

Population | 30.3 million

GDP per capita | 1,470 USD

Annual GDP growth | 2%

Govt. debt, % of GDP | 47.9%



Capital | Kathmandu

Government | Federal parliamentary republic

NEPAL

ISE Country Stocktaking

Key Findings, Future Scenarios and Critical Tasks for State Transformation
June 2022

ISE's country stocktakings present a view of a country to evaluate opportunities for reform during pivotal periods in its development trajectory. Stocktakings diagnose countries' "open moments" and pathways for reform by assessing the performance and capability of various state functions and citizens' view of the state while mapping the various international partners operating in the country and the alignment of key stakeholders around a potential reform agenda. Based on this assessment, ISE lays out the key medium-term issues facing the country, outlines potential scenarios for the future of the country and presents critical tasks that could bring about the best-case scenario.

Current Context

Nepal's history of democratic uprising, unstable multi-party coalitions, monarchic resurgence, and outside intervention create a complex picture of governance. From 1994 to 2006, Nepal experienced political instability, violence and democratic backsliding due to a rapid succession of coalition governments, a Maoist insurgency, and the leadership of King Gyanendra, who, beginning in 2001, wrested control from Nepal's democratic government. In 2006, an alliance of seven political parties and leaders of the Maoist insurgency met to negotiate a peace settlement, which concluded with the signing of the Comprehensive Peace Accord in November of 2006. Both parties agreed to end violence and support a United Nations-led effort to rehabilitate and integrate the Maoist forces into the Royal Nepali Army. After this landmark agreement, the Maoists and Seven Party Alliance negotiated an interim constitution in 2007, which created a Constituent Assembly tasked with both temporarily governing the country and drafting a more permanent constitution. The process faced repeated delays and at times lacked input from minority groups and vulnerable populations; however, by September 2015, the Constituent Assembly had drafted a finalized constitution.

The push to complete the new constitution in 2015 was catalyzed by the worst natural disaster to strike Nepal in 80 years. Damage from the Gorkha earthquake was estimated at around \$7 billion, and nearly 9,000 individuals perished, with another 22,000 injured. Following the earthquake, political actors increasingly coalesced around the need for a new constitution that could ensure rapid action in the face of another major disaster. Demands from prominent Madhesi civil society groups for constitutionally mandated federalism—a major shift from the historical centralization of power in Kathmandu—became more politically palatable, perhaps due to a recognition that greater local-level financial resources and self-government powers could make disaster response quicker and more effective.

The ultimate promulgation of the constitution in September 2015 was a major step forward, but Nepal's constitution still lacks full implementation of certain provisions, in particular federalism, the legalistic implications of which are under development. How Nepal's new governing institutions continue to be defined and shaped in the medium term will impact the country's ability to bring to bear its unique assets to improve service delivery and economic growth, including through strengthened private investment and decriminalization of key market sectors.

The goals of the 2015 constitution are reflected in the government's

two long-term reform and development plans, though the plans do not always inform policymaking or budgeting. The first of these is the Long Term Vision 2043, which aims to ensure that Nepal graduates from least-developed country status (in terms of human development) by 2022 and reaches upper-middle-income status by 2030. The Long Term Vision 2043 envisions greater development underpinned by developments in infrastructure, the human capital system, energy, housing, and the private sector. Nepal's medium-term national development plan, the Fifteenth Five-Year Plan, was inaugurated in 2019 and aims for Nepal to graduate from low-income status by 2022. The plan sets ten national goals, ranging from economic growth and poverty reduction to human capital development, infrastructure expansion, market development, social protection expansion and climate change adaptation.

Other key reforms emanating from the adoption of the 2015 constitution appear to lack sufficient support from the Government of Nepal. Primary among these is continued decentralization. The 2015 constitution established a federal governance structure within Nepal, and reforms undertaken between 2016 and 2017 began to devolve powers to, and build the capacity of, local and provincial governments. However, following the inauguration of the former Oli Administration in early 2018, decentralization stalled, hobbling subnational government functioning and raising serious questions about the government's commitment to the spirit of the constitution. Federalism was a key desire of Madhesi anti-constitution protesters in 2015 and central to Nepal's vision for the way forward: its stalled implementation has the potential to derail Nepal's current stabilization and lead to greater ethnic and caste-based tensions that sparked the last period of instability.

Performance of Core State Functions

Governance

Nepal faces an inherently challenging governance landscape. Ethnolinguistic diversity, a difficult topography, and the complex history of the caste system create complicated governance dynamics with few parallels in other countries. In response to these challenges, the 2015 Nepali constitution establishes a federal system with local municipalities, not subnational bodies like provinces, as its theoretical core unit of power. Provinces and the central government receive their power from these units. This system is a major asset for the country, and if utilized effectively, could help address the historical constraints posed by the country's history of ethnic, regional and caste-based tensions and inequalities by making legislation more local and increasing

citizen participation in and ownership of policymaking. However, this federal system is in practice only partly implemented, and governing power remains mostly centralized. The caste system of familial and ethnic social hierarchies continues to exert influence across all facets of governance, including political party leadership, government leadership, bureaucratic membership, and civil society participation. Even with the advent of federalism, vestiges of the *pajani* and *chakari* systems—systems that were intended to ensure nobles’ fealty to the Rana Dynasty, which held power until 1951—contribute to the continued concentration of power in personalistic elite networks in the Kathmandu Valley.

The history of the Nepali state as a tool of monarchic and elite enrichment has left a legacy of public distrust toward state institutions. Nepalis historically responded to this in two ways. First, they became deeply distrustful of state and governmental institutions, though trust in government appears to be slowly growing since 2017 (notably after the country’s first local elections in over 15 years). Second, everyday Nepalis built strong community-centered institutions and service delivery mechanisms to supplant lacking state institutions. These community organizations resolve some of the traditional regional and ethnic inequalities in access to services and are a strong asset to governance.

Nevertheless, with decentralization stalled and governance mostly centralized, services are generally delivered by national ministries, and the bulk of subnational budgets form from downward fiscal transfers, hampering the independence of local government. A lack of enabling legislation and political will means that powers among tiers of government remain poorly delineated, which has been exacerbated by recent efforts at the national level to recentralize certain powers. Capacity at all levels is constrained, but especially within local and provincial governments, which lack experience and human and financial resources, and face urban-rural financial disparities. Finally, accountability mechanisms exist, but often have limited power, and face ongoing politicization and political interference, though the media and civil society organizations have at times played important roles in this space. While some of these concerns may diminish with time, as subnational governments build more experience with governing, others appear likely to remain, barring the passage of more legislation delineating powers among government tiers.

Key governance issues for Nepal include:

- » Decentralizing power away from the national government and toward local municipalities and governments in accordance with the 2015 constitution.
- » Addressing implementation challenges that result from a dearth of domestic financial resources, lack of political will, and a democratic political system that tends to create short-lived political coalitions.
- » Managing capacity constraints faced by subnational governments and bureaucratic agencies due to deficiency of experience and institutional knowledge.
- » **Addressing the continued influence of the Caste system across all facets of governance, including in civil service hiring, firing and performance management.**

Security

Over the last 15 years, Nepal has moved from an active insurgency to sustained peace, and there appears to be agreement among most actors that the constitution is legitimate; however, many of the drivers of the Maoist insurgency remain only partly addressed, and these form the core of Nepal’s modern-day domestic security threats. Primary among these is caste-based and ethnic discrimination, which continues to cause intra-communal violence, including physical attacks, sexual assault, and homicide. Equally as important, and intertwined with ethnic and caste-based discrimination, is gender-based violence, which is Nepal’s largest category of systemic violence. Other domestic security risks include environmental degradation and climate change, unresolved conflict justice, small arms proliferation, labor market issues, and the ongoing governmental decentralization process.

Nepal’s greatest regional security challenge is its economic dependence upon India, a fact that India has repeatedly utilized to gain leverage over Nepal’s domestic policymaking. Nepal has worked to build connectivity with China, but doing so presents new risks to Nepal’s territorial integrity and sovereignty. Given its location, Nepal risks being subsumed into ongoing Sino-Indian tensions. While the possibility of outright conflict within Nepali territory is low, the potential for either China or India to utilize their economic power to coerce Nepal into geostrategic or geo-economic decisions remains high. Recent overtures toward greater economic ties with the United States also present risks due to a perception that these advances might violate the country’s non-aligned policy. In general, Nepal is likely to continue to pursue a strategy of balancing between its two major power neighbors to maintain territorial integrity and national sovereignty and to avoid entanglements.

Nepal’s regional security framework is formally centralized under the national government, while its domestic framework is federal in form, but centralized in function. Nepal’s regional security system lacks capability but is underpinned by high public trust in the Nepal Army. Still, there are concerns surrounding Nepal’s experience with post-conflict reconciliation. As a direct successor of the Royal Nepali Army that existed before 2008, deep distrust has historically existed between the army and former Maoist insurgents, including those now involved in the government. Nepal’s domestic security apparatus, on the other hand, is formally federal, but practically centralized under the Ministry of Home Affairs (MoHA), stymying efforts to shift control over policing to local and provincial actors and raising questions about the national government’s commitment to federalism. A remaining question is what impact reinvigorated policing decentralization might have upon Nepal’s domestic security threats, and whether greater community ownership of policing might help to de-escalate ethnic and caste-based tensions.

Key security issues for Nepal include:

- » Though Nepal no longer experiences widespread Maoist insurgent violence, many of the driving factors behind this violence continue.
- » Attempts have been made to lessen discrimination and violence based on caste, ethnicity, and gender, but informal norms supporting the caste system diminish the impact of these efforts.
- » Nepal is highly dependent on India for trade, which poses regional security concerns.

» Nepal’s engagement with China and the U.S. could lead to heightened geopolitical tensions. Climate change and environmental degradation pose a regional security concern, low in the near-term, but much greater in the long-term.

Rule of Law

Though it outperforms the South Asian average, Nepal’s rule of law apparatus presents a mixed picture of both moderate successes and critical shortcomings. Constitutional tenets are mostly respected, and lawmaking occurs in a discursive, federal parliamentary system. Limitations on governmental power and accountability mechanisms within the state apparatus do exist, but most, including formally apolitical bodies, are exceedingly weak. The judiciary has exhibited its independence in the past, but its functioning remains beholden to politicians, a trend that has worsened with time. The Supreme Court has been criticized for using its docket-setting powers to influence political outcomes by delaying politically sensitive rulings or de-prioritizing cases. Corruption remains widespread within the government. Nepal’s paramount anti-corruption agency, the Commission for the Investigation of Abuse of Authority (CIAA), has investigated and jailed some high-level cases of corruption. However, the organization remains feeble overall, and past controversial commissioners have further weakened and politicized the body.

Each of Nepal’s three tiers of government (national, provincial, and local) is vested with the power to write and pass legislation with a majority vote, though lawmaking structures are comparatively weak across various dimensions at the provincial and local levels. While the constitution outlines reserved and shared powers for the three tiers, the delineation of these powers remains vague and unclear in many cases, which can hinder efforts by provinces and local authorities to create legislation. Limited financial and human resource capacity also impedes lawmaking. Finally, many local government officials perceive their mandate as development project delivery, rather than management of budgets and service delivery, meaning that many municipalities continue to lack capacity for delivery.

Vertical relationships between the state and citizenry remain a mixed picture, as positive rights protections are strong for the region, but negative freedoms remain lacking. The rule of law apparatus continues to impact women, low-caste groups, and ethnic minorities in disproportionately negative ways. Access to justice remains prohibitively burdensome for many, who instead utilize informal justice mechanisms to settle disputes. Attempts have been made to address unequal access, but both this issue, and the lack of negative rights guarantees, present risks to continued reforms, domestic security, and trust in the state. Ordinary Nepalis may also face overwhelming obstacles when pursuing remedies through the formal justice system, including logistical challenges for more remote, poorer, and more marginalized communities. They may also turn to traditional justice mechanisms that are at times unfamiliar with national human rights laws and obligations, though the influence of these informal mechanisms has diminished in recent years. Government outreach programs have attempted to increase access to formal justice mechanisms.

Key rule of law issues for Nepal include:

» Limitations on governmental power and accountability mechanisms within the state apparatus exist, but most, including formally apolitical bodies, are exceedingly weak.

» The judiciary is increasingly politicized, though it has exhibited independence in the past.

» Government corruption remains widespread. While the Commission for the Investigation of Abuse of Authority (CIAA) has addressed some high-level cases, the organization remains feeble.

» Negative freedoms remain lacking, and the rule of law apparatus continues to impact women, low-caste groups, and ethnic minorities in disproportionately negative ways.

» Access to justice remains prohibitively burdensome for many, though government outreach programs have attempted to address this issue.

National Accountability Systems: Public Finance

Public financial management (PFM) and accountability reform have progressively become a top priority for both government and international partners in Nepal. Reforms have included supply-side initiatives to improve PFM systems and processes, as well as demand-side initiatives to strengthen oversight bodies. The Government of Nepal appears to have strong ownership over the PFM reform agenda—managed through the PEFA Secretariat and national-level PEFA/PFM Steering Committee—and many initiatives are funded by a Multi-Donor Trust Fund (MDTF) for PFM.

The credibility of the national budget is driven by Nepal’s use of policy and performance budgeting that attempts to link annual budget processes to medium-term fiscal strategies. The budget process is considered orderly, with strong leadership and a regularized budget calendar from the Ministry of Finance (MOF) and National Planning Commission (NPC). Despite strengths within MOF and the NPC, there is not substantial legislative scrutiny and regulation for approval of expenditure composition and in-year budget adjustments and implementation. The budget and related financial reports are as transparent as other South Asian countries, though Nepal will need to continue to improve the transparency, timeliness and effectiveness of the system for transfers and block grants to subnational governments as mandated in the 2015 constitution. While Nepal utilizes an effective Treasury Single Account (TSA) and financial management information system (FMIS) framework, many autonomous government agencies and donor projects are reported separately, and unreported expenditure is estimated at more than 10 percent of total spending. These failings make the system less capable of reporting fiscal risks, including contingent liabilities. While the availability of budgetary data to the public makes the budgeting system generally transparent, the country could benefit from the publication of citizen budgets and more timely online publication of in-year reporting and progress assessments.

If budgetary and fiscal planning are highly accountable, execution and treasury monitoring are only somewhat so: revenue and expenditure arrears are not well monitored, even if the processes for cash management and reconciliation of accounts are effective. Nepal’s procurement system poses a high risk to fiduciary accountability, both because of the dominance of familial networks in Kathmandu able to bid for public contracts and the capacity of local actors to manage the procurement process. Navigating and controlling the procurement responsibilities given to local and provincial governments—as outlined in the Local Government Operations Act 2074 and in line with the 2007 national statute—will be a critical task moving forward.

Among the strongest elements of the accounting and reporting system is the capability of the Central Bureau of Statistics, which was rated 72 out of 100 on the World Bank's Statistical Capacity Index in 2020. Compared to its accounting and reporting systems, Nepal's oversight and audit system is weak, rated with a low-to-medium level of accountability. Key to the weakness of this system is poor legislative oversight of the budget process, with the legislature often failing to publish reports on audit findings with recommendations for future budgets. Despite the risks associated with poor fiscal risk reporting noted above, the strong performance of the balance sheet and risk management system is driven by effective revenue risk management using a revenue management information system (RMIS), effective cash and arrears monitoring by MOF and a strong debt management strategy. Furthermore, because the government uses a cash-based accounting system that does not record or monitor financial and nonfinancial assets, public asset management weaknesses are a risk to the system.

Key public financial management issues for Nepal include:

- » Committing to fiscal federalism to enable functional and fiscal autonomy of provincial and local governments by expediting laws to distinguish concurrent powers of different levels, among other measures.
- » Continuing to strengthen the Treasury Single Account (TSA) system to reduce fiscal risks by further increasing its scope—with the ability to transparently monitor, report on and control risks associated with semi-autonomous agencies and public corporations.
- » Strengthening oversight, anti-corruption and supervisory functions to improve the performance of budget planning and execution, particularly in the outturn of capital expenditures, which are likely a primary source of leakage in public finance.
- » Integrating citizen needs and ideas into budgetary processes by publishing citizen budgets and timelier in-year reports to cut through social, cultural and regional divisions in Nepal while making public finances more effective and accountable.

Asset Management

Nepal benefits from democratic governance, world-renowned cultural and heritage assets, a sound system of financial management and the opportunity of structural transformation from an ongoing demographic dividend—which provide a basis for its nationhood and comparative advantage. Nepal is expected to experience a demographic dividend—when the growth of the working-age population is higher than the growth of the dependent population (i.e., children and the elderly)—between 1995 and 2047, which provides a window of opportunity for rapid economic growth. Nevertheless, Nepal is challenged by the significant emigration of skilled Nepalese as well as the new realities of rapid urbanization. Nepal's diversity—there are 129 spoken languages and 125 ethnic-caste groups in the country—and its history of community organization and mass activism are also significant assets. However, the history of the caste system is a constraint to inclusive growth and reform. Leveraging Nepal's great diversity and strong community organization while overcoming these cultural divisions will be key to strengthening state legitimacy and national unity.

Nepal also has rich natural and man-made cultural heritage, including the Himalayan Mountain range, UNESCO World Heritage

Sites, and cultural and religious sites and festivals. Nepal is unique in its strong inclusion of culture and heritage within its most recent national development planning. National planning and cultural asset management processes are supported by the inclusion of language and culture as a fundamental right within the 2015 constitution—though implementation of constitutional mandates has been slow. Moving forward, Nepal could improve asset management by pushing forward the implementation of cultural mandates within the constitution while managing the competing priorities of tourism, development, and preservation.

While Nepal lacks natural assets like minerals or fertile soil composition, it has strong community organization around the management of its vast forests and protected wildlife. Nepal is also one of the richest countries in the world in terms of water resources with several sources, including melting snow from the mountain region, several major rivers and lakes, and groundwater reserves. Nepal's wealth of hydropower resources presents an opportunity to not only meet the country's electricity demands with 100 percent environmentally sustainable energy but to also export to neighboring India to help fill its large supply-demand gap. Despite these natural assets, the country is confronted with serious environmental and climate risks—it is one of the most climate-vulnerable in the world. Managing natural assets, maintaining a “healthy and balanced environment” and adjusting to climate change are central tenets of long-term national plans in Nepal, with a national strategy to conserve and utilize natural resources for improved resilience and potential tourism gains.

Finally, Nepal's economy and financial asset base are heavily reliant on workers abroad and their remittances—which comprise around 25-30 percent of GDP. Though remittance income has helped Nepal to alleviate poverty over the last two decades and to maintain low public debt, overreliance on remittances carries risk, as remittances are susceptible to shocks, and other financial assets (e.g., commercial finance or social insurance) have not developed to cushion against drops in remittance inflows. Consumption-focused remittances—and not investment or savings by either the public or private sector—are the country's primary financial asset.

Key asset management issues for Nepal include:

- » Continuing to grow equitable access to education, technical training and formal employment opportunities to stem the outward flow of skilled, young Nepalese and take advantage of the country's currently low dependency ratio to spur economic transformation.
- » Using Nepal's cultural and heritage assets to develop a national identity that crosses divides created by caste-based discrimination and conflict.
- » Continuing to build capabilities in environmental and biodiversity management, as well as responsiveness to the existential threats posed by climate change, while more thoroughly integrating environmental health (e.g., air pollution control, sanitation and waste management) and the wellbeing of citizens.

Market Engagement

Nepal has the opportunity to adopt an agenda that develops its unique market by relying on its strong cultural assets in an environment defined by competition and inclusive growth. Historically, Nepal's approach to domestic market building has

involved state-led industrial policies and economic activity with limited cooperation with or competition within the private sector, but the role of the market—and the quality of domestic strategic market development—has grown in Nepal, particularly in the state’s encouragement of private investment in the manufacturing and tourism sectors. While the critical task of constituting the market has not yet been completed and there is concern that weak anti-corruption systems and the growth of political cartels are leading to the criminalization of the economy, there is also significant optimism in Nepal’s opportunities to constitute its market within local, regional and global value chains. The government’s Fifteenth Plan outlines goals for private sector-led growth through public-private partnerships (PPPs) for infrastructure, commercialization of the agriculture sector, service delivery and strong corporate governance. In terms of its cross-border strategy, Nepal recognizes its comparative advantages for foreign direct investment (FDI) and trade in specialized agricultural products, IT services and tourism, but has not integrated into regional and global value chains. Setting out clear economic, industrial and trade strategies around its identified comparative advantages—particularly within Chinese and Indian markets but also globally—would help build an export-focused industrial sector and is a key goal in Nepal’s Fifteenth Plan.

Since 2015, Nepal has demonstrated a growing domestic market and the effectiveness of post-reconstruction market-building strategies. Unlike most low-income countries that transition from agriculture to industry and manufacturing, Nepal’s geographic advantage between China and India has led to prolonged growth in services, driven by large import-export and transport sectors, construction after the 2015 earthquakes, and tourism. Despite signs of current economic and market growth, the country’s weakening trade balance and limited domestic and foreign investment point to limited future growth prospects. Since the late 1990s, the export-to-GDP ratio has fallen from 25 to 10 percent, driven by a collapse in Nepal’s goods exports as mainstays like textiles have struggled to compete with rivals in Bangladesh and India. Foreign investment in Nepal has underperformed the region because of investor concern over perceived operating risks, unclear FDI policies and poor infrastructure. The opportunity for sustained market and export growth in Nepal is underpinned by the need to create a more organized, competitive and stable market through the collaboration of public and private actors. The need for collaboration and stability is recognized in the country’s Fifteenth Plan and other strategic documents, but the legal framework for competition is a constraint to effective market engagement. Effective monetary policy and economic management are also limited by institutional instability and weak licensing frameworks.

Key market clusters and opportunities in Nepal include tourism, agribusiness and IT services. The Government of Nepal has recognized the centrality of tourism and national branding to the country’s economic development—with the goal of increasing the contribution of the cluster to 10 percent of GDP by 2024. Buoyed by Nepal’s rare and varied climatic conditions, the agricultural sector, which in 2019 contributed 27 percent of GDP and employs 60 percent of the population, is another central pillar of inclusive market growth. The country has a comparative advantage in high-value niche agricultural products, which can build on the perceived uniqueness of Nepalese products for export. Nepal’s strategic approach to the IT cluster has thus far been limited, with the 2019 Digital Nepal Framework serving as a framework for the expansion—

but an industry-level approach to the sector could be beneficial. While Nepal will not compete with India in global IT outsourcing, the country can leverage its existing and quickly growing IT services cluster to set a foundation for high-quality jobs and catalyze other market and service delivery sectors.

Key issues for market engagement in Nepal include:

- » Setting the preconditions for a broad-based, inclusive and competitive market by developing more comprehensive competition and anti-trust policies while maintaining the current climate of political and economic security.
- » Promoting and supporting export clusters with specific comparative advantages, including tourism, agribusiness, and IT services.
- » Investing in innovation to leverage the country’s unique location and challenges to understand how new techniques and technologies can contribute to Nepal’s comparative advantages, catalyze growth and build productivity.
- » Building a better labor market for formal employment and comprehensive growth by investing more in education and setting up mechanisms to align skills to market needs.

Infrastructure

An infrastructure network of poor quality and limited interconnectivity is one of the greatest constraints to Nepal’s continued development, economic growth and access to international markets. A lack of physical connections with neighboring countries makes Nepal reliant on India for two-thirds of imports and exports, posing an economic and security threat. Limited connectivity also hinders access to health, education, consumer financial services and formal justice, and holds back private investment and exports. The country’s ability to rapidly fill growing consumer infrastructure needs, though, points to the government’s development delivery capabilities. For instance, basic water and sanitation services are quickly approaching universal accessibility, a surprisingly swift improvement since 2000, when only 25 percent of the population had access to basic sanitation facilities. Despite gains, infrastructure gaps remain significant in some areas. Nepal’s road network is limited and the quality is lacking; electricity demand still outpaces supply, despite great strides in increasing access since the 1990s; a wealth gap has arisen around the use of more advanced (as opposed to basic) water and sanitation services; rapid urbanization places stress on existing infrastructure; and air and rail transportation also remain underdeveloped. The government has prioritized energy—particularly hydropower—and road transportation but also aims to construct urban infrastructure and air and rail transportation. Eventually, the government also intends to export hydropower to the northern states of neighboring India. Effective management of water resources and infrastructure is also critical for flood management and response.

Infrastructure development and management is formally federalized, but subnational leaders have questioned the Government of Nepal’s commitment to federalism in light of funding from the federal level for ever-smaller infrastructure projects, including local bridges and roads. Centralized financing as well as lack of private-sector involvement are the two greatest constraints to further infrastructure development. The 2019 Public-Private Partnership and Investment Act aimed at boosting private investment, but investment remains low due to a variety of constraints, including a lack of enabling legislation and investor-oriented financial instruments. Though the

country's overall budgeting capabilities are quite strong relative to other low-income countries, its infrastructure budgeting system faces challenges. The national government has infrastructure budget mobilization issues, and the limited application of a variety of reforms has hampered the public investment management system's ability to properly appraise and screen projects before allocating financing. Because Nepal's infrastructure needs outpace its domestic resource availability, it supplements its budget with international finance. Nepal receives more than 95 percent of its infrastructure support from bilateral, multilateral and private donors—most notably India, which has supported transport infrastructure development, particularly in Nepal's southern provinces.

Key infrastructure issues for Nepal include:

- » Developing an enabling environment for private sector investment, including investor-oriented financial instruments and enabling legislation, to reduce reliance on development partners for infrastructure financing.
- » Addressing a lack of planning and technical infrastructure development capabilities at the national, provincial, and local levels to improve planning and prioritization and to ensure compliance with sustainability and risk mitigation processes.
- » Decentralizing the planning, financing, and control of infrastructure projects to increase input from provincial and local leaders in accordance with Nepal's federal structure.

Human Capital

Nepal's human capital system has improved rapidly over the last 70 years. However, the system remains flawed and fragmented. Public education is mostly of poor quality and Nepali society exhibits gaps in educational attainment. The country ranks within the bottom quintile of harmonized test scores globally. Literacy rates also remain below 70 percent. Poor quality education is exacerbated by a variety of access issues, including logistical and language barriers. Fourteen percent of students nationwide live more than an hour from their nearest school. There is also an opportunity cost issue, particularly for those in remote, rural areas where schools are of low quality and households may see agricultural skills as a more practical pursuit than education.

Conflicting market incentives simultaneously create a high opportunity cost for education and a binding skilled labor shortage. Although the service sector provides disproportionate growth for the economy overall, individuals (especially in rural areas) are incentivized to build skills in agriculture. Industry only employs about 15 percent of the country's population and has historically exhibited slow growth rates. Nepal's remittance-based economy also creates significant labor shortages in skilled employment sectors. As much as 80 percent of Nepali young people seek employment abroad. The Nepali government possesses a clear understanding of the reforms necessary to better connect its market development goals with its human capital system, but these reforms are not well prioritized. For instance, The Ministry of Education's School Sector Development Plan (SSDP) focuses on the expansion and integration of technical and vocational education and training (TVET) programming, but it is not clear if this strategy is aligned with in-demand skills. Overall, despite the government's efforts to increase the provision of TVET programs, poor integration into the traditional educational system hampers progress

Much of Nepal's education system continues to be administered under the pre-2015 centralized system. While subnational governments do play a role, resources and capacity remain limited and governance is fragmented. In practice, education governance and financing go through a centralized system leads to service duplication, a lack of transparency and accountability and makes education less adaptable to local needs. Ultimately, while the education system does exhibit a few key assets, its numerous constraints threaten continued human capital development that could spur future economic growth and stability.

Nepal has made significant strides in improving public health in the past two decades but remains held back by limited and unequal access to healthcare resources. Federalism has brought major changes to the governance of the health system, but slow implementation has often led to fragmented delivery at local and provincial levels. Limited access to health services because of inadequate transport infrastructure is a major constraint, which is unequally felt across regions and castes, particularly as limited investment was made in the reconstruction of public health institutions outside of the Kathmandu Valley following the 2015 earthquakes. While Nepal was largely insulated from early waves of the COVID-19 pandemic in 2020, the spread of the delta variant went widely unchecked in spring 2021, in part because of weak access to health services in rural areas, leading to over 6,000 deaths in six months.

Key human capital issues for Nepal include:

- » Improving the quality of education and matching the educational system with the needs of the market and aspirations of the Nepali populace.
- » Reforming technical and vocational education and training (TVET) programs to better align education with the market through integration into the broader education system, improvements in the prioritization of TVET program reforms, increasing access to TVET programs and implementing cross-program standard-setting.
- » Decentralizing and clarifying education responsibilities among national, provincial and local authorities to avoid service duplication, improve transparency and accountability and diminish access barriers.
- » Increasing access to health services by investing in the reconstruction of public health institutions and improving transport infrastructure.

Citizenship and Social Policy

The strength of Nepal's diverse communities and culture of community mobilization is one of the country's key assets. Nepal's long history of protest movements has led to increased democratization of the country's political structures and improved access to citizenship rights over time. As mentioned previously, Nepal is diverse but divided. The country features 129 spoken languages and 125 ethnic-caste groups. These divisions and historic discriminations play a role in the granting of citizenship and the provision of social services. Leveraging Nepal's diversity and strong community organization has been and will continue to be a key issue for the country moving forward.

Nepal's Constitution of 2015 provides the legal and rights-based foundations for overcoming the country's longstanding social divisions. However, constitutional implementation has been slow,

often constrained by ethnic elitism and traditional social cleavages. While Nepal has made substantial gains in the delivery of social rights outlined in the constitution, there are concerns that those rights are not delivered equitably. Legally sanctioned inequality on the basis of ethnicity, language, caste and gender was until recently a defining feature of the state. Caste-based inequalities—and their relationship with class and regional inequalities—are the key constraint to effective social policy and the delivery of citizenship rights in Nepal. Activist legal action in Nepal has led to gender-discriminatory laws being struck down in the last decade. However, the new Constitution still restricts mother’s rights to independently grant citizenship to their children. One in five women (and one in four married women) have experienced physical violence, and legal gaps and a lack of political will have limited accountability for sexual violence, especially for victims of lower caste groups and minority communities. Finally, across these social cleavages, there is a need for state-led social protection. Many Nepalese people are still trapped in poverty, and access to social protection benefits and services remains a privilege. Given citizens’ limited access to alternative credit and a poorly developed market sector, most must instead turn to remittances.

In 2018, the government introduced a large social protection agenda meant to fulfill the Constitution’s promise of citizenship-based (universal) rights, special rights for marginalized groups, labor rights and contribution-based social protection schemes. State funding for social protection and related rights-based delivery allocations has increased in recent years, and the government introduced a large relief package in response to the COVID-19 crisis. However, social protection policies are often not disaster-responsive, which leads to a welfare-based mindset rather than the rights-based approach taken in the Constitution. Policies are often fragmented and poorly targeted, and the allowances for social assistance are often calculated arbitrarily and are too small to significantly create social change for disadvantaged groups. The potentially revolutionary contribution-based system introduced in 2018 initially intended to include both formal employees (through registered employers) and informal sector workers (through government accounts), but in practice only applies to the much smaller formal sector, partially due to informal employers’ concerns about administrative and financial costs. Finally, the lack of delineation of responsibility between federal, provincial and local governments on the registration of poor households, labor governance and delivery monitoring can be confusing and ineffective.

Key citizenship and social policy issues for Nepal include:

- » Leveraging social protection reforms to strengthen lower-caste opportunity, moving beyond rhetoric and implementing the relevant 2018 legislation and proposed programs.
- » Expanding social insurance to the informal sector through the Contribution-Based Social Protection Act 2018.
- » Improving intergovernmental coordination of social protection through decentralization of the National Social Security Fund and a clearer framework of laws on social policy responsibilities.
- » Clarifying the citizenship rights of women and their children through the new draft citizenship bill by granting women and all genders equal rights to citizenship provisions.

Disaster Resilience

Reports and diagnostics have rated Nepal among the 20 most disaster-prone countries in the world, with high risks of earthquakes, flooding and landslides. More than 80 percent of Nepal’s total population is at risk from natural hazards. Though the average Nepali citizen accounts for little carbon output or environmental degradation, the country, particularly its poor and vulnerable populations, is at risk of disproportionately high impacts due to climate change and man-made environmental degradation. Disaster and climate vulnerabilities also pose an important regional security risk. Nepal is an integral part of the Ganges River Basin, which sources many of the Ganges River’s major tributaries. Flooding and droughts on these rivers often have downstream humanitarian impacts and climate change-driven extreme weather events could lead to increased famine or flooding in northern India. Finally, while epidemic risk has diminished over time due to increased access to piped drinking water and sewerage, it remains particularly relevant in light of the COVID-19 pandemic. The country also receives as much as 99 percent of its medical supplies through India, making medical provisioning highly susceptible to shock.

Nepal’s experience with the post-2015 earthquake response and recovery produced two key lessons about disaster readiness and resilience. First, was the need for local-level disaster readiness and resilience, as the central government faced difficulties in responding to more remote communities. Second, was the need to better incorporate resilience into reconstruction and future development, which would inform the two disaster recovery frameworks introduced in 2018: the National Disaster Risk Reduction Policy 2018 and Disaster Risk Reduction National Strategic Plan of Action 2018-30. The former aims to increase national disaster readiness by incorporating disaster risk education into public education and awareness campaigns, establishing regular disaster monitoring, conducting disaster risk mapping exercises, and developing disaster funds, among a number of other specific disaster management tasks. The latter develops four priority risk management areas: understanding disaster risks, strengthening governance across federal tiers, promoting investment in resilient infrastructure, and enhancing disaster preparedness. It also develops three implementation timeframes, enumerates detailed strategic goals, and specifies an implementing ministry or agency.

In practice, national government disaster response capabilities remain severely constrained. Under Nepal’s constitution, disaster management is decentralized, but powers among levels are poorly delineated. The Disaster Risk Reduction and Management (DRRM) Act, 2074 (2017), does help to clarify federal power distribution by establishing a National Disaster Risk Reduction Management (NDRRM) Authority to lead, facilitate and support coordination among government tiers, as well as Provincial Disaster Management Executive Committees. Even so, the act does not succinctly define which disasters should be handled by which tiers of government and delays in the operationalization of the NDRRMA exacerbate these issues. Disaster response agencies often lack the necessary equipment, personnel, skills and training to respond to disasters properly. The Government of Nepal has implemented some key financial instruments targeted at responding to natural disasters. Foremost among these is the Prime Minister’s Disaster Management Fund, a relatively well-established fund for large-scale disaster response. The national government also possesses a

Climate Change Financing Framework (CCFF), which aims to better incorporate the costs of climate change and its mitigation into the central budget, but this remains poorly incorporated into the actual budgeting process.

Key disaster resilience issues for Nepal include:

- » Nepal encounters considerable risks from both natural disasters and climate change due to its unique topography and ecosystem, but its disaster response, recovery and resilience systems do not yet meet these challenges.
- » Federalism presents an opportunity for a new standard of community-based disaster resilience, but as it currently functions, decentralization may present a roadblock to effective disaster response.
- » Implementing proactive (instead of reactive) disaster response mechanisms.

Scenarios for the Nepal of the Future

Moving forward, Nepal and its partners will need to address the key constraints facing the country while leveraging its significant assets. Key drivers for Nepal's future are contingent on how it addresses these key constraints, including (i) the longstanding ramifications of the caste system—and its implication on citizenship rights, inequality, effective governance and the rule of law; (ii) a slow erosion of checks on government power—and the effects of non-democratic tendencies and support of patronage politics over good policy on government effectiveness; (iii) ongoing outflows of skilled citizens—and the need to effectively leverage remittance inflows while building domestic markets and economic opportunity; and (iv) being a pebble between two boulders—and the dual risks and opportunities of life between the world's two largest economies.

Given the high degree of uncertainty inherent in open moments in general and the current political infighting in Nepal, there are a set of scenarios that Nepal could face in the medium term:

- » **Status Quo:** Slow implementation of federalism without catalyzing transformational change, where Nepal's governance and market environment reform continues on its current trajectory (which is positive but slow) but misses opportunities to overcome the country's longstanding social divisions or deliver on social protection guaranteed by the Constitution
- » **Worst Case:** Collapse into identity-driven politics and criminalization of the state, where actors choose politics and criminality over policy and more intensively turn to political and social divisions for citizen mobilization, leading to weakened service delivery, stalled implementation of federalism and the Constitution, broken accountability systems and reduced perceived legitimacy of the state amid an impending climate crisis
- » **Best Case:** Consensus on spaces for agreement and key issues and priorities for transformation, where political and civic actors are able to prioritize key policies and programming for inclusive growth that generates market development, the provision of rights-based guarantees and "unity in diversity"

Key Opportunities and Critical Tasks

Nepal has a great opportunity to seize its next open moment, whether now or in the near future—at which point it can consider how to address a set of critical tasks. In 2006, after conducting

a Critical Stakeholder Inquiry in the country, ISE and Nepalese stakeholders coalesced around a set of critical tasks following the end of the Maoist insurgency that included (i) restructuring the state through new rules; (ii) consolidating security; (iii) delivering inclusive development; and (iv) constituting the market. Stakeholders then added an updated task in 2008 of consolidating and expanding areas of agreement to focus on priorities and focus on governing beyond party politics. Since that time, Nepal has met some of these tasks (e.g., restricting the state and consolidating security) but has yet to deliver on others (e.g., delivering inclusive development and constituting the market).

Delivering inclusive development

The critical task of delivering inclusive development has not been completed but is promised through the 2015 constitution. The constitution serves as a key asset for Nepal's future by presenting the legal framework for rights-based citizenship and the decentralization of service delivery and investment promotion. Leveraging the opportunities presented in the foundational legal framework to mitigate the longstanding ramifications of the caste system, oscillation of democratic norms and challenges posed by difficult topography and connectivity will be critical to the country's next stage of development. This includes creating a better system of intergovernmental coordination for delivery, investment and public finances while also reinforcing commitment to the federalism agenda. Stakeholders can further leverage strong national budgeting processes and fiscal-monetary stability to improve the performance of accountability and public finance systems for subnational governments, allowing them to thoroughly deliver inclusive development moving forward. While evidence shows that the capabilities of local governments have improved since 2015, identifying and diffusing the practices of pockets of excellence in the federalism experiment to lower-performing regions will be a key strategy for delivering inclusive and equitable development among the provinces.

Constituting the market

The critical task of constituting the market has not yet been completed but is supported by increasing market optimism, interest in the role of the private sector in development and opportunities to leverage the country's vast assets. While there is concern that weak anti-corruption systems and the growth of political cartels are leading to the criminalization of the economy, there is also significant optimism in Nepal's opportunities to constitute its market within local, regional and global value chains. Stakeholders must leverage the current optimism around the market and relative political certainty to continue increasing the role of the domestic and global private sector in investment and development. Building market clusters with specific comparative advantages (e.g., hydropower, agribusiness, tourism, catalytic IT services) provides an opportunity to organize and grow market activity and production. A clear economic strategy and competition policy, coupled with infrastructure development and investment in the human capital development of the country's young population, could lead to both physical and social connection across the country via roads, cultural circuits and digital connectivity—spurring both further economic growth and a sense of nationhood.

Maintaining political stability and commitment to policy-driven governance

Against a backdrop of slow democratic backsliding, the critical

task of maintaining commitments to political stability and policy-driven governance is crucial to enabling other tasks and reducing the likelihood of worst-case scenarios for Nepal. In 2008, ISE and stakeholders noted the need to consolidate gains made toward political stability; now, the task is to move past consolidation into maintenance and the establishment of mechanisms for commitment. Stakeholders, including high-level political actors, need to reaffirm their commitment to some of the country's key assets: namely, its commitment to press and speech freedoms and social, grassroots democracy. Maintaining this political stability is key to optimism in the market, and committing to federalism is key for inclusive development, making this task a key enabler for others.

Getting a grasp on climate resilience

The world faces the existential threat of climate change, and Nepal will need to take action to improve its resilience and capacity response to future climate-driven disasters—both within its borders and in the region more broadly. The country has made strides in improving its disaster readiness and planning capacity for climate adaptation in recent years, but stakeholders must do more to build resilience. Improving the capacity for response by local and provincial governments and enforcing regulations around riverbed extraction and other unsustainable activities that contribute to disaster are crucial to the security of Nepal's other gains. At the same time, effective management of water resources from the Himalayas and related infrastructure will become increasingly critical to prevent excess flooding and limit the impact of climate change regionally—making the country a key player in future regional security efforts. While Nepal has not significantly contributed to the climate crisis, it will need to be prepared to respond to its effects.

Conclusion

Addressing and focusing on the long-term vision of the future and needs of Nepal's diverse citizenry through an inclusive, prioritized and climate-prepared approach will be central to Nepal's next open moment. The country has a vision of graduating to middle-income status by 2030 by sustainably growing its market and escaping poverty in the next 25 years. These goals can be achieved, and the country can meet the preconditions necessary to address the constraints that have traditionally held it back and new risks to come. Buoyed by an inclusive legal structure in the Constitution of 2015 and building on a unique heritage, Nepal has the opportunity to push through to the vision of a new Nepal—one that is healthy, prosperous and independent.