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The Investment Climate, Governance, and Social Inclusion in Nepal

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Abstract

This is without doubt that Nepal has a strong possibility of moving forward in the fight for a better standard of life for all its people provided all Nepalese from rural and urban areas and from all socio-ethnic groups participate in the growth process. For this, there is a need for secured investment climate. good governance and social inclusion of all the Nepalese through improvements in delivering of basic services and through closing of gender gaps. This paper offers some thoughts about the challenges going forward, drawing on lessons from experiences of development in other countries.

His Majesty's Government of Nepal has embarked on a journey which involves laying a foundation for peace and prosperity, regaining the people's trust in the state through good governance, building on the reform efforts started under the previous governments, and managing the transition to a democratically elected government.

The government is well on its way to completing the first "Immediate Action Plan". As part of this Plan, an important process has started to hand over public schools and health posts nation-wide to community management (with an inclusive representation), along with significant block grants. In a few communities near Pokhara it seems that turnaround in the performance of rural education and water supply are visible – in quality of service, outreach to neglected low-caste villages, and meeting women's special needs. Structural reforms in Nepal are truly "home grown"; and they are essential both to recovery and to the acceleration of development. The government is looking beyond peace negotiations and is thinking about "peace dividends" and about a post-conflict humanitarian, rehabilitation and reconstruction program. Such rebuilding is not only vital to meet the immediate needs of the Nepalese people, it will also lay the foundations for, and help shape, a longer-term program for development. Central to this program, as the government has argued, should be better governance and stronger social cohesion. The history of development has taught us that these are fundamental for achievement of the faster and sustained poverty reduction that Nepal is seeking. This is a period during which the Nepalese people will be discussing and shaping a strategy for the future of the country. I would like to contribute to this strategic debate by offering some thoughts today about the challenges going forward, drawing on lessons from experience of development in other countries.

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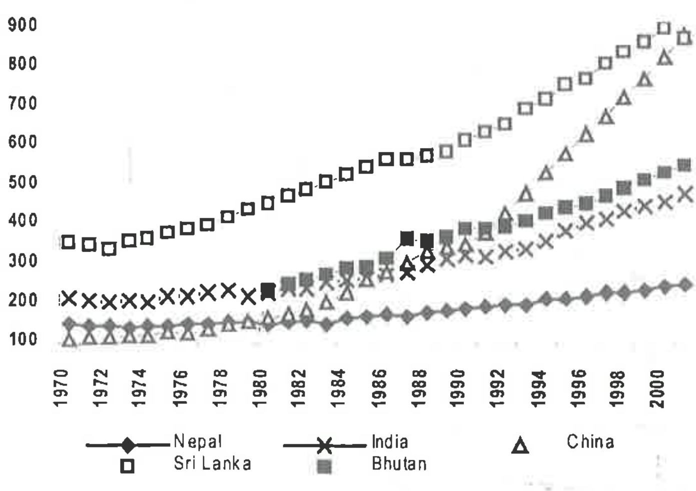
Nepal's Long-Term Growth Performance

In terms of total GDP, Nepal's economy has grown fairly strongly and consistently over the last two decades. GDP growth more than doubled from 2.1% p.a. in the 1970s to 4.8% p.a. in the 1980s. In the 1990s, Nepal's growth accelerated further to 5.1% p.a., and was much higher than GDP growth in low and middle-income countries as a group (3.3% p.a.). It was also higher than GDP growth in some nearby economies such as Bangladesh (4.8 % p.a.) and Pakistan (4.0% p.a.), and not far behind Sri Lanka (5.2% p.a.) and India (5.5% p.a.). However, continued population growth at 2.3% p.a. over the last two decades has partially dissipated the gains derived from accelerated growth. Growth in GDP per capita at 2.6 % p.a. during the 1990s was slower than Bangladesh (3.0% p.a.), India (3.6% p.a.), Sri Lanka (3.9% p.a.) – and much slower than China (9.0% p.a.).

Indeed in 1970, China's GDP per capita (at US$109 in 1995 prices) was lower than Nepal's (at US $148); 31 years later, in 2001, China has far outstripped Nepal with a GDP per capita (878) which is 3.5 times higher than Nepal's (248), and in the same period the ratio of GDP per capita of India to that of Nepal has increased from 1.4 to 1.9. And one cannot argue that country size is the primary reason for this widening gap – the same widening gap is also seen between Nepal and Sri Lanka, which are similar in population. The ratio of GDP per capita of Sri Lanka to Nepal increased substantially from 2.4 to 3.5 over this 31-year period (see Figure 1).

Figure 1: GDP Per Capita (Constant 1995 US $)



In any assessment of prospects for Nepal, geography will loom large. Nepal is landlocked and suffers from high transport costs, both internationally and domestically. Whilst many Nepali people are convinced about the importance of improving on the basics – such as governance and education, they also wonder whether, because of geography, these efforts will be frustrated. But geography, whilst important, is not destiny. One cannot argue that it is the landlocked nature of Nepal which is the primary reason for its falling behind its neighbors – the widening gap is also seen between Nepal and Bhutan, which are both landlocked countries situated in the Himalayas, with Bhutan also smaller in size than Nepal. Between 1980 (data on Bhutan prior to that date are not available) and 2001, the ratio of GDP per capita of Bhutan to Nepal has increased from 1.6 to 2.2.

When we look beyond GNP per capita to social indicators, what do we find? Let us, for example, examine developments in Nepal in relation to the Millennium Development Goals (MDGs) which look to strong progress, across a range of indicators, by 2015.[1]

First of all, income poverty remains high, with about 42% of the population living below the local poverty line in 1995/96.[2] Growth in Nepal has been far from uniform across urban/ rural areas, geographic regions or socio-ethnic groups. Growth has been concentrated in urban areas, and that too within the Kathmandu Valley, leaving behind the 86% of the population that lives in rural areas. Rural poverty at 44% is almost twice as high as urban poverty (23%). The incidence of poverty also rises as one moves from the urban Kathmandu Valley (4%) to other urban areas (34%).

Turning now to the non-income dimensions of poverty, data from the Nepal Demographic Health Surveys indicate that net primary enrollment rates have risen between 1996 and 2001 from 69% to 73%, but there is still a long way to go in achieving universal primary school enrollment. The gender gap in education remains high, with a 13 percentage point difference at the primary level and a 6 percentage point difference at the secondary level. The same surveys indicate that there has been progress on child mortality: both infant mortality rate and under-5 mortality rate have declined between 1996 and 2001 – the infant mortality rate fell from 79 to 64 per 1000, and under-5 mortality rate fell from 107 to 91 per 1000. This may in large part be attributed to successful immunization campaigns. On the other hand, the nutritional status of children shows little improvement with, in 2001, 50% of the children

[1] The MDGs, which were endorsed by nearly 150 Heads of State at the United Nation's Millennium Summit in September 2000, are as follows:

- halve, between 1990 and 2015, the proportion of people living on an income of less that $ 1 a day;
- achieve universal primary education by 2015;
- eliminate gender disparity in primary and secondary education by 2005 and at all levels by 2015;
- reduce by two-thirds, between 1990 and 2015, the under-five mortality rate;
- reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio;
- combat HIV/AIDS, malaria and other diseases so that their spread would have been halted by 2015;
- halve by 2015 the proportion of people without sustainable access to safe drinking water; and
- integrate the principles of sustainable development into country policies and programs to reverse the loss of environmental resources.

[2] This is based on the 1995/96 Household Survey and a poverty line of Rs. 4404 per person per year; in the same year, based on the international poverty line of $1 per person per day, poverty incidence in Nepal measured 38%. A Nepal Living Standards Survey (NLSS) to be launched in 2003 will provide an update on poverty incidence; the official estimate currently being used by the government of Nepal is 38% based on extrapolation carried out by the National Planning Commission.

under 5 years of age stunted, 48% underweight, and 10% wasted. Maternal mortality remains very high at 539 per 100,000 live births as estimated in 1996. Access to drinking water has increased rapidly and it seems that Nepal may reach near universal access to drinking water by 2015. There are, however, questions about whether many rural drinking water schemes that have been built by the government are still functioning, and the safety of drinking water remains a concern. Thus, it seems that Nepal faces three challenges: first, the acceleration of economic growth; second, participation in growth by rural areas, weaker geographic regions, and poorer socio-ethnic groups; and third, specific programs fostering progress in health, education, and the environment .These are challenges which are recognized by the government in the reform agenda outlined in the Poverty Reduction Strategy Paper (PRSP).

A Development Strategy

Addressing these challenges successfully depends on a concerted effort on two broad dimensions or two pillars. The first pillar is to improve the investment climate, which shapes the conditions for investment, growth, and jobs. The second is to increase the inclusiveness of the development process. This will require improvements in education and health for all groups and regions, and particularly for women and girls. But inclusion involves more than simply investment in health and education. It also involves the participation of all groups in the community in the processes that shape their lives. Improving the investment climate and inclusion will both require major improvements in governance. This perspective on the challenges, which Nepal faces, draws on lessons from the experience of development over the last 50 years.[3] Our understanding of the meaning, or goals, of development has changed substantially over this period, particularly in the last 20 years. We now look beyond incomes to health and education. Indeed we now look beyond these basic elements of human development and see the objectives or ends of development as concerning the ability of people to shape their own lives.

In thinking about the promotion of these goals we must recognize that the process of development has involved fundamental change in economic and social structures. This process is not simply one of economic expansion. We have seen, and will see, movement of resources out of agriculture to services and industry, migration to cities and peri-urban areas, and transformations in trade and technology. Change – change in health and life expectancy, in education and literacy, in population size and structure, in gender relations and in social relations – is at the heart of the story of development. The challenge for policy is to help release and guide these forces of change so that they foster development in the sense we have defined. Thus we see both the objectives and processes of development in far more subtle ways than twenty years ago.

What are the essential elements of these two pillars? The first pillar is the creation of a good investment climate – one that encourages firms, especially small firms and farms, to

[3] Further discussion of the lessons and strategy can be found on my website at the World Bank, including lectures in Munich and London in November 2002 (http://econ.worldbank.org/staff/nstern/).

invest, create jobs, and increase productivity. In many countries, and it seems Nepal, the investment climate is damaged by poor infrastructure, and by problems of governance. In agriculture – which has a crucial role to play in development and the reduction of poverty in Nepal – inadequate irrigation facilities and poor transport and roads have led to very slow agricultural growth. Indeed Nepal's agricultural output has scarcely changed in per capita terms over the last thirty years and much of it is still subsistence. Problems of governance include: bureaucratic harassment and corruption; rigidities in the labor markets imposed by excessive regulation; and "soft budget constraints", associated with the combination of government action and the functioning of the financial sector, which together inhibit exit and dampen incentives for firms.

The second pillar of the development strategy is to empower and invest in poor people – by enabling their access to health, education, and social protection, and by fostering mechanisms which allow all Nepalis – women as well as men, and Dalits and ethnic minorities as well as traditionally dominant social groups – to participate in the process of growth and to participate in the decisions that shape their lives.

Improving the Investment Climate

The main engine of sustained aggregate growth is the private sector in the present day world.. It is also the main provider of economic opportunity and activity for poor people. Private-sector growth, particularly of smaller firms and farms on which most poor people depend, is vital to the reduction of poverty. A central policy question for poverty reduction is then how we can construct policies to promote this kind of growth. As we have seen, the answer proposed here is in terms of the investment climate. This shapes not simply the level of investment but also to productivity, the productivity of economic activity more generally, and entrepreneurship and innovation in the economy as a whole.

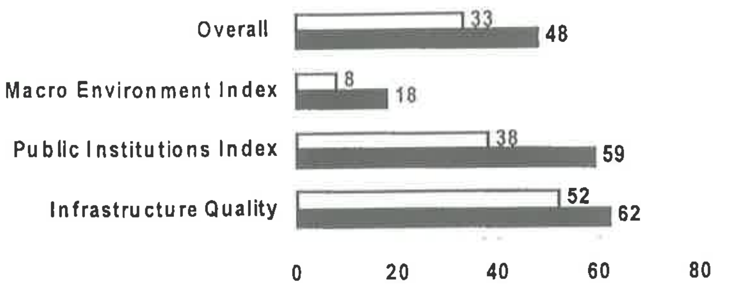
We can define the investment climate, as the policy and institutional environment, both present and expected, that affects the risks and returns associated with investment. We can then identify three broad components of the investment climate:

- The basics of economic policy: macroeconomic stability; trade openness; and competitive markets.
- Governance and institutions: low levels of bureaucratic harassment and corruption, especially in the areas of regulation and taxation; a functioning legal and regulatory framework; strong and secure financial institutions; skilled labor force and good labor relations; low levels of crime; and, of great importance, social and political stability — nothing is more damaging to the investment climate than conflict.
- Infrastructure: transport, particularly roads and ports, telecommunications, dependable supplies of power and water.

The perspective of the investment climate provides valuable insights into the structural drivers of growth. Let me illustrate with a comparison of China and India – Nepal's neighbors and the two biggest developing countries with, together, well over 40% of the population of developing world.

In comparing India and China, we must recognize that by historical standards both have grown rapidly in the last 20 years; however, China has grown much faster, and that the stronger improvement in the investment climate has been an important part of the story. Whilst there are always problems in comparing GDP across countries, the difference in experiences is striking. The ratio of GDP per capita of China and India has increased from 0.5 in 1970 to 1.8 in 2001 (see Figure 1). And their attraction as a destination for FDI has also been sharply different: in 2001, FDI inflows (net) as share of GDP were 3.8% in case of China and only 0.7% in case of India.

Figure 2: Competitiveness Rankings, India and China, 2002 (Among 80 Countries)



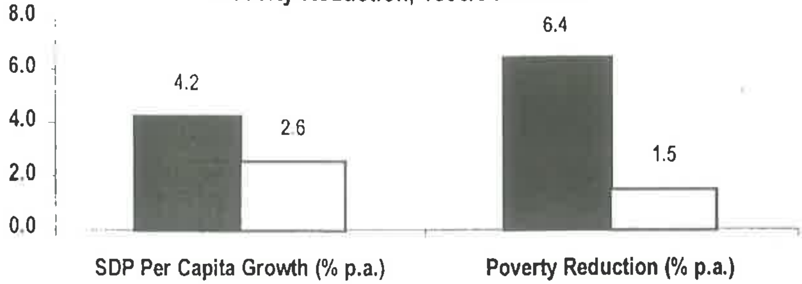
Source World Economic Forum, Global Competitiveness Report, 2002/03

In comparing the investment climate in the two countries we have a number of sources, one of which is the Global Competitiveness Index published by the World Economic Forum (see Figure 2). More detailed and informative data are now becoming available from the firm- level survey work being carried out by the World Bank in partnership with institutions in developing countries. Domestic firms, down to small enterprises, are asked about how long it takes to get goods through customs, how often they are visited by local authorities, reliability of infrastructure, and so on, as well as, more conventional data on output, costs, etc.

On all investment climate indicators except one (government inspectors) China is far ahead of India. India is generally ahead of Bangladesh. Thus we see that the rankings in terms of economic growth rate is strongly associated with the rankings in terms of investment climate. The importance of investment climate can be illustrated by using another example: the differential progress which different states within India have made in terms accelerating growth and reducing poverty. What this example shows is that India's national level reforms yield their greatest benefits in states that are complementing these reforms with improvements in investment climate at state level.

Take the states of Karnataka and Bihar, for example. Between 1993/94 and 1999/00,[4] the average annual growth rate of per capita real state domestic product (SDP) and the average annual rate of poverty reduction, respectively, were 1.6 times and 4.2 times faster in Karnataka as compared to Bihar (see Figure 3). These differences can be largely attributed to the difference in the investment climates in the two states.

Figure 3
Growth of Real State Domestic Product (SDP) Per Capita & Poverty Reduction, 1993/94-1999/00



Source : GoI, Planning Commission, and Deaton (2001) for Poverty Estimates; GoI, Central Statistical Organization for GDP per capita

Bihar is perceived as one of the states with the worst conditions for investment in India, while Karnataka is perceived to be one of the states which is, relatively speaking, much better in this respect. Karnataka's status as a relatively better off state in terms of investment climate is confirmed by a firm-level competitiveness survey, covering 1032 Indian firms in 10 states, completed by the World Bank in collaboration with the Confederation of Indian Industry (CII) in 2002. The survey asked business managers to identify the states that they thought had a better or worse investment climate than the state in which they were currently based. They were also asked to identify the state that had the best investment climate, and the one that had the worst. The responses enabled categorization of Karnataka as a "good climate" state.

Simply focusing on the governance aspect of the investment climate, the differences between the two states can be seen very clearly. Bihar has been facing administrative breakdown, widespread corruption, and poor public service delivery. The administrative machinery has been rendered dysfunctional by frequent transfers of staff, serious overstaffing at lower levels, and patronage-based rather than meritocratic promotions. Whilst these problems occur in other states of India they are particularly severe in Bihar. All this compounded by caste politics, populism, violence by Naxalite extremist groups, and violent para-military groups

[4] The two points in the 1990s, for which poverty data is available based on the quinquennial National Sample Surveys.

among the upper castes. A series of high-level scandals have given the state a reputation for being exceptionally corrupt.

The administrative breakdown in Bihar, along with corruption and chronic under funding, have deeply eroded the ability of the state to deliver basic services. Per capita expenditure on social services in Bihar is the lowest in India, contributing to low outcomes. Poor health services have resulted in the lowest level of immunizations, lowest use of contraceptives, and very low level of supervised births. Schools are poorly equipped and lack basic amenities, absenteeism is high and Bihar has the lowest literacy rate among all states in India (48%, as opposed to 67% in Karnataka and 65% average for all India, see the 2001 Census).

Karnataka, by contrast, is a state with relatively better governance and institutional capacity. In fact, it is one of the front-runners among Indian states in introducing significant governance reforms. To address the problem of frequent transfers, Karnataka imposed a ban on premature transfers; consequently, such transfers declined from 50,000 in 2000/01 to less than 17,000 in 2001/02. To streamline departments and eliminate duplication, it has commissioned an independent evaluation of 13 major departments with the objective of extending the exercise to other departments. It has been very active in passing legislation to promote transparency and reduce corruption – the Right to Information Act, Transparency in Public Procurement Act, and the Industries (Facilitation) Act. To improve service delivery, Karnataka has introduced citizen's charter initiatives covering many key services — for example, transport and land-related services. Corruption in the re-engineered transport department has been substantially reduced; the time needed to secure urban land has been reduced from five years in the 1990s to one year now. Karnataka has also been among the pioneering states in introducing information technology and using it to improve the functioning of the government. A particularly significant achievement has been the computerization of millions of farmland records under the so-called "bhoomi" initiative, which has drastically reduced access time from months to minutes, thereby reducing harassment and corruption.

Uttar Pradesh (UP) and Maharashtra – two other Indian states – provide another example of how differences in investment climate can translate into differences in growth and poverty reduction. The same World Bank-CII Survey mentioned above indicated that among the 10 states covered by the survey, Maharashtra and UP were at opposite ends of the spectrum in terms of the investment climate. More than 70 percent of the respondents thought that the investment climate of Maharashtra was better than in their own state; about 65 percent thought that UP had a worse investment climate as compared to their state. These responses enabled categorization of Maharashtra and Gujarat as "best climate" states in India and UP as a "poor climate" state. These perceptions are indeed acted upon by entrepreneurs as is evident from the differential investment rates, FDI flows, and growth in these states. In the sample covered by the survey, the firms in best climate states exhibited higher investment rates, increasing their capital stock at about 8 percent per year, while there was much more modest growth of capital stock at 3 percent per year in UP. Almost all FDI in the 1990s has gone to the best and the good climate states in India. Best climate states also exhibited much faster growth and poverty reduction than the poor climate ones – growth of real SDP per capita and rate of poverty reduction, over the period 1993/94-1999/00, were both about 1.2-1.3 times faster in

Maharashtra as compared to UP.

Let me now say a few words about the challenges that are specific to Nepal in terms of the investment climate. In spite of the global economic slow-down and restrictive trade practices by trading partners, there has been a rebound in the growth rate of ready made garments (RMG) exports to around 30% in the first five months of the current fiscal year over the previous year. This points to the resilience of this key export sector – a strong example of Nepalese initiative. Given stable conditions and a positive domestic investment environment we should all have confidence in Nepalese entrepreneurship and creativity. The necessary confidence can be built and the arguments for the Government's emphasis on this issue and its action program in this area are strong.

One cannot minimize potential risks and difficulties externally. The forthcoming phasing out of the MFA in January 2005 deserves special mention. RMG exports to the US, constituting around 20% of all export earnings, can be sharply and adversely affected by the lapsing of quota protection under the MFA. Nepal will have to make significant progress in increasing productivity and lowering transport costs (which are caused less by the long distance to the ports, and more by customs, port and trans-shipment obstacles and inefficiencies) to overcome this change in trading regime. On the other hand, possible improvements in these areas can also provide Nepal with significant growth opportunities far beyond the garment sector.

The nominal anchor that is provided by pegging the Nepali Rupee to the Indian Rupee has been valuable in maintaining the competitiveness of exports. But there are several factors that will have important effects on the real effective exchange rate and Nepal's competitiveness, which need to be studied further. These include: the appreciation of the real effective exchange rate in the second half of the 1990s (which helped to halt the decline of Nepal's unit labor costs in manufacturing), the forthcoming challenges to Nepal's competitiveness posed by the repeal of the MFA, the WTO accession, and the "Dutch Disease" implications of the large jump in labor remittances from abroad – if it proves to be lasting.

While a global economic slow-down and restrictive trade practices by trading partners are growth-dampening factors that Nepal can do little about, there are other impediments to growth that the government can influence. Conflict in rural areas, heavy dependence on rain-fed agriculture, high transport costs, unreliable power and telecom services, a weak financial sector, a rigid labor market and the limited effectiveness of public investments currently constrain growth in Nepal. Restoring peace is particularly important not only for the overall investment climate but for the tourism industry in particular.

Looking further ahead, strong agricultural growth will depend on improving the effectiveness of irrigation, rural transport and power sector investments. These are key components of the agricultural growth strategy which is adopted in the Government's PRSP. They are likely to involve partnerships between the public and private sectors, the form of which will depend on the sectors. The lack of irrigation in Nepal is very striking compared with North India and investment here seems of special importance in the fight against poverty given that the large majority of poor people depend on agriculture for their livelihood. Maintaining macro-economic stability, greater efforts at domestic resource mobilization, expenditure prioritization, better financial management and procurement practices can all work to create the fiscal space for investments in infrastructure and human development and improve the effectiveness of public investments, thereby benefiting all sectors of production. Of particular importance to improving the productivity and competitiveness of domestic manufacturing will be greater flexibility in labor markets, significant strengthening of the financial system and more reliable telecom and power services.[5]

Social Inclusion, Good Governance and Poverty Reduction

The second pillar of the development strategy guides action to enhance the ability of poor people to shape their own lives. It promotes and enables their investment in themselves. It fosters social inclusion and participation in growth, but it also promotes growth itself by bringing the assets and energies of poor people into the story. Thus the processes embodied in the two pillars are mutually reinforcing in their effects on growth and poverty reduction.

In Nepal the planned gradual process of decentralization and greater empowerment of local communities in the management of social services is likely to improve service delivery — crucial if inclusion is to move forward effectively. In education the key objectives are to improve primary completion rates, increasing access for girls and ethnic minorities and to enhance access to post-primary education. Recent governments have started to implement the required reforms designed to achieve these objectives. A process of devolving primary school management to communities has begun and represents a fundamental shift in approach from the current centrally managed system. Targeted scholarship programs for girls and ethnic minorities will also be implemented.

In health, the Government has developed a sector strategy that will focus on implementing an Essential Health Care package focused on a wide range of preventative care, maternal and child health and family planning. Improvements in service delivery are also expected to occur through a process of devolving sub-health posts to local communities. For access to clean water – which is vital for health outcomes – the aim stated in the PRSP is to increase access in rural areas from 71% to 85% of the rural population by 2006. Key actions to achieve this involve both the rehabilitation and maintenance of existing projects and the development of new projects. For the latter, the demand-driven user- group approach supported by various programs, including the Rural Water and Sanitation Development Fund is likely to identify priority projects for local communities and improve their effectiveness. Urban water supply management in Kathmandu and other cities is expected to be contracted out to the private sector over the next few years and, if managed well, this has the potential to improve the quality and efficiency of service.

In order to promote social inclusion, the PRSP proposes targeted programs for the poorest of the poor, ethnic minorities, people living in remote areas, and female-headed households and women. It is important to obtain convincing results in order to gain the confidence of those who have thus far been left behind by development efforts. In this task the central

[5] Electricity costs in Nepal are not subsidized as they are in India, and are the highest in the region.

government faces serious capacity constraints. This is why the integrated infrastructure development program (drinking water, small irrigation, schools, health posts, and trails) to be implemented in remote areas through local government, community groups and NGOs is a very promising development. To address gender issues, girl's education will be promoted through scholarship programs and greater hiring of female teachers. The Essential Health Care package will have a strong focus on maternal and reproductive health and the community user group approach to expand drinking water has explicit provisions for the involvement of women. Similarly, programs to promote the inclusion of marginalized ethnic groups will be developed within each sector's main programs.

The government has adjusted its fiscal policy to make expenditures more pro-poor. And the share of actual expenditures on education and health in total expenditures increased from 17% in FY99 to 21% in FY02 even while security expenditures increased. Within these sectors, primary services have also been provided relatively more resources: e.g. the share of primary education increased from 44% in FY00 to 55% in FY03, while the share of preventive health care in the health budget increased from 26% in FY02 to 40% in FY03.

Taken together the policies and programs of the PRSP embody strong measures, via decentralization and local empowerment, health and education programs with a focus on previously excluded groups, and budget reallocations, that are likely to generate real progress towards inclusion.

Governance

As we have seen in discussing actions to improve the investment climate and inclusion, improved governance is fundamental to the success of most or all-effective policies to promote growth and poverty reduction. The strategy of the government of Nepal is to improve governance has three main elements: (1) improving the effectiveness of the civil service; (2) strengthening anti-corruption and accountability institutions and (3) improving the functioning of key agencies. This strategy has the strong support of the World Bank.

Civil service reform: The core civil service in Nepal comprises 106,000 positions, or roughly 0.4 civil servants per hundred population, which in per capita terms is one of the smallest in both South Asia and the developing world. The actual numbers are even lower, as the estimated vacancy rate is around 16 percent. The composition of Nepal's civil service is particularly skewed towards the lower tiers, with a much smaller number of senior administrative staff than India and relatively more civil servants at the lowest classless level (e.g. peon, driver, guard, etc).[6] Accountability mechanisms have historically been weak, performance and productivity low, and political interference in daily operations a chronic problem.

In order to improve the efficiency and accountability of the civil service, the government has taken several important actions. A complete Personnel Information System (PIS) has

[6] Source: IMF (2002), 'The Civil Service Sector : Key Issues and Reform Plans' Nepal Selected Issues Paper.

been developed with support from the Asian Development Bank. In spite of resistance from various ministries, approximately 7,500 vacant positions were eliminated in late 2002 out of a total of 17,000. A partial "decompression" of salaries took place in mid 2000, though the salary structure remains very compressed or narrow in its range from highest to lowest. There have also been significant steps towards reducing politically motivated transfers in government.[7] Further actions planned include connecting the PIS to the payroll system to create a comprehensive human resource database (essential for tracking posts, vacancies, transfers, and forecasting future salary and pension liabilities) and the design of an ordinance to delineate more clearly the roles of civil servants and politicians in administration, thereby reducing the scope for political interference. Outsourcing of selected support activities; a position reclassification exercise to permit greater decompression of salaries; and selective elimination of remaining vacant positions are planned by mid-2004. Transfer data will be publicly reported on the internet in order to promote greater transparency by mid 2004. Various measures to enhance the ethnic and gender balance of the civil service are also under consideration.

Anti-corruption measures: The government has taken significant preventive measures to stem corruption. New legislation, particularly the Prevention of Corruption Act, has given the Commission for the Investigation of Abuse of Authority (CIAA) the power to initiate cases against all top officials, including the Prime Minister and his Cabinet, without the need to secure permission to do so. In order to improve its effectiveness, the CIAA is developing an electronic database to track complaints and monitor action; improve training for its officers (mostly on deputation from other Ministries) in interrogation and prosecution techniques; and trying to secure better facilities by mid-2004. An inquiry commission, headed by a Supreme Court judge, was given sweeping powers to investigate the properties owned by political leaders and bureaucrats and I understand that it has recently submitted in its findings. Future priorities will include strengthening the CIAA's presence at the district level and addressing the backlog of earlier cases currently pending within the justice system. The CIAA is enjoying increased status and prestige and, empowered by the recent legislation, has recently initiated a number of high-profile anti-corruption cases.

But defeating corruption involves much more than new laws and institutions. It depends crucially on three further aspects: (i) strong example from leaders to set standards of behavior; (ii) transparency (see below); (iii) promoting policies which limit bureaucratic discretion by reducing and simplifying licensing, etc. Thus defeating corruption is about changing behavior and reducing opportunities for corruption as well as detecting and punishing it.[8]

Functioning of Key Agencies: The government has also taken action to improve the functioning of key agencies. For example, the assessment, collection, and audit functions have been separated in the Income Tax Department to prevent all three tasks from being concentrated in the hands of a single officer, as was earlier the case. The Income Tax

[7] The number of transfers has been substantially reduced in the last three fiscal years: from 4653 in FY00 to 2500 in FY01 and 2143 in FY02 (Source: ADB Governance Reform Program).

[8] The CIAA has filed charges against three former ministers, 22 MoF civil servants, the Executive Director of the national airline and the Joint Secretary of the Ministry of Physical Planning.

Department has introduced a Citizens' Charter. We would suggest, however, that this needs to be revised, based on stakeholder consultation, to reduce the time-limits for receiving refunds, introduce tax-payer identity cards, and to clarify grievance redress procedures.[9] Other agencies with large public interface where service delivery gains could be made by mid 2004 are land and property registration as well as passports. Improvements in other functions of district administration are expected by mid 2005.

Transparency: Major measures were introduced recently to promote transparency, including a Political Party Law adopted in 2002 requiring the Auditor-General to audit the accounts of all parties; a decision to open up FM radio programming to both private and community participation; and the establishment of a National Vigilance Centre in the Prime Minister's Office. These steps will be furthered by public reporting of audit findings relating to political parties; by the creation of a web-portal for His Majesty's Government of Nepal (initially with links to other departments, forms, information on schemes and programs, and an official directory) by end 2003; by drafting Freedom of Information legislation, based on wide public consultation, by mid 2004; and by institutional strengthening of the National Vigilance Centre by mid 2004. Transparency should go beyond laws and institutions to encourage it, necessary as these are. It should be embedded in the principles and practices of behavior generally – the first presumption should always be for release of information.

Why is it important to make rapid progress on governance? Because the evidence is clear that weak governance has profoundly damaging implications for growth and development outcomes. In recent years, various papers, including those by Hall and Jones; Acemoglu, Johnson and Robinson; and the work on governance of Dani Kaufmann and Aart Kraay at the World Bank show that good governance and per capita incomes tend to be strongly positively correlated across countries. There is also a strong association between good governance and better development outcomes such as lower infant mortality and higher literacy.[10] One governance index that is commonly used comes from the International Country Risk Guide. The governance index is a on 0-50 scale created by combining 5 separate indicators measuring subjectively (but it seems fairly robustly) corruption, bureaucratic quality, rule of law, risk of expropriation, and risk of government repudiation of contracts.

Let me give an example using data from the South Asia region. Of the 79 countries in the world for which we have these data on governance, Pakistan ranks 61st on the governance index; by contrast, India ranks 30th, Sri Lanka ranks 53rd, and Bangladesh ranks 76th – unfortunately we have no data for Nepal. Econometric work using these data suggests, for example, that Pakistan's growth rate would have been nearly doubled, over recent years, if it had possessed the same quality of governance as Thailand.

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[9] There is a weekly public hearing to resolve issues but the current charter makes no reference to it.

[10] See, for example, R.E. Hall and C. Jones (1999), "Why Do Some Countries Produce So Much Output per Worker than Others?" *Quarterly Journal of Economics* 114(1); D. Kauffman, A. Kraay, and P. Zoido-Lobatón (1999), "Governance Matters", Policy research working paper 2196, The World Bank; D. Acemoglu, S. Johnson, and J.A. Robinson (2001), "Colonial Origins of Comparative Development: An Empirical Investigation", *American Economic Review* 91(5); D. Kauffman and A. Kraay (2002), "Growth without Governance", The World Bank.

Conclusion

We must conclude that Nepal is at a turning point in its history. It has a real opportunity to move forward strongly in the fight for a better standard of life for all its people. Poverty reduction will require an acceleration of growth and policies to ensure that all Nepalis, from rural and urban areas and from all socio-ethnic groups, can participate in the growth process. It seems that this is a period of challenge and opportunity and, therefore, of responsibility for the Nepalese people and decision makers. At the center of this effort is likely to be concerted and sustained efforts to improve the investment climate, and to increase the inclusiveness of the development process through improvements in the delivery of basic services including education and health for all groups and regions, through closing of gender gaps, and through major improvements in governance.

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