

**Nepalese Fiscal Policy:
Economic Stagnation & Poverty Perpetuation**

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CHAPTER I

INTRODUCTION

1.1 The Third World State and Fiscal Policy

The state stands for the final repository of agreement of the people to be ruled and, therefore, it is backed up by the state's monopoly over the legitimate use of force. The government speaks and acts in the name of the state (Doern;ed.,1985:6). The state, composed of numerous institutions including the government, the administration, the military, the police, the judicial branch, local government and parliamentary assemblies, make it possible to wield state power by those who occupy the leading position in these institutions.

Born out of anti-colonial nationalism and into a world dominated by industrialised powers, states in the Third World had inherited two mandates in the post-colonial periods: they were expected to create a viable state (political legitimacy) and to generate economic development (Koli: 1986; 170). At the lack of the latter, the states are presently equally vulnerable to international changes as they were in the pre-colonial period. Moreover, the modalities of relations between developed and developing worlds have not changed qualitatively; even today, there is a net transfer of resources from the developing to developed world just as there was in the colonial era. Local governments in the Third World are creating and perpetuating poor and restive masses by maintaining undemocratic

ownership of domestic resources and consequently prolonging the economic stagnation for decades.

There is nowadays far less readiness to assume that the state is benign, acting on behalf of the public interest to maximise social welfare (Killick; 1989: 14). The development theory applicable to the Third World is based on the erroneous assumption that development is a national goal that can be distinguished from other competing political goals and can be given paramount and unquestioned priority among them. In fact very few, if not none, of the governments in the Third World generally consider economic development a high priority. They are busy keeping themselves in power by suppressing their compatriots (Hettne; 1990; 31). The failure of the state to stimulate the positive development of productive capacity has raised doubts about the role of the state as a promoter of development.

The development model, that arose immediately after the emergence of the new Third World states, has produced economic structures highly dependent on imports, foreign skills and external investment. The Third World states, whether they export traditional primary products or non-traditional manufacturing products, are mostly subordinate to the developed world. The deteriorating terms of trade for primary products and heavy borrowing from the outside world has made these countries less self-sufficient. The cheap labor supply in these developing countries has stimulated some of

the industrial relocation of material production but ironically the internal markets have been compressed. At the lack of firm determination by the local governments in favor of industrialisation, mass manufacturing has displaced the market for indigenous craftsmen and artisans. Whatever market for manufactured products emerges, it becomes part of the internal market of foreign economies. Consequently, there is no profitable opportunity for native industries in developing countries. Just as massive investment becomes self-propelling, the lack of investment has been self-perpetuating.

The developing countries have gone through different economic programmes (slogans!) designed in collaboration with international agencies like the World Bank and International Monetary Fund. These programmes include, to name just a few of them, "growth", "growth with redistribution", "fulfilment of basic needs programme", "integrated rural development programmes", "human development", "poverty alleviation" and finally the "structural adjustment programme" characterized by a "market friendly" approach (The World Bank: 1991a). Each of these successive programmes has provided a good excuse for local governments and international institutions to conceal the failure of every preceding programme. What the poor people in the poor countries need is not the cavalcade of new concepts introduced every year but the redirection of resources so as to lessen their economic hardships. After four decades of development exercises launched both by internal and external

resources, economies are everywhere shrinking, economic hardship tightening, the gulf between the poor and rich widening and growth, let alone development, has been a lost hope for the Third World.

Since the beginning of the 1950s, it has been explained that government, through the public sector, would accomplish both of the state's primary objectives: the acceleration of growth and more equitable distribution of income (trickle down). Among different policies, fiscal policy is the single most important instrument for public sector operation. Tax and expenditure policies, which play a vital role whether positive or negative, are left to the discretion of politicians and bureaucrats for formulation. The actual policies implemented depend upon the socioeconomic strength of different interest groups, their relative involvement in the policy formulation process, and the political ideology of the government (Becker; 1983:371). Since fiscal policy also helps define actual decision making power, it is itself an object of political competition (Doern, ed.1985:12).

The unequal distribution of resources within and between countries has made the fiscal system of developing countries more regressive and imbalanced which, in turn, has caused these economies to be less productive, highly repressive and debt-ridden. In the absence of productive capacities, the internal surplus generation has been wrinkled. Additionally, whatever is observed as economic surplus has been absorbed by various forms of excess consumption of the

upper class, by increments of hoarding at home and abroad, by the maintenance of unproductive burgeoning bureaucracies. Consequently, the governments in these countries, who themselves are responsible for creating this situation, are looking for more aid to exceed the political limit of domestic revenue generation in their home countries.

The reckless spending of resources by the government in the developing countries, both mobilised internally and borrowed externally, has created serious macro imbalances. The Structural Adjustment Programme (SAP) was initiated in 1980 by the World Bank and IMF in response to serious balance of payments problems and mounting debts. It is said that the lack of economic development in the developing world is due to the imbalances in the macroeconomic policies, particularly fiscal deficits and balance of payment deficits. The imbalances are supposed to be corrected through a reduction in the size of the government budget and hence through cuts in fiscal deficits. No doubt, these mounting deficits were and are serious impediments to the sound macro performance of these economies, but the fundamental question is whether SAP has addressed the root causes of these structural imbalances. For one reason or another, these root causes are not mentioned.

Some economists correctly argue that there is a growing tendency of rent seeking activities in developing countries because of government intervention in economic activities (Tullock, 1980:

Colander:1984) but at the same time they forget(!) that there are rentier economies as well. These economies are earning more and more income through an ongoing and never ending process of devaluation of currencies in developing countries vis a vis their currencies. The solution they provide to eliminate these rent seeking activities is to adopt completely market-oriented economies. Although there remains the fact that poor people are not becoming better off despite a growing public sector in most of the developing countries, it cannot be concluded as a corollary that the market mechanism will improve their condition. The market itself is a slave of the prevailing socioeconomic structure and particularly of income and wealth distribution (Haq: 1976).

1.2 Macroeconomic Imbalances: A Statement of the Problem

During the 17th and 18th centuries, the Nepalese state was maintained largely by the appropriation of surplus in the form of taxes from the direct producers - the peasantry (Blaikie and Others, 1979: 22). It caused the progressive impoverishment of the peasantry, increased indebtedness and inflicted hardships on them (Shrestha, 1985; 4). During the period of British rule in India, the Nepalese ruler accepted the patronage relationship with them. The rulers were extracting more and more resources to maintain lavish lifestyles and to satisfy the demands of British rulers in India. Thus in Nepal, the role of the state has been historically, and even today to a very considerable extent, one of surplus

appropriation through taxation and other means, both serving, in the absence of an effective national strategy for economic planning, to reinforce the 'control' of capital city over the 'periphery' (the rest of the country) and of the ruling classes over the subject classes (Blaikie and Others; 1980: 56). Throughout history, the Nepalese state can be described in most respects as an extractive one (Feldman and Fournier: 1976; 448).

Since the starting of the planned effort in 1956, Nepal has already launched seven periodic plans with successively greater outlays and more and more 'heavy fiscal policy' financed through foreign aid and internal extraction of resources. As in other countries, the basic premise of development effort in Nepal was that, since the country is in a resource gap situation as shown in Table 1, it could be financed through foreign resources. Even today, the development programmes launched by both the IMF and the World Bank are based on the presumptions of saving gap and trade gap situations of developing countries. The rationale given in support of this development strategy is that all developing countries are always in a resource gap situation and the money flown from developed to developing countries will formulate capital in a short period of time. Both assumptions are very strong and there is no historical evidence to support these claims. Rather the foreign capital which was supposed to bridge the gap and make the country able to finance its expenditure has enlarged the budgetary gap situation (Table 1). Subsequently, the two gap model (expenditure

more than income and imports greater than exports) has been a logical, but wrong, justification for the IMF and the World Bank to request budgetary cuts and devaluation of domestic currencies in developing countries.

TABLE 1

Saving and Investment as Percent of GDP

| YEAR | Gross Domestic Saving | Gross Domestic Invest. | Resource Gap | Total Govt. Expenditure | Foreign Aid | Internal borrowing |
|----------|-----------------------|------------------------|---------------|-------------------------|---------------|--------------------|
| 1975/76 | 11.7 | 15.1 | 3.4 | 11.0 | 2.9 | 1.7 |
| 1976/77 | 13.5 | 16.0 | 2.5 | 13.5 | 3.2 | 2.6 |
| 1977/78 | 12.9 | 17.8 | 4.9 | 13.6 | 4.3 | 1.2 |
| 1978/79 | 11.6 | 15.8 | 4.2 | 13.6 | 4.5 | 1.0 |
| 1979/80 | 11.1 | 18.3 | 7.2 | 14.9 | 5.7 | 1.1 |
| 1980/81 | 10.9 | 17.6 | 6.7 | 15.0 | 5.7 | 0.4 |
| 1981/82 | 9.9 | 17.2 | 7.3 | 17.3 | 5.6 | 3.1 |
| 1982/83 | 8.6 | 19.6 | 11.0 | 20.7 | 6.2 | 6.1 |
| 1983/84 | 9.9 | 18.7 | 8.8 | 18.9 | 6.5 | 3.8 |
| 41984/85 | 14.0 | 22.9 | 8.9 | 18.9 | 6.0 | 4.1 |
| 1985/86 | 11.7 | 21.0 | 9.3 | 19.4 | 6.9 | 3.3 |
| 1986/87 | 12.4 | 21.8 | 9.4 | 19.4 | 5.6 | 3.7 |
| 1987/88 | 11.6 | 21.4 | 9.8 | 20.5 | 7.4 | 2.4 |
| 1988/89 | 9.8 | 21.9 | 12.1 | 23.0 | 7.2 | 5.8 |
| 1989/90 | 9.3 | 18.2 | 8.9 | 22.2 | 7.3 | 4.4 |
| AAGR* | 0.6 (12.4) | 2.1 (14.1) | 9.6 (22.6) | 6.5 (18.9) | 7.8 (21.0) | 52.5 (70.5) |

Source : Economic Survey 1991: Ministry of Finance, HMG/N

AAGR: average annual growth rate over GDP per annum growth rate of 11.95. Figures in parentheses give the absolute annual growth rate.

Starting from the National Income Identity

$$Y = C_g + C_p + X - M + I_g + I_p$$

Where Y = Gross Domestic Product at market prices

C_g = Government consumption

C_p = Private consumption

X = Exports

M = Imports

I_g = Government investment

$$I_p = \text{Private investment}$$

$$Y \equiv C+I+ X-M$$

$$Y-(C+I) \equiv X-M$$

$$(Y-C)-I \equiv X-M$$

$$S-I \equiv X-M$$

This last equation clearly shows that if exports are not sufficient to finance imports, then the economy will be necessarily in a resource gap situation. If developing countries are in a ever widening resource gap situation, it might be because of unequal trade patterns and never ending devaluation of their currencies. The equation is a tautology. the basic problem is the trade deficit which causes a saving deficit, not the other way round as suggested in the present IMF and the World Bank model.

In almost all developed and developing countries, this type of resource gap (investment higher than saving) situation can be observed at some point in time. The resource gap of the public sector may arise as a result of some combination of the following practises.

1. The government has not utilised potential resources to their full extent to finance public investment.
2. Government consumption (that is expenditure on bureaucracy and military) is increasing more than proportionately than domestic resource mobilisation.
3. Either government investment is increasing less than proportionately to consumption or even if it is increasing, it is not contributing to production.

But it is not valid to conclude that at every stage the developing countries are suffering from saving less than investment and a lack of capital. No country can be historically and permanently in a gap situation. All three practices mentioned above are almost the same in that they refer to the mode of utilisation of resources. Of course, the economic stagnation of the country has limited the economic surplus to a greater extent due to underutilized and unutilized human and material resources. Thus the economic surplus has necessarily been small in absolute terms. But the problem of the mode of utilisation of economic surplus is more acute than the level of absolute surplus.

But another equally important factor when analysing these types of data is that the data may overestimate the actual resource gap situation of the country (one simple example: the saving of international firms are not included in this account). In a country like Nepal, where the distribution of wealth is skewed, where there is free movement of both resources and people to India and where unlimited convertibility of the Indian vis a vis the Nepalese currency prevails, there are high chances of underestimation of national saving. The gap, if it exists in real terms, is mostly due to the unproductive expenditure of the government and unrecorded saving in the economy due to capital flight. Macro imbalances have exacerbated the poverty situation which in turn has led to further imbalances.

As in other developing countries, Nepal has also been implementing the SAP since 1985/86, it is said, to alleviate the harsh economic situation. The evaluation of structural imbalances, the equity and efficiency aspects of fiscal policy, the situation of the poor and the probable impact of SAP on the poor will be the main concern of this paper.

1.3 Objectives of the Study

Government fiscal policy is considered one of the most important vehicles for economic growth. Likewise, in the absence of direct government policy for income and wealth distribution in Nepal, it is also the single most important instrument for redistribution. This paper will focus on the redistributive and economic efficiency aspects of Nepalese fiscal policy and relate it to the presently undergoing Structural Adjustment Programmes of the IMF and World Bank to analyze its effects on overall economic performance in general and poverty alleviation in particular.

1.4 Research Hypotheses

The present study will analyze the economic system of Nepal in order to test the following hypotheses.

1. The crucial missing variable for economic development is not only capital (including foreign aid) if at all there

exists such a missing variable.

2. The fiscal system is unable to enlarge the productive base of the whole economy. The productive capacity of the economy has remained stagnant due to the present fiscal policy. Hence, it is inefficient in resource mobilisation.
3. Both the tax structure and expenditure patterns are regressive in their distributional effects. The expenditure pattern is biased against the social sectors and within the social sectors there is a misallocation of resources.
4. Both productivity and efficiency can be improved by changing the tax structure in a manner that increases equity and also by supporting the economically weaker section of society through changes in expenditure patterns.
5. The Structural Adjustment Programme will not improve the efficiency and equity aspects of government policy. In fact, it will likely worsen them.

CHAPTER II

FISCAL GAP OF THE COUNTRY: EVER WIDENING**2.1 Budgetary Gap: Its Perpetuation**

The increasing resource gap situation has led the economy toward increasingly more foreign aid and internal deficits. As the following table shows in the period from 1975/76-1989/90, the government was able to finance 57.68% of its total expenditure, but in 1985/86-1989/90 it could finance only 48.37%. Due to a rapid increase in current expenditure, the revenue surplus¹ for development programmes has decreased. In the second half of the '70s, the revenue surplus was sufficient to finance 35.6% of the development programmes whereas in the latter half of '80s it had decreased to 21.51%. This ratio has been decreasing each year. In 1989/90 this ratio was only 20%. It clearly indicates that with the increasing gap between government expenditure and total revenue, government is heavily dependent on internal and external borrowing to fill the gap during this period. Revenue surplus available for development projects, has been eroded both with respect to development expenditure and foreign aid. This means either government should reduce its expenditure or try to mobilise more foreign aid with stronger conditionalities. If so, the government may have little influence in its own development plan. But this does not necessarily mean that even if government has absolute

¹The Nepalese budget is split into two headings: regular and development expenditure. Revenue surplus is equal to the total government revenue minus regular (i.e. administrative) expenditure.

authority in formulating the plans and programmes they would be different and more beneficial to the poor.

TABLE 2

Revenue and Expenditure Pattern of the Government
(in percent)

| Year | 1975/76- 1979/80 | 1980/81- 1984/85 | 1985/86- 1989/90 |
|----------------------------------------------------|---------------------|---------------------|---------------------|
| Total revenue as % of total govt. expenditure | 57.68 | 48.46 | 48.37 |
| Foreign aid as % of total govt. expenditure | 30.69 | 33.24 | 32.95 |
| Internal borrowing as % of total govt. expenditure | 11.63 | 18.30 | 18.68 |
| Revenue surplus as % of development expenditure | 35.60 | 24.83 | 21.51 |
| Revenue surplus as % of foreign aid | 78.23 | 50.28 | 43.21 |
| Debt servicing as % of total govt. expenditure | 0.73 | 1.70 | 4.36 |
| Foreign aid as % of development expenditure | 46.59 | 48.64 | 50.13 |

Source: Economic Survey 1991; Ministry of Finance: HMG/Nepal

By the '50s, this resource gap was considered the only obstacle to development and it was supposed to be bridged up and solved by foreign aid. But the experiences of 4 decades has proven that the developing countries are not missing only (if at all) capital. The above Table 1 shows in Nepal's case foreign aid (both grants and loans) has increased annually by 21% whereas government expenditure has increased by 19%, but the resource gap is increasing by 23%. If capital were the only shortage, then the gap would have decreased

with foreign aid. In contrast, the gap is increasing with the increase in foreign aid. As the ratio of foreign aid with respect to GDP has risen from 3% in 1975/76 to 7% in 1989/90, the corresponding ratio measuring the resource gap has increased from 3.4% of GDP to 9% during the same period. Thus the resource gap position has been aggravated and the debt crisis is the cumulative effect of this situation.

Foreign aid enables governments to do what they are already inclined to do for the simple reason that aid usually consists of a transfer of resources to the recipient government. An increase in the government's resource availability is highly likely to help it stay in power. In this sense, foreign aid maintains the status quo. This is true of Soviet aid to Cuba as it is of US aid to El Salvador (Griffin: 1991; 668). If the status quo is a barrier to poverty alleviation and development, as in Nepal, aid may not remain part of the solution. Since the government wants to help those people who help them stay in power, it may be in the government's best interest to make the beneficiaries predominantly the local elites. At least at the time of Cold War, the evaluation² of foreign aid could not provide substantial evidence to reject flatly the following statement:

'In a sentence the kernel of criticism is that foreign aid tends to serve narrow donor interests and those of the classes in recipient countries that will most benefit: that it incorporates the lesser developed country into dependent

²The econometric evaluation is done by Mosley, P. and others (1987) and Gupta and Islam (1983)

relations with industrialised nations; and that through a series of bureaucratic filters, special interests and general bungling, frequently does harm not good' (Blaikie: 1985;61).

Nevertheless, as Nepal is getting very soft loans and grants, it is reasonable to believe that aid money could be utilized as a part of solution if domestic economic policies are changed to promote equity and increase productivity.

2.2 Debt Service Ratio: "Stripling" not "Dwarf"

As we have seen in Table 2, the debt servicing to total government expenditure ratio has increased from 0.73% to 4.36% during a 10-year period. However, the debt service ratio of Nepal looks relatively "dwarf" as compared to other highly debt-ridden countries. The "low" level of the debt service ratio was possible

TABLE 3
Foreign Debt Service Situation

| Fiscal year (5 year averages) | 1975/76- 1979/80 | 1980/81 1984/85 | 1985/86- 1989/90 | 1989/90 |
|--------------------------------------------|---------------------|--------------------|---------------------|---------|
| Debt service ratio ³ | 0.9 | 2.6 | 7.0 | 10.2 |
| Debt service as % of external borrowing | 7.2 | 9.2 | 17.7 | 18.8 |
| Net outstanding debt as % of GDP | 5.0 | 14.0 | 31.0 | 41.5 |

Source: Economic Survey 1991; Ministry of Finance: HMG/Nepal

due to the higher share of aid in the form of grants. Till the

³Total foreign debt payment, in principal and interest, as a share of total earnings from exports of goods and services.

start of 1980's, 50% of aid was in grant form. Even in 1989/90, 47% of aid was composed of grants. Despite the higher share of grants, the debt service ratio is increasing fast. The debt service ratio has reached 10% and the ratio of net outstanding debt to GDP was 41% in 1989/90 whereas these respective ratios were 0.9% and 5% in late '70s. Debt service as a ratio of external borrowing has increased from 7% to 18.8%.

Nepal is on the same unfortunate track as were other debt-ridden countries a few years ago. It will approach soon the heavily debt-ridden countries since the grant portion of foreign aid is decreasing and loan utilisation is unproductive.

From the previous two tables 1 & 2, it is clear that the fiscal system of Nepal is running toward a deficit and this trend has been getting worse in recent years. This structural problem of fiscal policy in Nepal is an inevitable consequence of the structural gap between expenditures and revenue created by contradictory objectives of the government. The unequal distribution of resources within the society has made the fiscal system regressive. This regressiveness has made it necessary for the government to undertake more and more expenditure to hide its nature and to legitimise itself. For further spending, it will require the enlargement of tax collection, which again would perpetuate inequality. This, in effect, will necessitate a reallocation of state expenditures even more in favor of narrow political ends. As

this growing expenditure is not possible through internal resources, particularly because the capacity to tax the wealthy section of the population has not been utilised in the name of administrative difficulties, the country has to look for more foreign aid to finance its expenditure thereby creating an even greater gap in the economy. More borrowing leads to less credibility and the country should prepare for bitter medicine.

CHAPTER III

REVENUE ASPECT: WHO PAYS?**3.1 Tax Structure of Nepal: The Worst Scenario**

The essential nature of fiscal policy is either to place taxes on some commodities or permit subsidies on others, or to impose taxes on some individuals and to grant to others. The 1980's had witnessed an unprecedented pace of 'tax reform' in both developed and developing countries. Today, tax reform is on the political agenda everywhere in order to raise revenue either to pay mounting debts or to spend more in the public sectors.

According to a cross sectional study of 86 developing nations, only three countries, Uganda, Ghana, and Bolivia have a lower ratio of tax revenue to GDP than that of Nepal (Tanzi, 1987: 218). The only three countries viz. Chad, Bangladesh and Ethiopia, which have lower GDP per capita than Nepal, have higher ratios of tax revenue to GDP compared to Nepal. However, this does not mean that the effective tax rate in Nepal is low. The problem lies more in the tax structure than on the tax rate itself. In all these three countries with lower GDP per capita than Nepal, the percent of income taxes to total GDP is about 2% but in the case of Nepal this percentage is only 0.53% whereas the ratio of indirect taxes to GDP is almost the same in all these four countries. Thus the tax rate seems simultaneously low in the case of direct taxes and high in the case of indirect taxes in Nepal.

The following table shows that since 1975/76 the tax structure has not changed substantially and whatever has changed has resulted in a less sound and more vulnerable tax base. The share of total revenue and total tax revenue to GDP indicates that the revenue

TABLE 4

Composition and Structure of Different Taxes
During 1975/76- 1989/90

| | 1975- 1980 | 1980- 1985 | 1985- 1990 | Annual Share | AAGR |
|----------------------------|---------------|---------------|---------------|-----------------|-------------|
| <u>As percent of GDP</u> | | | | | |
| 1. Total Revenue | 7.66 | 8.68 | 10.07 | 8.63 | 3.86 |
| 2. Total Tax | 6.22 | 7.16 | 7.85 | 6.95 | 3.48 |
| 3. Direct Tax | 1.37 | 1.30 | 1.48 | 1.37 | 3.46 |
| 4. Indirect Tax | 4.85 | 5.86 | 6.37 | 5.59 | 3.74 |
| <u>As % of Tax Revenue</u> | | | | | |
| 1. <u>Direct Tax</u> | <u>22.23</u> | <u>18.09</u> | <u>18.82</u> | <u>19.86</u> | <u>0.03</u> |
| (i) Land Tax | 10.85 | 7.65 | 6.42 | 8.73 | -5.10 |
| (ii) Income Tax | 9.26 | 9.19 | 11.27 | 9.63 | 8.08 |
| (iii) Urban House Tax | 0.40 | 0.42 | 0.29 | 0.36 | 4.39 |
| (iv) Other | 1.72 | 0.83 | 0.84 | 1.14 | 4.83 |
| 2. <u>Indirect Tax</u> | <u>77.77</u> | <u>81.91</u> | <u>81.18</u> | <u>80.15</u> | <u>0.24</u> |
| (i) Custom Tax | 38.71 | 34.55 | 35.98 | 36.57 | -0.03 |
| (ii) Excise Tax | 13.99 | 14.40 | 14.83 | 14.39 | 0.71 |
| (iii) Sales Tax | 22.06 | 27.55 | 24.06 | 24.44 | 0.44 |
| (iv) Other | 3.01 | 5.41 | 6.31 | 4.68 | 8.52 |

Source: Economic Survey 1991: Ministry of Finance; HMG/Nepal.

AAGR: Average annual growth rate during 1975-1990 (in nominal term).

collection of the government is almost at the same level contributing around 8.6% and 6.9% respectively on an annual basis. The share of direct tax to GDP is very low throughout the whole study period. The table clearly shows that the share of indirect tax to total tax which was very high at the beginning of the study

period (77.77%) is still increasing at the rate of 0.24% annually, whereas the direct tax has contributed around 20% of total tax revenue. The ratio of direct tax to total tax has decreased from 22% during 1975/76-1979/80 to 18.82% in 1985/86-1989/90.

This present tax structure is not only incapable of generating additional resources, but is equally inefficient in resource allocation and regressive in social redistribution. The taxation pattern of the past 15 years exhibits the government's deliberate negligence in mobilising domestic resources.

Government cannot deal with the deficit in the same easy way as it did before. When loans start to mature, the situation will be even worse and eventually the country will fall into a debt trap if fiscal policy is not framed in a long-term perspective. Even to maintain the present level of revenue, the tax structure should be revised substantially. The tax base on which current revenue depends cannot be exploited any more intensively than at present. Moreover, these bases are more likely to shrink than to grow in relative terms as time goes by. The basic problem for Nepal is to build a sound tax structure. The country cannot escape from the fiscal problem only by addressing the emerging issues on an immediate basis. The tax structure of Nepal is more or less the worst scenario in the world.

3.2 Income Tax: Regressive in Content

The share of direct tax to GDP has remained absolutely at the level of 1% during the course of 15 years. Though in almost all developing countries, the share of income tax is low, it is surprisingly low in Nepal as a ratio of both GDP and total tax revenue. Income, as an index of tax-paying capacity, should be defined broadly as total accretion to a person's wealth, whether regular and fluctuating, expected or unexpected, realised or unrealised. Moreover, income from all sources thus defined should be treated uniformly and combined into a single or global income to which tax rates are applied. Without globality, the application of a progressive (even highly progressive) tax rate schedule cannot serve its purpose of indexing the tax according to tax payers' ability to pay (Musgrave & Musgrave, 1989: 332).

The prime defects of the existing income tax system are its incomprehensiveness, exemptions and concessions for different sources of income and tax administration. Agricultural income, which accounts for around 60% of GDP, is not included in the taxable income. It is completely exempted in the name of administrative difficulties which will be explained in more detail in the discussion of the land tax. Urban housing and land taxes, which contribute significantly to the wealth and income composition of urban dwellers, is not included in taxable income. Though there is a large potential for revenue collection from these sources, the

contribution of this tax to total tax is 0.36%. Nepal is quite ahead in the process of wealth accumulation in urban areas and poverty and debt piling in rural areas. The wrong pattern of government expenditure and high exemptions for urban property have further reinforced the metropolis hinterland relationship.

The different components that generate income are not considered in a broad and comprehensive manner. Government is avoiding both the ability to pay, that is equity aspect, and the efficiency aspect. People are not paying according to their abilities. There are many legal and illegal loopholes created by the government to evade the tax and for low assessment of the taxable income. Income from every item is treated separately and for every item, there is the provision of numerous exemptions, so that the taxable income will be low automatically, no matter how high the tax rate is.

Although there are administrative difficulties in creating a comprehensive income tax in the case of Nepal, it is true that with a little effort, the contribution of income tax can be increased substantially. It depends upon the objectives of the government, whether to create a sound tax base with a long-term development strategy or to postpone the problem for the future, with a complete tax holiday today. As policy makers themselves will be negatively affected by comprehensive taxation and non exemption, it is more a political problem than administrative one. Of course there are administrative problems, but it does not mean that government

should exempt all agricultural income and other urban income for the sake of administrative simplicity. Subsequently, poor people have to pay high taxes on basic necessities in the form of import or sales taxes to compensate for the loss that has resulted due to the poor revenue generation of the income tax.

Without any guidelines for national industrial policy, a strong incentive is provided for most of the industries at the rhetoric of industrialisation and efficiency. Because of a lack of clear cut macroeconomic policy incorporating every aspect of the economy, a mere tax holiday cannot lead to industrialization, particularly in the case of Nepal due to its geopolitical and economic relation with India. Whatever industries have been established, they were established to take advantage of government exemption policy and have failed to add significantly to the industrial base of the country.

The basic challenge for Nepal regarding industrialisation is embedded in its trade relations with India and subsequently with the action on commercial capital to force it on industrial capital, not on tax holidays. Besides, when the degree of tax compliance is low and tax evasion is possible, fiscal incentives are inefficient in promoting industrialisation. If taxes are not paid fully in all sectors, there is no special advantage in getting tax concessions on particular activities. It means the high direct tax exemption cannot be justified from the industrialisation perspective too.

3.3 Land Tax: "Hard to Tax"!

The land tax is a very old tax in Nepal and it was a major source of government revenue in the past. Recently, in the absence of any agricultural income tax, it is the only direct tax that landowners pay in the rural areas. While the value of land has increased, the contribution of the land tax has decreased in subsequent years. The land tax rate has not changed since 1967/68. If anything, the rates have been revised downwards in the name of giving relief to the marginal and small farmers (IDS, 1987: 59). The land tax rate is flat at the minimum level and holdings smaller than 1 hectare are exempted.

As the above Table 4 shows, the average ratio of land tax revenue to total tax revenue has declined from 10.85% in 1975/76-1979/80 to 6.42% in 1985/86-1989/90. It has decreased at an annual rate of 5.1%. The other noteworthy observation is that even at this low level, almost 75% of the land tax comes from land registration. There is a great potential for resource mobilisation through an agricultural tax, especially from large landlords. In Nepal, land accounts for a large portion of wealth and it is highly concentrated among a small percentage of the population. The land tax in Nepal is kept to a minimum because the state is often controlled by elites, with deep roots in the agrarian power structure. It is the agrarian landed class that has supplied the higher echelon of state bureaucrats and politicians. Thus they have

controlled every mechanism to keep the tax rate low on land and to exempt all agricultural income from tax.

The distribution of land ownership is highly skewed in Nepal. For an efficient land tax and productivity increases in the agricultural sector, Nepal needs land reform. This inequality in rural land holdings is only the tip of the iceberg since these are the big landlords who also hold all urban land, real estate and trade. The following table clearly shows the non-existence of an

TABLE 5

Social Distribution of Land
(Landholding in Hectares)

| | 0.0-0.5 L-NL | 0.5-1.0 Subsistence | 1.0-3.0 Small | 3.0-5.0 Medium | >5.0 Large |
|-------------------|-----------------|------------------------|------------------|-------------------|---------------|
| Household (%) | 50.5 | 16.2 | 24.4 | 5.5 | 3.4 |
| Land holdings (%) | 6.6 | 10.7 | 35.3 | 18.5 | 28.9 |
| Average Holdings | 0.15 | 0.75 | 1.62 | 3.80 | 9.49 |

Source: Shrestha N. R. Landlessness and Migration in Nepal: 1990.
L-NL: Landless near landless

agricultural income tax and that the very low land tax has made the tax system inequitable. It also indicates why the relative contribution of the land tax to total tax revenue could not improve. Large landlords are under-taxed, almost untaxed. Among the different varieties of fiscal instruments available to tax agriculture, the agricultural income tax and the land tax are among the most effective ways when taking into account efficiency, equity and revenue collection. Although the amount of revenue generation

will depend on the amount of agricultural transactions that take place through the market, the initiation of an agricultural tax would be a vital step in tax reform. Without a land tax, the increase in urban house and land taxes are difficult to implement. The concession to the urban population with regard to the urban property tax is made politically feasible by the counterpart concession of the land tax for rural areas. But in reality, many of the same individuals have benefitted from both these exemptions. No doubt, almost all rural landlords are the major occupants of urban property.

A large fraction of wealth in Nepal consists of land ownership and the inequality in land ownership thus correlates well with inequality in wealth. Taxing the agricultural sector could be a key instrument for development policy. Such taxation influences income distribution and the pace of growth in significant ways, even if the volume of agricultural tax revenues directly accruing to the government is not appreciably large. The role of agricultural taxation in economic development cannot be gauged merely from its visible contribution to government revenues (Rao, 1989: 809).

Actually, the land tax in Nepal has an important role to play on three grounds: to increase government revenue, to increase productivity through penalizing the inefficient utilization of land resources and to promote equity in society. The real crux of agricultural policy should remain land reform. If it is not

possible politically, a progressive land tax would ease the fiscal situation and help reduce inequality. Land should not simply remain a virtually untouched "hard to tax" area.

3.4 Indirect Tax: Tax on Necessities

Personal income taxes can be employed to promote equity in a manner that indirect taxes cannot. Since indirect taxes are regressive in nature, one has to devise a very complicated structure of rates and exemptions to impart a measure of progressiveness to the system. Such a complicated rate structure, however, results in inefficiencies, higher administrative costs and revenue losses. A general tax on every basic item instead of considering income as the measure of ability to pay discriminates against the poor (O'Connor; 1973: 205).

Without any consideration for equity, Nepal is adopting a tax structure highly dominated by indirect taxes. Custom duties provide about 37% of the total tax collection. As three-fourths of the sales tax (contributing about 24% of total tax revenue) is collected on imported items, the real contribution of custom taxes (tax on trade) is 54% (about 68% of indirect tax). Thus indirect taxes consist mostly of custom and excise duties. The share of customs duties to total tax revenues has decreased from 38.71% in the late '70s to 35.98% in the late '80s. This decrease is due to the decrease in the share of export duties influenced by the export

led strategy of SAP.

Though it is relatively easier to tax traded items, its rationality depends on the different economic and political factors of the country. The different tax patterns on imports and exports will affect the trade pattern, industrial policy and fiscal policy as well. Custom duties may not necessarily be bad from an equity point of view if they are levied on luxury items from abroad. If this policy is not accompanied by a tax on domestic production of those luxury goods, then it will create distortions in the economy by protecting the local industries producing luxury items. But in Nepal's case, taxes are spread on most of the necessities imported from outside, not only on luxuries. Since Nepal's has no strong industrial base, which can be seen from the minimal contribution of the excise tax, it has to import most of its basic needs items from abroad. As more than 92% of customs duties come through import duties and export duties are negligible, the high contribution of custom duties was possible because of taxes on necessities which burden only Nepalese citizens. In this case it is important to do further study on the incidence of the custom duties on each product to find out the exact burden on different groups in society.

3.5 Import Duties: A Shadow Rate of India

Nepal is a landlocked country handicapped both by high transport costs and problems of transit for its imports and exports. The

level of trade would consequently be lower compared to a situation, *ceteris paribus*, where these handicaps did not exist (Islam and others, 1982: 78). Besides, given the full convertibility between the Nepalese and Indian currency and the virtual impossibility of avoiding smuggling throughout the 1400 km long open border with India, prices in Nepal cannot differ from Indian prices by more than the transport and smuggling costs (Blejer & Szapary: 1990; 256). Hence it will be difficult for Nepal to sustain any trade regime which ensures border prices different from prices in India. By the same token, the level of tariffs in Nepal cannot be significantly different from Indian levels. So implicit tariff rates of Nepal are basically dictated by the tariff rates of India. If the "unpolicable" open border issue is not addressed in a different way and the fixed exchange rate of the Nepalese currency with respect to the Indian currency along with their unlimited convertibility is not reconsidered, Nepal will not be able to implement different trade policy, commercial policy and industrial policy.

Ironically, from the revenue point of view, this dependent nature of Nepalese tariff policy has been beneficial for the government at the cost of the country in the past. The too high tariff wall system of India to protect its industry had made it possible for Nepal's government to increase import tariff rates for mobilisation of additional tax resources without revising the minimum contribution accrued from direct taxes. Nepal has had to utilise

this opportunity for the establishment of some industries within a broad national industrial policy. To put it clearly, the high tariff rate of India has been a boon for the government to increase its own tariff rate almost to the same level thereby subsidising the direct tax.

Given the tax structure of Nepal, the very low level of excise taxes (14% of the total tax) with a constant share of total taxes provides an indication of the weak industrial base in the economy and stagnation in industrial growth. Of the total excise duties, tobacco products contribute 53% and alcohol contributes 18% amounting altogether to 71%. This figure reveals a lot about the industrial structure of the economy. Moreover, a low quality of these two items are highly consumed by the poor.

From the above discussion of different taxes, it is obvious that the tax structure has two distinct features. First, it permits rural landlords and urban property owners to expand their income and wealth, consequently making them politically powerful. Second, to meet the cost of increasing government expenditure, the system appropriates money from poor peasants. By imposing taxes predominantly on goods of daily consumption and hence raising their prices, the economic system weakens mostly the poorer section of the population. So in the due course of time, the government taxing system compels them to be more and more dependent on the state.

CHAPTER IV

EXPENDITURE ASPECT: WHO BENEFITS?

4.1 Government Expenditure: A Redistributive Mechanism

If tax reform is not accompanied by corresponding changes in the expenditure pattern, the country will end up only with more surplus extraction by government from the public. In that case, the proposal developed in the previous chapter for a capable, elastic and progressive taxation system leads to the rapid spread of the state machinery and the expansion of bureaucracy which, in essence, prolongs the backwardness. It is the expenditure pattern which should be designed to address the issue of poverty in cases where the resource ownership pattern is unequal. Even a complete removal of the tax system will not make poor people better off if they do not benefit from government expenditure. But when the tax system is not progressive, as mentioned before, the expenditure pattern should be quite progressive even to hold the inequality at the present level. To quote R. M. Bird (1974):

... Taxes cannot make the poor richer, which is after all, the main concern of distributional policy. Even the complete removal of all taxes on the poorest members of society would not make them much better off, simply because of the low absolute amounts of the income and tax involved. Furthermore, many of the poorest people, particularly those in rural areas, take part only marginally in the economic life of the country and are thus little affected by taxes. While the regressiveness of the tax system, where it exists, ought to be reduced as much as possible in order not to make things worse, it is clear that, if our main concern is with poverty as such, with the waste and misuse of human resources and the stunted opportunities in life afforded those with income below some minimum level, any fiscal corrective

must be exercised primarily through the expenditure side of the budget (Bird: 1974; 4).

In a practical sense, government expenditure can play a redistributive role but the question of in whose favor depends upon the nature and formation of the government. Free markets alone cannot perform every social justice (Williams; 1982: 80) nor would government control in each and every sector. The expansion of state power itself does not necessarily strengthen the poor and can often weaken it if state power expands under the firm control of the feudal elite. Moreover, the state is a human creation, but not the creation of everyone interacting equally; people come to the political process with their strength already partly determined by their roles in the process of production. So, government intervention is not beneficial for the poor if they were not given the opportunity to participate in the political process and consequently government programmes are not designed to address their concerns. Moreover, if government policies are not well balanced, sometimes there is a possibility that the needs of the private sector are fulfilled through shifting cost to government budgets, and thus to taxpayers as a whole (Deaton: 1973 ;19).

4.2 Expenditure Pattern: Benefits According to "Ability"

Nepal does not have any long-term expenditure strategy. The government priority for budgetary allocation is determined according to the availability of foreign aid. The table below

clearly indicates that government expenditure is continuously in favour of economic services. The budgetary allocation for the social sector was at a very minimal level of 17.42% in 1975/76-1979/80 and it has decreased to 16.84% of total expenditure in the late '80s. The loan repayment ratio has more than doubled in a period of one decade. Nepal pays 10.62% of its total revenue in loan repayments. The latter five year period (1985/86-1989/90) should be analyzed as a period under SAP. Since the loan repayment ratio is increasing, government is releasing more resources from social sectors to cover loan repayment. In essence, SAP acts as a mechanism to guarantee that loans are paid back.

Government expenditure on economic services is distributed among people on the basis of the economic ownership of resources. When

TABLE 6

Government Expenditure Pattern During (1975 -1990)
(in percent)

| Budget Headings | 1975/76- 1979/80 | 1980/81- 1984/85 | 1985/86- 1989/90 | 1975-90 |
|----------------------------------------------|---------------------|---------------------|---------------------|--------------|
| <u>Administration & Defence</u> | <u>16.48</u> | <u>14.64</u> | <u>13.38</u> | <u>14.83</u> |
| <u>Social Services</u> | <u>17.42</u> | <u>16.14</u> | <u>16.84</u> | <u>16.80</u> |
| - Education | 10.59 | 10.03 | 10.36 | 10.33 |
| - Health | 5.17 | 4.37 | 4.20 | 4.58 |
| - Other Social Services | 1.66 | 1.74 | 2.28 | 1.89 |
| <u>Economic Services</u> | <u>56.21</u> | <u>56.94</u> | <u>53.01</u> | <u>55.39</u> |
| - Agriculture | 18.08 | 19.93 | 18.47 | 18.83 |
| - Industry | 4.55 | 5.31 | 4.11 | 4.66 |
| - Transport Communication and Electricity | 27.77 | 23.32 | 23.29 | 24.79 |
| - Other Economic Services | 5.81 | 8.38 | 7.13 | 7.11 |
| <u>Loan Repayment</u> | <u>4.95</u> | <u>5.97</u> | <u>10.62</u> | <u>7.18</u> |
| <u>Miscellaneous</u> | <u>4.94</u> | <u>6.31</u> | <u>6.15</u> | <u>5.80</u> |

Source: Economic Survey 1991; Ministry of Finance: HMG/Nepal

the resource ownership pattern is skewed, the expenditure on agriculture, industry, transport, communication and electricity will benefit the landlords, trade merchants, urban dwellers and "industrialists", almost the same people with different occupational engagements in Nepal's case, leaving the majority of the population in abject poverty.

Out of the total agricultural budget 40% goes for irrigation, 20% for forestry and the remaining 40% for agricultural programmes like improved seed, fertilizer and other related activities. The benefits of agricultural expenditure are distributed proportionally to land ownership. Government provides subsidies for fertilizer prices, fertilizer transport costs, and irrigation which is undoubtedly beneficial for those agricultural households that can afford fertilizer and who have viable plots of land to productively use fertilizer. Due to the lack of a water charge collection and unnecessarily high costs for operation and maintenance, the bulk of the amount goes for irrigation through the central authority benefitting households with land possessions. It is clear enough that such subsidies are not only quite regressive in nature, but also impede agricultural productivity in the long run due to people's negligence of operation and maintenance.

Expenditure on administration, road construction, and expansion of urban areas has neither promoted productivity nor equity. The dramatic growth in the size of the bureaucracy, and of towns, as

well as the expansion of commerce is a product not of the development of the national economy, but of its underdevelopment and enforced stagnation (Blaikie and Others, 1980: 101). The state has been unable to build the roads for the purpose of transforming agricultural production. The roads provision has increased the consumption of imported commodities from India and elsewhere, thereby leading to the decline of small scale indigenous industry, once of considerable importance in Nepal. The roads serve to support a tiny proportion of the population (the bureaucracy, the merchants) and leave the bulk of Nepalese unaffected.

The growing euphemism that infrastructure building will promote industrial capital and encourage industrialisation, has proven to be an illusion. In spite of its large claim on expenditure (one-fourth of the total budget), infrastructure spending has not been able to promote the productive base of the economy. From an equity point of view, this expenditure has benefitted only those few people who can use the road and communication network.

4.3 Social Sector: Always Neglected

As compared to other sectors, public involvement in social sectors is considered more justifiable on equity grounds. One argument is that public expenditure on social sectors can be used as an effective method of income redistribution, particularly if they are financed out of progressively collected revenue sources. Again, the

incidence depends on how the subsidy pattern is designed. In the case of Nepal, as we explained earlier, whatever may be the government expenditure on education and social sectors, it is not financed by progressive taxation. Moreover, the involvement of the government in this sector has not been successful in improving the national distribution of resources if not worsening it.

As seen from Table 6, there is a very low priority assigned to social sectors. Hence, the physical infrastructure for education and health is not developed. Government expenditure patterns are continuously biased against education and health programmes.

TABLE 7

Budget Allocation on Education and Health as a Share of GDP

| | 1975/76- 1979/80 | 1980/81- 1985/86 | 1985/86- 1989/90 | 1975-1990 |
|-----------|---------------------|---------------------|---------------------|-----------|
| Education | 1.30 | 1.75 | 2.10 | 1.98 |
| Health | 0.67 | 0.73 | 0.90 | 0.77 |

Source: Economic Survey 1990: Ministry of Finance; HMG/Nepal

Health status is poor in Nepal- with infant mortality rates (113 per thousand) among the highest in the world, and life expectancy (52 years) among the lowest. Public expenditure for health is less than 1% of GDP and less than 5% of total budgetary expenditure. The annual per capita health expenditure in Nepal is only NRS 80 (US\$1.75). Though there are some hospital facilities for out patients at lower registration cost, the most vulnerable group cannot benefit since they live in isolated rural areas and cannot afford medicine. Mainly in the rural areas (where 93% of Nepalese

live), a rate of one physician/100,000 population is the rule rather than the exception. Thus the health service coverage is highly inadequate. It is estimated that about 10-15% of the total population are reached by health services, mainly urban and wealthy people with a strong bias against female patients.

The budget on education as a share of GDP is just 2% and it is about 10% of the total government budget. This puts Nepal among the lowest spenders on education in the world, both as a proportion of GDP, and in absolute terms (The World Bank: 1991b; 80). This is not the end of the story; the most serious misallocation is within the social sector itself. Most of the subsidies go to higher education where enrolment is practically confined to the richer section of the society.

Nepal is afflicted with a serious poverty of human resources. Only about 34% are literate (15% of females), and it is estimated that 8% of the post school age population have completed secondary education. All these shortcomings are the systematic results of the

TABLE 8

Gross Enrolment Ratios for the Year 1985
(percentage of the school aged population)

| | <u>Female</u> | <u>Total</u> |
|-----------------------------|---------------|--------------|
| Primary (Grade 1-5) | 50.0 | 82.1 |
| Lower Secondary (Grade 6-7) | 15.9 | 31.2 |
| Secondary (Grade 8-10) | 9.2 | 20.5 |
| University | na | 3.0 |

Source: Nepal Social Sector Strategy Review 1989: The World Bank

education policy. As the above table shows, the gross enrolment ratio is also very low for the lower secondary and secondary level. The enrolment ratio in primary school is relatively higher because this education is provided free but dropout rates are very high. The efficiency table below shows that it takes more than 12 years to complete 5 grades of schooling and only 28% pass primary education. Hence the 18% who do not enroll at all into the system

TABLE 9

Efficiency of Primary Schooling

| | <u>Total</u> | <u>Girls</u> |
|-------------------------------------------------|--------------|--------------|
| Numbers of years needed to produce one Graduate | 12.84 | 14.18 |
| Average study year per Student | 3.55 | 3.45 |
| Graduation per 100 Students | 28 | 24 |

Source: Nepal Social Sector Strategy Review: 1989: The World Bank

and the 72% who drop out at the primary education level are virtually illiterate, making altogether 77% of the total children. The performance of girls is significantly worse than that of boys. The average number of years (12.84) to produce one graduate for 5 grades indicates that it costs almost 3 times more to graduate grade 5 for one student compared to a situation if the system were completely efficient.

The performance in secondary and higher education is even more disappointing. Only 20% of the students enrol for the secondary level (both lower secondary and secondary combined) and 3% for higher education. The reason for this poor performance in education is due to the government budgetary priority between education and

other sectors and choices of programmes within the education sector.

4.4 Economics of Education

In Nepal, on average, 75% of students are in primary education yet they obtain only 45% of the resources devoted to education. In contrast, the proportion who attain higher education is only 3%, but this group obtains 36% of total resources. Keeping in mind the adult illiteracy of 74%, the subsidy allocation reveals a strong regressive nature of public spending on education.

TABLE 10

Government Subsidies on Education by Category

| | Primary | Secondary | University |
|--------------------------|-----------|-----------|------------|
| No. of Student | 1,952,504 | 579,517 | 78,490 |
| (percent) | (75) | (22) | (3) |
| Gov't Subsidy (NRs mil.) | 467.3 | 196.8 | 365.6 |
| (percent) | (45) | (19) | (36) |
| Per Student Subsidy | 239 | 339 | 4,658 |

Calculated from Nepal: Social Sector Strategy Study Review: 1989; The World Bank and Statistical Yearbook 1990; CBS/Nepal.

The important fact to recall here is that those households that benefit from the subsidy in higher education also get their respective share in primary and secondary levels. If we compute the total subsidies, the 3% who go on to the university level get more than 40% of the total government resources devoted to education. The annual subsidy for a student studying at the university level is 20 times higher than the subsidy at the primary level. In other

words, the cost of a subsidy for one student at the university level is sufficient for 20 students at the primary level.

Although primary level education (up to grade 5) is tuition free, it does not mean that every family can get primary education. Only 28% of the gross enrolment and approximately 23% of the school aged children graduate from primary school. Tuition fee elimination alone does not guarantee primary education, especially for those who are poor. The supply of primary education facilities itself is not enough if the household cannot make effective demand. Other non-tuition costs, and the opportunity cost of the consumer's time, are real constraints to poor households. The high non fee cost virtually inhibits the poor household from getting even primary education.

The arrangement of primary education for all people is warranted both from equity and efficiency criteria. According to one study, investment in education is more profitable than other public investment and investment in basic education is more profitable than in higher education. The study of 94 countries confirmed that the social rates of return to primary education are much higher than those to post primary education for the developing countries (Psacharopoulos: 1985: Table 1).

At the secondary level, tuition fees are very high. Thus even those limited few who pass free primary schooling are not guaranteed to

continue secondary education. The implementation of high tuition fees at the secondary level is unfair from an equity point of view. The nation badly needs to encourage successful but poor children who have overcome the many hurdles placed in their way and have successfully finished grade 5 to continue their education. According to one study from the World Bank, at least one third more students would enroll if fees were eliminated (The World Bank: 1989; 16).

At the university level, there is another misallocation of resources. Though most of the subsidy goes for technical education like agriculture, forestry, medicine and engineering, it has not been utilised to create physical facilities. As a result, only a few (8% of the total students studying at the university level) get the chance to enter into these fields. Thus even a competitive entrance examination system to select students for these subjects in fact discriminates against those who have high ability but could not afford private secondary education.

In summary, the distribution of government subsidies in education is highly regressive. The present policy regarding the public provision of educational services has not been instrumental in improving the national distribution of resources. In contrast, the positive correlation between a person's level of education and his level of lifetime earnings actually perpetuates and even increases inequality (Todaro: 1990; 346). But the share of education in the

total budget is unlikely to grow significantly without a conscious change of public expenditure policy.

CHAPTER V**EFFICIENCY OF FISCAL POLICY: STAGNATION****5.1 Stagnation on Demand Side**

Supply does not create its own demand in the Nepalese economy where a majority of the population is lacking even one meal a day. At the lack of economic resources for their survival, most of the laborers work in India on a seasonal basis. Nepal is a supplier of working labor and primary agricultural products, both an indication of backwardness and stagnation, to India. The fact that 91% of the total working force in the country relies on agriculture as their main occupation is more than enough to conclude that there are no other job opportunities in Nepal outside agriculture, bureaucracy and military. Those who are deprived of land ownership and educational opportunity cannot benefit from these job sectors. Despite the long history of failure of the trickle down theory at home and abroad, government programmes are always designed, unsuccessfully, from the supply side. The demand side stagnation of the economy has strengthened the supply side stagnation and poverty perpetuation. Through the Structural Adjustment Programme (which is explained in more detail in the next chapter), the government is asking the poor people to reduce their demand. There is no conclusive evidence that the demand for luxury items and their import will be reduced under SAP. Moreover, SAP will help the market for luxury items from abroad flourish without increasing value added in the domestic economy. The lack of resources, the

negligence in creating employment opportunities in sectors other than the agricultural sector and the regressiveness of government expenditures are responsible for the demand side stagnation of the economy.

5.2 Stagnation On Supply Side

We saw in Table 1 that though total government expenditure has increased by 18.9% during a period of 15 years, this rapid increase in expenditure has not contributed to the GDP growth rate. The high priority given to economic sectors, tax holidays for industry and the minimal ratio of direct to total taxes have created stagnation in the economy rather than dynamism. As indicated in the following table, GDP has increased by an average of 3.99% in real terms per annum. In the last half of the 1970s, the negative agricultural growth rate was compensated by a high growth rate in the non-agricultural sector and in the early 1980s, the agricultural sector had relatively better performance simply due to good weather in most of the years. But in the latter half of the 80s, the

TABLE 11

Real Gross Domestic Product Annual Growth Rate (%)
(in 1974\75 prices)

| Sectors (5 year averages) | 1975\76 1979\80 | 1980\81 1984\85 | 1985\86 1989\90 | Average Annual |
|------------------------------|--------------------|--------------------|--------------------|-------------------|
| Total GDP | 2.37 | 4.99 | 4.59 | 3.99 |
| Agriculture GDP | -1.05 | 5.15 | 5.72 | 3.27 |
| Non-Agriculture GDP | 9.05 | 4.86 | 2.97 | 5.63 |

Source: Economic Survey 1991; Ministry of Finance; HMG/N

agricultural sector is capturing its growth rate whereas the non-agricultural sector has been halved in its growth rate. It seems that both sectors, that is, the economy as a whole, have started a declining trend. Despite the fact that the non-agricultural sector is at a rudimentary level, contributing only 43% of GDP, its growth rate is declining. In the agricultural sector, even this meagre growth rate of GDP is the effect of expansion in cultivable land rather than productivity increases of existing facilities. The following table shows the productivity of different major crops.

TABLE 12

Average Annual Productivity of Major Crops
(Metric Tons/Hectare)

| Crops | 1961/62 | 1970/71 | 1980/8 | Growth Rate (%) |
|------------|---------|---------|--------|--------------------|
| | 1969/70 | 1979/80 | 1988/8 | |
| Paddy | 1.86 | 1.89 | 1.95 | 1.60 |
| Maize | 1.89 | 1.71 | 1.46 | -0.73 |
| Millet | 1.08 | 1.10 | 0.95 | 0.57 |
| Wheat | 1.20 | 1.09 | 1.29 | 0.96 |
| Barley | 0.99 | 0.90 | 0.86 | -0.56 |
| Oilseed | 0.53 | 0.56 | 0.63 | 1.64 |
| Potato | 6.80 | 5.59 | 6.26 | -0.20 |
| Tobacco | 0.88 | 0.73 | 0.69 | -1.10 |
| Sugar cane | 15.27 | 16.73 | 24.51 | 3.46 |
| Jute | 1.11 | 1.16 | 1.18 | 1.01 |

Source: Agricultural Statistics of Nepal - 1990 ; HMG/N, Ministry of Agriculture, DFAMS: ASD, Nepal

The productivity growth rate of four crops is negative, and that of two crops is positive but less than one. Despite the rhetoric of the government to provide priority to the agricultural sector, the performance is at the level of the 1960s and even worse. Productivity growth of secondary crops like maize, millet and barley has been more disappointing than other crops. These are the

crops which are mostly planted by poor farmers on their own land. This is because the poor, in general have less access to irrigation and chemical fertilizer, and have lower quality soil. So they are more likely to grow rough cereals like millet and barley.

In agriculture, since the government expenditure favors rich farmers by spending on fertilizer subsidies, research and extension work for those crops which uses irrigation and highly marketable inputs, the productivity of rice, wheat, oilseed and sugarcane is maintained. Many large landlords, who use wage labor to produce agricultural commodities on a large scale, are involved in the production of industrial crops such as jute and sugarcane (Blaikie and Others: 1980; 53). Production of these and other cash crops is not necessarily bad, but in a country like Nepal, where there is already unequal control over productive resources, promotion of these "rich farmers crops" at the cost of secondary crops strengthen the forces that generate hunger and promote inequality. The budgetary process of the government has exacerbated this situation.

Among other things, the declining trend in agriculture is caused by the land ownership pattern. It would be possible to achieve both a more egalitarian distribution and increased production at the same time through land reform. It is due to the skewed distribution of land (Table 5) that the productivity of agriculture has remained at the level of the 1960s. Since the present land tenure system has

created absentee landlordism and the tenant has to bear all the costs of inputs, land reform will increase productivity. Moreover, the distribution of the land system suggests that even if the economic performance of the economy increases, the benefit will not trickle down to the poor farmers in Nepal where the concentration of land underlies the concentration of political and economic power. To conclude, land reform is not a luxury that can be avoided in the name of growth, rather it is a necessary prerequisite for growth. The low tax on land is a crucial factor for agricultural stagnation.

In the non-agricultural sector, the manufacturing sector has a minimal contribution to the economy and its growth rate is very low. The sectors whose relative contribution to the non-

TABLE 13

Average Annual Share of GDP by Industrial Origin (%)

| Sectors (5 year averages) | 1975/76 1979/80 | 1980/81 1984/85 | 1985/86 1989/90 | Growth Rate |
|--------------------------------------------------|--------------------|--------------------|--------------------|----------------|
| <u>Agriculture, Fisheries & Forestry</u> | <u>64.48</u> | <u>60.16</u> | <u>56.98</u> | <u>-1.1</u> |
| <u>Non-Agriculture</u> | <u>35.52</u> | <u>39.84</u> | <u>43.02</u> | <u>3.03</u> |
| - Mining & Quarrying | 0.16 | 0.27 | 0.17 | 0.40 |
| - Manufacturing | 4.27 | 4.55 | 5.47 | 1.72 |
| - Electric., Gas & Water | 0.24 | 0.37 | 0.74 | 10.21 |
| - Construction | 6.51 | 7.78 | 8.40 | 5.99 |
| - Trade & Hotel | 3.76 | 3.95 | 4.99 | 2.28 |
| - Transport & Communication | 5.82 | 6.87 | 5.87 | 0.91 |
| - Financial & Real Estate | 8.05 | 8.14 | 8.51 | 1.42 |
| - Community & Social Serv. | 6.71 | 7.91 | 8.87 | 3.14 |

Source: Economic Survey 1991, Ministry of Finance; HMG/N

agricultural sector have increased relatively in higher proportion are construction, hotel, transportation and electricity. With the expansion of the resource base, there is a possibility that the terms of trade will shift away from tradable in favor of nontradable goods. It is thus possible that without strong and effective counter measures, hydro development will provide benefit only to the real estate sector and will raise the prices of necessities thereby making poor people worse off. Anyway, since the contribution of electricity in the non-agricultural sector is very low, (less than 1%), and negligible in total GDP (about 0.06%), it can be concluded that the mentioned growth rate of the non-agricultural sector is due to the growth of the former three sectors, namely construction, hotel and transportation. The performance of the manufacturing sector is unsatisfactory despite the fiscal incentives. Besides, most of the industries that were established in 1980s have very low value added if not nil to the economy. Most of them are assembly industries promoted due to the government tariff structure which charged differently for finished goods and spare parts, lower rates being charged for the latter.

The share of agriculture in GDP has decreased not because of structural change in the economy, but particularly because the productivity of major crops in this sector has been declining. Nepal is a trade centre that experiences no enlargement of productive capacity. Whatever may be the surplus in the economy it is used for construction of rural and urban residences. And the

remainder is invested in the acquisition of rent bearing land, in financing mercantile activities of all kinds, in usury and speculation. The cities that have sprung up in Nepal in connection with their briskly expanding trade, mostly the import trade, did not turn into centres of industrial activities but snowballed into vast market places providing the necessary living space to wealthy citizens crowded by the population of petty traders, agents, and commissionmen.

The growing expenditure of both internal and external resources, the proportionally high expenditure on economic sectors, the expansion of cultivable area, the construction of private houses and hotels in urban areas has increased GDP to a very limited extent and is not associated with any increase of per unit productivity. This tendency combined with population growth of 2.7%, increased dependency on foreign aid, macro stagnation and environmental degradation has demanded some different policies from those of the past incorporating major shifts in the distribution of power and resources. Otherwise, the government should rely on higher rates and a more regressive nature of the tax structure to improve the poor performance of the economy. This will have a serious implication on the resource mobilization capacity and political stability of the government.

CHAPTER VI

STRUCTURAL ADJUSTMENT PROGRAMME: IS IT A PANACEA?

Government Officer: "You have to tighten your belt."

Citizen: "I ate it yesterday."

Hunger Machine: Bennett, John.

6.1 SAP: An Introduction

The confluence of ballooning foreign debt in developing countries, the failure of all previous development programmes suggested by IMF and the World Bank and hence the threat of the collapse of volatile international financial market led these institutions to implement a joint programme, the Structural Adjustment Programme. The "cheap money" of the Western banks and the massive borrowing from the developing countries in 1970s created the debt crisis. When a country is not able to pay debt, it is to a large extent true, among other things, that borrowed money was not used for productive uses. In the meantime, one should bear in mind that the unequal exchange between developed and underdeveloped worlds and the increase in the real rate of interest during the '80s for the formerly low interest bearing loans are equally responsible for the present situation. As the seriously debt-ridden countries today were and/or are military dictatorships and most of the resources were used to enhance "prestige", it is rather a nuisance to blame either one of them (creditor or borrower) while keeping other as an alibi.

SAP consists of a policy package including the removal of government subsidies and price controls, the withdrawal of protectionist measures, the introduction of user fees, significant real devaluation, tight control of domestic credit, privatisation of parastatal institutions and cuts in public expenditure (Stein: 1992). SAP regards the structural problem as a result of two imbalances in national income accounts. The first is the current account deficit (total domestic demand minus national income) and the second is the budgetary deficit (government expenditure including debt servicing minus revenue minus foreign aid). Consequently, it provides export promotion and a reduction in the size of the budget as two basic policy prescriptions for correcting the imbalance. The real reason for structural maladjustment, that is maldevelopment practices of the government investing in ill-conceived and ill-considered projects and past policy suggestions of donor institutions themselves, are not considered responsible.

The IMF and the World Bank intend to perform this work through "the magic of market forces." The tools that they use to justify the programme are free trade and the theory of comparative advantage. But history has proven the bankruptcy of comparative advantage theory as a development doctrine except for developed countries (George: 1989). Market policy as an objective may be more harmful if it operates on the basis of a priori reasoning without special attention to specific causes (Miller 1986: 187). It will integrate the developing countries into the global developed market in which

the developed countries are badly in need of expanding their export markets. The G-7 are anxious to export their recession (Chossudovsky: 1992; 2).

Developing countries need structural adjustment. In fact the essence of growth is structural adjustment from agriculture to industry, from urban to rural, from illiteracy to high technology, from poverty to prosperity etc. But structural adjustment defined here is limited, contradictory and even incorrect in some sense. The objectives of SAP, that is the reduction in the balance of payment deficits and budget deficits, are the constraints for development themselves. Satisfying constraints to development cannot be an objective. Furthermore, the fundamental questions arise: "Adjustment for what purpose?" "Adjustment to what?" "Adjustment by whom? Who benefits and who loses?" (Streeten: 1987)

6.2 SAP and the Nepalese Economy

Within the joint context of the decreasing concessional aid flow, the widening revenue gap due to the incomprehensive and minimal direct tax, the growing resource gap due to unproductive use of both internal and external resources and the increasing debt service ratio, the Nepalese government started a stabilization programme, the initial phase of SAP, in late 1985. This stabilization programme, consisting of all the same policy

prescriptions of SAP, was like a probation period for the country to get a structural adjustment loan, presumably considered another panacea for all malstructures of developing countries. Effective November 1985, the Nepalese Rupee was devalued by 15% and as a result Nepal entered into a standby agreement with the IMF on December 1985.

Since the stabilization programme was a prerequisite for the structural adjustment loan (SAL), the World Bank approved the first SAL for Nepal in April 1987 for a sum of US\$ 50 million. In parallel, Nepal negotiated an arrangement with the IMF in October 1987 for a Structural Adjustment Facility (SAF) loan for a total of SDR 24 million to be disbursed over a three year period. The second SAL was approved in July 1989 for the amount of SDR 46.2 million (US\$ 60 million equivalent). It may be appropriate to mention here that the total debt service of Nepal in 1989/90 was US\$ 37.50 million. The policy package as formulated by the Bank includes the following (The World Bank: 1989):

Macroeconomic Policy:

- (i) increase fiscal efficiency through an enhanced tax base, increased elasticity, improved tax administration and improved elasticity of tax structure;
- (ii) increase development expenditure from 11% of GDP in 1985/86 to 16% of GDP in 1990/91;
- (iii) carefully control net domestic credit expansion and

- concessional external borrowing;
- (iv) maintain the flexible exchange rate system so as to make the exchange rate more realistic;
 - (v) maintenance of bank interest rates at positive real levels through a more flexible exchange rate policy;

Industrial and trade policy:

- (vi) design the trade sector as more outward looking and activate the private sector for its development;
- (vii) liberalize trade including more import licences;

Agricultural Policy:

- (vii) improve the availability of agricultural inputs and services by liberalizing the pricing and distribution of inputs while increasing the role of the private sector and improving irrigation services;

Public Enterprise Policy:

- (viii) increase prices charged by public enterprises and significantly reduce their subsidies;

The Structural Adjustment Programme was designed in a medium term framework with fiscal year 1990/91 as the target year considering 1985/86 as the base year. As explained in the preceding chapters 1 & 2, the macroeconomic imbalances have not improved during the last half of the 1980s, the period under SAP. The fiscal situation of

the country is worse after the implementation of SAP despite its proclaimed objective of correcting fiscal imbalances. There is not any sign of improvement in overall macro indicators. Predictably, all targets made under SAP are lagging behind but the level of

TABLE 14

Macro Targets under SAP
(1985/86 - 1990/91)

| | 1985/86 base | 1990/91 target | 1990/91 actual ¹ |
|--------------------------------------------------------------|-----------------|-------------------|--------------------------------|
| Annual rate of growth in GDP (%) | 4.2 | 4.5 | 4.0 |
| Gross investment (as % of GDP) | 19.8 | 24.4 | 19.5 |
| Gross domestic savings (as % of GDP) | 10.3 | 13.5 | 9.3 |
| Total revenue (as % of GDP) | 9.1 | 12.0 | 10.5 |
| Regular expenditure (as % of GDP) | 6.5 | 7.5 | 7.5 |
| Revenue surplus for development expenditure (as % of GDP) | 2.6 | 4.5 | 2.9 |
| Development expenditure (as % of GDP) | 12.0 | 16.0 | 14.7 |

Source: Nepal Structural Adjustment Programme and External Assistance Needs (1987) and Economic Survey 1991: HMG, Ministry of Finance: Kathmandu.

regular expenditure, which in turn was possible due to a freeze on the salaries of government employees at surprisingly low levels. However, the root problem is how the SAP perceives and analyzes the present situation rather than the gap between targets and accomplishments.

¹Some of the progress figures have been calculated from the fiscal year 1989/90 because data for 1990/91 are not yet available for all indicators.

With the almost non-existence of any industry in addition to being a landlocked high cost economy, Nepal cannot increase exports in the due course of time. Besides, the export led strategy proposes that every country can correct its current account deficit by increasing exports (although one country cannot reduce its deficit without exacerbating others). It is a contradiction: the aggregate impact of SAP is self-defeating. In addition, efficiency considerations of the SAP have capped the wage rate increases. Only wage decreases have been a "trump card" for cost reduction. To quote the World Bank,

"Nepal could strengthen external competitiveness through tight wage and contractionary monetary policy and continual real depreciation of the Nepalese Rupee against third countries" (The World Bank: 1990; 35).

If increased productivity is not chased by increasing wage rates, it will again increase inequality making worse the already bad situation and promote stagnation of domestic production and demand.

Devaluation of the Nepalese currency under the SAP has increased the national debt automatically which is dollar denominated and has raised the price of basic foods. The theoretical justification for devaluation is that it will switch off the demand from foreign to domestic goods. But in practice devaluation only raises the cost of living by increasing the prices of imported consumption and capital goods. In Nepal, where all goods are imported from outside, there does not remain any justification for devaluation.

6.3 SAP: Incompatible with Poverty Alleviation

Fiscal policy has hampered the growth and impoverished the country by poverty perpetuation. In Nepal, any programme implemented in the name of poverty alleviation has either dried up of funds or is enjoyed by the rich or medium income families. Will SAP help improve this situation and eradicate poverty? Nepal is one of the poorest countries in the world with per capita income of \$170 (combined with extreme inequality). The proportion of population below the poverty line can be defined under two different sets of assumptions. The first is the poverty line defined by the National Planning Commission (NPC), Nepal on the basis of an income needed to supply minimum caloric requirements. In 1989/90 Rupees, it translates into about US\$7.80² per person per month (NPC: 1987). This is a very conservative estimate influenced by political motives rather than the economic reality of the price level of food in the market. Even with this poverty line, about 42% of the population lies below this absolute poverty line (NPC: 1983). The conservativeness of the above definition can be seen by considering the implications of a poverty line equivalent to US\$ 150 per capita per annum. This is an internationally accepted definition (The World Bank, 1991: 7). Contrary to this, the Bank itself has used US\$370 as the poverty line for South Asian countries in its World Development Report 1990. With this standard, the percentage of the poor in Nepal reaches 90% of the total population. The proportion

²using average exchange rate Rs 25.5/ US\$1

of the population with incomes below US\$150 is about 70%. Following the definition of NPC for the poverty line, the composition of income of the poor (let us say ultra poor) 42% of the total population is as follows (Nepal Rastra Bank: 1988):

TABLE 15

Composition of Ultra Poor Household Income
(1984/85 Rs/household/month)

| | Rural | Urban | National Average |
|--------------------------------|------------|------------|---------------------|
| <u>Agriculture</u> | <u>357</u> | <u>227</u> | <u>348 (51%)</u> |
| Cash | 59 | 43 | 58 (8%) |
| Kind | 298 | 184 | 290 (43%) |
| Nonagricultural | | | |
| Enterprises (cash) | 28 | 87 | 32 (5%) |
| <u>Wages and Salaries</u> | <u>184</u> | <u>352</u> | <u>196 (28%)</u> |
| Cash | 116 | 332 | 131 (19%) |
| Kind | 68 | 20 | 65 (9%) |
| Other Cash Income | 28 | 40 | 29 (4%) |
| Other Income in Kind | 84 | 70 | 83 (12%) |
| TOTAL INCOME | 681 | 776 | 688 (100) |
| ----- | | | |
| Per capita monthly income | 97 | 111 | 98 |
| (US\$ equivalent) ³ | (\$5.4) | (\$6.2) | (\$5.5) |
| Total Income of which: | | | |
| in cash | 231 (34%) | 502 (65%) | 250 (36%) |
| in kind | 450 (66%) | 274 (35%) | 438 (64%) |

Source: Computed from Multipurpose Household Budget Survey (MPHBS)
A Survey on Income Distribution, Employment and Consumption
Pattern in Nepal. Nepal Rastra Bank; 1988 and Nepal: Poverty
and Incomes. The World Bank; 1991.

The following main characteristics can be seen from the above table:

- (1) among the poor only 36% of incomes are in cash coming mostly from wages;

³Using exchange rate Rs 17.8/US\$1

- (2) after agriculture, the most important source of income is wages and salaries;
- (3) a significant portion of wage income is in kind rather than cash;
- (4) cash income from agriculture (representing sales of foodgrains, cash crops and livestock products) are insignificant - equivalent to less than US\$3.3 per household per month;
- (5) off-farm enterprises contribute only 5% to household incomes.

It is clear that the ultra poor can get more income only if the agricultural productivity on their farms, the level of off farm employment and the wage rate increase. Agricultural productivity has decreased (Table 11). Employment generation is at a very low level. Whatever is generated is mostly for skilled (educated) labor. Instead of improving this situation, SAP worsens it by restraining wage rate increases. Even more, due to budget cuts, the sector absorbing the most unskilled labor, the construction sector, has contracted hampering the off-farm employment for the poor.

The poor are consuming a minimal bundle of goods, the cost of which is not covered by their available income. Food accounts for three quarters of their income, leaving very little for their other essentials. The following table, among other things, clearly shows the capacity constraint of the poor to pay for public services

under the "cost recovery" or "user pay" principles. After essential food and fuel purchases, which even then do not bring them up to minimum caloric intake levels, and clothing-housing costs, only US\$ 0.17 per month is available for other purposes. They have no way to contribute to the cost of public services. They can afford to spend only minimal amounts even on essential services like education and health (\$0.17).

TABLE 16

Conditions of a Poor - Expenditure
(1984/85 Rs per capita per month)

| | Rs | US\$ | Percentage |
|----------------------------------------------------|-----------|---------------|------------|
| <u>Total Food</u> | <u>77</u> | <u>\$4.33</u> | (74) |
| <u>Total Non Food</u> | <u>27</u> | <u>\$1.52</u> | (26) |
| Fuel, Water, etc | 7 | \$0.39 | |
| Clothing and Housing Cost | 11 | \$0.62 | |
| Education and Health | 3 | \$0.17 | |
| Transport | 1 | \$0.06 | |
| All other | 5 | \$0.28 | |
| TOTAL EXPENDITURE | 104 | \$5.85 | (100) |
| TOTAL INCOME | 98 | \$5.50 | |
| ----- | | | |
| Income after Food, Fuel clothing & housing cost | 3 | \$0.17 | |

Source: Ibid.

Subsidy elimination programmes may not hit the poor in Nepal directly because it can be argued that subsidies in Nepal are not targeted for the poor. It is quite true that a lot of money is poured into public enterprises through the budgetary process. Prices of public goods are set according to politically dictated needs. Mostly it is the high and medium income level families and

urban dwellers who are benefitting from subsidies. Hence to be a consumer of public goods, either the subsidy programme should be implemented with drastic changes to its regressive nature or the poor should get more resources and more income. Neither of these options is possible under SAP. Consequently, schools or hospitals even if erected on their doorsteps, will not improve the literacy and life expectancy of the poor.

The trend of the past 5 years and the policy packages of SAP indicate that the SAP of the IMF and the World Bank is inconsistent with the goal of poverty alleviation in Nepal. In a practical sense, it is almost impossible to undertake these two programmes together. Against their own fanfare, the IMF and the World Bank have occasionally confessed the failure of SAP in improving the well-being of the poor. To quote the Bank, " When it came to the fore, little attention was paid to the effects on the poor the need to cut public spending for SAP can lead to a short sharp conflict for delivering social services and providing transfers and safety nets" (The World Bank, 1990: 103). It will conflict not only in the short run, but in the long run too. The World Bank tries to explain that the "undesired side effects" of SAP pertain to a particular sector called the social sector. So for the Bank, the programme can safely be implemented in conjunction with some social programme to compensate for the "social cost" of the programme for the poor. But the undesirable side effects for the poor stem from the inner logic of the SAP. The social consequences must be

considered an integral part of the whole economic policy of SAP.

Evidence shows that the poor are the worst hit under SAP. In a nutshell, poverty alleviation is incompatible with the fundamental parameters of the economic model of SAP. The poverty situation in Nepal and the even more regressive budgetary trend for social programmes after 1985 (Table 6) have made it impossible to believe that SAP has a "human face" given its programme (the word human face is taken from Cornia and Others 1987).

The SAP will promote the already strengthened process of concentration of wealth among a few people in Nepal and in creditor countries as well. The elite and the military in developing countries, who enjoyed the huge amount of foreign aid in the 1970s, pushing the economy into the present debt trap, will benefit while asking the poor to tighten their belts. It is true that if the developing countries integrate themselves in the volatile international market, it will be beneficial for a small section of the population in these economies. Otherwise, the vast majority of the people will be "redundant" and they will be considered evidence of "population pressure" (Bienefeld, 1990:7).

6.4 Poverty: Not a Cause but an Effect

Even by the most conservative estimate, 42% of the population in Nepal is deprived of minimum food requirements. 50.5% of households

rely on land units of less than 0.15 hectare (Table 5). Unemployment and price rises are on the upswing. All in the growing labor force are candidates for hunger. In the name of poverty alleviation, the government asks the poor to work for others rather than for themselves.

Both the donor agencies and the Nepalese government consider that poverty is the cause of all misfortune and they claim that it should be eliminated but both government and foreign aided programmes are not really concentrating on the alleviation of poverty and employment creation for the poor mentioned above (with per capita monthly income of \$5.5). Donor agencies claim to attack and eradicate poverty. But they "forget" that poverty is an effect not a cause. To get to the cause of poverty, one must ask why people are poor. The answer is that they do not have the power to secure the income, food and housing that they need. Power is the social relation determined by resource ownership and the production process. Then only by addressing the ownership issue can society get rid of social problems (Lappe: 1980; 154).

Poverty will not be reduced if the ownership pattern is not altered. It is said that this is not politically feasible. However, The World Bank and IMF could use their influence to "convince" the government to modify the existing wealth and asset distribution in a very short period of time if they chose. They refuse to do so on the grounds that such behaviour would provide undue interference to

"sovereign nations". Yet they consider the dictation of all macroeconomic policies including budget priorities, exchange rate determination, fixation of the interest rate and the size of the money supply as benign suggestions.

Poverty will not be eliminated whatever amount of funds is flown from developed countries to Nepal if the present situation of inequality and government policies remain intact. The governments in developing countries, of course including Nepal, are asking for more aid without being ready to share it with their population. There has been a transfer of resources from the donor agencies to the elite of the Third World and the result is the debt which the poor are forced to pay even more than the amount borrowed by their elites. There is no ground to believe that the money will not go in the same way into the coffer of the military and nonmilitary dictators as it went before.

Unless the regressive nature of resource ownership pattern is not addressed, it would be almost impossible to design any programme for the benefit of the poor in Nepal simply because development priority and thinking is always positing alternative agendas (Goldsworthy, 1988: 507). If the situation continues, which is most likely, sooner or later people from the grassroots level in the Third World would be ready to define their poverty by themselves. If with such a long history of "efforts" poverty cannot be reduced let alone alleviated, then it is the global as well as national

system which should be changed, not the poor themselves (Rahnema, 1990: 27).

CHAPTER VII

CONCLUSIONS AND RECOMMENDATIONS

7.1 Conclusions

The idea that the availability of additional capital can help the decolonised countries mimic the development path of their predecessors has proven to be an illusion. Furthermore, in contrast to the assumption that with more money these poor nations would be able to step up the development ladder, they are becoming more and more enervating and weak. With the crisis of development, there is a crisis in the state since development theory until recently has been based on the assumption of purposeful, positive intervention of the government. Alternatively, it is argued that the market can compensate the misfortunes of the past if they are completely liberalised. Of course, the market should be allowed to do what the market can do in an efficient manner but it should not be the license for oppression and exploitation, whether nationally or internationally.

As most of the developing countries, Nepal is facing macro imbalances. These structural imbalances are the inevitable consequences of the structural gap between expenditures and revenue, which in turn, are created by inefficient and inequitable tax and expenditure policies of the government. These policies, by perpetuating poverty and stagnation, have required the government to engage in more external and internal borrowing even to

legitimise itself. At the lack of productive capacity of the economy and negligence of the ability to pay principle for taxation, the resource gap is ever widening leading to a debacle. The fiscal policy by reaching fiscal deficit ex-ante in fact encourages fiscal collapse ex-post.

The Nepalese public finance structure is unsustainable on both the revenue and expenditure sides. The tax bases on which its current revenue structure depends cannot be exploited much more intensively than they now are. Moreover, these bases are more likely to shrink than to grow in relative terms as development proceeds. Thus relatively more fiscal self reliance, let alone the absolute self sufficiency, is far from reach. The government has to consider at least that foreign aid is not a free good and it does have an opportunity cost as tax money.

The question about taxation of "For what?" is equally important as the question of "Who will pay?". Tax issues cannot be separated from the question of state expenditures and spending priorities. It is extraordinarily difficult at best and normally impossible to influence significantly the distribution of the tax burden (and thus the distribution of wealth and power) without a simultaneous challenge on spending priorities. Even a good progressive taxation system cannot be justifiable if the expenditure pattern is regressive.

Despite a larger amount of government expenditure on economic sectors both agriculture and non-agriculture sectors continue to experience declining trends. The meagre growth of the economy is due to high input consumption rather than due to productivity increases of the economy. In agriculture, government expenditure on secondary crops is very minimal compared to "rich farmers crops" like paddy, oilseed, sugarcane and jute. This is why the productivity of minor crops is more disappointing than other crops.

The expenditure pattern is not only biased against social sectors, but the distribution of government subsidies in social sectors is highly regressive. Thus the present policy regarding the public provision of educational services has not been instrumental for improving the national distribution of resources. The traditional assumption that the expenditure of the government has increased due to its enhanced welfare function has been questionable in certain respects because the expansion of state expenditure has not necessarily enriched the poor.

In response to this harsh situation, Nepal is implementing the SAP. It is said that SAP will help arrest the poverty and structural imbalances. There is no doubt that Nepal needs drastic structural adjustment. The question is who should bear the burden of this adjustment. The structural imbalances mentioned by the Bank are the effect of resource imbalances in the international financial situation and in the internal domestic economy. The remedy should

be based on the cause. The SAP necessarily asks only the poor people to shoulder the load consequently further aggravating the situation. It should have become abundantly clear by now that, both on theoretical and empirical grounds, the conventional SAPs are inadequate in addressing the real causes of economic, financial and social problems facing Nepal.

At the lack of any direct programme of the Nepalese government to distribute resources, fiscal policy is the single most important indirect instrument for redistribution. Through this policy, as analyzed, resources are distributed in favor of the wealthy. Poverty has been a myth word. Any amount of resource misallocation in the name of alleviating poverty, like war, has been justifiable for the government. Evidence suggests it is a political problem which appears and flourishes amidst economic affluence and plenty of consumer goods. The affluent societies are producing reservoirs of plenty and at the same time are creating a new island of poverty. Since poverty is perpetuating itself in Nepal, then, the cause of poverty must be found in the institutions, their intentions and the process of public policy formulation. Poverty will remain a fact of life until the poor are considered the most valuable resource for the development of Nepal.

7.2 Recommendations

The structural problem of fiscal policy is related to unequal

income distribution which will be perpetuated in the future due to its internal contradictions. Without any change in ownership patterns, there is no scope for a sustainable solution to the structural fiscal problems in a long term perspective. On the basis of this study, the following policy options seem to be the minimum agenda for the government in the near future as the country is limited to its revenue generation capacity:

- 1 The proportion of direct taxes should increase. The income tax should be comprehensive enough to cover all income accruing to taxpayers from all sources. The taxation of residential real estate and urban land is a convenient way of reaching consumption of high income households. Real estate is visible and may be considered an indicator of wealth, in the lack of another better indicator. A progressive property tax would be a better option for both resource mobilisation and equity considerations.

- 2 Since a large fraction of wealth in Nepal consists of land ownership and the inequality in land ownership thus correlates well with inequality of wealth, and because agricultural productivity has declined due to the present ownership pattern, land reform should be the real crux of agricultural policy. In light of the lack of political will of the government to reform the land tenure system, a quite progressive land tax will be the second best option, which

will ease the land reform in the future. Moreover, it reduces the regressiveness of the tax system to some extent and helps increase resource mobilisation and increase agricultural productivity.

3 Despite the high concessions on industrial activity, the stagnation of the manufacturing sector has proved that sound industrial and trade policy is the prime mover for industrialisation in Nepal rather than tax holidays or other fiscal incentives. Nevertheless, these trade and industrial policies should be analyzed within the whole gamut of the Nepal-India trade relation.

4 The government expenditure pattern should be changed drastically in favor of social sectors. The subsidies to irrigation, transportation and communication should be eliminated since subsidies to these sectors are always absorbed by the already well off, not the poor section of the population who should be targetted. The subsidies on some programmes in the agricultural sector are necessary but it is extremely difficult to reach the needy and targeted people under the present administrative set up. The whole amount released should go as subsidies toward education and health expenditure. Besides, the change in the distribution pattern of subsidies within the social sector is extremely necessary.

- 5 Along with free tuition, the government should arrange some credit programmes for covering some of the non fee costs of primary level education to enable the poor people to get primary education. The tuition fee in secondary level education should be eliminated. If these arrangements create heavy financial constraints, then in the second stage, government should think about cost recovery programmes for higher education. Unlike the present policy, the government priority for higher education should be based on infrastructure creation rather than fee subsidization.
- 6 The health sector should be considered a prime area for government expenditure. Rural area primary health care with equal focus on women's health should be the policy thrust of the government.
- 7 Since it is presently impossible for Nepal to earn foreign currency through exports in excess of imports, at least for a few years for sure, it needs new foreign currency for its economic development. If the domestic policies are well developed for equitable growth, the grant and the concessional loan that Nepal is mobilising now can be used as a part of the solution.
- 8 Provided that government programmes are well designed considering all the above recommendations, the fiscal deficit

financed by domestic borrowing will not be counter productive to some extent. But at the lack of any fiscal reform, the ongoing deficit financing, either internally or externally, will lead to serious problem in the future.

- 9 Poverty cannot be eliminated by subsidies. Subsidies are costly to manage and it is difficult to ensure they go to the target group. Probably, the social sector is the easiest area for subsidy management. In essence, subsidies create more dependent people for the state. Thus poverty should be addressed in the long-term perspective providing the basic resources to the poor to work and make their own livelihood. This resource entitlement mechanism will strengthen the fiscal capacity and accelerate the development process.

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