Democracy and Economic Reform in Nepal:

CONFLICT AND CONSEQUENCES FOR DEMOCRACY

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The views expressed in this presentation represent the analysis and opinions of the speaker and do not necessarily reflect those of the National Endowment for Democracy or its staff.

Outline of Presentation

- Political Forces in Nepal
- History of Economic Reform
- Political Resistance to Economic Reform Today:
  - Financial Sector
  - Labor Law
  - Governance
  - Public Expenditure
- Consequences for Democracy

Political Forces of Nepal

- Nepali Congress
- Communist Party of Nepal (UML)
- Communist Party of Nepal (Maoists)
- Monarchy

Political Parties

The Nepali Congress

- 1946: Nepal's largest political party, the Nepali Congress, founded
- 1950: Plays a lead role in toppling the Rana regime and establishing constitutional monarchy
- 1959: Secures an absolute majority in Nepal's first-ever multiparty elections
- 1960: King overthrows government in a military coup & imposes direct rule under single-party Panchayet regime for 30 years.
- 1990 and 2006: Congress plays a key role in pro-democracy movements of 1990 and 2006.
- 2007: Following suspension of the monarchy in December 2007, president of Nepali Congress G .P. Koirala becomes both head of state and of government.

Political Parties

Communist Party

- Since its founding in 1949, the communist movement has been characterized by numerous mergers and splits
- 1991: Nepal's largest communist party CPN (United Marxists Leninists) formed
- 1995: CPN (Maoists) formed.
- 1996: Launches armed insurgency to establish a communist state
- 1990 and 2006: Communist parties collaborate with Nepali Congress to play major roles in movements to restore democracy

Monarchy

- 1769: King Pritivi completes conquest to unite Nepal
- 1846: Rana regime captures power in bloody military coup
- 1960: King overthrows the first democratic government and imposes direct rule under the single party Panchayet regime for 30 years
- 1990: Democracy restored
- 2001: Royal Massacre, Crown Prince kills royal family
- 2005: King Gynendra stages military coup and imposes direct rule for 15 months
- 2006: People's uprising forces King abandon his direct rule
- 2007: Interim parliament votes to abolish nearly 240 year-old monarchy.

Modern Nepal

Nepali Economy at a Glance

	Nepal(2005)	India(2005)	China(2005)
Population	27.1 million	1.1 billion	1.3 billion
GDP (current US$)	7.1 billion	805.7 billion	2.2 trillion
GNI Per capita (US$)	270	730	1,740
Life expectancy at Birth (years)	62.7	63.5	71.8
Military expenditure (% of GDP)	2.0	2.09	2.0
Internet users (per 1000 people)	4.1	54.8	85.1
Primary school completion rate (%)	74.4	89.8	-

Source: World Bank Indicators

Economic Reforms before Democracy (1985–1990)

- A serious financial crisis in the mid-1980s brought the IMF and World Bank to the rescue with conditional economic assistance. The early reforms were focused mainly on the financial and trade sectors.

<u>Financial sector</u>

- Removal of entry barrier for joint-venture banks
- Deregulation of interest rates
- Allowing private sector to establish financial institutions

<u>Trade sector</u>

- Devaluation of Nepali currency to check imports and make exports competitive
- Introduction of import license auction system to replace quota system

Economic Reforms Before Restoration of Democracy (1985–1990)

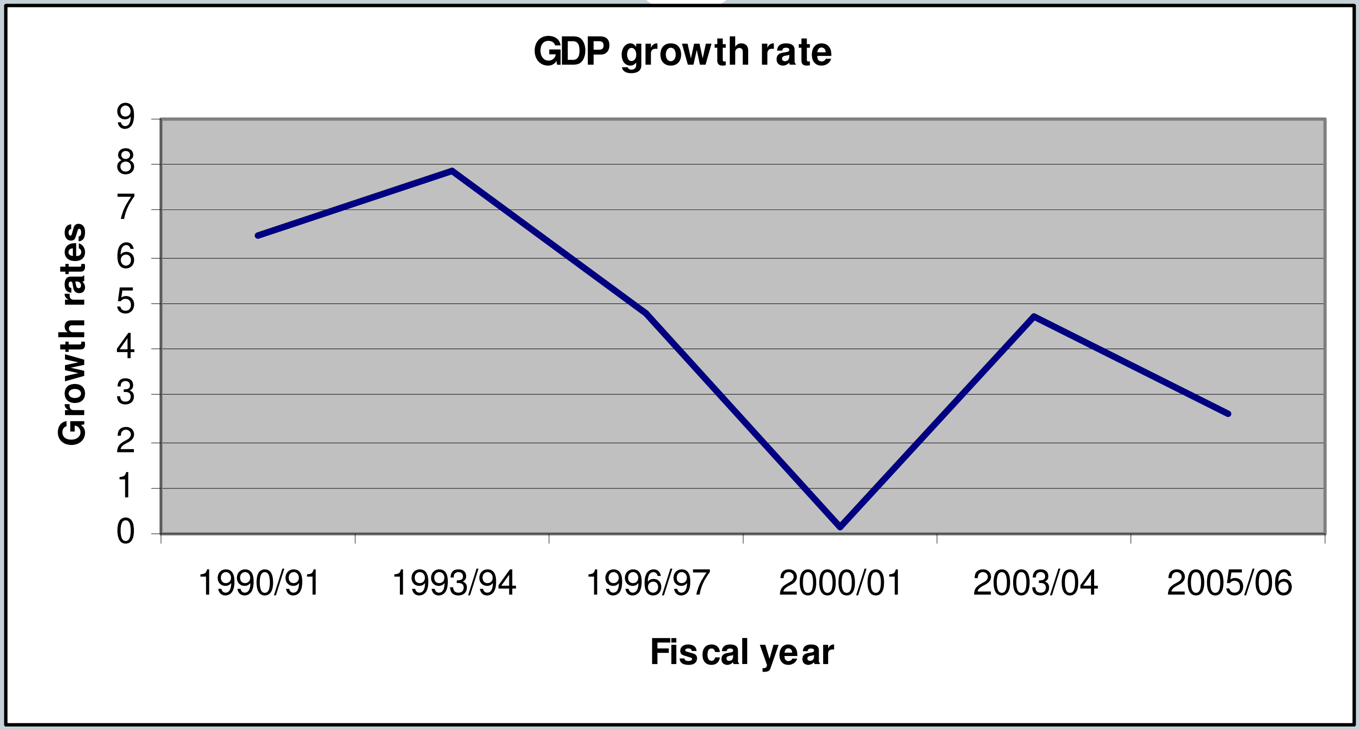
<u>The Impact</u>

- Number of banks increase from 2 to 5
- Deposits increase by 160 percent
- Lending increase by 150 percent
- With increases in both imports and exports, total volume of international trade *doubles*

Reforms After Restoration of Democracy (1990–2006)

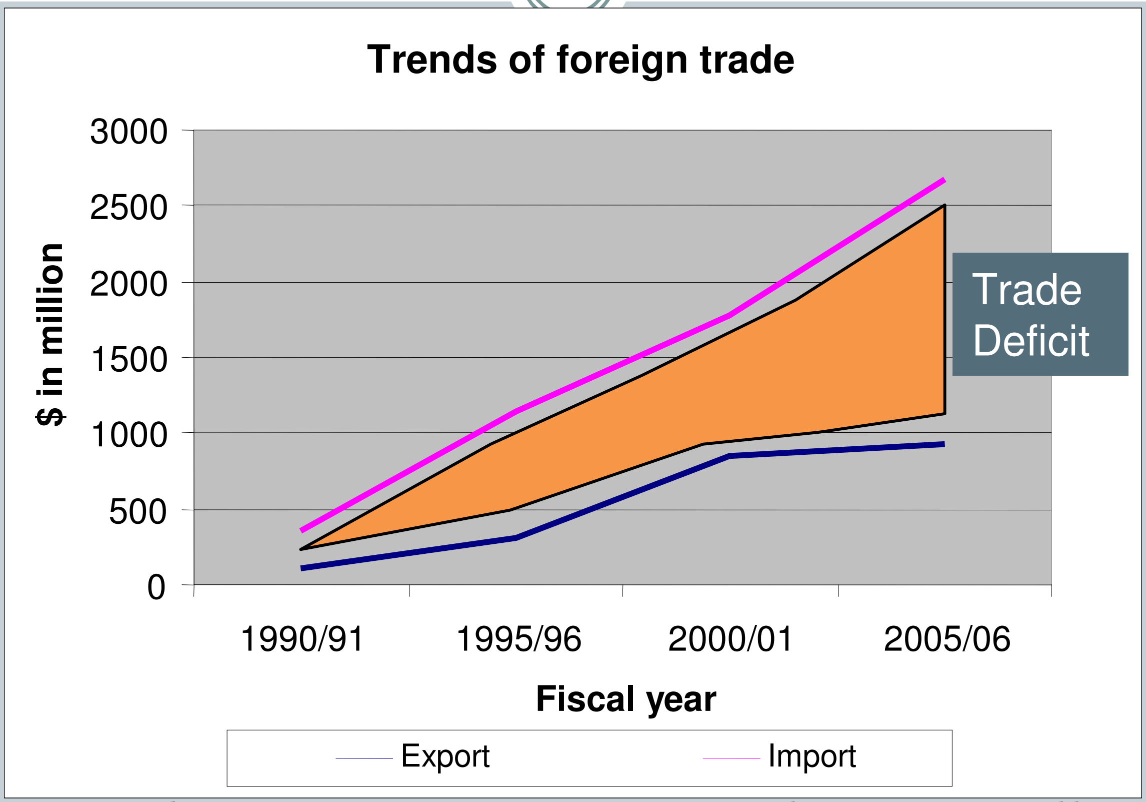
- Market-oriented, liberal economic policy, with limited government intervention in the private sector
- Almost all sectors are opened up to foreign investment and policies are announced to lure foreign investments:
  - Further privatization of public enterprises (PEs)
  - Exporters allowed to retain their foreign exchange earnings
  - Entry for private sectors' financial institutions further liberalized
- The Local Self-governance Act (LSGA) is enacted to further expedite decentralization and to share revenues between central and local governments.
- Government enacts the Labor Act, further strengthening labor rights, occupational safety and health

Impacts of Initial Reforms (1990–2006)



- Despite initial gains following the restoration of democracy, Nepal's GDP growth rate drops to an all-time low in 2001, mainly due to the escalating Maoist insurgency.

Impacts of Initial Reforms (1990–2006)



- During the period 1990-2006, exports reach $ 927 million, up from $ 230 million. Imports reach $ 2.6 billion, up from $ 727 million. However, the trade deficit widens to $1.75 billion in 2006.

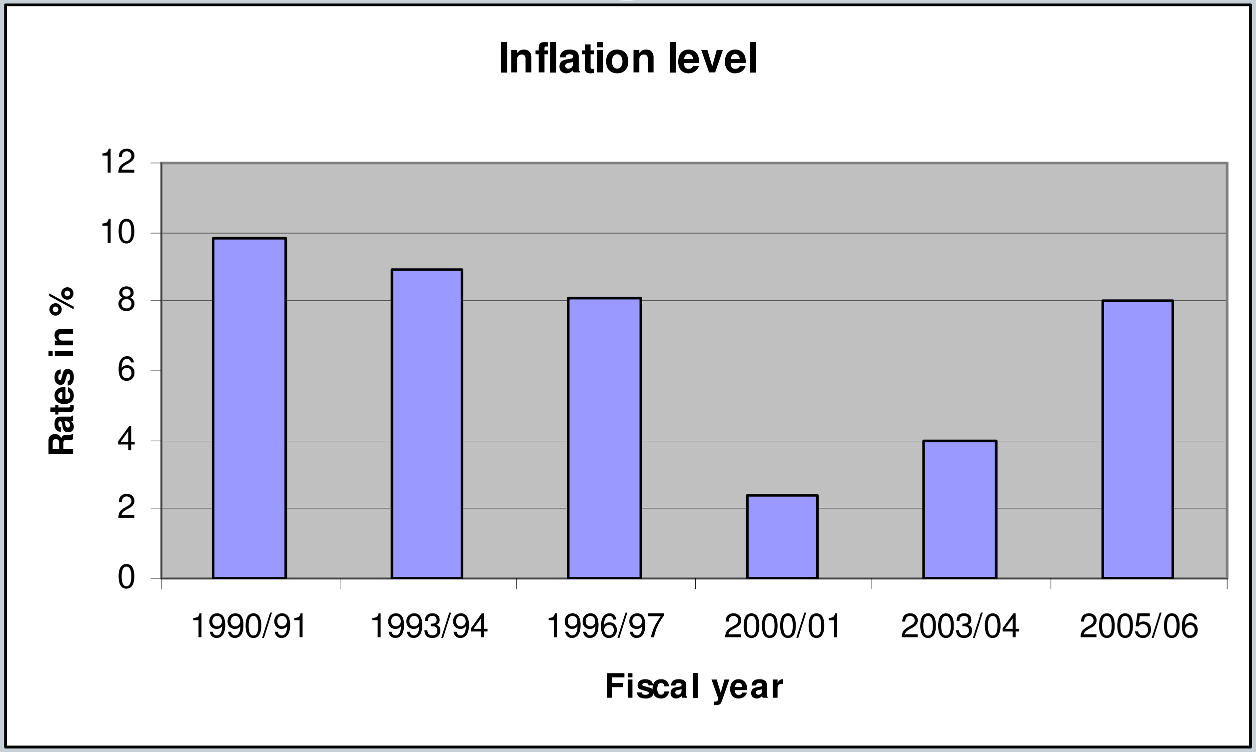
Impacts of Initial Reforms (1990–2006)

- As a result of economic liberalization, 203 financial institutions come into existence by 2006, total deposits touch $4.13 billion, and total loans and investments almost $4 billion.

Types	1990	2000	2006
Commercial Banks	5	13	18
Development Banks	2	7	35
Finance Companies	-	45	72
Microcredit Banks	-	7	11
Cooperatives	-	19	19
NGOs	-	7	47
Total	7	98	203

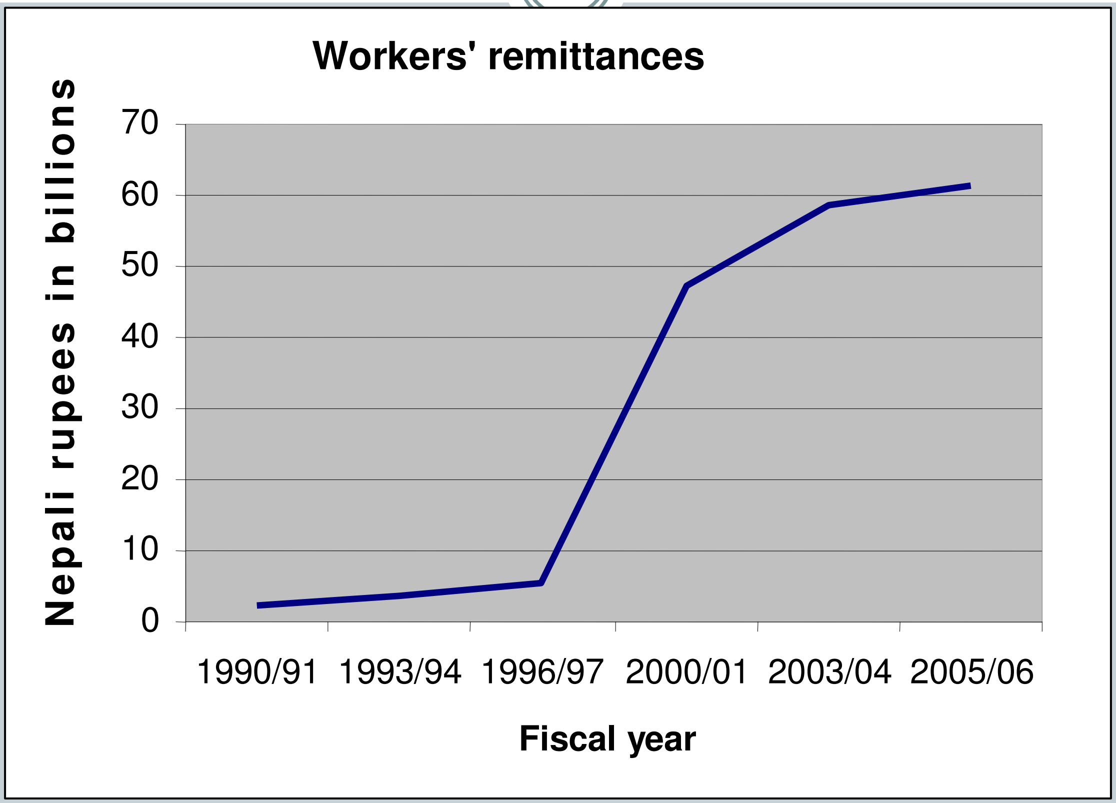
Source: Nepal Rastra Bank

Impacts of Initial Reforms (1990–2006)



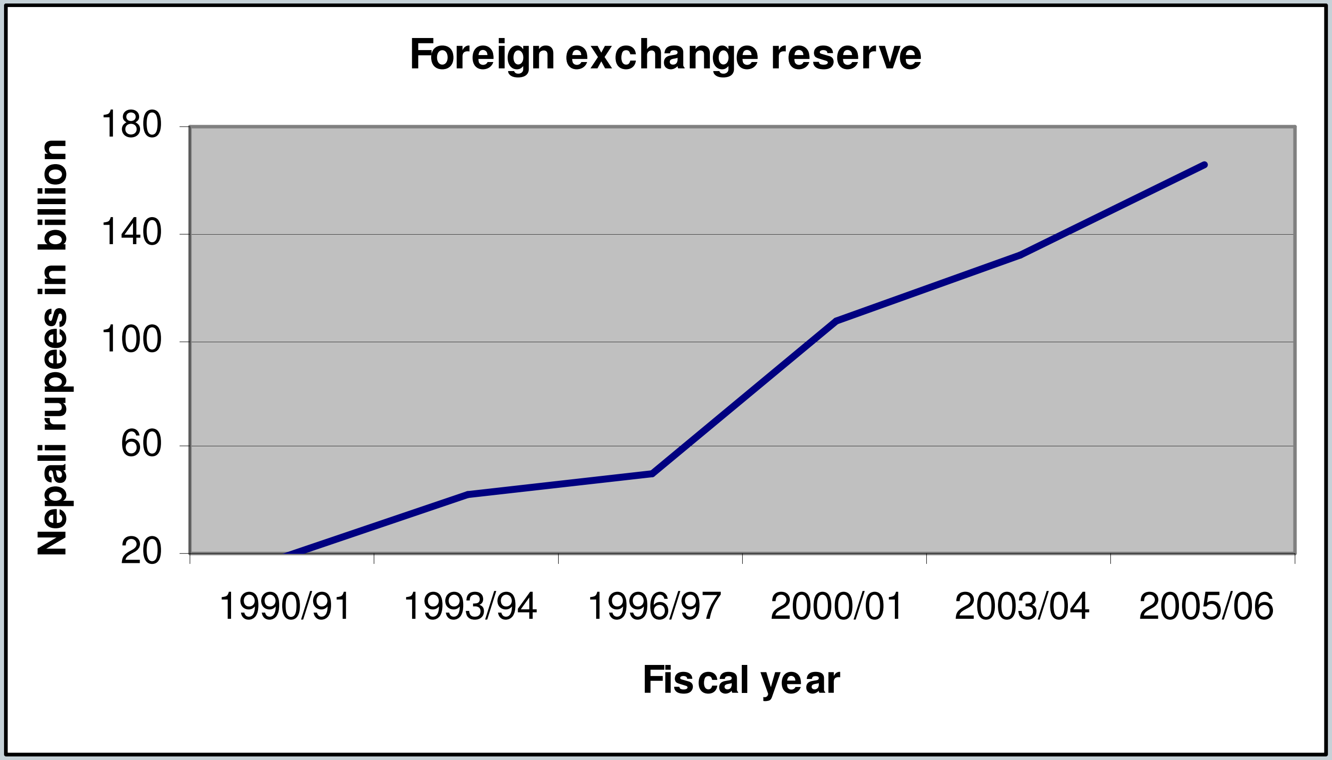
- Inflation gradually declines from 1990 to 2000
- The escalating Maoist insurgency, which obstructed supplies of goods and services in rural areas, causes inflation to climb after 2000

Impacts of Initial Reforms (1990–2006)



- Remittance income gradually grows as the backbone of the economy, and is credited with preventing an economic crisis amidst unprecedented levels of violence and economic contraction in 2000.

Impacts of Initial Reforms (1990–2006)



- Despite a widening trade deficit, the foreign currency reserve of the country maintains impressive growth, thanks to ever-increasing remittance income.

Resistance to Economic Reform Today

I. Financial Sector
II. Labor Law
III. Governance
IV. Public Expenditure

Synopsis of Resistances and Effects

Resistance on	Responsible Actors	Immediate Impact	Socioeconomic Effects
Financial sector reforms	Willful bank Defaulters	Defaulters' defy weakened state, huge debt burden, corruption and rise in inequality	Squeezed financial services, limited capacity to invest to lower poverty
Labor law reforms	Trade Unions	No private investments, no job creation	Mass youth unemployment, no competition in labor market
Governance reforms	Central Government; Maoist Insurgency	Financially & legally weak local bodies, continued dependency at center	Poor service delivery, no decline in poverty, no accountability and ownership;
Public expenditures reforms	Central Government	Misuse of resources, fewer resources available for development	Rural development activities compromised, no job creation

Leading to Overall Frustration with Democracy

I. Financial Sector Reform

- 1989: Study finds that the two largest state-owned banks of Nepal, Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), are short of capital, due to imprudent and risky lending decisions and weak recoveries.
- 1991–93: Government injects some $ 98 million to save banks, but pays no attention to the recovery of outstanding loans.
- 1999: A KMPG study reveals that NBL and RBB, which represent half of total banking assets, are financially insolvent, a huge negative net worth and on the verge of collapse.
- Study finds that the estimated loss, as of mid-1998, is $450 million—equivalent to around 46% of the government budget or about 8.6% of GDP.

I. Financial Sector Reform

- The central bank found 53 business houses have willfully defaulted on some $350 million in loans from the two banks, and is the root cause of the financial problems of the banks.
- Nepal initiated massive banking reforms in 2001, with support from World Bank. Management of the banks handed over to foreign management teams to accelerate loan recovery drives.
- Foreign management teams were unable to recover the loans from major defaulters due to the government's unwillingness to take timely actions. As a result, the financial condition of the banks is still fragile, with net worth at a negative $370 million.
- By the end of 2007, Nepal had invested some $ 92 million in making the banks financially solvent, with loans taken from the World Bank.
- The total cost of reforming the two banks will touch $460 million, 70% of total development expenditure of 2006.

Cost of Resistance to Financial Sector Reform

- Debt burden: Has increased by $18, or 6% of per-capita income
- Waste of resources: The resources and energy put into saving the banks has come at the opportunity cost of raising the livelihood of the rural poor.
- Loss of national output: Since 2003, Nepal has lost 1% potential growth *per year* (roughly $460 million) due to the slow pace of reforms in financial sector.
- Restricted banking access: Due to their fragile financial condition, banks have been unable to provide financial services in rural areas.
- Corruption: Willful defaulters use the 'easy money' to bribe politicians, bureaucrats and even some members of civil society to protect their 'hard-earned wealth.'
- Income inequality: Accumulation of wealth by the defaulters, at the cost possible development activities in the rural areas, is one of the reasons for Nepal's growing economic inequality.

II. Labor Law

Gender	Employed %	Unemployed %	Economically inactive %
Male	73.3	3.1	19.6
Female	71.7	2.7	25.6

- The annual labor force growth rate of Nepal is around 2.75%, with up to 300,000 fresh laborers entering the market each year.
- Nepal's labor market is characterized by slow job creation as compared to its rapidly growing labor force, along with a strong presence of huge unskilled labor.

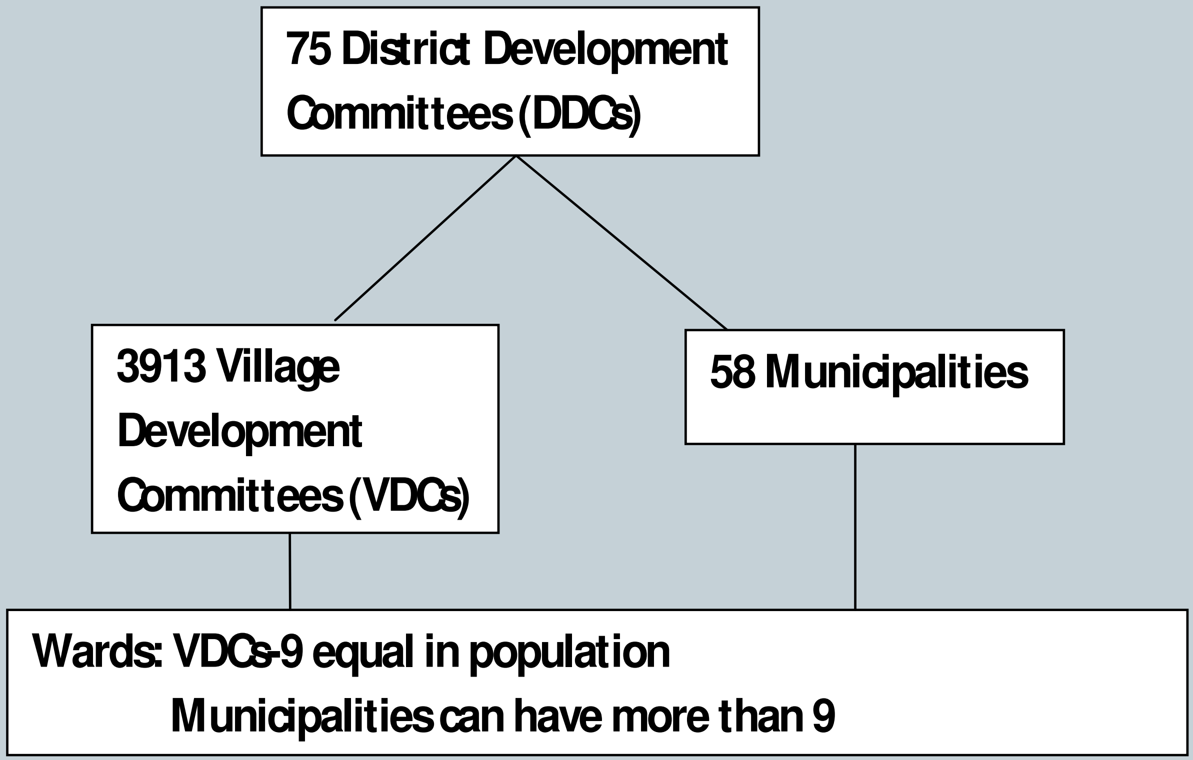
Labor Law Reforms of 1992-93

- 1992 Labor Act acknowledges universal rights of labor, like trade unionism, collective bargaining, and social security.
- Labor Act mandates that any employee working in a business unit with more than 10 workers is entitled to become a 'permanent' worker after a 240-day (9 month) probationary period.
- Nepal's rigid labor law lacks effective exit legislation similar to the United States' Chapter 7 and Chapter 11. Closing large failing ventures requires government's permission, which is a lengthy procedure.
- Employers are required to pay the permanent workers of the factory until its registration is legally terminated.
- Trade Unions Act 1993 effectively makes trade unions an arm of the political parties—unions' activities are focused more on politics than on labor welfare.

Reasons for Further Reform

- Businesses use other means to remain competitive; not providing written contract to workers; hiring foreign workers; and firing workers before they complete 240 days.
- A recent survey shows that only 46% of Nepali businesses abide by the existing labor legislation, due to difficulty in implementation.
- Labor Market Survey 2005: 52% of businessmen say they are unwilling to invest or expand their production base due to rigid labor laws.
- 2005: Based on the survey, the country loses potential domestic private investment worth $63 million and thousands of new jobs.
- 2008: World Bank's "Global Survey on Doing Business 2008" shows Nepal down 7 positions to rank 111 out of 178 economies.

III. Governance Reform



- The government formed after the 1992 election promulgates three separate acts for villages, municipalities and district bodies.
- A provision of a two-tier local governance structure with District Development Committees (DDCs) on the top tier and Municipalities and Village Development Committees (VDCs) in the grass-roots tier.

III. Governance Reform

- Local elections are first held in 1993 and again in 1998.

- 1995: Government authorizes local bodies to use 40% of local land revenue and arranges central grants of $4,000 per VDC per year. These are raised to $7,200 in 1996 and $15,000 in 2006.

- 1999 Local Self Governance Act (LSGA) seeks to:
  - create economically viable and development-oriented local bodies
  - enhance the participation of all people
  - enable local bodies to mobilize local resources for local development

- 2001: Joint Coordination Forum for Decentralization (JCFD) created

III. Governance Reform
The Stalled Process of Decentralization

- Despite the presence of good laws, the process of decentralization has been hampered by three main factors:
  - Financial Barriers
  - Maoist Insurgency
  - Political Barriers

Financial Barriers to Decentralization

- Limited resources prevent most local government authorities from launching development activities on their own.
- Despite LSGA provisions, revenue-sharing mechanisms between the center and local governments have not been developed.
- The lack of financial self-sufficiency forces local government authorities to depend upon central grants, which greatly limits their independence.
- The financial situation of local bodies weakens in 2000 when the central government abolishes *octroi*, a locally collected tax.

Maoist Insurgency: Impact on Decentralization

- Due to the escalating Maoist insurgency, local bodies have had no elected representatives since 2004.
- The issue of decentralization is losing attention due to the absence of elected local bodies, once the driving force pushing the issue.
- The government has tried to fill vacancies through appointment, but has been unsuccessful because Maoists have forced the appointees to resign.
- Many buildings belonging to local authorities have been destroyed or burned down by Maoist insurgents.

Political Barriers to Decentralization

- Political parties and bureaucrats all agree on the concept of decentralization but there is an absence of political will, commitment, and real support on the matter.
- Old mindset of politicians continues to regard local bodies as subordinate agents of local development, rather than autonomous units of local self-governance.
- Leaders at the center fear that local bodies will not remain under their control once they are strong enough to work independently.
- Politicians want local bodies to remain dependent, so that they can be used for political means.

Overall Impact of Resistance on Governance Reform

- The overall performance of financially weak local bodies has remained inadequate in rural areas.
- The quality of basic service delivery in the areas of primary education, health, & drinking water has shown no improvement.
- Resource dependency has allowed for central intervention and imposition of development programs without any understanding of local needs.
- Many development programs have remained unsustainable due to weak ownership of local people.
- <u>People gradually have lost their faith in elected local bodies, as they have failed to bring about change.</u>

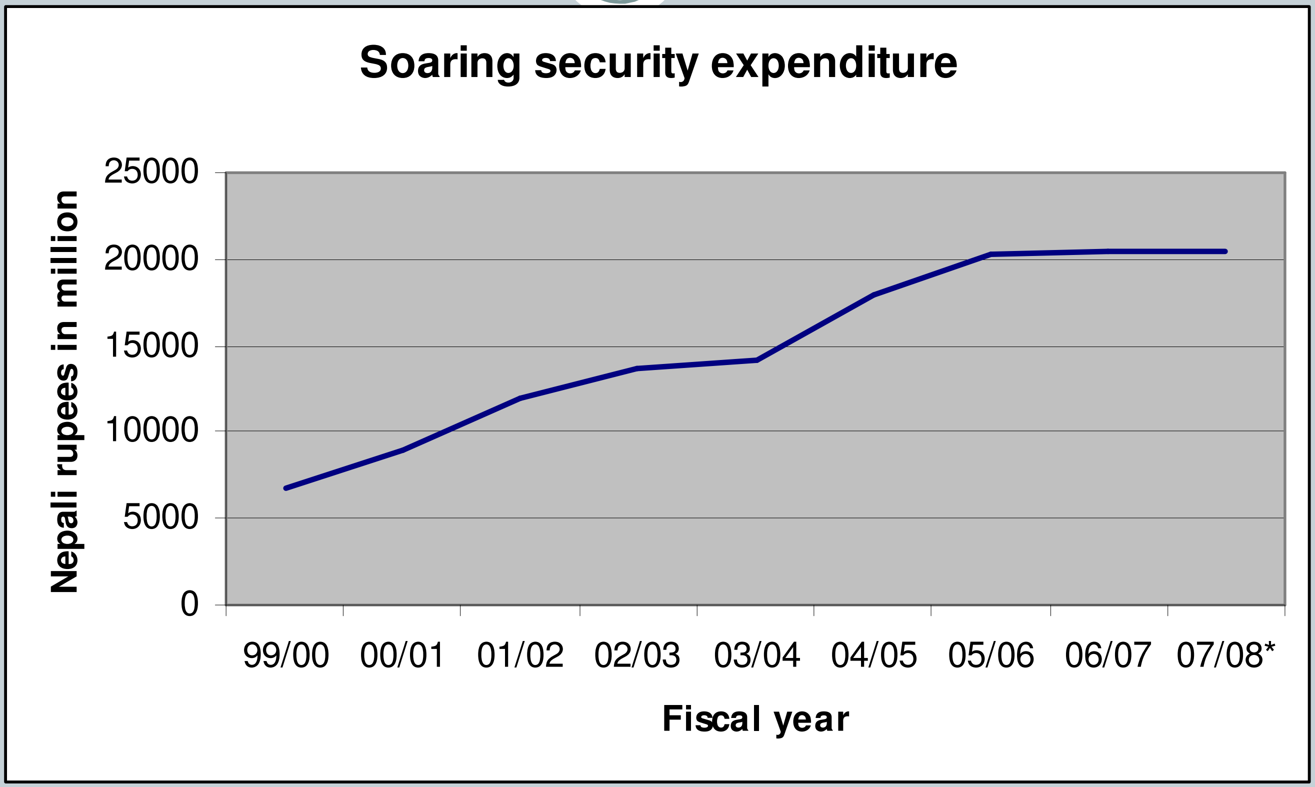
IV. Public Expenditure

- Subsidies on Petroleum Products
  - The total losses for the state-owned petroleum trading company has surpassed $215 million since 2004
  - Current monthly losses in petroleum products trading stands at more than $8 million; the amount is enough to build:
    - 14 Km of road in hilly Taren
    - 200 primary schools each accommodating 250 students
    - Around 500 health posts.
  - About 15-20 percent of petroleum products are smuggled back to India through the open border since they are cheaper in Nepal than in India.

IV. Public Expenditure

- Financing Public Enterprises
  - Of the total 36 PEs, which employs a workforce of 36,957, 19 were in loss in July 2006.
  - 42% of the total government's $1 billion dollar net worth in PEs has been eroded by July 2006.
  - July 2006: Government invests $77 million in Agriculture Development Bank, a loss-incurring PE. Government provides $50 million for other PEs.
  - The presence of sick PEs is discouraging private sectors' investment

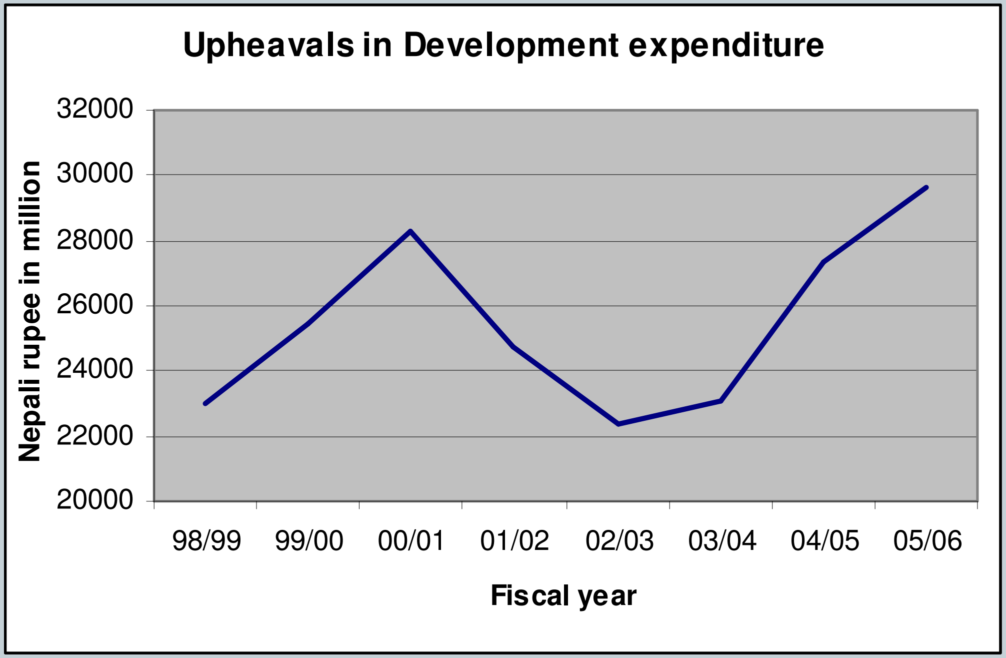
IV. Public Expenditure



- Despite restoration of peace, the total security expenditure was still $315 million in 2007.
- With the wartime recruitment drive, the size of army ballooned to 96,000, with salaries and benefits totaling $160 million.

Impact of Wasteful Public Expenditure

- 1995-2000: Expenditure for district level projects grows at 1.5%, while average inflation tops 4%.
- 2002-03: The rural areas, which represent 70% of Nepal's population, remain ignored in terms of budget allocation. District projects receive just 18% of development expenditure, with 82% going to national level projects.
- 2005-2006: Amid the sluggish economy and the Maoist insurgency, the budget deficit (before loans) increases to $380 million, squeezing expenditure capacity for development activities.
- Dependency on foreign aid increases.



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Leading to Overall Frustration with Democracy

Consequences for Democracy

- Failure of democratic governments to deliver goods and services coincides with a rapid rise in public awareness, resulting in deep-seated anger and frustration toward political system.
- The Maoists tactfully use public frustration and anger to persuade rural youth to take up arms to topple the democratic system and to form a communist state that ensures 'equal society free from poverty.'
- Brutal suppressions in the initial phase of the insurgency add fuel to the already high levels of anger and frustration, resulting in further support for the Maoists.

Scholars' Comments

- "The Maoists' movement was no longer a temporary phenomenon without social bases, but had roots deep in the country's social and economic order, and a by-product of unsuccessful development endeavors." –Deepak Thapa, author of *Kingdom Under Siege*.

- "Governments changed—sometimes even before they could settle down—but governance remained centralized and money allocated for development of the interiors barely reached the villages," *Whose War?* Edited by and Arjun Karki and Binod Bhattrai.

- "How do you expect social peace and harmony to prevail in a system which increasingly generated poverty, unemployment, illiteracy and all round underemployment," –Dr Babu Ram Bhattarai, Maoists second in command

Origins of Resistance and Remedies

<u>Why do leaders resist reforms?</u>

- To protect the interests of special interest groups–bank defaulters, trade unions.
- To avoid possible career risks because they are not educated or convinced about need and are unsure of outcome of reforms.
- Reform programs are externally imposed and lack local ownership.

<u>How can these resistances be overcome?</u>

- Educate people about what they are losing by not reforming and create grassroots pressure for reform.
- Use media for a platform to advocate and gather support for reform.
- Form an alliance with like-minded people to form a civil society to put pressure for reforms.

"In-depth, massive economic reform, which provides opportunities for local people to raise their overall quality of life, is one of the most powerful means to strengthen democracy in Nepal, and is crucial in preventing the emergence of populist, anti-democratic forces, and in preventing a return to autocracy."

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