiency and better targeting.

Public expenditure should be largely oriented toward capital formation as well as deepening. It means increasing both the quantum and quality of public capital spending, especially in terms of relaxing the

supply of electricity, transport bottlenecks, lack of raw materials leading to high import content of manufactured goods, inadequate supply of key inputs to boost productivity, and political disruptions, among others.

most binding constraints to economic activities. Currently, Nepal's capital spending hovers around 3.2% of GDP and the absorption rate is about 75%. This is far below the required investment to close the infrastructure deficit¹³ and to “crowd in” private investment. On the one hand, the government has a low absorption capacity, leading to a wide wedge between planned and actual capital expenditures. On the other hand, public expenditure is already too far stretched to significantly increase capital expenditure without jeopardizing fiscal sustainability as revenue growth has almost plateaued (ADB 2013b).

Rationalization of recurrent expenditures and subsidies will free up more resources for increased capital expenditure even if revenue mobilization remains unchanged. Recurrent expenditure has been rising so fast that even the impressive tax revenue mobilization (16.2% of GDP in 2014) is lower than recurrent expenditures (16.4% of GDP in 2014). High recurrent expenditure does not necessarily promote sustainable

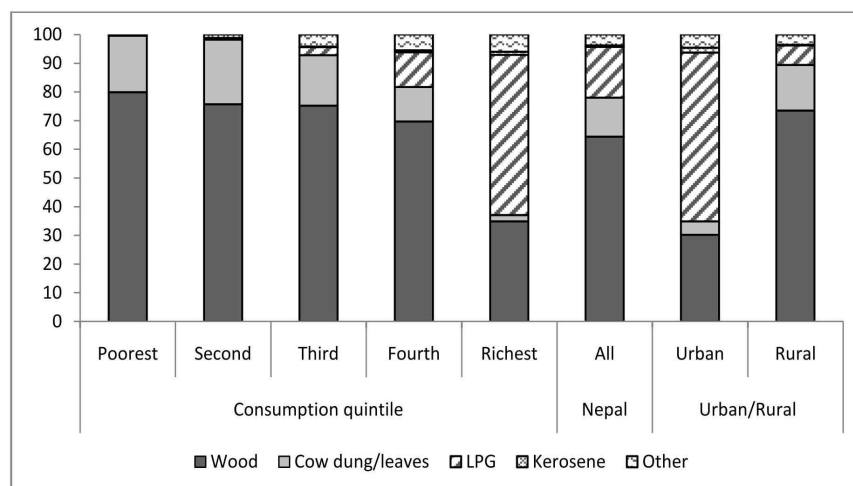


Figure 23. Distribution of households by main fuel used for cooking in 2011. Source: CBS (2012).

¹³ Nepal faces an infrastructure financing deficit of between 8.2% and 11.8% of GDP annually until 2020 (Andres et al. 2013).

IEG, for which high capital expenditure is essential. So, rationalization of recurrent expenditure by culling unproductive expenditure items and efficiency enhancement by bringing about administrative reforms, especially in public enterprises, may be helpful.

Another associated issue is the unproductive subsidies on fuels and electricity tariffs that do not reflect the cost of production. For instance, the net losses of the Nepal Oil Corporation, the state-owned enterprise which sells diesel and cooking gas below the cost price, amount to about 0.6% of GDP. This subsidy disproportionately benefits the middle class and the well-off, who actually do not need a subsidy in the first place. About 64.4% of households use firewood as a main source of fuel for cooking. Only about 17.7% of the total households in Nepal use gas for cooking (about 55.8% and 12.1% of households in the richest and second richest quintiles, respectively). Furthermore, 58.8% of urban households use it while the figure for rural households is just 6.8% (Figure 23). Hence, the cooking gas subsidy is severely mistargeted as less than 3% of households in the first three quintiles use it for cooking. The blanket subsidy should be done away with and the poorest households provided a highly targeted subsidization. Similarly, the losses of the Nepal Electricity Authority (NEA), another big state-owned enterprise, amount to about 0.7% of GDP, as electricity tariffs do not reflect the cost of production. Again, this subsidy disproportionately benefits wealthier households.

The nature of public spending also matters for IEG. For instance, public spending on education and skills development, specially targeted to the poorest households, tends to make growth inclusive over the medium-to-long term as incomes in this group grow either equally or higher than others sections of society (World Bank 2013). Since formal sector jobs require at least a secondary education, expanding its access to the poorest quintiles and financing technical and vocation education training (TVET) that is responsive to the skills and knowledge requirements in the market tend to increase the likelihood of employability. Similarly, increases in public health services spending

tend to benefit poor households more than the richest households, especially with regard to the rate of decline in child mortality rates.

In addition to targeting for high growth and expansion of access to economic opportunities, fiscal policy also should allocate public funds for tested social protection schemes such as conditional or unconditional cash transfers and public workfare programs. These transfers could play a crucial role in bringing historically disadvantaged groups into the overall economic development process. Fairly successful policy interventions in Latin America such as Progres-Oportunidades in Mexico and Bolsa Familia in Brazil, along with public workfare programs such as Mahatma Gandhi National Rural Employment Guarantee Scheme in India are some of the good and replicable examples (see Zepeda et al. 2009; 2013).

Another area of policy reform relates to increasing jobs creation through encouraging private investment. Cumbersome taxes and bureaucratic and regulatory red tape need to be reduced. The government could also provide tax incentives to strategic firms so that they produce niche, labor intensive manufactured products. In the case of capital intensive production, the government could provide the necessary income and custom duty waivers.

Furthermore, to increase revenue mobilization by instituting a progressive tax system, the government could increase tax rates for property, capital gains and inheritance. Also, even though a VAT is a regressive tax, the final outcome can be made progressive if the increased revenue is used to fund inclusive spending (International Monetary Fund 2014). Alternatively, a relatively high VAT threshold can help small businesses grow further and also help to bring efficiencies in revenue administration as the cost of taxing small taxpayers (per unit of revenue) is relatively higher. Currently, Nepal's VAT registration threshold is one of the lowest in Asia (ADB 2014b).

Another important driver of IEG is monetary policy. This can play a vital role in facilitating access to inclusive finance, and thereby lead to inclusive economic growth. Mandatory productive sector lending,

though inefficient and distortionary in principle, could promote IEG if the final reach of such policies extends to the poorest unbanked households. Overall, policies to maintain macroeconomic stability, good governance, human capital, institutional, and structural reforms (product, labor and financial markets, and tax and benefits regimes) are the main determinants of inclusive economic growth (Anand et al. 2013; de Mello & Dutz 2012). In this regard, the overarching objective of any such policy should be to generate productive and respectful employment. This is contingent on both the pace and the pattern of GDP growth. Recently, Gupta et al. (2014) proposed inclusive policy reforms such as the stimulation of investment, creation of jobs, boosting farm productivity, and improving delivery of public services.

Conclusion

Developing countries and bilateral and multilateral development agencies seek inclusive economic growth as a core development outcome. This paper not only applied the ADB's inclusive economic growth framework (ADB 2013a) to evaluate the progress toward inclusivity in Nepal, but also complemented it with an intra-country analysis by incorporating a set of country-specific indicators such as the stock of out-migrant workers, remittance inflows, worker earnings by sector, main source of fuel, per capita consumption, and access to finance.

The results show that along with the remarkable progress in reducing poverty and inequality over the last decade, Nepal has also done a commendable job in expanding access to economic opportunities and social services, which are largely led by the public sector. In the progress made toward greater inclusivity, two important features, generally reflecting pillars 2 and 3 of IEG, are apparent: (i) access to electricity, cellular phone subscriptions, and education enrollment are generally better in Nepal compared to other regional economies; and (ii) the bottom quintiles have seen a more than proportional increase in access to

economic opportunities and social services. However, the progress in pillar 1 of IEG (sustained high growth and creation of production jobs and economic opportunities) is unsatisfactory as the inadequate supply of critical physical infrastructure, in particular electricity and road transport, continue to constrain economic activities, income per capita growth and employment generation. This has resulted in large-scale migration of workers in search of overseas jobs.

The progress in pillars 1 and 2 is largely driven by exogenous factors such as remittances and foreign assistance. However, these alone are not sufficient to generate and sustain IEG in Nepal. Generating gainful and respectful in-country employment is the most powerful tool for IEG in a low income country like Nepal where the fundamentals to support higher and sustainable economic growth are severely crippled. Currently, while the pace of economic growth is too slow to make a dent in the low rate of employment generation and inadequate economic opportunities, the pattern of growth could be made more inclusive by both creating new opportunities and by ensuring that the existing ones are shared proportionately more with the bottom quintiles.

By investing in critical physical infrastructure, in particular hydroelectricity and road transport, Nepal now has to reignite industrialization in an environmentally-friendly way so that the economy grows at a high and sustainable rate, creating appropriate job opportunities for people from all consumption quintiles. On top of this, Nepal also has to enhance the quality, reliability and adequacy of physical and social infrastructure. The initiatives have to be supported by enhanced government effectiveness in formulating and implementing policies that would not only facilitate the efficient use of public resources, but also stimulate private sector activities to boost economic growth and jobs creation.

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